CORPORATE GOVERNANCE REPORT FOR CROATIA

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SHORT INTRODUCTION TO CROATIA

The Republic of Croatia is located on the Adriatic cost, bordering with Slovenia, Hungary, Serbia & Montenegro and Bosnia & Herzegovina.

Croatia declared it's independence from former Yugoslavia in 1991 and was admitted as a Member of the United Nations by General Assembly resolution A/RES/46/238 of 22 May 1992. However, sporadic, but often bitter, fighting to clear occupying Serb armies from Croatian lands lasted until 1995. Few basic numeric indicators may be found in the Appendix at the end of this Report.

LIST OF ABBREVIATIONS

AA	*Accountancy Act*
AuA	*Auditing Act*
BA	*Banking Act*
CA	*Companies Act*
CASFS	*Croatian Agency for Supervision of Financial Services*
CASFSA	*Croatian Agency for Supervision of Financial Services Act*
CDA	*Croatian National Bank*
CSD	*Central Depository Agency (Central Securities Depository)*
GSM	*General Shareholders Meeting*
MOF	*Ministry Of Finance*
SA	*Securities Act*
TA	*Takeover Act*
VSE	*The Varazdin Stock Exchange*
ZSE	*The Zagreb Stock Exchange*

1. EXECUTIVE SUMMARY AND MAIN CONCLUSIONS

Since 1991 Croatia, as former socialist country, tried to implement legal and other infrastructure suitable for development of free market capitalist system. At the same time, large privatization programs were undertaken. These activities were further complicated by war and post-war reconstruction efforts.

Legal infrastructure was developed with mixed results partly by simple legal transplantation (CA), partly by implementing original solutions (first stage of privatization) and partly by mixture of these approaches.

Being candidate for membership of European Union, laws and regulations are currently being harmonized with EU legislation[1].

Corporate governance was not considered to be high priority issue at government level and is only recently being given some consideration by securities regulators. Corporate governance issues were addressed to some extent by stock exchange rules and in some cases by Croatian companies that were exposed to international markets and thus comprehended importance of corporate governance.

There is plenty of space to improve corporate governance at national level, and some of them require significant effort on side of government, legislative body and various regulatory bodies.

Legislation – Croatia should adopt more consistent and coordinated approach to process of drafting laws in general and laws and regulations regulating economy in particular. Presently, processes are highly fragmented, resulting in conflicting and partially incompatible regulation of different areas. High level of coordination between different government institutions that prepare laws and regulation should be of paramount importance. Focus in legislation in area of company law should move from literally copying German legislation to resolving issues burdening Croatian businesses.

Judiciary – Croatia should further increase efforts aimed at reformation of judiciary branch. Courts of lay should be better equipped, lawyers, notaries and judges should be additionally educated and trained and amount of time required to finally settle disputes should be reduced to minimum.

Regulatory bodies – Regulatory bodies should adopt transparent procedures and clear rules for liability should be in place. Regulated entities should have possibility to challenge rulings of regulatory bodies in courts of law.

Some more specific measures should be applied, such as:

- Enhance privatization efforts and also privatize entire securities market infrastructure;
- Adopt OECD Guidelines on Corporate Governance of State-Owned Enterprises on level of national and regional government;
- Introduce through appropriate legislation or other regulation various measures

[1] See also: http://www.mei.hr/default.asp?ru=273&sid=&akcija=&jezik=2

addressing different corporate governance issues (such as: introduction of cumulative voting procedures, simplify participation in general meetings of shareholders, clarify dividend related issues etc.);

- Stimulate companies to list in on Official Market tier (for example through tax incentives);
- Enhance integrity of the market by strongly addressing issues such as insider trading and other types of market abuse, etc.

Means to achieve significant advances in field of corporate governance are mostly well-known and not extremely complicated or difficult to apply. Therefore, applying them is probably only matter of political will and culture.

2. OVERVIEW OF LEGAL AND INSTITUTIONAL FRAMEWORK RELEVANT TO CORPORATE GOVERNANCE

2.1. LAWS AND REGULATIONS

2.1.1. Companies Act

CA deals with formation, functioning, transformation and winding-up of joint-stock company. It provides rules for establishment and operation of its principal bodies: General Meeting of Shareholders, Supervisory Board and Management Board (two-tier board system is mandatory)[2].

CA is copy of corresponding German legislation and therefore typical example of legal transplantation further complicated by translation-related difficulties.

2.1.2. Securities Act[3]

SA regulates issues related to supervisory and regulatory body, brokerages, issuing and listing of securities, operations of exchanges, CDA and custodians and procedures for trading of securities.

2.1.3. Croatian Agency for Supervision of Financial Services Act

CASFSA entered into force on January 1st 2006. Its main purpose was to unify existing regulatory agencies into new mega-regulator. CASF is in effect established by merging together Croatian Securities Commission, Croatian Agency for Supervision of Insurance Companies and Croatian Agency for Supervision of Pension Funds and Insurance.

2.1.4. Investment Funds Regulation

Activities of investment funds are regulated by Investment Funds Act, Mandatory and Voluntary Pension Investment Funds Act and Privatization Investment Funds Act[4], regulating issues related to fund management companies and investment funds of different types, as indicated by titles of mentioned laws.

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[2] In common law countries, (such as UK, USA), under so called one-tier system, GSM elects Board of Directors. Outside directors are members of the board that are not involved in day-to-day operations of the company. Inside directors are top managers of the company. CEO may or may not be President of the Board. In Croatia, different (German) model is adopted. GSM elects members of the Supervisory Board. Supervisory Board appoints top management (one or more natural persons referred to as "directors") which legally represent company, make decisions on behalf of the company and conduct company's day-to-day operations. Directors are not allowed to be members of the Supervisory Board. Therefore, it is usually referred to as two-tier system. Term "director" in two-tier systems does not apply to members of Supervisory Board, whereas in one-tier system there is only one Board and all it's members are referred to as directors. To avoid confusion we shall use terms "member of Supervisory Board" and "director" in sense attributed to them in "two-tier system", as explained above.

[3] Can be found at: http://www.crosec.hr/eng/zakoni/ZTVP.htm

[4] Can be found at: http://www.crosec.hr/eng/zakoni/PIF.htm (amendments at http://www.crosec.hr/eng/zakoni/PIF_1.htm)

2.1.5. Banking Act[5]

BA regulates activities of banks. Banks may directly participate in stock exchange trading (ie. be members of the exchange).

2.1.6. Takeover Act[6]

TA regulates procedures and conditions for (compulsory) takeover-bids.

2.2. REGULATORY AND SUPERVISORY BODIES

2.2.1. Croatian Agency for Supervision of Financial Services[7]

CASFS was instituted only recently (January 1st 2006) by merging Croatian Securities Commission[8] (which was responsible for oversight and regulation of issuance and issuers of securities, securities intermediaries, exchanges, investment funds (other than pension funds) and SDA), Croatian Agency for Supervision of Insurance Companies (which was responsible solely for oversight and regulation of insurance business in general) and Croatian Agency for Supervision of Pension Funds and Insurance[9] (which was responsible solely for oversight and regulation of pension funds and insurance).

2.2.2. Croatian National Bank

CNB is responsible for oversight and regulation of banking sector.

However, some overlaps exist. Banks are allowed to act as broker/dealers and to acquire membership of stock exchange. Banks also operate Fund Management Companies that manage pension and other investment funds. Therefore, line between HNB and CASF is sometimes blurred.

2.2.3. Ministry of Finance

MOF supervises and regulates auditors and accountants.

2.3. CAPITAL MARKETS INFRASTRUCTURE

2.3.1. Stock Exchanges

There are two stock exchanges (one in Zagreb[10], capital of Croatia, and other in Varazdin[11], in north-east part of the country). Both exchanges are joint-stock companies and have virtually same ownership structure (banks and brokerage houses).

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[5] Can be found at: http://www.hnb.hr/propisi/zakoni-htm-pdf/ezbanke-7-2002.htm

[6] http://www.crosec.hr/eng/zakoni/ZPDD.htm

[7] Still has not have own website.

[8] http://www.crosec.hr/eng/index_en.asp

[9] http://www.hagena.hr/index.php (no website in English)

[10] http://www.zse.hr

[11] http://www.vse.hr

2.3.2. Central Securities Depository[12]

CSA is responsible for maintaining securities accounts for individual investors and custodians, as well as foe clearing and settlement of all on-exchange transactions. It is joint- company fully controlled by state which directly and indirectly holds 77,3% of stock.

2.3.3. Central bank[13]

Central bank operates Large Value Payments System (LVPS)[14] and National Clearing System (NCS)[15]. Accessibility of LVPS and NKS is of paramount importance for shortening of settlement cycle pursuant to exchange transactions, and thereby reducing systemic risk of the market.

[12] http://www.sda.hr

[13] http://www.hnb.hr/eindex.htm

[14] In essence, netting system for payments between banks.

[15] More on: http://www.hnb.hr/platni-promet/eplatni-promet.htm

3. OVERVIEW OF PRIVATIZATION AND CAPITAL MARKET DEVELOPMENT

3.1. PRIVATIZATION

Mass privatization process in Croatia started soon after country gained its independence, and applied several privatization models. What follows is a very short description of privatization models applied, and many important particulars are deliberately omitted for the sake of brevity.

1. In accordance with first model, companies were transformed into joint stock companies and up to 50% of the were made available for sale to present and former employees under favorable conditions (deferred payment and discount to nominal value which depended on length of employment), while the rest was divided between government Pension fund and Croatian Privatization Fund which was established in order to achieve further privatization by selling it's share. Nominal value of the shares was established by dividing appraised value of the company with number of shares (all shares were ordinary shares). Value of the company was established by "quick and dirty" appraisal. Most of the largest companies (national oil company, largest insurance company, national telecom company, utilities etc. were exempted from this model).
2. Second model was developed mainly for special categories of citizens (war veterans, war casualties, families of the soldiers KIA etc.). They were awarded vouchers that could be traded for shares from HFP portfolio or invested in Privatization Funds that would than convert them to shares from the same source.
3. Third model employed auctions of shares from HFP portfolio and had few sub-variants that differed from each other mainly by means of payment for shares purchased:
    - First variant was developed as substitute for payment to the construction companies for post-war reconstruction projects. Tradable securities (called "Rights") were issued to such companies by government Ministries. These "Rights" were ultimately exchanged for shares from HFP portfolio on auctions conducted via Exchange.
    - Second variant was developed in order to further clear HFP portfolio and shares were offered for sale with payment in cash. This model was used mainly to sell HFP minority stakes.
4. Third variant facilitated payment with quasi-bonds that represented "Frozen Foreign Currency Deposits" and were issued to the owners of hard-currency that was kept on accounts with Croatian banks when Croatia gained independence and was not available to owners since all foreign currency was kept by Central Bank of (former) Yugoslavia.
5. Fourth model was reserved primarily for large companies (Telecom, Oil) that were sold in chunks to strategic investors.

Public offerings were employed extremely rare. Croatian pharmaceutical company Pliva, which was privatized via public offering, was later quite successful and is listed in Zagreb and London.

Pursuant to such privatization policies (especially through first two models described), great number Croatian citizens became shareholders, many under false expectations that purchase of shares in their companies of employment will somehow guarantee their jobs.

It is estimated that almost half million[16] citizens emerged out of privatization as shareholders, without developed investment culture and knowledge or understanding of the fundamental issues related to shareholding or securities in general. Their suspicion was further enhanced as it turned out that majority of the shares they own are worth much less than their nominal value[17], and by the fact that clever individuals purchased from them undervalued stocks for petty cash. No transparent market existed during that period.

For those and other reasons, there is still fair degree of suspicion and mistrust into fundamentals of free market economy, and enhancements in area of CG are urgently needed in order to regain sufficient trust an confidence in market institutions.

Level of privatization in Croatia is still insufficient and many large and important corporations are still fully or majority state-owned. As opposed to OECD countries, development of the stock market in Croatia did not match the magnitude of privatization.

3.2. CAPITAL MARKET

Croatian market is rather small. Still, as mentioned hereinabove, there are two stock exchanges. Both Exchanges have virtually same ownership structure (banks and brokerage houses).

Due to World Bank sponsored pension reform and introduction of mandatory pension funds that receive significant cash inputs on monthly basis, demand for investment-grade securities is much larger than supply.

Increased number of subscriptions to ZSE on line trading monitoring software packages by individuals suggests that individual investors play increasingly important role in market development within last two years.

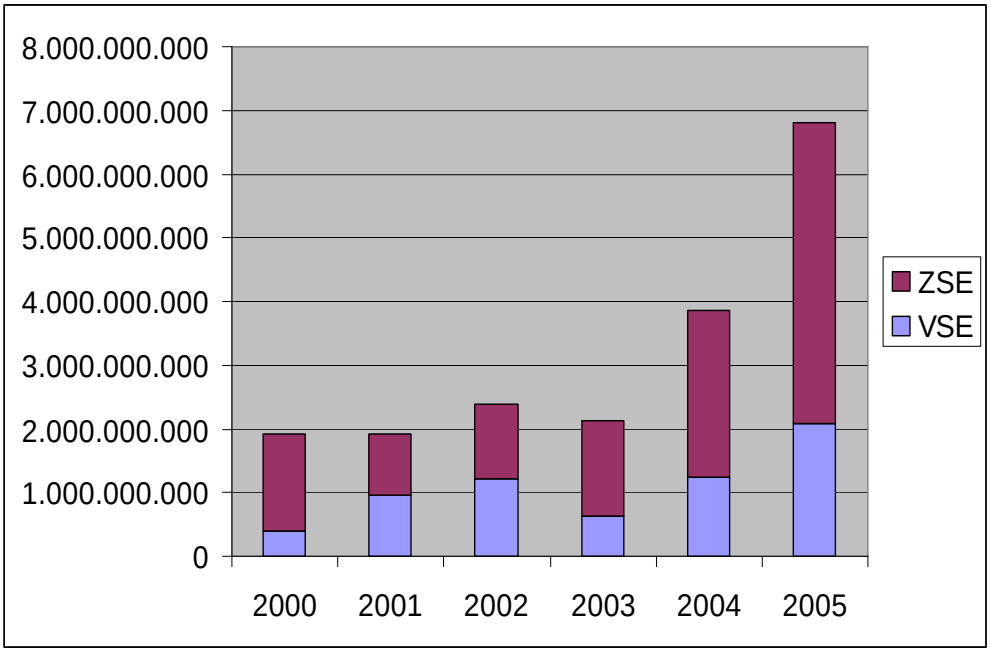
Comprehensive monthly, quarterly, semi-annual and annual trading reports may be downloaded from:

http://www.zse.hr/periodicals.php?sessionId=3764e02cd82d3011e2c1130ad878cf27&languageId=EN

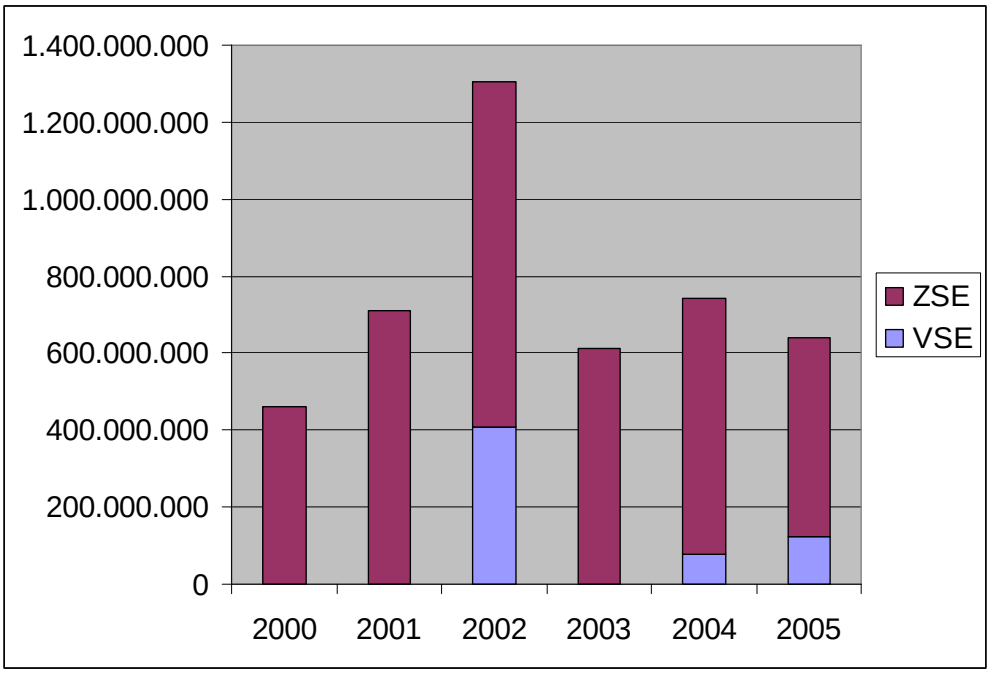
Following graphs serve to illustrate basic market developments and trends:

[16] SDA statistics show total of 510.718 client accounts, out of which 495.058 are accounts of Croatian citizens.

[17] There was misconception in popular mind that nominal value reflects at least real (market) value.

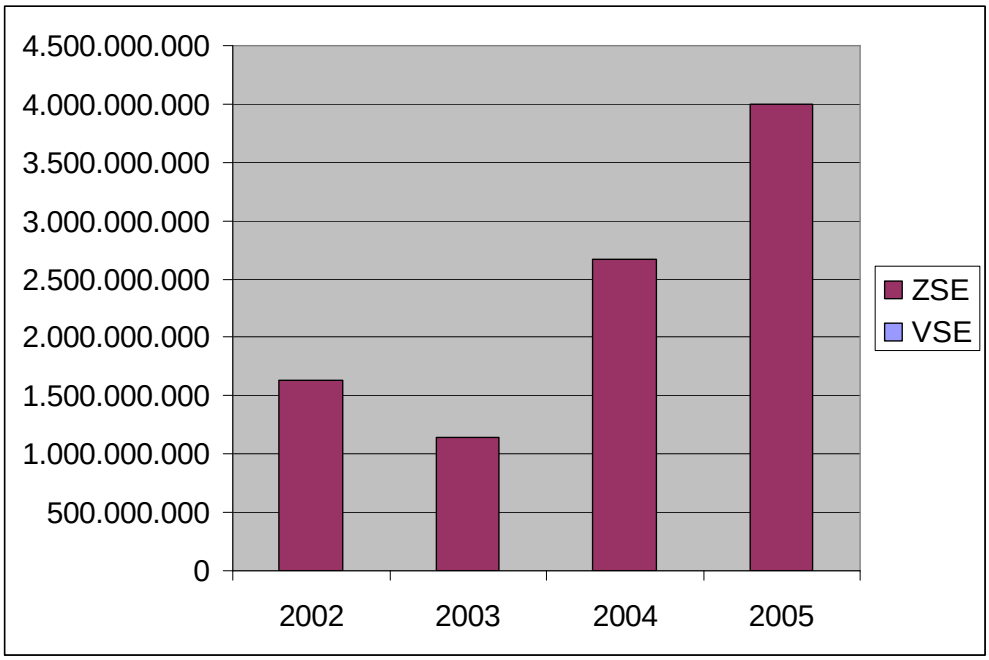


Total equity turnover on Croatian Stock exchanges 2000 – 2005 (in HRK[18])

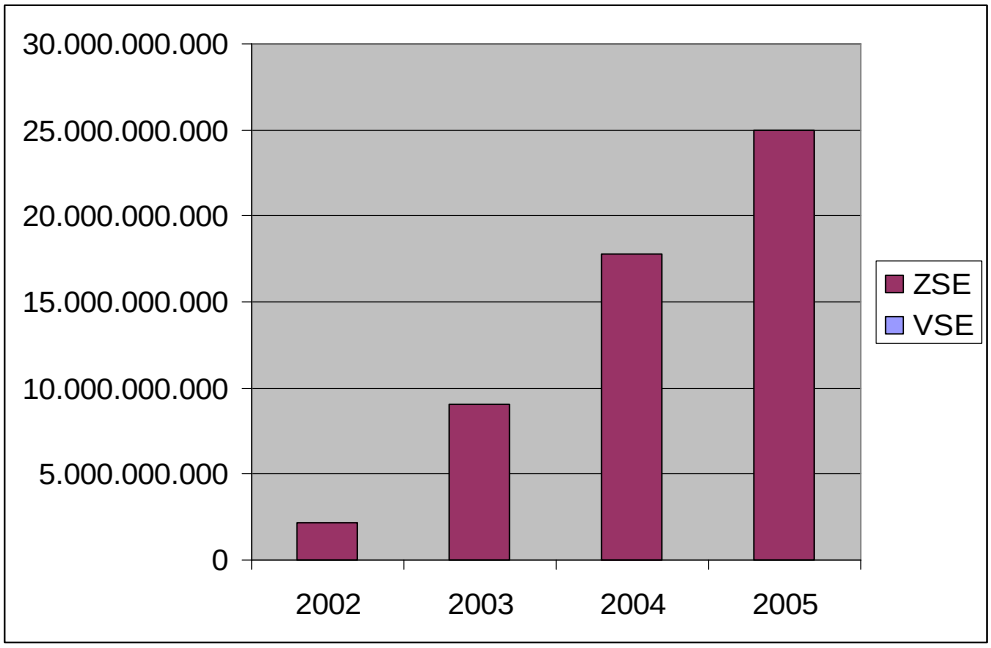


Total debt turnover on Croatian Stock exchanges 2000 – 2005 (in HRK)

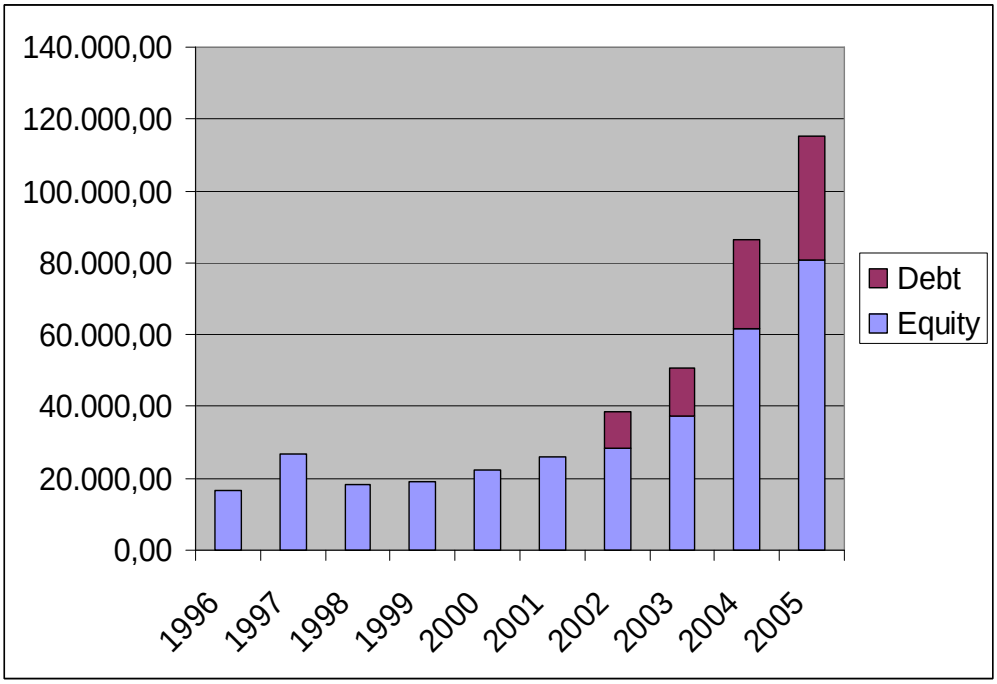
[18] € = 7.3 HRK; US$ = 6,1 HRK (approx.)



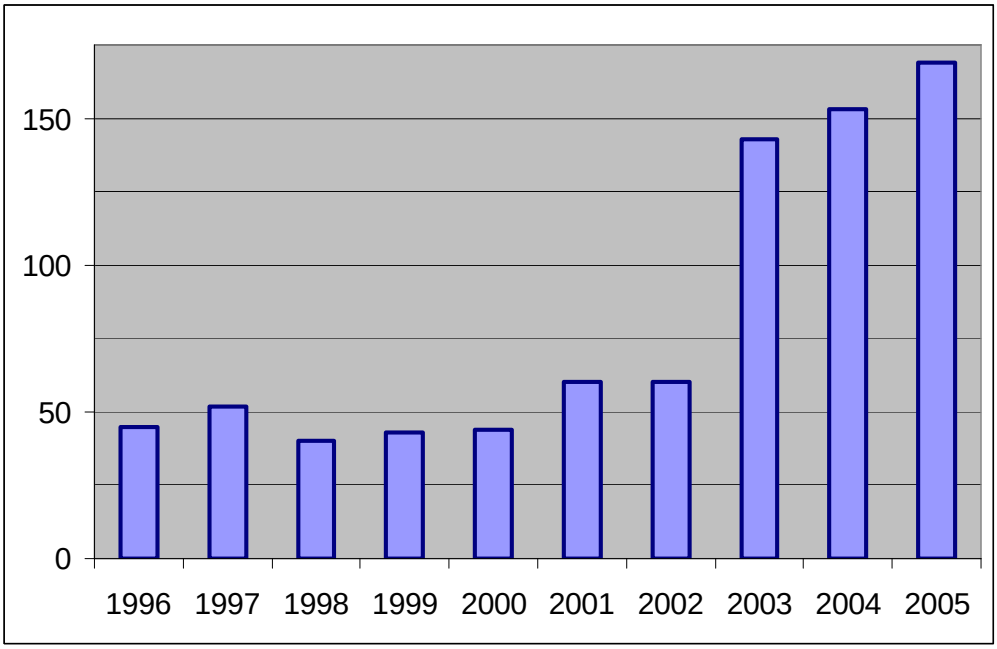
Total value of reported transactions on Croatian Stock exchanges 2002 – 2005 (in HRK)



Total value of reported institutional transactions on Croatian Stock exchanges 2002 – 2005 (in HRK)



Market capitalization of ZSE 1996 – 2005 (in HRK 000.000)



Number of actively traded securities on ZSE 1996 – 2005

Both exchanges developed several market segments or tiers (existence of some tiers is expressly required by SA).

At present moment only five issuers list their securities in Official Market (most demanding market tier on ZSE[19]) and one in First Quotation (roughly equivalent tier on VSE).

Two peculiar aspects of market structure must be mentioned: JDD and trading with securities issued by companies that provide no disclosure.

3.2.1. JDD

Companies are required by the law to list their shares on Croatian exchange if they:

1. have more than 100 shareholders and paid-in capital above 30 million Kn, or
2. have issued stock through IPO.

These companies are referred to as JDD[20] and exchange must provide special tier or market segment for listing of JDD stock. However, listing requirements are moderate and exchange is not allowed to terminate listing of JDD in case when it does not fulfil it's obligations regarding disclosure or other duties required by exchange rules or law.

There are over 200 JDD presently listed on both exchanges, but only limited number is regularly traded.

Government provides no incentives to companies that list their securities.

3.2.2. Parallel[21] or Free Market[22] segment

Parallel or Free Market segment allows for trading in securities issued by Issuers that;

- have not required or initiated listing,
- have not entered into contract or agreement with the exchange regarding listing or trading of their securities, and
- are not under any obligation imposed by exchange Rules.

Since there is virtually no transparency or disclosure provided by issuers of securities traded within Parallel or Free Market segment it is fair to assume that most of the trades reflect insider knowledge of at least one of parties involved.

Due to very limited disclosure requirements for JDD companies, same observation is to certain (but lesser) degree also valid for trades with securities issued by companies listed in JDD market segment.

[19] ZSE Rules may be downloaded from http://www.zse.hr/docs/PravilaZSE-2003-ENG.pdf

[20] JDD stands in Croatian for "Javno dioničko društvo" – which translates to English as Public Joint Stock Company, but should not be confused with meaning and normal usage of that term in English.

[21] In terminology of ZSE Rules

[22] In terminology of VSE Rules

3.3. OWNERSHIP STRUCTURE

Data on structure of ownership of 209 JDD companies (that by definition have more than 100 shareholders) show extremely high concentration of ownership.

On average:

- largest single shareholder owns 50% of shares outstanding;
- largest five shareholders own 75% of shares outstanding;
- largest ten shareholders own 79% of shares outstanding.

Also, level of state ownership is quite high, especially if we take into consideration fact that all JDD companies went through process of privatization.

State is directly or indirectly[23]

- largest single shareholder in 31% of JDD companies,
- second largest single shareholder in 25% of JDD companies, etc.

Such structure of ownership obviously creates specific CG problems.

3.4. COMPANIES ACT AND CORPORATE GOVERNANCE CODE

In accordance with CA Supervisory and Management Boards of the companies listed on the Exchange have duty to report once a year which provisions of the CG Code they complied with and which not in the previous period, and to state which provision of the Code they intent to comply with in the future (and which not).[24]

That provision of CA is not fully adhering to "comply or explain" principle since no explaining is required by CA.

Abovementioned provision of CA provides for no sanction in case when Board fails to produce required report.

Furthermore, CA does not give authority to any body, organization or person to produce CG Code it refers to. Therefore, CG Code which will be adopted by Corporate Governance Council established by securities regulator will have relevance for the listed companies only if adopted (possibly with some modifications) by exchange(s). Exchanges are at liberty to adopt entirely different CG codes (provided that Code in question is approved by regulator since all Exchange regulation requires such approval).

Term "companies listed on the exchange" requires further clarification since both Exchanges allow trading with shares which are not "listed" by the issuers themselves ("Parallel Market" on ZSE and "Free Market" segment in VSE), but by exchange members. Therefore, no legal connection exists between issuer and the exchange. Issuer

[23] Through state owned companies.

[24] CA, Art. 272.a: "Management and supervisory boards of companies with stock listed on exchange are under obligation to annually produce declaration stating whether they have acted in concurrence with recommendations contained in corporate governance code and whether they intend to comply therewith in the future, and state which of recommendations they did not comply with or will not comply with. Such statement must be available to shareholders at all times."

may be listed or de-listed without his initiative, participation or even knowledge about it (of course, transparency of issuers business in this case for all practical purposes equals zero). Hence, it must be clarified whether such companies are bound by reporting requirement imposed by CA (in other words: are they considered to be "listed companies" in the meaning attributed to the term by CA or not[25]).

Peculiar situation regarding corporate governance code provisions of CA has its roots in fact that entire CA is copy of corresponding German regulation. German legislators decided at one point to pick one of five corporate governance codes that existed in Germany at that time and make it "official". Since not a single corporate governance code existed at that time in Croatia (and still doesn't exist), authors of CA draft ended up referring to non-existing document.

[25] In wording of ZSE Rules such companies are not considered to be listed but just "traded".

4. OBSERVATIONS REGARDING RECCOMENDATIONS CONTAINED IN WHITE PAPER ON CORPORATE GOVERNANCE IN SOUTH EASTERN EUROPE[26]

4.1. SHAREHOLDERS' RIGHTS AND EQUITABLE TREATMENT

4.1.1. Privatization

Privatization should be accelerated and pursued in such a way as to contribute to the creation of competitive markets and with a view to improve corporate governance in both state-owned and newly privatized companies.[27]

Croatian privatization process has led to highly concentrated ownership structure. Therefore, main corporate governance related conflicts develop between majority or dominant shareholder and other (minority) shareholders.

Cumulative voting is virtually non-existent and minor shareholders (even if they own significant part of the votes) are not represented in board.

4.1.2. State ownership

In cases where the State remains a shareholder, other shareholders should be especially protected from abuse.

Government ownership of the companies is one of largest if not the single largest problem related to future development of corporate governance practices. Government owned companies are disrupting functioning of the market (for example, they are often privileged in obtaining government contracts) and therefore significantly slow down development of free market economy based on fair and competition between players. Places on boards are often awarded to bureaucrats as sinecures and they pose serious obstruction to further privatization.

Therefore, increased effort should be directed towards persuading Croatian central (and local) government to adopt and implement OECD Guidelines on Corporate Governance of State-Owned Enterprises.

4.1.3. Independent and secure registration of shares

Independent and secure registration of shares should be guaranteed for all companies above a minimum size, and not only for companies quoted on the exchanges.

By establishment of SDA, goal of independent and secure registration of shares is technically achieved. However, SDA is more than ¾ state gowned and enjoys monopolistic position which causes inefficiencies in performance. Charges for services of SDA are considered so high that it seriously impedes trading.

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[26] Reccomandations contained in White paper are divided in five Chapters: (1) Shareholders rights and equitable treatment, (2) Stakeholders, (3) Transparency and disclosure, (4) Board, and (5) Implementation and enforcement. This part follows closely structure of the White paper.

[27] White paper Recommendations are quoted in *italics*.

SDA should be privatised and performance of its functions de-monopolized.

4.1.4. Free transferability of shares

The free transferability of shares should be granted for joint stock companies.

Although CA allows restriction of transferability, SA provides that all book entry shares are by definition free-transferable.

It would be desirable to alter CE correspondingly.

4.1.5. Participation in general shareholders' meeting

Shareholders' participation in general shareholders' meetings should be encouraged. To this end, procedures to convene shareholders' meetings should be more stringent and provide all shareholders with sufficient, relevant and timely information regarding issues on the agenda.

Problems have been observed in some cases with certain shareholders not being allowed to participate in general shareholders' meeting. Problem lies mostly in area of enforcement, since right to participate, vote and receive relevant information is established by CA. Unfortunately, courts are slow and securities regulator claims to lack power to act in such cases.

4.1.6. Voting Procedures

Companies should be prevented from setting up procedures that impede shareholder voting and should provide effective and secured procedures to vote in absentia as well as for proxy voting.

Voting and participation on general shareholders meetings still may be and sometimes is subject to unnecessary and impeding (but legally allowed) procedures such as registration.

Regulation should be adopted which clearly defines record date and prohibits imposing needles conditions for participation in general shareholders meeting by company bylaws.

There is no regulation for solicitation of proxies.

Position on voting in-absentio is not clear and regulations need further refinement in that area,

4.1.7. Investor relations department

Shareholders may benefit if large and widely held companies establish an investor relations department.

Sophisticated companies listed on ZSE have established investor relations departments or appointed investor-relations officers and provide information for investors on their websites. ZSE encourages such practices but it is not expressly required by law or securities regulator.

4.1.8. Institutional investors

With the goal of protecting the interests of their investors and beneficiaries, institutional investors should be encouraged to pursue their shareholders' rights in an informed and active way.

Institutional investors are sophisticated enough and need no further encouragement to use their voting power (and other means of influence) in order to promote their interests.

4.1.9. Individual investors

Informed participation by individual investors and their associations should be encouraged.

Small shareholders associations have been established within shareholder communities of some large companies. However, with one notable exception, they were formed by employees that became shareholders during first phase of privatization process. Therefore, they act more as unions than association of investors.

Still, in some cases shareholders associations gained significant influence over issuers.

4.1.10. Dividends

Dividends should be paid within a reasonable period and follow clear rules regarding who is entitled to such dividends.

There are no clear rules regarding dividend date and payment date, making it easy for insiders to gain profit from advanced knowledge of such information.

Obviously, clear rules regarding dividend procedures should be established either by law or by regulator.

4.1.11. Changes in the capital equity structure

Changes in the capital equity structure should be made in a manner that ensures equitable treatment of shareholders, through the respect of pre-emptive rights in the case of new issues.

Shareholders have pre-emptive rights due to CA provisions. However, this is not enough especially considering shareholding structure in Croatia (due to privatization process described earlier). In order to be able to gain advantage from pre-emptive right, shareholder should be embedded into transferable security which can be sold if he/she does not have resources for additional investment into new issue.

In present situation, when such pre-emptive rights are not easy transferable, it has been observed that insiders buy shares on the market prior to issuing new shares. New shares are than issued below market value, and insiders use preemptive rights attached to previously acquired shares to buy new issue and profit from difference between market price and price at which new issue has been acquired.

New regulation should be adopted, forcing issuers to issue preemptive rights as transferable securities to existing shareholders.

4.1.12. Changes in the control structure

Specific and pre-established procedures that guarantee the equitable treatment of shareholders should be respected if there are changes in the control structure.

Takeover legislation is in place, and new takeover act is currently being drafted which will hopefully make up for inefficiencies contained in present one.

Squeeze out procedure is regulated by CA, but prices at which they are exercised are frequently subject of bitter disputes and court cases.

Clearer regulation related to pricing within take over and squeeze out would be appreciated by market.

4.1.13. Procedures for approval of major transactions

Procedures for approval of major transactions should be strengthened and respected.

Super-majority is required for approval of major transactions. However, disclosure of all relevant facts is sometimes inadequate.

4.1.14. Fair and transparent evaluation

Special attention should be paid to fair and transparent evaluation for share issues, squeeze-out procedures, major and related party transactions.

There are no rules requiring any procedure for evaluation of share issues (see 4.1.11.) or squeeze out pricing (see 4.1.12.).

Regulation and implementation of regulation of related party transactions should be improved.

4.1.15. Monitoring, control mechanisms and enforcement

Monitoring and control mechanisms should be established and strengthened to prevent abusive related party transactions as well as any situation entailing conflicts of interest. Enforcement should be strongly improved, especially through the development of private civil remedies and the establishment of effective criminal liability for executive managers and board members failing to disclose their interest.

Effective criminal or civil liability for executive managers and board members failing to disclose their interest the establishment has not yet been fully established.

4.1.16. Insider trading

Insider trading should be forbidden by legislation or securities regulation and monitoring and enforcement of such abusive practices reinforced.

Insider trading is forbidden by SA, but enforcement is non-existent. Although small Croatian market is considered to be very much under influence of insiders (as is the case with other small securities markets established within transitional countries), and there are many cases where obvious indications of insider trading have been observed, there is no action taken by relevant authorities and there are no court cases or convictions based on anti insider trading legislation.

Monitoring and enforcement of anti insider trading provisions should be seriously improved.

4.2. THE ROLE OF STAKEHOLDERS

4.2.1. Consistency of regulation

The rights of stakeholders should be clarified and legislators should make sure that the various laws and regulatory acts concerning stakeholder rights are consistent.

Generally, various laws that influence corporate governance related issues are drafted by different government bodies with no (or with insufficient degree) of coordination.

For example, banking legislation is drafted by Croatian National Bank, SA is drafted by securities regulator, CA is drafted by Ministry of Justice etc. When drafting legislation, government bodies are often too much focused on their role, position and power. Industry is only sporadically involved, and rarely (or too late) invited to comment on draft legislation.

There is no overall strategy or pre-defined goals of legislation (to certain extent that will be imposed externally during period of harmonization of legislation with EU requirements).

Procedures of preparing legislation should be improved.

4.2.2. Role of boards and managers

Boards and managers should make sure that they are familiar with relevant stakeholder rights. They should also establish internal mechanisms to ensure compliance with these rights.

There are no programs for education of board members related to corporate governance issues in place. However, stakeholders often manage to exercise influence in various ways. (employees through unions or shareholder associations, creditors – mainly banks – through their expertise and financial strength etc.).

Boards do not, in general, formulate or communicate their policy regarding stakeholders.

4.2.3. Effective communication with stakeholders

Whatever the legal requirements, companies should establish effective communication with employees and other stakeholders on matters that affect them directly.

Some (larger) companies have internal newsletters serving, among other purposes, to inform employees on various company policies, decisions etc.

There are no regulatory requirements regarding such communication.

4.2.4. Communication with investors

Companies should communicate with investors regarding their stakeholder policies.

So far there is no widely established practice related to communication with investors regarding stakeholder issues.

4.2.5. Effective redress mechanisms for employees

Employees should have access to effective redress mechanisms in case their rights are violated. Such mechanisms could include third party mediation and arbitration.

Mediation and arbitration as alternative dispute resolution methods may be established via collective agreements concluded between union(s) and employer(s).

There is no regulation requiring mandatory establishments of such dispute resolution mechanisms.

Labor law disputes have priority over other matters when dealt with by the courts of law.

The provisions of the Labor Act regulate employees' participation in the company's supervisory board depending on the company's size and ownership structure.

4.2.6. Bankruptcy procedures and exercising of secured claims

Bankruptcy procedures and mechanisms to exercise secured claims should be strengthened and enforced effectively.

Despite extensive legislative activity in area of bankruptcy law, bankruptcy procedures as implemented are too slow and complicated. Additional training for officials in charge of implementing bankruptcy procedures is of paramount importance. In significant number of cases corruption has been reported.

Decisions of the general shareholders meeting are void if they violate the regulations protecting, exclusively or predominantly, the interests of the company's creditors (or the regulations protecting the public interest).

Commercial court has right will refuse to register a company if its statute contains provisions restricting or diminishing creditors' rights.

Judging by profits reported by Croatian banks for years, it seems that debt collection difficulties are not affecting them at any significant level.

4.3. TRANSPARENCY AND DISCLOSURE

4.3.1. Adoption of IFRS

The adoption of full International Financial Reporting Standards (IFRS) should be pursued and fully implemented for listed companies. Special attention should be given to consolidation requirements and related party rules.

Use of IFRS is mandated by provisions of AA. However, issuance of binding translations to Croatian is sometimes significantly delayed.

Mechanisms ensuring competent and proficient translation and publication of IFRS should be established.

4.3.2. Major ownership and control structure

Information concerning major ownership and control structure of listed and widely held companies should be accessible to all shareholders and publicly available.

Information regarding ownership structure may be obtained:

- via CSD website which lists top ten shareholders, but without disclosing their share in ownership, or
- via securities regulators website which lists top ten shareholders, and their share in ownership, but on delayed basis (and updates every 3 months).

Shareholder may obtain complete list of all shareholders from CSD (as text file on CD) for approx. € 100.

System of reporting large shareholding should be integrated and reflect changes on real-time basis.

Obtaining of shareholders list should be simplified (for example by downloading it from Internet), cheaper, and not be unnecessary limited just to shareholders.

4.3.3. Ongoing disclosure

Ongoing disclosure of significant events should be considerably improved.

For companies listed in Official Market, ZSE rules provide for ongoing disclosure requirements (for companies listed in Official Market) in line with European standards of disclosure.

However, companies listed in JDD market segment sometimes provide insufficient or almost no disclosure at all. Securities regulator does not allow exchange to de-list issuers that do not meet disclosure requirements.

4.3.4. Complete disclosure

Companies should disclose all relevant information material to an informed understanding and assessment of the company's business, activities and situation.

Further improvements regarding regulation of timeliness and completeness of disclosure are expected due to harmonization requirements imposed by EU.

4.3.5. Responsibilities of the different company organs

The respective responsibilities of the different company organs and the external auditors regarding disclosure should be clarified.

Responsibility and liability of board members and external auditory may be regulated more clearly.

Auditors allowed or even required to incorporate and thereby limit their liability towards investors that rely on their work.

4.3.6. Monitoring

Securities regulators and stock exchanges should strengthen their monitoring of companies' compliance with disclosure requirements. Securities regulators should have the capacity to prescribe and enforce these requirements.

Securities regulators in Croatia do have the capacity to prescribe and enforce disclosure requirements.

However, there s enough room for strengthening the monitoring. On the other hand, in our experience, market would benefit if clear line is drawn between authority of securities regulator and exchange in matters of monitoring issuers that list securities on the exchange, regarding disclosure requirements and otherwise.

ZSE has in its Rules provided for various measures related to compliance with disclosure requirements, from trading halts to suspension and ultimately, in most severe cases of non-compliance, delisting of securities.

4.3.7. Access to information

Shareholders' access to information needs to be enhanced, through the use of efficient and modern communication by companies as well as authorities.

ZSE encourages listed companies to establish their own Internet websites and utilize them to publish important information they must disclose. ZSE website is routinely used for dissemination of information.

Access to information should not be limited to shareholders only, and information should be accessible by general public, since quality of market requires informed potential investors as well as shareholders.

4.3.8. Regulation of the accounting and audit function

The regulation of the accounting and audit function should be strengthened.

Regulation of all professions having strong impact on corporate governance related issues (primarily accountants, auditors and lawyers) should be additionally strengthened and their duties, responsibilities and liability should be determined by law i clear and unambiguous manner.

4.3.9. Professional organizations

The quality and strength of professional organizations of accountants and auditors should be significantly reinforced.

4.3.10. Independence of auditors

The independence of auditors should be reinforced by adequate regulatory provisions and effective monitoring.

Auditors are already independent. However, regarding limited liability, small auditing firms may be tempted to discharge their duties in a manner not fully in accordance with highest standards required by profession.

4.3.11. Training

An effort should be made to develop the training of accountants and auditors, as well as officials concerned in the regulatory bodies and the government. This should constitute a priority for international technical assistance.

In our opinion, there is enough training opportunities for accountants and auditors presently in Croatia.

4.3.12. Media

The role of the media in the dissemination of company information and in promoting global transparency in business practices needs to be strengthened and supported.

Increasing number of media dedicated (fully or to significant level) seems to encourage hope that competition among them will eventually help to promote high professional standards.

On the other hand, some media still rely too much on inputs from securities firm and that may use their influence to promote their own interests which may not necessary be in line with interests of general public.

4.4. THE RESPONSIBILITIES OF THE BOARD

4.4.1. Best interest of the company

Regulatory provisions and by-laws should articulate that boards should act in the best interest of the company and treat all shareholders in a fair and equitable manner.

CA imposes requirement to treat all shareholders in fair and equitable manner. However, in real life it is of course not always so, and securities regulator should gain means to deal with observed irregularities.

On the other hand, requirement to act "in the interest of the company" may result in different types of behaviour, depending on how different interest groups interpret interest of the company. Within conditions presently existing in Croatia, and in our humble opinion in other transitional countries, further clarifications of what constitutes interest of the company ij various situations are strongly needed.

4.4.2. Procedures

In addition to legal requirements, companies should clarify in their by-laws the boards' main functions and responsibilities. Boards should also put in place procedures that document and regularize the fulfillment of these functions.

It is up to each company to clarify main functions and responsibilities of board and its members, as well as to

4.4.3. Liability of the board

Collective as well as personal liabilities of board members should be clarified. Sanctions should be dissuasive and effectively enforced.

Creditors and shareholders may file a claim for damages against a person who used his or her influence in the company to make a management or supervisory board member, take an action causing damage either to the company or to the company's shareholders.

So far liability of board members or persons who might influence them has not been successfully enforced by court of law.

4.4.4. Independent board members

Companies should be required to have a sufficient number of independent board members. The condition of independence should be clearly defined.

Existing laws and regulations do not impose any requirements regarding independent board members and do not define conditions enabling someone to qualify as independent director.

Draft Corporate Governance Code contains such requirement and necessary definitions in form of recommendation on "comply or explain" basis.

4.4.5. Bard committees

Large companies would be well served by establishing specialized committees within the board structure in order to help the board as a whole to perform some of its most essential and critical functions.

CA allows but does not mandate establishment of board committees. More sophisticated companies have established audit and remuneration committees.

4.4.6. Access to information

All board members should have explicit and broad power to access information that is necessary to the performance of their functions.

CA guarantees access to information to board members.

4.4.7. Remuneration

The remuneration of board members should be adequate and transparent.

Remuneration in Croatia seems to be adequate, but more transparency is required.

4.4.8. Guidelines

Practical guidelines could be developed and disseminated in order to provide boards with useful directions to perform their functions in a professional manner. These guidelines would insist on the necessity for board members to devote enough time to their board duties and to work collegially.

No such guidelines exist in Croatia.

4.4.9. Training

Training for board members should be a priority in order to improve the corporate governance practice in SEE. Efforts should be made to develop national Institutes of Directors as well as a regional network of such institutes, and international donors should support these efforts.

Some (but still inadequate) training programs exist within Croatian Employers Association.

4.5. IMPLEMENTATION AND ENFORCEMENT

4.5.1. Judicial system

The capacity of the judicial system to effectively deal with commercial disputes should be strengthened.

Judicial system is not up to task of dealing effectively with commercial disputes, primarily since it is slow and therefore inefficient. Also, large and everincreasing number of new laws and regulations (that are often inadequate and are often followed by rapid sucession of amendments) make it even more difficult for judges to adopt to new legislative environment.

Programs for education of judges are insufficient or non-existent[28]. Strategy for improvement of efficiency of judiciary has men adopted by Ministry of Justice and first steps in implementation are already underway. However, it is a long, and complicated project and it remains to be seen haw it wil develop in future.

4.5.2. Securities regulators

Securities regulators in SEE countries should have the independence, resources, remedies and accountability necessary to oversee financial markets and self-regulatory organizations effectively.

Formally, Croatian securities regulator is fully independent body. It only depends on people appointed to head it if and to what extent they will choose to exercise their independency.

Accountability, as well as transparency of procedures of securities regulator should be further enhanced. Also, parties to proceedings instituted by securities regulator must have recourse to the courts of law in order to contest regulators rulings.

4.5.3. Effective redress mechanisms for shareholders

Shareholders should have access to effective redress mechanisms, including professional arbitration and low cost collective efforts.

Introduction of class action concept would probably be most efficient single measure for improvement of corporate governance practices in Croatia.

4.6. IMPACT OF WHITE PAPER ON CORPORATE GOVERNANCE DEVELOPMENTS IN CROATIA

White paper, which indeed provides excellent blueprint for corporate governance reforms in all countries covered, did not have significant impact on development of corporate governance related issues in Croatia. That is primarily because implementation of comprehensive set of measures listed in White Paper implies major and concentrated effort on the side of government. That did not happened because government did not understand significance of corporate governance or consequences of poor corporate

[28] Some documents on reform strategy are at http://www.pravosudje.hr/default.asp?ru=315&gl=&sid=&jezik=1

governance practices. Only recently did one of regulatory bodies take interest in corporate governance, and we can only hope that it will with time translate into coordinated action of all parts of administration.

On the other hand, private sector (or important parts thereof) has much more appreciation for developments in field of corporate governance and approached related issues with a lot of enthusiasm and motivation. That is probably because corporate governance issues are inherently closer to businessmen than bureaucrats.

Therefore, major program of implementation of White Paper recommendations on government level is hopefully something that awaits Croatia in near future.

APPENDIX – CROATIA IN NUMBERS

	2000	2003	2004
Population, total	4.4 million	4.4 million	4.5 million
Population growth (annual %)	-3.8	0.1	1.4
Surface area (sq. km)	56,540.0	56,540.0	..
GNI, Atlas method (current US$)	19.7 billion	23.9 billion	29.7 billion
GNI per capita, Atlas method (current US$)	4,500.0	5,370.0	6,590.0
GDP (current $)	18.4 billion	28.8 billion	34.2 billion
GDP growth (annual %)	2.9	4.3	3.7
GDP implicit price deflator (annual % growth)	4.7	3.2	3.1
Value added in agriculture (% of GDP)	9.1	8.4	8.2
Value added in industry (% of GDP)	30.3	30.1	28.8
Value added in services (% of GDP)	60.7	61.5	63.0
Exports of goods and services (% of GDP)	47.1	47.1	47.5
Imports of goods and services (% of GDP)	52.3	56.8	52.9
Gross capital formation (% of GDP)	20.2	30.4	27.7
Trade in goods as a share of GDP (%)	66.9	70.5	..
Trade in goods as a share of goods GDP (%)	131.6	142.7	..
High-technology exports (% of manufactured exports)	8.5	12.3	..
Foreign direct investment, net inflows in reporting country (current US$)	1.1 billion	2.0 billion	..
Source: *World Development Indicators database*, August 2005			