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Corporate Management in Armenia

Simon Sargsyan, Director, Corporate Finance,
Securities Commission of Armenia

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In July 2000 the Law "On Securities Market Regulation" (Law on SMR) was adopted in the Republic of Armenia (herein after referred to as RA) based on which the Commission on Securities (Commission) was established as well as some other institutions such as the Stock Exchange of Armenia (SEA) and the Central Depositary of Armenia (CDA). In fact with the Commission a new body was established regulating relationship (including corporate management) in respect to regulatory activities at the securities market. The idea of an accountable issuer introduced by the Law on SMR included those corporations for which the idea of a corporate management is the most actual at present time.

According to the general definition in concurrence with the Law an accountable issuer is an issuer:

1. any securities of which have been registered at any stock exchange (meaning a stock exchange of Armenia). Currently there is only one registered stock exchange in Armenia – SEA);

2. the number of registered owners of securities of the same class is 50 or more, and net assets of which exceed the value fixed by the Commission.

The following securities have been excluded from this definition: (i) issued securities or secured by the RA and CBRA, (ii) not assessable securities of banks and insurance agreements of insurance companies in the RA, and (iii) some other securities of a non-investment type.

It is important to notice that even though the fundamental regulator of corporate relations in the RA is the new Law on Joint Stock Companies (adopted in September 2001) (Law on JSC), the definition of an accountable issuer facilitates regulation of corporate relationship of other legal entities, which are not joint stock companies.

Introduction.

General description of the securities market in Armenia.

Currently the securities market in Armenia is at the stage of development that is why it would be too early to speak about a well-formed market. It can be mentioned that the Law on Securities Market Regulation was adopted only in 2000 even though previously there were laws and resolutions of the government regulating the market. The main securities in circulation in Armenia are public bonds and stocks of privatized companies; it should be mentioned though that the majority of transactions were made with public bonds. Thus, the volume of such transactions in 2001 made 89,56 % of the total number of operations whereas transactions with shares made 10,31% and 7,47% correspondently. It is necessary to tell that there were transactions with other securities such as promissory notes. However they were non-recurrent and did not influence the general situation at the securities market (transactions with securities of banks were not included).

Volumes of transactions with corporate securities are the main factor of assessment of the securities market for any country. Despite of the fact that in Armenia the corporate securities market due to a large-scale privatization has a good potential, it still provides insignificant volume of transactions in total volume

of securities operations (the above relates to the secondary market and does not take into account stocks of enterprises sold in the process of privatization and does not include shares issued and floated by other companies, in particular by banks).

1145 joint stock companies of an open type were registered in Armenia as of 1 January 2002, approximately half of which have 50 and more shareholders. At these enterprises the control packet of shares has been concentrated in hands of one or more shareholders.

By 1 January 2003 340 enterprises were classified as accountable issuers, 220 of which registered their shares at the stock exchange or with the Commission on Securities. The above data are updated from time to time, based on data provided by the Central Depositary of Armenia and by results of inspections held by the Commission.

At this stage the current and strategic management of practically all of joint stock companies in Armenia is being implemented by big shareholders (including the government disposing the state packet of shares). At such enterprises corporate management environment is being formed based on personalities' qualities and aspirations of a large shareholder; and very often such type of management is accompanied by incorrect interpretation of the idea of holding. The above often lead to violation of rights and interests of small shareholders, for example, the right of access to information such as financial position of a company, its activities, big transactions made by a company's management, etc.

Changes in such situation require time and effective consistent measures.

We think it would be appropriate to disclose general errors and shortcomings discovered at companies by results of inspections held by the Commission. They can be divided into the following groups:

- Shortcomings related to arrangement of meetings;
- Shortcomings related to holding of meetings;
- Shortcomings coming of the incorrect choice of an auditor for a company;
- Shortcomings related to auditing reports made with violations of law.
- In some cases some other shortcomings can be met:
- Publishing of financial statements of companies.
- Violations related to the staff of the Board of Directors and a supervisory body.
- Violations related to evaluation of a company's property.
- Violations related to reevaluation and inventory of assets of a company.
- Violations related to pay out of annual dividends.
- Violations related to process of the reorganization of a company.
- Violations related to the introduction of accounting not in compliance with the accounting standards.
- Violations related to large or interested parties' transactions.

- Violations related to maintenance of a register of shareholders.
- Violations related to the process of registration of securities.
- Violations related to purchase of securities.

Complaints from shareholders submitted to the Commission are mainly as the above. Currently all of them were investigated and resolved.

Analyses of some aspects of corporate management.

1. Concentration of ownership.

In Armenia as well as in majority of the post-soviet countries there is a situation when companies are being controlled by two to three major shareholders. Since such control is being done over all levels of management the main problems of corporate management are as follows: (1) confrontation between large and minor shareholders and (2) problems of redistribution of powers in respect to transfer of large packets of shares.

Taking into account (1) the dominant position of many insiders (managers and large shareholders) connected with the control over financial flows and assets of companies and resistance of them to partly or fully lose such position and (2) imperfection of the court system as the main institute for conflict resolution; the Commission is implementing the functions of arbitration for the above conflict situations.

2. Transparency of the structure of property.

Actually today all companies securities of which (mainly shares) have been registered with the Commission or the Stock Exchange disclose in declaration information on their managers, persons who own 10% or more of assessable securities of any class (shares) and about affiliates including information about number of shares of the company belonging to them and about significant (more than 10%) of securities of other companies. Information is being updated as changed.

The Commission introduced a requirement starting from February 2004 to declare the structure of securities ownership for persons who are managers and owners of large (more than 10%) packets of assessable securities of accountable issuers.

3. Equal voting authority.

According to the Law on JSC joint stock companies can issue common shares of one class, which gives an owner the authority to: (i) dispose or transfer shares, (ii) get necessary information about the company timely and regularly, (iii) participate and vote (in person or indirectly) at general shareholder meetings, (iv) participate in election of Board members or management if it is stipulated by the charter, (v) get a share of a profit of the company. Joint stock companies can also issue preferential shares (normally without voting authority), the rights and obligations of owners of which must be fixed in the charter of a company.

Owners of shares of one class cannot be given additional rights disproportionate with number of shares in their ownership.

The Laws on JSC and SMR stipulate also mandatory transfer of registration of proprietary rights for securities with the CDA, which is the most reliable method of registration of the title.

4. Notification on the meeting of shareholders.

By the Law on JSC joint stock companies with 50 and more shareholders must notify shareholders and managers about shareholders' meeting not less than 15 days ahead of the date of a meeting. The charter of a company may specify another period.

In practice such terms are acceptable since they are agreed upon with foreign shareholders the biggest number of which are majority shareholders.

The Commission monitors from time to time shareholders meetings disclosing shortcomings in arrangements and holding of meetings including ensuring of participation of shareholders in the work of a general meeting in real time mode.

When violations are discovered the Commission makes a decision with a preliminary notification and giving an opportunity to get familiarized with them and then it issues a direction with an instruction to eliminate violations and/or possible future violations.

In case of deliberate non-execution of directions or obvious negligence the Commission imposes a penalty on a person responsible for violation.

The Commission intends by its resolutions to establish additional requirements and order of use of bulletins by owners of assessable securities for public sale (by shareholders), which significantly reduce violations at preparation and holding of meetings. However taking into consideration the financial burden that such requirements bring to companies (preparation of a big packet of records and information, distribution to a big number of shareholders), which can have a significant impact on a financial position of a company, the Commission is yet refrains from approval of such a resolution.

5. Responsibilities of the board.

Organization of a board and administration of majority of companies in Armenia is being done at the expense of large (controlling) shareholders and persons affiliated with them by economic and other interests, i.e. there is a merger of management and control. The main problem of such situation is actual informal relationship between shareholders, members of a board of directors, the board itself as a governing body and managers. In lack of formal code of corporate management clearly describing formation, cognizance, rights and obligations of a board of directors and managers, the burden of regulating of a company's corporate relations will fall on jurisdiction and a regulating body.

According to the Law a joint stock company with 50 and more shareholders must elect a board of directors (supervisory board). The same law specifies general principles of formation, key functions and responsibilities of a board of directors, which in general are in compliance with the principles of corporate management. Even though the Law does not make it mandatory to include independent directors and a board of directors it stipulates limitation of the majority of management in a board of directors and holding of positions of a chair of a board and an executive director. The laws stipulate provisions according to which members of a board and managers of a company must act honestly with due care to the best interest of a company and shareholders.

From the moment of its establishment the Commission took certain steps directed at improvement of effective work of a board of directors (supervisory board) of accountable issuers. Based on the Law on Securities Market the Commission made it mandatory for a board of directors to disclose general plans and goals of activities, management structure and strategy, financial position of accompany and its relationship with affiliated persons when they submit a declaration for registration of securities, which is mandatory for accountable issuers. Responsibility and punishment specified by the Law for incorrect or not full disclosure of information give the possibility for the Commission and any person to make responsible the majority of members of a board of directors (supervisory board) for violation of laws or for the damage occurred.

6. Standards of accounting and audit.

The resolution of the government of the RA as of November 1998 became the basis for the new process of improvement of accounting in the republic. The Ministry of Finance and Economy of the RA developed the new chart of accounts and standards of accounting (in compliance with international standards). Beginning from 2000 joint stock companies had to do accounting in compliance with the new standards.

Taking into account problems of introduction of the new system of accounting the Ministry of Finance and Economy, Association of Accountants and Auditors of Armenia and international organizations arranged many workshops and seminars on technology of transition from old accounting system to the new one including training on new standards. Seminars and workshops are still being held. To provide comprehensive statements, which are published for public, the decision was made that statements subject for publication will be prepared by accountants who were attested as qualified accountants by the special commission.

In the process of work the Commission studied a big number of financial statement submitted by accountable issuers as a result of which some shortcomings and errors were discovered. The above is mainly the consequence of difficulties in adaptation of accountants to new standards of accounting. The Commission had a clear picture of problems that accountants had in preparation of financial statements in compliance with the new standards; that is why they organized a series of seminars and everyday practical work with accountants giving explanations on-site thus trying to minimizing possible errors. Since in concurrence with the Law the accountable issuers must submit annual statements including with auditors' opinion the Commission had the opportunity to compare results of its analyses of financial statements with auditors' opinion. As a result, they came to a conclusion that financial statements were not analyzed in full by auditors. Beginning from 2001 the Commission organized many meetings with auditors and as a consequence of these meetings the quality of audit significantly improved in 2002. Such meetings and consultations are still held. Having researched the market of auditing companies the Commission has the intention in future to restrict audit of accountable issuers by auditors, which do not meet requirements of the Commission.

It should be noted that out of 245 enterprises inspected by the Commission by the 1st January 2000 81.3% did not pass through the audit, 82.7% companies did not publish their financial statements and balance sheets in mass media (i.e. joint stock companies did not observe principles of transparency set up by the law and actually were working in the shadow). According to the data received by the 1st January 2003 the situation changed significantly. In the process of research held in the first quarter of this year there were only 7.9% of companies, which made some violations in regard to financial statements publication, and the number of companies, which did not pass through the annual audit, was less than 1%.

7. Disclosure of information.

According to the Law on JSC joint stock companies must submit annual reports and financial statements to the annual general meeting of shareholders for approval. Joint stock companies of an open type after audit made by an independent company also must publish the above reports. The law stipulates possibility of a shareholder to get a copy of records of a company (except for confidential records and orders of director).

The innovation in disclosure of information was the system introduced by the Law on Securities Market in concurrence with which: (i) all accountable issuers must register their securities via submission of a declaration for registration of securities by such disclosing information on financial and economic activities, type of business and competitive position, charter contents and corporative policies, structure of ownership, general information on managers and affiliated persons of a company, (ii) all managers and owners of major packets of shares (more than 10%) of assessable securities of accountable issuers must declare the structure of ownership for securities, (iii) information must be updated regularly and as

changed, (iv) issuers, stock exchanges and the Commission must provide access to disclosed information to any interested parties.

The volume of disclosed information is set up in compliance with international norms and standards of a stock exchange market.

Taking into account the situation at the market the Commission takes steps to format the general system of electronic communication, which will facilitate collection, processing, and publication (including foreign languages) of disclosed information in concurrence with laws.

To provide public access to disclosed information the Commission also intends to require from issuers such forms of disclosure, which will guarantee access of all interested parties on site to disclosed information.

Measures taken by the Commission on improvement of corporate management partly have achieved results. However it should be noted that to achieve satisfactory level of corporate management corresponding state bodies must be involved in the process.

It would be incorrect to assume that corporate management will develop as soon as ownership will transform. Transfer of corporate ownership to private persons will be not enough to develop a strong corporate sector. Enterprises will not work effectively without appropriate rules of management and institutions, which will follow up on performance, as well as without establishment of the culture of corporate management among managers, shareholders and interested persons.

Obviously in the situation when the discipline of capital and commodities markets cannot work effectively due to shortcomings of the market the best mechanism of corporate management will be a mechanism based on legislative norms. Even though in the majority of countries of Eurasia the laws on such companies have been already adopted which are the basis for a corporate system, in many cases such laws do not contain clear and full rules of implementation. In this respect improvement of cooperation and abilities of mandatory execution of a legal base of corporate management becomes the primary objective of politicians for reorganization of micro economy of a country.