

STABILITY PACT

**SOUTH EAST EUROPE COMPACT FOR REFORM,
INVESTMENT, INTEGRITY AND GROWTH**



WHITE PAPER ON CORPORATE GOVERNANCE IN SOUTH EAST EUROPE

Prepared by

**THE SOUTH EAST CORPORATE GOVERNANCE ROUNDTABLE AND THE CORPORATE AFFAIRS DIVISION
IN CO-OPERATION WITH THE INVESTMENT COMPACT TEAM**

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The Stability Pact for South East Europe is a political declaration and framework agreement adopted in June 1999 to encourage and strengthen co-operation among the countries of South East Europe (SEE) and to facilitate, co-ordinate and streamline efforts to ensure stability and economic growth in the region. (see www.stabilitypact.org)

The South East Europe Compact for Reform, Investment, Integrity and Growth (“The Investment Compact”) is a key component of the Stability Pact under Working Table II on Economic Reconstruction, Development and Co-operation. Private investment is essential to facilitate the transition to market economy structures and to underpin social and economic development. The Investment Compact promotes and supports policy reforms that aim to improve the investment climate in South East Europe and thereby encourage investment and the development of a strong private sector. The main objectives of the Investment Compact are to:

- Improve the climate for business and investment;
- Attract and encourage private investment;
- Ensure private sector involvement in the reform process;
- Instigate and monitor the implementation of reform.

The participating SEE countries in the Investment Compact are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Romania, Serbia and Montenegro¹. Building on the core principle of the Investment Compact that “ownership” of reform rests within the region itself, the Investment Compact seeks to share the long experience of OECD countries. It provides region-wide peer review and capacity building through dialogue on successful policy development and ensures identification of practical steps to implement reform and transition.

The work of the Investment Compact is actively supported and financed by seventeen OECD member countries: Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Norway, Sweden, Switzerland, Turkey, United Kingdom and United States. (see www.investmentcompact.org)

NOTE

1. On 4 February 2003, the Yugoslavian Parliament adopted a new constitution for a state union called Serbia and Montenegro.

FOREWORD

The OECD and the World Bank Group have combined their efforts to create and support Roundtables on Corporate Governance where national policy-makers, regulators and market participants can share experiences and debate corporate governance policies and reform. Today, such Roundtables meet in Russia, Asia, Eurasia, Latin America and South East Europe.

The Roundtables address both general corporate governance issues, and matters of specific concern to their respective regions. Each Roundtable employs the OECD Principles of Corporate Governance as a framework for developing a regional white paper or comparative paper on corporate governance. The Roundtables have helped to increase awareness, identify areas where reform is needed and build solid regional coalitions for that reform. They have also contributed to building capacities, especially in the area of enforcement.

The South East Europe Corporate Governance Roundtable has enjoyed strong, high level support from the governments and market participants in the region. An outgrowth of its debates is this White Paper on Corporate Governance in South East Europe. The White Paper features a unique set of recommendations to improve corporate governance practices and the supporting institutional framework in South East Europe.

On behalf of the OECD I would like to thank the participants in the South East Europe Corporate Governance Roundtable and the regional institutions that have co-hosted its meetings to discuss this White Paper. While practices and challenges sometimes differ among countries, participants have carried out the work in a constructive and professional manner, and in so doing, have built a strong coalition for reform. I would also like to thank the South East Europe Compact for Reform, Investment, Integrity and Growth within the Stability Pact as well as the Global Corporate Governance Forum for having financed and supported this Roundtable. As underlined in the Preface by the Co-Chairs of the Investment Compact, the momentum for reform must be maintained and the recommendations set out in this document need to be implemented. This White Paper should therefore be seen as a step in an on-going process. I hope that it will constitute a basis for continuing dialogue on policy design, implementation and enforcement, and that it will be an effective tool to help governments promote and assess progress towards good corporate governance in South East Europe.



Donald J. Johnston
Secretary-General

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PREFACE

Good corporate governance is now widely recognised as essential for establishing an attractive investment climate characterised by competitive companies and efficient financial markets. The OECD and the World Bank Group have combined their efforts to promote policy dialogue in the area of corporate governance and have established Regional Corporate Governance Roundtables in close partnership with national policy-makers, regulators and market participants. Today, Corporate Governance Roundtables exist in Asia, Eurasia, Latin America, Russia and South East Europe (SEE). The work of the different Roundtables is adapted to the specific issues in the respective regions. But each Roundtable is using the OECD Corporate Governance Principles as a common framework for discussions and has agreed to issue a Regional Corporate Governance White Paper formulating key policy objectives and reform priorities.

This Roundtable is part of the South East Europe Compact for Reform, Investment, Integrity and Growth (the “Investment Compact”) and has been carried out within the framework of the South East Europe programme of the Centre for Co-operation with Non-Members. The Investment Compact aims at improving the region’s economic and business environment. It sets out the commitment of countries in the region to lay the structural policy foundations for sustainable growth and reform so as to create a robust market economy and encourage private investment. In their Ministerial Declaration on “Attracting investment to South East Europe: Common Principles and Best Practices”, adopted in Vienna on 18 July 2002, Ministers from SEE sent an important signal about SEE countries’ commitment to corporate governance reform. They noted that “despite promising investment opportunities investment flows to and within the region fall short of needs and expectations”. They have also acknowledged that “sustained and intensified efforts are needed within the framework of the Investment Compact to implement economic, legal and administrative reforms and to provide for good governance structures”. They recognised that, among other key principles and best practices, good corporate governance, “to the extent applied, contributes to a favourable climate for both international and regional investment”. Finally, they committed to consider adhering to the OECD Principles of Corporate Governance.

SEE countries have made significant progress in corporate governance over the last few years. Recent and current reforms have improved the legal and regulatory framework by providing better protection against abuse. Several national initiatives to issue guidelines, statements of best practices or to set up specialised good corporate governance tiers on the stock exchange have contributed to raising the awareness and improving the practices. Stock exchanges and securities regulators have reinforced their monitoring of companies’ conduct.

It is important to maintain the momentum for reforms and put in place credible enforcement mechanisms. Markets have to be reassured that corporate governance reforms in SEE are irreversibly shifting towards global standards. The publication of this White Paper is a step in an ongoing process and it is our sincere hope that the recommendations in this White Paper will be followed by a range of important national initiatives. These recommendations, which have been developed on a consensual basis, are a key tool for promoting, assisting and assessing progress in SEE corporate governance thereby helping to enhance confidence and international credibility in the reform process.

The organisation of the South East Europe Corporate Governance Roundtable and the development of this White Paper are the result of a co-operative effort and have benefited from the strong commitment of all the institutions involved as well as from individuals participating in the Roundtables. We would like to express our sincere gratitude to the World Bank Group and to all South East Europe and OECD countries institutions that have supported this work, in particular the Romanian National Securities Commission, the

Bucharest Stock Exchange, the Zagreb Stock Exchange, the Securities Commission of the Federation of Bosnia and Herzegovina, who have all hosted meetings of the Roundtable, and the Turkish International Co-operation Agency (TICA). We would also like to thank all private sector participants, labour union representatives, representatives of civil society, professional associations and other interested parties from across SEE. We thank our partners at the Global Corporate Governance Forum, the Deutsche Gesellschaft Für Technische Zusammenarbeit (GTZ) for their financial support to this important work.



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INTRODUCTION

1. Corporate governance is the system by which companies are directed and controlled. “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide the proper incentives to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources effectively”¹.

2. One key element in improving economic efficiency is good corporate governance. Corporate governance is now widely recognised as essential for establishing an attractive investment climate characterised by competitive companies and efficient financial markets. The importance of efficient financial markets for growth is now supported both at the macroeconomic and microeconomic level, as well as the broader relationship between corporate governance arrangements and growth². There is an increasing amount of empirical evidence showing that some fundamental aspects of good corporate governance play a key role in improving performance, by facilitating corporate access to capital markets, improving investor confidence and contributing to corporate competitiveness.

3. In the aftermath of the Asian financial crisis in 1997, the OECD Council meeting at the Ministerial level called upon the OECD to develop a set of corporate governance standards and guidelines. The OECD Principles of Corporate Governance were agreed in 1999. Today, they are the only internationally accepted body of governance principles that address the entire corporate governance framework – the legal, institutional, and regulatory structures and practices that create the context within which firms operate. The OECD Principles are recognised by the Financial Stability Forum as one of 12 core standards for sound financial systems. They are an important component of the Review of Standards and Codes (ROSC) undertaken by the World Bank and the IMF. They have been endorsed by the International Organisation of Securities Commissions (IOSCO), as well as by private sector bodies, such as the International Corporate Governance Network. The OECD Principles have also served as a reference point in the development of an increasing number of national codes of corporate governance.

4. The OECD was asked to encourage the implementation of the OECD Principles of Corporate Governance in non-member countries by organising regional roundtables in co-operation with the World Bank, and with the support of the the Global Corporate Governance Forum. Such roundtables have been set up in Asia, Latin America, Russia, Eurasia and South East Europe. These roundtables serve as regional fora for structured policy dialogue on corporate governance. They comprise senior policy-makers, regulators, and representatives from stock exchanges, private sector bodies, multilateral organisations, and non-governmental institutions. Each roundtable³ has completed or will be completing a region-specific Corporate Governance White Paper formulating key policy objectives and a practical reform agenda to improve corporate governance in the region concerned.

5. The South East Europe Corporate Governance Roundtable was launched in spring 2001⁴ and is a regional flagship initiative of the Investment Compact for South East Europe. The Investment Compact established in February 2000, is a vital part of economic reform activities to be carried out under Working Table II of the Stability Pact for South East Europe, dealing with economic reconstruction, co-operation and development. The Roundtable has benefited from the financial support of the Deutsche Gesellschaft Für Technische Zusammenarbeit (GTZ).

6. Between September 2001 and March 2003, four Roundtable meetings were organised to discuss improving corporate governance in SEE. Using the OECD Principles as a conceptual framework, the Roundtable examined the five key elements of a strong corporate governance framework described in the Principles: (i) the rights of shareholders; (ii) the equitable treatment of shareholders; (iii) the role of stakeholders in corporate governance; (iv) disclosure and transparency; and (v) the responsibilities of the board.

7. Roundtable meetings were carried out in co-operation with regional and local partners and hosts, whose assistance has been invaluable in securing the success of these meetings. The Romanian National Securities Commission and the Bucharest Stock Exchange co-hosted the first Roundtable in Bucharest in September 2001. The OECD Centre for Private Sector Development and the Turkish International Co-operation Agency (TICA) co-hosted the second Roundtable in Istanbul in May 2002. The Zagreb Stock Exchange co-hosted the third Roundtable in Zagreb in November 2002. Finally, the Securities Commission of the Federation of Bosnia and Herzegovina co-hosted the fourth Roundtable in Sarajevo in March 2003.

8. This White Paper proposes a series of practical recommendations and should serve as a means for setting priorities and implementing reforms at the national and regional level. It is a non-binding, consultative document reflecting the discussions and recommendations of Roundtable meetings. It was written, debated, and endorsed on a consensual basis by all the Roundtable participants. To ensure maximum relevance, an inclusive approach was adopted, whereby all constituencies with an interest and expertise in corporate governance were considered. Roundtable participants were also invited to provide written comments on various drafts of this White Paper.

9. This White Paper provides region-specific guidance and suggestions to assist policy-makers, stock exchanges and regulators. The White Paper also targets companies, investors and other parties that have a role or interest in promoting good corporate governance practices. These recommendations represent aspirations. Given the financial and regulatory constraints faced by many SEE countries, some of these recommendations may need time to be implemented. However, this White Paper should help in prioritising reforms. Some recommendations may also be valid only for a subset of countries involved in the Roundtable, as they are not all at the same stage of reform or economic development. Some SEE countries may have already taken the necessary steps to address some specific issues.

10. The White Paper focuses primarily on publicly traded companies although in many aspects it also addresses issues related to widely held but not publicly listed companies. This is particularly important in SEE as privatisation has led in some countries to non listed but widely held companies and economic development will, to a significant extent, rely on the success of these small and medium-sized unlisted enterprises. Finally, the White Paper may also be useful in some aspects of the governance of privately held firms and state enterprises.

11. The substantive chapters of the White Paper match the five chapters of the OECD Principles. The White Paper contains an additional section on implementation and enforcement, which, along with adoption of the OECD Principles, forms the basis of a strong governance regime. A set of priorities are highlighted after this introduction, identifying the most important areas in which reforms should be undertaken. Finally, annexes contain a comparative overview of the corporate governance framework in SEE.

12. The White Paper will be translated into respective SEE languages and distributed to key national policy-makers, securities regulators and representatives of stock exchanges, standards-setting bodies, and relevant private sector institutions in SEE. It will be also submitted to relevant multilateral institutions and made available to the public through the Roundtable website (www.oecd.org/daf/corporate-affairs). Key national players will organise high level events to present this White Paper to national authorities and the business sector. This dissemination process will be carried out on the basis of national initiatives, supported by the OECD secretariat.

13. The White Paper is a key tool for promoting, assisting and assessing progress in SEE corporate governance, thereby helping to enhance confidence and international credibility in the reform process. It

is important that the momentum for reforms is maintained and that credible enforcement mechanisms are put in place. Markets have to be reassured that corporate governance reforms in SEE are irreversibly shifting towards global standards and the enterprise sector must realise the value of better corporate governance.

NOTES

1. OECD Principles of Corporate Governance, Preamble, 1999.
2. Survey of Corporate Governance Developments in OECD Countries, 2003.
3. Except the Eurasian Roundtable which is completing a comparative paper on corporate governance in Eurasia.
4. Countries participating in the SEE Roundtable are the following: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Former Yugoslav Republic of Macedonia, Romania, and Serbia and Montenegro.

KEY PRIORITIES

14. Poor corporate governance practices, lack of awareness of the value of good corporate governance and sometimes a weak institutional framework have been significant impediments to the development of efficient capital markets and the establishment of a sound investment climate in SEE.

15. Recent and current legal and regulatory reforms have improved the corporate governance institutional framework of many SEE countries by providing better protection against abuse. Several national initiatives to issue guidelines, statements of best practice or to set up specialised good corporate governance tiers on the stock exchange have contributed to raising awareness and improving practices. Investors have become more aware of the issues and have pressed for change, while some large corporations have changed their practice for the better. Finally, stock exchanges and securities regulators have reinforced their monitoring of companies' conduct and have taken the lead in corporate governance reforms.

16. Though progress should be fully recognised, significant abuse still occurs. The policy-makers and the public at large are not yet fully attentive and conscious of the stakes involved, while regulatory authorities do not have the necessary resources to effectively monitor companies' behaviour and enforce the legal and regulatory framework.

17. The credibility of SEE corporate governance practices, the development of financial markets and the improvement of the investment climate will depend on further reforms of the corporate governance institutional framework, the reinforcement of implementation and enforcement by the regulatory authorities and eventually, improvements in private sector practices. Momentum has to be maintained to deepen the scope and impact of recent reforms, to complete them and, more importantly, to make them enforceable.

18. To this end, priority should be given to key areas. Firstly, at global level, the focus should be on implementation and enforcement of the existing laws and regulations. A strong emphasis should also be put on the direct commitment of the private sector in corporate governance reforms and on training for all relevant professions and key players, in particular accountants, auditors, judges and board members. Reforms, enforcement and training efforts, as well as private sector initiatives should focus primarily on three overriding issues, namely the protection of minority shareholders, the empowerment of boards and the convergence towards international standards of accounting, auditing and non-financial disclosure.

19. Strengthen regulatory authorities to improve implementation and enforcement.

20. Given recent reforms in the legal and regulatory framework, it is now of the utmost priority to strengthen its effective implementation and enforcement. Laws and regulations in most SEE countries are now up to international standards regarding main corporate governance issues. However, there is a gap between the letter of the law, which is satisfactory, and actual practice. The most significant improvements can now come from effective implementation and enforcement of existing laws and regulations.

21. To this end, the capacity and authority of the regulatory authorities needs to be enhanced, primarily those of the securities regulators. Indeed, in countries with weak regulatory environments, such as transition economies, concentrated enforcement through the market regulators may be preferable. "Experience shows that in these circumstances the incentives of regulators to enforce the laws may be greater than those

of judges"¹. Regulators, and primarily securities regulators, should have the resources, capacity and authority to carry out their functions, i.e. to monitor companies' conduct, investigate wrongdoings and sanction bad practice. Where appropriate, the regulators also need to be able to enforce sanctions without their decisions being subject to automatic appeal through the judicial system.

22. The judicial system should be strengthened as it constitutes the backbone of a strong enforcement system and as such a prerequisite for a credible corporate governance system. The courts should be provided with sufficient resources to significantly increase their expertise and capacity to handle commercial disputes. Systematic training of judges in commercial areas and increased specialisation of the court system should be avenues to improve this expertise. Systematic disclosure of cases and court decisions in the area of corporate governance could also contribute to raising the awareness of the business sector and to making clear the public commitment to the rule of law.

23. Finally, alternative remedies and redress mechanisms, such as low cost collective efforts and professional arbitration mechanisms should also be developed.

24. Increase the commitment of the private sector in corporate governance reforms and facilitate the development of a corporate governance culture.

25. It is important that the private sector fully realises the value of good corporate governance practices. The private sector should understand that good corporate governance not only facilitates access to capital, but may also be instrumental in improving companies' performance. It provides more effective checks and balances for controlling the decision making process and enhances boards' efficiency, therefore improving strategic thinking. Finally, it increases stakeholders' confidence in the company.

26. The private sector should take the lead and assume primary responsibilities for the development of a series of tools and initiatives that enhance good corporate governance culture. Such tools and initiatives include first and foremost the drafting and implementing of national codes of corporate governance. Particular guidelines or best practices could also be developed, especially on the role of board members. Specific good governance tiers on the stock exchanges could also be set up. Finally, the private sector should be instrumental in developing relevant training programmes for the most important players in the governance field.

27. The private sector, and more particularly business leaders, should also play a prominent role in the public debate on corporate governance. They should serve as a reality check, guiding discussions and becoming a main driving force in the push for reforms. Active commitment by the private sector would allow a progressive building up of good corporate governance culture, which is instrumental in raising expectations for better conduct and increasing informal sanctions for failure to meet these expectations.

28. Legislators and regulators must also try not to burden enterprises with excessive administrative costs. Before intervening with new regulatory instruments, the authorities should be clear about the regulatory costs involved and whether there are more effective instruments at hand. The right balance must be struck between costs and benefits when developing new provisions aimed at improving the corporate governance framework.

29. Develop training for all parties and professions which are critical to good corporate governance practices.

30. A major effort should be made to train all key players in the corporate governance field. This particularly concerns accountants and auditors, judges, board members and executive managers. This training should raise the global awareness of good corporate governance practices. It would also help in keeping up with changes in the legal and regulatory framework and provide the expertise on how to

effectively apply or enforce laws and regulations. Finally, it should facilitate the transition to international standards.

31. To this end, educational institutions and professional organisations should develop relevant curricula. Individual companies should devote resources to train their executive managers and board members. Professional organisations and relevant regulatory authorities should ensure that accountants and auditors have the required level of expertise to carry out their duties in a professional way. Government bodies should also make sure that judges and public officials concerned with corporate governance issues acquire the necessary level of expertise.

32. International and bilateral donors should support this training effort, by providing financial resources and expertise. This training should help in the convergence towards international standards and practices, while being adapted to the specific context and difficulties encountered in SEE.

33. Protect minority shareholders against abuse by insiders and controlling shareholders.

34. Abuse of the rights of minority shareholders remains one of the most severe weaknesses of corporate governance practices in SEE. Regulatory reforms and implementation and enforcement efforts should therefore focus on measures and remedies to provide protection of minority shareholders against this abuse.

35. Protection of minority shareholders requires the effective implementation of specific procedures for changes in control and major or related party transactions. These procedures include strict disclosure requirements and approval by a qualified majority of board members and/or of the extraordinary shareholder meeting. They also necessitate the development of fair evaluation processes. At a more fundamental level, the protection of minority shareholders relies on the fiduciary duties of board members and on their independence. Their duty to act in the interest of the company and all its shareholders should be clarified and sanctions increased against misconduct by board members.

36. However, these measures can only be effective if monitoring and enforcement by regulatory authorities is heavily reinforced and if these authorities have the capacity to impose severe sanctions on related wrongdoings.

37. Reinforce boards.

38. Boards of directors are at the centre of the corporate governance system of a company, as they are the link between the shareholders and the executive managers. In SEE, boards of directors often do not play a strategic role yet their function is not clearly distinguished from that of management and they often lack independence from insiders or major shareholders. These shortcomings have had important consequences in terms of the abuse of minority shareholders' rights and inadequate disclosure.

39. Boards of directors in SEE should be reinforced in terms of authority, resources and responsibility in order to play their crucial role in setting the company's strategy, overseeing management, monitoring conflicts of interest and more generally in protecting minority shareholders rights. They should also fulfil their ultimate responsibility regarding disclosure.

40. To this end, board members should first better understand their functions and duties. Their loyalty towards the company and all its shareholders should especially be emphasised. The board structure should then be streamlined through an increased number of independent directors and the setting-up of specialised committees to help boards carry out their most fundamental functions. Finally, boards should be provided with the means and resources to carry out these functions, in terms of access to information, remuneration and training.

41. Maintain the evolution towards full convergence with international standards and practices for accounting, audit and non-financial disclosure.

42. The convergence towards International Financial Reporting Standards (IFRS) should be pursued as it is an indispensable step towards ensuring that the information disclosed by SEE companies will be of adequate quality, credible and comparable across countries.

43. This convergence will require extensive efforts from companies as well as from the accounting and audit profession and professional organisations. This effort should be politically supported at the highest level, nationally and regionally. It should also be financially supported by international and bilateral technical assistance donors.

NOTE

1. "The State of Corporate Governance, Experience from Country Assessments", Olivier Frémond and Miarta Capaul, WB Policy Research Working Paper, n°2858, June 2002, p. 28.

SHAREHOLDERS RIGHTS AND EQUITABLE TREATMENT

44. Privatisation 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 privatised companies.

45. After years of reform and numerous privatisation programmes, state-owned enterprises still dominate a number of major industrial sectors in the SEE region. There has been little corporate governance reform of state-owned companies as part of pre-privatisation restructuring. Moreover, experience in other transition countries shows that privatisation can lead to significant corporate governance problems. Comprehensive and efficient privatisation strategies should thus consider good corporate governance both as a means and as an objective, beginning with a pre-privatisation restructuring.

46. Firstly, the privatisation process should strive to improve the corporate governance practices of companies to be privatised, as this would facilitate placement, and ensure a higher valuation and better access to capital for these firms. Some important steps for *ex ante* improvement of corporate governance practices include the normalisation of the enterprise's status as a commercial company subject to the same rules as other commercial companies, the transfer of control from political bodies to professional boards with commercial objectives and the institution of performance-enhancing compensation combined with high standards for management.

47. Secondly, a successful privatisation strategy should seek to improve corporate governance *ex post* by facilitating ownership structures conducive to good corporate governance for newly privatised firms. Privatisation should give private shareholders a sufficient share of capital to allow for an efficient functioning of shareholder control mechanisms. Overly dispersed ownership for small and medium-sized enterprises can be a source of severe corporate governance difficulties.

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

49. The State will remain a significant shareholder and owner of commercial assets for many years in all SEE countries, notably in utilities and infrastructure. Efficient governance of these assets is therefore critical for the countries' overall economic performance.

50. In cases where the State remains a shareholder, it should exercise its role as such with due care. It should particularly respect the rights of other shareholders and not abuse either its dominant position in the ownership structure or its regulatory power. In this regard, it is crucial that there is clear separation between the State ownership and regulatory functions and that the State promotes good corporate governance practice both as an owner and as a regulator.

51. In developing good corporate governance for state-owned assets, tools available to the private sectors could be used in many instances. However, some issues may warrant special attention. OECD member governments have made great efforts in reforming the corporate governance of state-owned firms in the process of privatisation. Their experiences could provide the countries of SEE with guidance

regarding the reform of their state-owned enterprises, especially larger firms such as major manufacturers and utilities¹.

52. 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.

53. Ownership registration is relatively satisfactory for quoted companies in most SEE countries, as Central Depositories have recently been organised, providing both registrar and depository services that are often integrated into the clearing and settlement systems. These Central Depositories seem to work satisfactorily but do not always cover all quoted companies. The situation is more diverse regarding companies not quoted on the exchange but still having a significant number of shareholders. They are not always obliged to delegate ownership registration to an independent registrar.

54. Secure registration of ownership is the basis of investors' rights protection, as it is a prerequisite for shareholders to prove their ownership and thus to exercise their rights. For example, ownership information and proof is necessary when shareholder action requires the grouping of a minimum share of capital, such as calling for an extraordinary meeting, putting an item on the agenda, or initiating collective action. Besides, the right of shareholders to have full access to the ownership information about the companies they invest in is covered in Recommendations 161 to 168 of the Chapter 3 on Transparency and Disclosure.

55. Independent registration should be extended beyond current levels in most SEE countries. Firstly, independent registration should cover all quoted companies without exception. Listing requirements should make this strictly mandatory and securities regulators should effectively enforce this requirement. Regulation should also clearly require that all companies maintain a shareholders' register and that widely held companies above a minimum size should transfer their register to professional and independent registers. The size threshold could be based on assets and number of shareholders, and decided according to national circumstances. For countries where a Central Depository already exists and assumes the ownership registration of quoted companies, its capacity should be extended accordingly.

56. The regulation and monitoring of registrars should be the responsibility of securities regulators. This regulation should primarily aim at avoiding abuse in the registration process, thus ensuring the independence of registries. Securities regulators should also clearly enforce the right of shareholders to obtain proof of ownership from registrars without undue cost or excessive procedures. A central depository seems to be an efficient solution in most SEE countries given the size of these markets. However, the introduction of competition in this service activity may in some cases be superior to a monopoly situation. Whatever the choice made regarding the activity structure, registrars should be strictly regulated as they are providing a public good.

57. The free transferability of shares should be granted for joint stock companies (JSC).

58. The free transferability of shares is usually granted for JSC, or for quoted companies as part of listing requirements. However, important exceptions still exist in some SEE countries, where transferability restrictions may be included in the companies' statutes, or managers may restrict employees' shares transferability by abusive contracts. Thus, the transferability of shares may *de facto* be significantly restricted and this remains an area of potential abuse.

59. Legislation should not give JSC the possibility to limit the free transferability of their shares, through specific rights of first refusal or through provisions in the company statutes. Moreover, shares should not be subjected to unilateral restrictions on transfer imposed without the consent of the shareholder. This holds for any widely held JSC but even more for listed companies. For the latter, listing requirements should clearly prohibit such limits to share transferability. All transfers of securities should be recorded in the companies' share registers.

60. 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.

61. The right of shareholders to participate and vote in general shareholders' meetings is formally granted in all SEE countries. However, their capacity to effectively influence the decision process has been much more tenuous. Indeed, preventing them from participating in general shareholders' meetings has been a widespread practice in some SEE countries, usually through practical obstacles such as limited and late announcement of the meeting or the choice of a remote location. Legislative or regulatory amendments have recently improved the situation in some SEE countries. Nevertheless, in addition to the shareholders' lack of motivation, their effective capacity to participate in the decision process is still impeded by lack of information. If an agenda is provided to shareholders ahead of the meeting, it is often quite vague and general. There are not always provisions allowing shareholders to add items to the agenda. Moreover, in most countries, substantive information regarding issues on the agenda often remains insufficient, especially regarding major transactions or changes in capital structure to be approved. All these practices have prevented shareholders from participating in important corporate decisions, which constitute one of their primary rights.

62. Companies should understand that the general shareholders' meeting is an essential tool to build trust with shareholders on matters of fundamental importance to the company. Even if controlling shareholders may ultimately be in a position to decide on all issues on the agenda, the shareholders' meeting constitutes a useful experience for management and board members to expose themselves to public scrutiny. The question and answer session of the shareholders' meeting is in this regard quite essential. Active shareholders' meetings thereby can also contribute to reduce abuse of minority shareholders, as managers and board members have to account for the company's performance and present its strategy and policies.

63. Legislation or regulation should provide minimum requirements for calling and conducting shareholders' meetings. These requirements should clearly state that the announcement should be made well in advance (at minimum 30 days ahead of the meeting) and in such a way that all shareholders should have the possibility to inform themselves. In this respect, companies should respect the spirit of the law and use at least one well-defined standard source, such as the official gazette or the stock exchange website, plus two media with national coverage. In the same vein, the location of the general shareholders' meeting should be either at the company headquarters or at the stock exchange. Finally, shareholders holding together more than a certain percentage of capital should be able to add items to the agenda.

64. Shareholders should be provided with or have easy access to substantial, relevant and reliable information on issues on the agenda prior to the shareholders' meetings. They should also be provided with faithful minutes and results of these meetings within a reasonable timeframe and at low cost. In combination with the use of media, companies could develop their own corporate websites to this effect.

65. Finally, securities regulators should have and use the authority to actively monitor or investigate effective compliance by quoted companies with these procedures regarding shareholders' meetings. When appropriate procedures have been obviously breached, a possibility to void decisions taken by the shareholder meeting should exist.

66. 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.

67. Insiders and majority shareholders often do not need minority shareholders' agreement to have decisions approved, given the usual ownership concentration. Nevertheless, there have been some cases where companies have prevented shareholders from voting by various and abusive procedural manoeuvres, such as requiring the payment of fees or the physical presence of shareholders. Moreover, if the capacity to vote *in absentia* is usually granted theoretically, the actual use of proxy voting is *de facto* much more limited

in most SEE countries. This is due to restrictive practical provisions for such voting, for example, requiring the presentation of documents that are difficult and costly to obtain, such as notarised documents proving the ownership and the actual content of the specific proxy.

68. The capacity to vote in general shareholders' meetings is a crucial shareholder right that should not be infringed, as it is the shareholders' first and primary way of controlling the board of directors. With dispersed ownership structures, individual shareholders are not always able or do not have the incentives to participate personally in the general shareholders' meeting, but their effective participation should be made possible through procedures for voting *in absentia* or by proxy. As some SEE countries' experience has shown, it is particularly relevant for companies wanting to attract foreign institutional investors to facilitate such voting, as institutional investors are increasingly expected to vote their shares and required to disclose their voting policies.

69. Clear provisions should be provided in the law, in the stock exchanges listing requirements or regulations of the securities regulators to prevent companies from unduly impeding shareholders' ability to vote on procedural grounds. Stock exchanges and securities regulators should take firm and systematic action to discourage such practices. They could, to this effect, rely on shareholders associations to act as warning devices, systematically investigate reported abuse, effectively apply sanctions provided for by the law and widely publicise cases as a deterrent device.

70. Companies should simplify procedures for proxy voting and absentee voting, in order to encourage such voting while avoiding abuse. Such voting could be done using regular mail or through the use of secure electronic telecommunication. Specific requirements could be defined by the securities regulator especially regarding the sending and return of ballots to the company and the solicitation of formal instructions by the shareholders on the use of proxies.

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

72. In many SEE countries, the ownership structure derives from the privatisation process. Most individual shareholders have received their capital share through mass privatisation, i.e. without paying for it. They are consequently not considered as "genuine" investors by management and are not treated as such. A substantial change in attitude is still needed to develop an effective equity culture.

73. Companies might enhance their relationship with shareholders by setting up specialised investor relations departments, even when this is not mandated by any law or regulation. These departments would help in developing a more systematic consideration of shareholders' interests within the company and establishing more frequent communication between shareholders and management, not only around the time of the shareholders' meetings. Such departments would probably also be an important way of encouraging informed shareholder participation.

74. These investor relations departments should not become merely a promotional device and in no case should be perceived as a replacement for statutory obligations in terms of disclosure and dissemination of corporate information.

75. 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.

76. Institutional investors can play an important role in monitoring and improving the corporate governance practices of companies they have invested in. This is especially true in transition economies where voucher based privatisation has created large numbers of shareholders with individual holdings that are too small to warrant active monitoring. Most SEE countries have some institutional investors, including

official privatisation funds (or their equivalent); funds backed by the EBRD, IFC, etc; and some privately initiated investment funds. In addition, official pension funds have the potential to grow into major domestic investors over the coming decades. However institutional investors still play a small role in equity markets overall, and are often not active investors. Questions have also been raised about the accountability and transparency of some of these funds, further limiting their development.

77. Institutional investors in SEE countries could contribute to improving the corporate governance of, and hence return on, companies in their portfolios by becoming more actively involved as shareholders. At the same time, ensuring the integrity of institutional investors should be the highest priority, first and foremost to protect their investors and beneficiaries, and secondly to encourage their growth and in the process the overall development of equity markets.

78. To encourage institutional investors to become more engaged with the companies they own, restrictions on the fraction of the company they may own should be loosened. They should be required to consider using their voting rights and to formulate as well as disclose their voting policies and corporate governance practices. Such voting policies should be designed to further the interests of institutional investors' beneficiaries.

79. In order to credibly fulfil their ownership function and become legitimate players in the corporate governance of companies in which they invest, private sector institutional investors should be held to the highest standards and strive to improve their own corporate governance practices. The regulatory framework should require them to operate in a transparent manner, especially regarding their voting and corporate governance policies². Finally, the special role of pension funds as critical providers of retirement income should be recognised, and restrictions or requirements that interfere with this critical mission should not be allowed.

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

81. Until now, shareholder participation by individual investors has remained limited in most SEE countries, even though this is an important condition for the improvement of corporate governance practices. However, some countries already have active shareholders associations that have been at the forefront of corporate governance debates and legislative reforms.

82. Given concentrated ownership and the frequent identification or connection of controlling shareholders with executive managers, it is crucial that individual shareholders become more active in the corporate governance debate and in the monitoring of companies. Encouraging the informed participation of individual shareholders could be done through the development of shareholders associations, which can serve as a means for minority shareholders to inform themselves on events and to seek a common position on issues that come before a shareholders' meeting. Indeed, these associations have an essential role to play in improving the corporate governance culture and they would add an important voice in shaping the legal and regulatory framework in corporate governance. They could also be instrumental in co-ordinating collective actions.

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

84. The vast majority of large and listed companies have not distributed dividends in the last few years. When dividend distributions are approved by the shareholders' meeting, they are often paid with long delays, which may be particularly worrisome in an inflationary environment. Finally, dividend payment announcements do not always specify who is entitled to receive them, nor through which procedures.

85. When dividend distribution is decided, the general shareholders' meeting should clearly set payment procedures and deadlines for effective payment. The deadline should be reasonably short (no longer than 60 days) and procedures equal for all.

86. 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.

87. Frequent cases of dilution of minority stakes have triggered a lively public debate in several SEE countries. These dilution cases occurred especially during, or following, cash privatisation to strategic investors, and in spite of legal or regulatory provisions granting pre-emptive rights to existing shareholders. Recent attempts have been made to improve the legal provision protecting minority investors from such dilution. But technical aspects of capital increases, such as the valuation process or the possibility of in-kind contributions still leave substantial opportunity for abuse.

88. Any significant changes in the equity capital structure should be approved by the shareholders' meeting, with due respect to the usual procedures for such meetings especially regarding notification and voting.

89. Regarding new issues of equity securities, regulation should provide existing shareholders with pre-emptive rights. These pre-emptive rights have to be respected and enforced. It is also advisable to provide for tradable pre-emptive rights because, in many instances, shareholders who acquired their holdings through mass privatisation will not have the economic means to exercise their rights. Permitting the sale of rights allows these shareholders to realise some value for the rights and also introduces a market discipline whereby insiders and others who wish to use the rights to enhance their ownership will have to pay for them. On the other hand, when pre-emptive rights apply, it is also important to have a mechanism that permits shareholders to waive or dispense with such rights, for example to permit shares to be issued in acquisitions and pursuant to equity compensation plans.

90. Special attention should be given to fair and transparent pricing procedures for share issues, as developed in Recommendations 100 to 105. In-kind contributions to the share capital should be subjected to careful scrutiny as they may give rise to easy abuse.

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

92. Markets for corporate control have been almost non-existent due to the concentrated ownership structures, the low liquidity of stock markets and the low level of free float. However, these markets will probably develop in the coming years with the post-privatisation phase of capital re-allocation and restructuring. Not all countries have a well-defined take-over regulation, or at least one that has been tested.

93. In the case of a change in the control structure, specific and pre-established procedures should be respected. The regulation of take-overs should clearly define the obligations of shareholders passing defined thresholds and could include mandatory bids and squeeze-out procedures. It should ensure fair treatment of all shareholders, allowing them to fully understand their rights and to have recourse in case these are not respected. The value of the bid should be transparent and disclosed. Stock exchanges and securities regulators should co-operate in monitoring and enforcing these procedures in a consistent way.

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

95. Given the strong ownership concentration in most SEE countries, major transactions can easily be approved at general shareholders' meetings without the agreement of minority shareholders. The situation is made even worse by the frequent identification of executive management with controlling shareholders. Widespread abuse has been recorded.

96. Legal and regulatory provisions to protect minority shareholders' rights in case of major transactions should require approval by a super-majority at a general shareholders meeting. However, super-majority requirements should not be excessive. To avoid abuse of quorum requirements, these might be based upon

the requisite percentage of all shares outstanding rather than shares represented at a meeting. These procedures should also include a fair evaluation process as developed in Recommendations 100 to 105.

97. Apart from approval procedures, the disclosure of information is a crucial means of protecting minority shareholders' rights during major transactions. Respect for notification procedures and the quality of information given to shareholders prior to the general shareholders meeting should be taken extremely seriously.

98. Independent board members, or the audit committee if it exists, should closely monitor the degree of respect for these specific procedures, reviewing the information given to shareholders and checking the effective approval by the required majority.

99. Finally, shareholders should have access to an expedient remedy, such as appraisal rights, when the required procedures for approval of major transactions have not been respected, or in the event the valuation process is challenged. Breach of the stipulated procedures should be sufficient grounds for cancelling the transaction. Courts should in this case be able to rapidly suspend the execution of the transaction until the case is judged, within a reasonable time limit.

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

101. Pricing of new issues should be done with considerable care, given that market prices may not always be adequate proxies for the value of shares in the transition environment. Nominal values rarely have any relevance to the fair value at which shares should be issued. When stock markets are underdeveloped and suffer from low liquidity, they cannot always be considered as sufficiently efficient to provide fair price discovery. The issue of pricing is also critical in major transactions and related party transactions as the valuation of assets may also be very complex in the transition environment, and this is the most obvious avenue for abuse.

102. Independent underwriters are critical to the pricing of new issues. It is important for the securities regulator or appropriate self-regulatory organisations to review underwriting compensation arrangements to ensure that the compensation is not excessive and that it will not impair the underwriter's independence. Some company law regimes require shareholder approval of new issues while others place responsibility on the board of directors. In either case, it is important that these bodies have access to objective and expert advice. Independent board members can play an important role in this process.

103. The use of an independent assessment should be mandatory for any material issuance of shares for assets, squeeze-outs, major transactions and related party transactions in order to ensure a more equitable treatment of all shareholders. To perform such assessments, companies should hire qualified and independent experts. The identity, qualifications and compensation of such experts should be disclosed as well as the methods and assumptions used for determining the fairness of price or other considerations involved in the transaction.

104. Mechanisms should be designed to encourage the development of an independent and competent appraisal profession, possibly including the certification of professionally qualified experts. Such mechanisms could also include the provision by law and the effective enforcement of a specific liability for appraisers in case of obvious miscalculation of value or undisclosed conflicts of interest.

105. Liability of appraisers, however, should not diminish the overall responsibility of a company's board of directors for assuring the fairness of transactions involving share new share issues or related parties. The presence of an expert should not shield the board from liability, if the board is not acting in good faith, if it has reasons to know that the expert is not qualified or that information has been withheld from the expert, or if the board itself has not acted diligently or become fully informed of the facts of the transaction.

Similarly, if board members have a personal financial interest in a transaction, the presence of an expert opinion regarding the fairness of a transaction should not obviate the need for approval of the transaction by a disinterested majority of board members or the shareholders (see Recommendations 94 to 99), nor should it preclude the rights of shareholders to challenge the fairness of the transaction.

106. 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.

107. Abusive related party transactions have been one of the most widespread and serious abuse of shareholders rights in SEE countries. This derives from numerous weaknesses in the legal and regulatory framework as well as from a weak enforcement of legal and regulatory provisions when they exist. As for the former, the legal and regulatory framework does not always provide a clear and workable definition of related party transactions, nor provide clear procedures for approval of such transactions. Concerning the latter, credible sanctions for failure to disclose material interest are not always provided by the law. Indeed, the most serious underlying obstacle to equitable treatment of shareholders rights in case of related party transactions is the lack of information on transactions concerned and on the very existence of conflicts of interest.

108. Legal provisions regarding disclosure of material interest by managers and board members as well as approval of interested party transactions should be clarified and strengthened when necessary. The law should clearly require that managers and board members “fully” disclose their material interest in any transaction, whatever its size. It is essential that the board be provided with sufficient time and information to be able to judge the fairness of these transactions. These transactions should be submitted to prior approval by the board with the concerned board members not participating in the decision. The board should when necessary have recourse to independent and competent appraisers, as specified in the previous Recommendations 100 to 105. Boards, or Audit committees if they exist, should include in their priorities the review of approval procedures for such transactions.

109. Similarly, managers and board members should disclose to the board, or to the general shareholders meeting for JSC, when they use information or property belonging to the company for their own benefit. This should be subject to explicit authorisation by the board, with interested board members not participating in the decision. The decision should also be reported to the shareholders.

110. Severe sanctions should be enforced systematically for executive managers or board members failing to disclose their personal interests. These sanctions should include internal company disciplinary measures. But the possibility of court sanctions should be reinforced and the possibility and ease for shareholders or companies to seek legal redress improved. The development of private civil remedies, i.e. the possibility to bring a lawsuit individually or collectively, and derivatively, is one principal avenue to effectively develop such legal redress. These procedures need to be adapted to the overall legal system and reasonable safeguards should be put in place to avoid abuses. Courts should also be able to suspend a transaction preventively whenever there is sufficient indication of abuse or when it is proven that a personal interest of a manager or board member has not been disclosed. In this latter case, the transaction might be deemed to be illegal. Finally, following practices in some OECD countries, legislation could provide for broad-based criminal liability of executive managers and board members if they misuse corporate assets.

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

112. Frequent cases of market manipulation occur on SEE financial markets, due to insiders trading while in possession of confidential information. These abusive practices breach the principle of equitable

treatment of shareholders. Moreover, they prevent full market transparency, thus harming the integrity of financial markets and public confidence in securities.

113. When necessary, legislation or securities regulations should be completed to bring about prohibition of insider dealing and market manipulation⁴. Any person in possession of inside information should abstain from trading on the related security. This concerns primarily managers and board members, but also any person who has access to specific information by exercising his/her profession or duties, such as the auditors or professionals from the regulatory authorities⁵ as well as any persons who have been tipped off by insiders. They should abstain from trading directly or indirectly, for their own account as well as for the account of a third party.

114. Regulatory authorities should monitor more rigorously insider trading and market manipulation. They should to this effect actively supervise the market and effectively investigate suspicious transactions. Such investigations should include requiring any relevant documentation and data, as well as testimony, and carrying out of on-site inspections when necessary. Finally, they should be able to impose sanctions on wrongdoing, by freezing assets, prohibiting professional activity or imposing any other adequate administrative and criminal sanctions, as appropriate in co-operation with the judicial authorities.

NOTES

1. Specific guidelines or best practices for the corporate governance of state-owned assets are being developed by the OECD and will be submitted to SEE countries for consideration.
2. The OECD has developed specific guidelines for the corporate governance of pension funds and is foreseeing developing such guidelines for collective investment schemes such as mutual funds.
3. "Fully" meaning that the board is able to understand the use of the benefit in question.
4. Authorities could refer to the EU Market Abuse Directive, "Directive of the European Parliament and of the Council on Insider Dealing and Market Manipulation".
5. However, this does not prevent trading by companies in their own shares, in the framework of buy-back programmes or stabilisation operations. In order to avoid market manipulation, these operations should be transparent and within defined volume limits. Moreover, they should be restricted during specific periods, particularly before the release of financial statements.

THE ROLE OF STAKEHOLDERS

115. In a market economy a company has relationships, implicit and explicit, with many associated parties, who from time to time may take an interest in, and be in a position to influence, the company's goals and operations. These associated parties are termed "stakeholders". The relationship between a company and its stakeholders is sophisticated and only in some aspects specifically defined in law, but it is often appropriate to require companies to take into account a wider range of interests than shareholders alone.

116. The role of stakeholders in wealth creation is increasingly recognised. As resource providers, employees, creditors, investors, and suppliers all contribute to the success of the company. Protecting stakeholder rights and developing value-enhancing relations with stakeholders is now accepted as being often linked to the performance of companies and thus conforming to the pursuance of shareholders' benefits. Finally, stakeholders might be considered as an effective part of the monitoring system to limit excessive management power over companies. On this basis, the OECD Principles state that "it is in the long term interest of corporations to foster wealth-creating co-operation among stakeholders".

117. In particular, human capital is becoming a major source of competitive advantage for companies in numerous sectors of the economy. It is in many cases the employees and their knowledge that constitute the most valuable assets of companies. In order to protect and enhance employees' rights, various avenues have developed in different historical and political contexts as well as legal frameworks. The primary one has been through the trade unions. But growing attention is now being paid to complementary mechanisms, such as profit or equity sharing as well as direct employee participation in the governance of companies as a way to enhance the wealth creation process.

118. The issue of employees' involvement in the governance of companies is however more complex in the SEE transition context than it is in OECD economies. First of all, the legacy of the previous socialist system has blurred the roles of employees and owners of companies. This is particularly the case in former Yugoslav countries with their self-management system. In the previous system workers were supposed to be both owners and employees of their companies. In this dual capacity they in theory had certain rights, even though actual practice differed greatly. Regarding their employees' rights, SEE firms entered the transition with extensive social obligations. Moreover, privatisations often resulted in the distribution of a significant share of companies' capital to their employees. But employees remain not fully aware of their rights as shareholders. If they have these rights at all it has often been to protect their position as employees, in an environment where even some basic employees' rights, such as receiving their salaries, may not have been respected.

119. One objective of the transition is to transform enterprises from social units with unclear claims by various stakeholders into profit-making entities based on clear property rights and corporate governance structures. Thus it is essential as a first step to clearly distinguish the roles and rights of stakeholders from those of shareholders.

120. The role of stakeholders should also be considered with due respect to the development stage or specific difficulties of the transition period. This is even more important as large restructuring that will have to be carried out in all SEE countries will most probably include significant lay-offs. Granting employees excessive decision making rights as stakeholders could block the restructuring process.

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

122. Stakeholder rights are based on various pieces of legislation, related to many different areas of economic reforms in SEE. Employees derive their stakeholder rights mainly from labour and trade union laws, and only secondarily from new company laws. Creditors' rights are defined by many different laws and regulations, usually including banking law, company law, obligations law, mortgage law and, last but not least, bankruptcy law. A significant number of these pieces of legislation are in a process of substantial reform in most SEE countries. Some fundamental elements of the legal framework, in particular labour codes, have not yet been revised in some countries or will be totally restructured in the years to come.

123. Legislators should check the consistency between the different constituent elements of the legal framework concerning stakeholder rights. They should especially ensure that the stakeholder rights granted to employees and creditors in the newly adopted labour codes or bankruptcy laws are referred to and at least not in contradiction with provisions of the company laws. They should also check their compatibility with EU Directives in the relevant areas.

124. 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.

125. Boards and managers in SEE are not always well aware of stakeholder rights and some companies may not truly acknowledge the importance of stakeholder relation for building competitive and sustainable enterprises. This is true regarding employees and creditors, but even more so for stakeholders that have a less immediate or direct effect on the business.

126. However, those companies that want to survive the transition period and have a development strategy should recognise the link between stakeholder policy and profitability. They should be aware of the impact that an active stakeholder policy may have on the company's long-term strategic goals and reputation, in relation to investors who increasingly may consider stakeholder related issues in their investment decisions. They should also appreciate potential litigation risks linked to stakeholder issues.

127. Companies should first inform themselves and follow up legal developments regarding stakeholder rights. This is especially important in the areas of labour law, health and safety, mortgage and bankruptcy law, as well as environmental law.

128. Boards and managers should then clarify responsibilities among different company organs regarding relations with relevant stakeholders. They should make sure that an adequate structure and efficient mechanisms are in place to know the company's obligations *vis-à-vis* these different stakeholders and to ensure compliance with these obligations. Such mechanisms could include formal information of stakeholders, and especially employees, about their specific rights, entitlements and avenues for redress.

129. More generally, the board should recognise its responsibility and leadership in defining corporate policy towards stakeholders. The board is also responsible for supervising the implementation of the stakeholder policy decided on.

130. In areas where stakeholder interests are not regulated, companies may still find it useful to develop voluntary policies that include commitments which go beyond common regulatory or conventional requirements. Where the balance is struck is a matter for the board, whose duty it is, as stewards of the company's survival and prosperity, to take a view as to how the company relates to stakeholders. Policies, possibly in a codified form, should especially address the issues that might become more seriously scrutinised by international investors, such as labour relations and environmental record keeping in mind that the current trend is toward verification of code compliance.

131. In order to develop their own policies and codes, companies should look for inspiration from and engage themselves to respect internationally agreed instruments on corporate social responsibility. These instruments include primarily the ILO (International Labour Organization) Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, the OECD Guidelines for Multinational Enterprises as well as the EU Employee Information and Consultation Directive¹.

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

133. The legal rights of employees to participate in the governance of their companies vary significantly among SEE countries. As in most other transition countries, these rights have generally disappeared with the reforms. In some countries employees have no right to participate in the decision making of companies, while in others work councils have in theory retained the right to participate in the decision making process in some specific circumstances. Finally, in most countries employees still have a right to be informed and even consulted about major decisions. But in practice, the real power of work councils may be very restricted, while the right to be consulted or even informed about major decisions are often not respected.

134. Ongoing information of employees on matters that might significantly affect them could help greatly in establishing a sense of common purpose. Moreover, it could significantly prevent potential conflicts and help in their sensible resolution.

135. Whatever the rights explicitly granted by the law, companies should strive to inform employees as well as other stakeholders in relevant situations. However, informing employees does not imply systematically consulting or involving them or their representatives in the decision making process. In the SEE context, a clear distinction should be made between the three levels of involvement (information – consultation – participation to the decision) in order to clearly break away from past experience.

136. If specific procedures to involve employees are not provided by the law, they could be provided by companies on a voluntary basis for some relevant and well defined decisions. These decisions should be ones that significantly affect employees and decisions to which employees or their representatives can contribute most effectively.

137. Companies should communicate regarding their stakeholder policies.

138. Disclosure in itself is not a guarantee of value-enhancing relations with stakeholders. But it represents a willingness to operate more transparently and thus helps in fostering trust. By demonstrating their commitment to the protection of stakeholder rights, companies would also improve their reputation and thus increase their goodwill, i.e. their capacity to generate additional surplus due to the positive association the public has for the company and its products.

139. Companies should communicate with investors and the public at large on their stakeholder policies, in order to further benefit from their effective respect of stakeholder rights and from their voluntary policies in this regard. They should also provide credible information on the implementation of these policies. Companies could follow various guidelines on social responsibility disclosure² which have been developed in the past few years.

140. Companies could further strengthen their credibility by having their stakeholder reports independently audited. This assessment should particularly focus on implementation and check the integrity of reporting systems. Besides building credibility, such an assessment would also provide management and the board with useful information on the effective implementation of the company's policies, as well as with potential recommendations for improvement in this regard.

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

142. Stakeholders who see their rights violated do not have an easy access to legal redress in SEE. This is especially true for employees who can hardly use any specific mechanism to enforce their rights. Their most basic rights may even be threatened when they express their claims. It has happened that employees have been dismissed or even physically abused when trying to publicly denounce corporate malpractice.

143. Effective redress mechanisms should be available to stakeholders in case of a violation of their rights. These redress mechanisms include resorting to regulatory agencies and courts. Companies should not impede employees seeking legal redress. Moreover, protection should be given to employees who act legitimately as “whistle blowers” and reveal illegal acts by the company or its management. This could provide a useful check on corporate misconduct.

144. Given the problems inherent in the judicial system in most SEE countries, such legal redress mechanisms could be costly and lengthy. Consequently, companies and stakeholders could also resort to mediation and arbitration by third parties to solve conflicts. By avoiding going to court, companies do less damage to their reputation and the goodwill of their employees³.

145. In the same vein, companies could develop credible internal mechanisms to deal with stakeholder conflicts at an early stage. In particular, they might establish and inform employees about procedures for reporting on work conditions, discrimination, or various abuse and wrongdoing from management or other employees. Finally, they should put in place specific procedures to investigate these claims.

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

147. Creditors are crucial stakeholders, as they provide companies with indispensable financial resources. This is particularly the case in SEE where equity financing is underdeveloped. The legal defence of creditor rights remains an institutional weakness in all SEE countries. The legal framework regulating relationships between creditors and companies has gone through deep and successive reforms in most SEE countries. A number of pending amendments have not been adopted yet. Moreover, various provisions of loan agreements are still not sufficiently regulated. Consequently, banks remain over-exposed to credit risk as it is still difficult to recover their debts even when these are secured by collateral. Thus, the effective rights of creditors remain to be clarified in many cases.

148. Moreover, private legal remedies have not been tested or yielded conclusive results⁴. To recover their claims and prevent borrowers' defaults, creditors avoid resorting to private remedies, as these are slow, costly, and ineffective. Moreover, they often destroy the relationship with borrowers. Creditors in general rely on acting prudently prior to loan disbursement, on private contracting and on working directly with their borrowers. The degree to which private remedies would be effectively enforceable through the court system is dubious. Court practice in SEE still provides a variety of avenues for a less than *bona fide* borrower to drag out or even derail legal proceedings. For example, mortgage and fiduciary transfers may be difficult to execute due to the poor state of property registration in some SEE countries.

149. Bankruptcy laws have been recently adopted in most SEE countries but the adverse social and political consequences of effective bankruptcies have delayed the establishment of adequate procedures. These laws and procedures often remain overly biased in favour of debtors. Although progress has been substantial in recent months, the enforcement of bankruptcy procedures is still problematic. Bankruptcies are especially challenging for large insolvent firms which represent a substantial share of employment and possibly of social infrastructure in their territories.

150. A major step in the transition to a market economy is to develop credible exit mechanisms in case of proven insolvency. This is a fundamental condition to an effective allocation of resources to their most productive use. More generally, the protection of creditor rights is the underlying mechanism allowing the hardening of budget constraints. Debtors should be convinced that they will have to face their obligations in order for them to behave in a responsible way. Creditors should also be fairly reassured about their ability to recover their debts in order to provide commercial enterprises with debt capital. In spite of an increase in banks' lending capacity and in the private sector's credit worthiness, debt financing will remain at its low level without effective protection of creditors' rights.

151. When insolvency triggers are reached, creditors should be provided with an independent review by qualified experts on the debtor's business and prospects. These experts should also work out options for restructuring in co-operation with the debtor. These mechanisms should provide the road to taking corrective action in order to avoid liquidation. They should force managers of potentially viable but financially distressed firms to negotiate rapid restructuring.

152. In the case of insolvency, when restructuring fails, automatic and efficient liquidation has to be implemented in order to let creditors recover part of their claim in an orderly manner. Bankruptcy mechanisms should be consistently enforced in order to promote their anticipation and thus constitute a credible deterrent. To this end, specialised courts should be provided with enhanced resources to deal with bankruptcies in an expedient but fair manner. Judicial training in this area should also be a priority for donors.

153. Bankruptcy mechanisms should not be abused to facilitate undue transfers of control. Various dubious schemes have involved collusion of significant shareholders, external managers and sometimes even creditors to cause firms that were not really insolvent to be declared bankrupt. To avoid this, triggers for bankruptcy have to be adequately fixed. They should not be too early or too low, forcing liquidation of potentially viable firms. Bankruptcy courts should be particularly vigilant in this regard. The aim should be to give companies breathing space in which to see rescue as a viable option, to develop a rescue package and increase the chances of the business surviving, not merely to benefit the persons who initiated the bankruptcy at the expense of other shareholders or creditors.

NOTES

1. Companies could also refer to the European Green Paper: Promoting a European Framework for Corporate Social Responsibility (2001), or the UNDP Global Compact, encouraging companies to respect stakeholders and pushing for corporate citizenship (2000).
2. Such as the Association of British Insurers' "Disclosure Guidelines on Social Responsibility" (2001).
3. However, effective use of such mediation requires *bona fide* parties that will accept and implement decisions reached by this mediation or arbitration. Otherwise, the enforcement will still require court involvement as a last resort.
4. These include exercising mortgage or fiduciary transfers, litigation, and, as a last resort, bankruptcy process.

TRANSPARENCY AND DISCLOSURE

154. Transparency and disclosure is a central pillar of effective corporate governance practices and the functioning of capital markets. Without access to regular, timely, reliable and comparable information, investors will not be able to evaluate corporate prospects and make informed investment and voting decisions. This will result in a higher cost of capital and a poorer allocation of resources. Disclosure and transparency is also a building block of a market-based monitoring of companies. It allows shareholders and the public at large to assess management performance, thus influencing its behaviour. Moreover, efficient information systems provide managers with quantitative tools allowing them to manage more effectively. Finally, transparency and disclosure gives the public the opportunity to understand the company's structure, activities and policies as well as assessing its performance with regard to environmental and ethical standards.

155. While transparency and disclosure ranks amongst the weakest areas of corporate governance in SEE, legal requirements for disclosure are generally high, with company law, securities legislation or listing requirements asking for companies to file with the securities regulators annual, semi-annual and even sometimes quarterly financial reports¹. In most cases these financial statements have to be audited. However, in most SEE countries they are still typically based on national accounting standards that may present problems in some critical areas. Most countries are nevertheless in the process of adopting international accounting and auditing standards². Most stock exchanges or securities regulators have recently set up stricter and more detailed regulations related to content, form, date and sometimes place of publication of annual reports. Certain stock exchanges have also created specific market segments for companies agreeing, on a voluntary basis, to meet higher disclosure standards. However, disclosure requirements are not evenly complied with and the reliability of the disclosed information still remains a central issue. In some countries, even the most basic disclosure requirements such as the publication of annual reports are not always met and published turnovers may be misleading. Consequently, investors and the public at large currently do not trust information provided by some companies in the region.

156. Improvement in transparency and disclosure in SEE requires that state-of-the-art disclosure norms are accompanied by an in-depth transformation of the attitude of all relevant players towards the very idea of transparency. This attitude derives partially from the legacy of the socialist system, where accounting primarily served statistical and tax purposes and information was a major power tool in the central planning bargaining process. Consequently, managers became experts in manipulating companies' accounts *vis-à-vis* the central administration. This sentiment still serves as an impediment towards more corporate transparency, as companies remain reluctant to be more transparent as long as information may be used in a manner perceivable as discretionary. In this regard, it should be recalled that private transparency goes hand in hand with public transparency and that administrative and legal pressures are not sufficient in order to ensure a satisfactory level of disclosure. Corporations should be convinced that disclosure is an asset rather than a burden. In this respect, the lack of an articulated demand from actual or potential shareholders remains the primary reason why companies are not interested in publishing mandatory or extensive information. Without active primary and secondary markets, there are very few incentives to make information available.

157. 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.

158. In most SEE countries, Annual Reports are currently prepared following national accounting standards, which even when meant to be consistent with IFRS do in fact differ substantially from them on specific issues. This is especially the case regarding inflation accounting, undisclosed liabilities, valuation of assets and reporting of related parties transactions. Inadequate depreciation and lack of provisions, in particular the allowance for doubtful receivables, can be distorting, and the valuation of inventories often leads to hidden losses. There is also strong pressure to avoid the impairment rules on assets, as this could lead to a significant decrease in the asset value of some of the current or former large state-owned enterprises. Meanwhile, full accrual of all liabilities and disclosure of contingent liabilities is often lacking, especially regarding tax issues but also on environmental matters. Last but not least, consolidation was not traditionally required in most national accounting standards and this constitutes a major and crucial divergence between IFRS and prevailing national standards.

159. Most SEE countries have however adopted or are in the process of adopting IFRS for large enterprises. EU accession is a principal driving force in this process but harmonising with EU directives regarding accounting practices is still in its infancy. It is important that this process be accelerated and that all SEE countries take the necessary steps to adopt and implement full IFRS for at least all publicly listed companies³. The relevant authorities should elaborate staged plans for the transition to IFRS. A gradualist but consistent approach would prevent the process from stalling at the early stages or when the bulk of companies would be required to apply IFRS⁴. In order to minimise the administrative burden on companies, these plans should provide clear guidelines and procedures on how to make the transition from national to international standards. These procedures should be particularly precise regarding the most problematic areas, for example the issue of how taxable profit is to be determined, and extensive documentation as well as training should be provided on asset valuation, depreciation and consolidation⁵.

160. Importantly, attention should be given to consolidation. There is continued widespread reluctance to adequately consolidate affiliated or subsidiary companies, while the availability of consolidated financial statements is critical for understanding the company's business, financial situation and value to the shareholders. Companies should use criteria for such consolidation as well as guidelines and specific procedures provided for by the IFRS. Monitoring and enforcing bodies should carefully check that the companies in question have provided duly consolidated accounts and develop their own ability to scrutinise these consolidated accounts thoroughly.

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

162. A transparent ownership and control structure is necessary for potential outside shareholders to evaluate the extent to which they will be able to influence the decision making process. Moreover, knowledge of the ownership and control structure is key in the fight against abusive transactions, especially related party transactions and insider dealings, and thus for protecting market integrity. These two types of transactions represent the most common and severe minority investors' rights abuse in SEE countries, as in other transition countries. As these transactions often involve holding structures controlled by management as well as controlling or significant shareholders, they can be addressed only if ownership and control structures become fully transparent.

163. In most SEE countries, even when share registration is efficient, shareholders do not have easy access to information on the ownership and control structure of the company they invest in. This is due in part to cumbersome administrative procedures and excessive prices charged by registries, central depositories or by local courts when the latter are in charge of ownership registers. This also derives from a lack of disclosure by significant shareholders. Even when law or regulation requires such disclosure,

stock exchanges and securities regulators are not always able to monitor and enforce these disclosure requirements. Finally, companies often lack a clear policy for collecting reliable information on their ownership and control structure and disseminating this information to the public.

164. Shareholders should at reasonable cost have access to full ownership information contained in the registries or central depositories. The responsibility for disseminating such information and for answering shareholders' requests should be clearly attributed between the registrars, stock exchanges, securities regulators and the companies themselves. All legal and regulatory provisions related to ownership disclosure should also encompass the case of connected shareholders acting in concert as well as beneficial ownership above a defined threshold. Ownership by management and board members should also be explicitly disclosed in annual reports of listed or other regulated companies. Registrars should co-operate more actively with companies by providing them with complete and accurate data on their ownership structure.

165. Shareholders should comply with relevant laws and be responsible for disclosing their beneficial ownership of voting securities to the regulator whenever certain thresholds are passed. They should inform the companies, the stock market, the securities regulator and the public at large about changes in their ownership following clearly set procedures. The securities regulator should make sure that the legal and regulatory framework clearly defines these thresholds as well as shareholders and registrars' obligations in this regard, including specific time limits for disclosure.

166. The obligation of custodians or other financial intermediaries regarding information on ultimate owners should be specified and enforced. Efforts should be made to improve co-operation between registries and the financial institutions concerned in order to identify significant beneficial owners and to inform companies, the stock exchanges and the securities regulators, as well as the general public. This search for the identity of significant beneficial owners may entail considerable costs and difficulties, but it is still necessary if any regulation about related party transaction is to be meaningful.

167. Companies themselves are best placed to investigate their own ownership structures. They should actively inform themselves about their ownership structure, through co-operation with the registries and significant shareholders. They are well placed to validate and assure that the information provided to the authorities by the owners is correct. They are also well placed to appreciate which shareholders may be connected or act in concert. They should have clear policies regarding disclosure of information on ownership structure and co-operate with stock exchanges and securities regulators to make this information easily accessible to shareholders. They should report this ownership information through the periodic reporting requirements.

168. Securities regulators and stock exchanges should actively monitor and enforce legal and regulatory provisions related to ownership disclosure. They should actively check that listed companies provide reliable, accurate and timely information on their ownership structure. Adequate administrative and criminal sanctions should be provided in the law for significant shareholders who fail to disclose their shares, financial institutions failing to co-operate in identifying beneficial owners and companies not providing accurate information. Regulators should credibly enforce these sanctions and private civil enforcement should also be made possible.

169. Ongoing disclosure of significant events should be considerably improved.

170. It is crucial that companies disclose on an ongoing basis and in an equitable manner any material information, i.e. information on any new developments or event related to its activity that may have a significant impact on the pricing of its shares or otherwise be material to an investor decision. Delayed or manipulatively timed disclosures have a much reduced value and are equivalent to missing or misleading information. Privileged access to material information by major shareholders creates favourable conditions for market manipulation and insider dealings, and consequently harms the integrity of financial markets and general public confidence in securities.

171. Information provided to shareholders regarding major corporate events is often unsatisfactory, even though most company laws require that companies disclose any “material information” that may influence investors’ decisions. Regulatory authorities have recently become more demanding in this regard and begun to sanction companies failing to comply. However abuses are still frequent.

172. SEE authorities and regulatory bodies need to strengthen and complete the legal and regulatory framework related to ongoing disclosure⁶. Such regulation should remain sufficiently broad regarding the type of events triggering mandatory disclosure. It could provide a list of events to be disclosed in all cases, but this list should not be exclusive. This should include dealings in the company’s shares by corporate insiders or by the company itself. Disclosure may be mandatory even if some uncertainties remain regarding certain characteristics of the event. In such case, uncertainties have to be clearly spelled out. The regulation should however be precise regarding the procedures for disclosing events, specifying the means of communication that may or should be used and providing precise deadlines for specific events⁷. This would provide SEE companies with clear guidelines and facilitate monitoring and enforcement by relevant authorities.

173. Companies should not retrench behind the concept of proprietary information with the aim of withholding important information from shareholders and the public at large. Regulation on ongoing disclosure could exempt companies from disclosing some specific material information, provided that the company justifies to the regulator how such disclosure would be detrimental to its legitimate interests. Regulators could refer to the European practice in this regard, which authorises omission of information if the information is of minor importance, or if disclosure would be seriously detrimental to the company and the omission would not mislead the public⁸. Particular attention should be paid in this case to avoid preferential dissemination and companies should abstain from trading unless information is publicly disclosed.

174. Companies should introduce and implement procedures⁹ that encourage effective ongoing disclosure. They should ensure that the information provided to stock exchanges, securities regulators and the public is complete, non-misleading, clear and brief.

175. Stock exchanges should develop an active policy regarding ongoing disclosure. Firstly, they should introduce efficient procedures to disseminate widely and promptly information on material events provided by companies. This should be made through various means ensuring the widest dissemination, including daily bulletins, websites, the trading floor, data vendors and the press. These procedures should preserve confidentiality until public disclosure. Secondly, they should regularly communicate with companies regarding their disclosure obligations. Thirdly, stock exchanges should reinforce monitoring and publicly expose failure to report.

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

177. It is important for companies willing to attract outside equity capital or to distinguish themselves as transparent market participants, to provide the market with additional non-financial information on a voluntary basis. This would contribute greatly in enhancing their corporate governance image and would also increase their market value.

178. Few SEE companies have adopted a pro-active policy regarding public disclosure. The vast majority of them are still striving to comply with the mandatory financial disclosure requirements, or they formally comply whilst not truly meeting investors’ expectations in terms of transparency. This derives once again from the overall lack of transparency in corporate as well as public affairs.

179. Companies should thus develop their own policies regarding disclosure of non-financial information. In doing so, they should not only take mandatory requirements set up by laws, listing requirements or other regulations into consideration. They could consult the IOSCO guidelines on non-financial disclosure to develop their policies in this regard. The board should decide in good faith which information is material¹⁰ for an

outside investor to be able to properly evaluate its business, activity and expected results in the foreseeable future¹¹. The question of what is sufficiently material to be disclosed should be left to the board members alone. They are the most likely to appreciate the particular shareholder and stakeholder relationship they face, and are the best placed to make the necessary judgement about the need to publish additional material, and in what form. Moreover, they are the ones who will carry the responsibility before the courts if their judgement is seen to be inadequate.

180. Companies should also ensure timely and accurate disclosure of all material information related to: a) overall company objectives and objectives for the upcoming period; b) nomination of management and board members, their resume, the internal distribution of functions among board members, reasons for resignation when this occurs; c) management and board members remuneration policy and its application; d) information on auditors; e) segment reporting; f) material risk factors; g) corporate governance policy; h) significant questions concerning employees and stakeholders; i) related party transactions.

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

182. The responsibility of different company organs for disclosure of information should be set forth in the law or regulatory acts concerned. Management and the board of directors have primary responsibility for setting up efficient internal systems allowing the collection, elaboration, and disclosure of relevant information to shareholders, stakeholders, regulators and the market in general. They should also develop specific procedures ensuring a regular, timely and equitable dissemination of information to all shareholders and the public at large.

183. Management should be actively engaged in the process of collecting, compiling and verifying internal information in order to prepare the financial statements. It has an ongoing duty to ensure that every company organ, department or individual complies with its obligations regarding disclosure. It also has the responsibility to check the effective disclosure of information and the quality of this information. It should be held liable for any material omissions and misstatements.

184. The board is responsible for the reliability of information disclosed by the company. It has first to make sure that effective information systems and procedures have been put in place and that adequate internal controls are provided in the overall disclosure process. It should then establish internal structures and ensure that they provide the respective company organs, departments or individuals with sufficient incentives and means to fulfil their responsibilities regarding disclosure. To reflect this responsibility, the board should receive an annual evaluation of the internal control system and the information policy of the company. Finally, the board is responsible for ensuring that communication of information to the public is carried out correctly¹².

185. In order to perform its task more efficiently, the board should consider constituting an audit committee that will focus on disclosure issues. The audit committee has to monitor the financial situation of the company and its accounting system and helps the board to effectively fulfil all its responsibilities regarding disclosure. The audit committee should consist of a majority of independent board members. Traditional independent supervisory organs provided by the law in some countries (such as the Censors in Romania) should not be considered as substitute for an audit committee of the board. The latter is composed of board members with direct relationships to the other members of the board and management, and as such has better access to information and resources of the board.

186. The audit committee is also responsible for monitoring the relationship with external auditors. This relationship should be subject to detailed scrutiny and precise guidelines, in particular regarding auditors' independence. The board or its audit committee should have the right to recommend appointment and dismissal of the external auditors, whose appointment should nevertheless be submitted to shareholder approval. It should then supervise and review the audit process itself. It is the duty of the audit committee to thoroughly question the auditors, and communications between them would benefit at several points

from the exclusion of management. Finally, the entire board should approve the audit process and disclose any divergence from accounting standards in the annual report.

187. The external auditors should ensure that all financial statements and other financial information fairly present the company's business and financial situation, according to the accounting and auditing standards adopted by relevant laws and regulations. The external auditors should perform their task in full independence from the company's management or controlling shareholders. They should disclose any other relationship with the company and affiliates and make a written declaration stating that their independence is not compromised.

188. Boards and managers are responsible for overseeing information disclosure. This would include providing a representation letter to the shareholders with the annual financial statements. This letter should state that the financial statements fairly represent the financial information of the company and that to the best of their knowledge the company has fully complied with all rules and regulations. Boards and/or management should also provide a brief discussion and analysis explaining the main features of the financial statements.

189. Liability for material omissions and misstatements of information should be set forth in the law and enforced. Board members should be required by law to provide any information required by an auditor. Board members who recklessly and knowingly provide false or misleading information should be deemed to have committed a criminal offence and be liable to criminal sanctions. Similarly, auditors who make deliberate material misstatements and omissions should be criminally liable, in accordance with respective laws. In addition, the liability of auditors for lack of disclosure should also include administrative sanctions and civil liability. Auditors should be exposed to professional negligence claims for financial loss caused by errors in accounts. Individual SEE countries may also wish to consider whether a breach of duty by company board members to assist the external auditor should also give rise to civil liability.

190. 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.

191. The significant lack of disclosure by companies of basic financial information as well as material non-financial information is a major obstacle to the development of financial markets in SEE. An adequate degree of disclosure is necessary to give investors, i.e. shareholders as well as ADR/GDR owners, the data to act in an informed fashion and pursue their rights more effectively. It is also a necessary tool to prevent managers and/or controlling shareholders from expropriating company assets. A significant improvement in such disclosure should be a prime objective of securities regulators. Without active monitoring and effective enforcement, companies will be tempted to not comply.

192. Disclosure is perhaps the area that shows the widest discrepancy between existing regulation and compliance in SEE countries. As mentioned in the introduction, disclosure requirements are generally high, but are not uniformly respected. When information is published or filed with the regulatory bodies by the companies, the quality, reliability and accessibility of this information is often quite poor.

193. Stock exchanges should play an important role in monitoring information provided by listed companies. They are the first level of control and can monitor listed companies' disclosure on a day-to-day basis. They can thus react very quickly and inform the securities regulators as well as the market in case a company does not fulfil its obligation regarding disclosure. Moreover, stock exchanges have at their disposal a variety of sanctions that may deter some companies from infringing disclosure requirements. Measures taken by the stock exchanges could include additional disclosure requirements, trading halts, warnings and publications regarding violations in regular bulletins, temporary or permanent de-listing as well as notification to the securities regulator. Securities regulators should nevertheless exercise effective oversight on stock exchanges regarding the performance of their duties.

194. Securities regulators are crucial monitors of information disclosure. They should become more active and stringent regarding disclosure of information by companies. Firstly, they should review the legal and regulatory framework regarding disclosure and complete it where necessary. They should have the power to prescribe more rigorous or specific requirements regarding disclosure when they deem it necessary. In doing so, securities regulators should strike a proper balance between detailed regulation and administrative burden put on companies or individuals, keeping in mind financial and human resources required to comply with these rules. Secondly, securities regulators should significantly reinforce the monitoring of disclosure by listed as well as widely held companies. Thus they should systematically check that companies disclose the required documents on time. They should also investigate more regularly the quality of these documents. Finally, they should strengthen enforcement and begin to effectively sanction companies that do not comply. Some significant, effectively implemented and widely publicised sanctions could provide a positive signal that the disclosure requirements are not just formal and that the securities regulators have become effective gatekeepers.

195. In order to be able to fulfil their duties regarding disclosure, securities regulators should have the necessary financial and human capacities. They should also be independent in carrying out their duties and have sufficient administrative power to monitor, investigate and sanction non-compliance (see Recommendations 293 to 298 in the Chapter 5 on Implementation and Enforcement).

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

197. The channel through which information is disclosed is critical to ensure actual effectiveness of disclosure regulations. The disclosure of information by companies may not be useful to investors unless they have an effective access to such information (i.e. easy, cheap and timely). To ensure fair disclosure and thus equitable treatment of shareholders, all shareholders should also have simultaneous access to the same information. Modern means of communication are in this regard, effective tools in meeting disclosure objectives and requirements.

198. Companies in SEE may adequately fulfil legal and regulatory requirements and provide information to the stock exchanges or securities regulators, but in many cases the access for shareholders to this information remains *de facto* limited and costly. This is especially the case for outside shareholders and is even true for inside minority shareholders such as employees. Companies do not usually provide their shareholders with direct access to information through modern means of communication such as the internet. Sometimes, shareholders can obtain, at their own expense, copies of financial statements as well as board and/or censor reports but are prevented from doing so by high prices. Finally, financial statements approved at the general shareholders' meeting are usually required to be recorded in the local trade registries. Nevertheless, not all companies fulfil this obligation, or else it is done late and trade registries are not easily accessible to shareholders. This situation has improved recently, as some securities regulators are now providing the public with electronic access to company information.

199. Following the example of a few securities regulators in the SEE region, a convenient solution would be to create a unified electronic access portal giving market participants access to officially published information. All the information requiring disclosure by law or regulation to the stock exchange and the securities regulator should be made available through this channel. This information should also include commercial registry information, relevant press announcements and a database of ownership and voting rights. Shareholders should have free access to this information, on top of the usual information channels they are used to. An online and secured query system could also provide selective access to non-published information filed in commercial registers.

200. Companies and all regulatory bodies that receive information according to relevant regulation should strive to make this information available directly to shareholders and the general public in a timely and equitable manner. The usual means of communication used by companies should be agreed upon with shareholders and clearly identified. In addition, listing requirements should require mandatory for companies

to put and keep up to date all public information that they are required to file with the stock exchanges or the securities regulators on their own internet website. Finally, they could use electronic mail to send mandatory documents¹³ or place these documents on their website and send a notice of availability to shareholders who agree to this procedure and provide their electronic addresses to this end. Companies could also systematically put on their website in secured form information relevant to duly identified shareholders or stakeholders requiring such information.

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

202. Due to regulatory and institutional shortcomings, the regulation of the accounting and the auditing profession is often far from effective in SEE. It is usually the responsibility of sometimes weak and often non-independent professional organisations that rarely have the authority to impose sanctions. Moreover, when penalties do exist, they are usually quite low. Until now there have not been any significant cases regarding auditor liability in most SEE countries. The quality and independence of external audits is often challenged.

203. SEE countries should not rely solely or even predominantly on self-regulation to ensure the integrity of the audit process. The accounting and audit profession should be subject to independent oversight¹⁴. First, since the statutory auditors' report adds credibility to published financial information and value to investors and other stakeholders, the audit contract should be considered not only as a private contract but also as a public good. Secondly, self-regulation has shown its limits and has given rise to some fatal weaknesses in more sophisticated market economies, where reputational mechanisms would have presumably been relatively efficient in disciplining auditors.

204. The regulation of the accounting and the auditing profession should be significantly reinforced. To this effect, the relevant regulatory bodies should be provided with adequate financial and human resources to carry out their crucial mission. International experience has shown how some individual audit failures or frauds may jeopardise the overall confidence in publicly disclosed information and thus in the integrity of financial markets in general. Current reforms in OECD countries regarding audit regulation should be considered as they usually aim at this very same objective, namely to reinforce the oversight of the audit profession¹⁵. Technical assistance could also provide international expertise in the area of auditing and accounting regulations.

205. The main functions of the accounting and auditing regulatory bodies would be to actively monitor and control the quality of the audit process. They should first make sure that auditors have adequate qualifications and professional competence. They should then build a robust incentive structure to ensure proper conduct by accountants and auditors. To this effect, they should have the administrative authority to define the rules and require compliance. They should then focus their activity on conducting regular inspections in all audit firms which carry out work on listed and large companies. They should also be granted sufficient investigative authority and sanctioning powers to deter significant misconduct and violations. These sanctioning powers should include the right to impose adequate fines on individuals or firms as well as to bar them from exercising accounting or auditing functions. Finally, they should also be able to make referrals to the court system to consider criminal cases.

206. The judicial systems should retain the authority to prosecute auditors. These should be subject to civil and criminal sanctions as appropriate for professional negligence or misconduct. However, auditors should be protected if they are misled by managers or board members. Finally, parties suffering from negligent, fraudulent or tainted audits should also have effective means of redress and be able to resort to private civil remedies¹⁶.

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

208. Strong professional organisations are crucial in improving the overall quality of accounting and auditing by raising the qualifications, professional standards and ethical norms of their members. They should have

sufficient resources to perform their task adequately and ensure their independence. They should thus receive support from SEE governments when this is necessary. International assistance in the form of financial support and expertise should also be provided in this very critical phase of accounting reform. These professional organisations should nevertheless work out plans to become progressively self-sustainable.

209. Professional organisations of accountants and auditors need to be strengthened and to acquire more independence from big audit firms or public administration. This strengthening should enable them to carry out a reasonable oversight of the accounting and auditing professions, and to contribute more significantly to the necessary improvement in qualifications and expertise of SEE accountants and auditors. This would greatly contribute to the improvement in quality and credibility of financial information provided by companies.

210. Professional organisations of accountants and auditors could participate in and inform the process of setting adequate qualification criteria for their members. They could play a leading role in training them and contribute to the appropriate testing and certification of accountants and auditors

211. Professional organisations should also develop their supervisory functions and actively participate in the progressive improvement of compliance of accountants and auditors' with professional standards. They should develop and advocate codes of conduct for their members¹⁷. Finally, they should also supervise their members' compliance with these standards and sanction those who do not adequately fulfil their responsibilities.

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

213. It is crucial to enhance the independence of auditors in order to ensure the quality and reliability of financial statements. Public confidence in the information disclosed can only be obtained if there is an assurance that the auditors' opinion is not compromised by self-interest, self-review, advocacy, familiarity or intimidation.

214. It is not always mandatory for companies in SEE to have an independent audit of their financial statements. When an independent audit is required, independence is often generally defined in Audit Laws, referring only to capital links between the audited company and the audit firm. Even when an external audit by certified public accountants is legally required, independence is often far from being the case in practice.

215. SEE authorities should ensure that adequate legal and regulatory requirements are provided regarding auditors' independence. Firstly, an independent audit of financial statements should be mandatory for all listed or widely held companies in all SEE countries. Secondly, as this has already been done in some SEE countries, the law or regulation should also define the criteria for such independence, i.e. the kind of financial, business, employment or personal relationship that an auditor is prohibited from having with the audited company¹⁹. While these provisions should be adapted to the specific national context, the recent EU recommendation regarding the independence of auditors as well as the IOSCO Principles of Auditor Independence²⁰ may provide useful guidelines.

216. The regulatory body should develop and put in place adequate safeguards to prevent auditors from lacking objectivity or integrity in performing their tasks²¹. These independence safeguards might include mandatory rotation of firms or audit personnel, a strict separation of auditing from other advisory services as well as disclosure of non-audit assignments and restrictions on the employment of auditors by their former clients. Most importantly, external audit firms should be prohibited from performing internal audit tasks. Any fee paid out to the audit firm by the audited company should be publicly disclosed. Any conflict of interest should be disclosed and any transaction entailing a conflict of interest with the auditors should be approved by the Audit Committee.

217. The regulatory body should focus its activity on monitoring the audit firms' independence and its compliance with related safeguards. To this effect, it should regularly evaluate the relationships between the audit firms and management as well as the boards of large audited companies.

218. 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.

219. Without duly trained and adequately compensated accountants, auditors, as well as financial specialists within the governmental or regulatory bodies concerned, there is little chance of improving the overall quality and reliability of disclosure. Companies will not be able to improve the quality of their financial statements, nor have the resources necessary transition to the new accounting standards. There will not be enough external auditors to adequately verify companies' financial statements. Finally, governmental or regulatory bodies responsible for monitoring and enforcing disclosure will not be able to perform their crucial task.

220. The insufficient number of duly trained Certified Public Accountants is a major obstacle to improving accounting and auditing practices in most SEE countries²². This alone prevents a great number of companies from being audited by qualified auditors. Qualification programmes have just begun to be implemented, but their limited resources make them unable to face such a huge task. The necessary transition to International Financial Reporting Standards makes this training effort even more necessary.

221. Training of accountants and auditors should thus constitute a priority area for technical assistance in the region. Professional associations should play the leading role in developing training and qualification programmes for accountants and auditors. Regional training and qualification programmes could also be developed, as this would allow saving on resources and facilitating access to international expertise²³. Finally, the review of university curricula would also help in developing an adequate pool of qualified professionals in the medium-term.

222. 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.

223. The role of the media in promoting disclosure and transparency is essential. They may constitute a critical information source for securities regulators and are a powerful way of disseminating information on important company events to the market and the public at large. Moreover they may also be instrumental in deterring market fraud and in disclosing private personal interest in making companies decisions. However, the performance of SEE media to date has been mixed and controversial. While they may have played a role in bringing major scandals and debates to public notice, they have also been criticised for being insufficiently educated in business matters as well as for being easily influenced by interested parties.

224. It is important that companies and regulatory bodies co-operate more systematically with the media in order to more widely disseminate information on companies and to promote transparency in business practices in general. Regular co-operation will enhance journalists' understanding and awareness of the issues at stake and thus improve the quality and accuracy of their articles. Furthermore, a well-educated and independent press may play an active and positive role in monitoring companies' behaviour and in discovering or even investigating misconduct or fraud. The media should understand its responsibility in increasing transparency and strive to enhance reliability and independence of the information they provide to the public. Journalists should disclose their interest or indicate conflicts of interest in case they produce or disseminate information on specific securities, or advise on buying or selling securities. Finally, they should also be sanctioned if they disseminate false or misleading information²⁴.

225. Training for selected and specialised journalists on issues relative to corporate governance in general, and auditing and accounting in particular would be a very useful investment. Stock exchanges and

securities regulators could contribute to this by inviting companies' representatives to journalists' sessions on listing requirements and especially on disclosure issues. This could be an area where international technical assistance may have immediate and positive returns.

NOTES

1. Some company laws also require a publication of a "Board Members' Review" with the financial statements, and/or a Report by "Censors" to be approved by the general shareholders meeting. The content of these reports is not specified in much detail and their quality varies significantly.
2. Notably through their participation to regional initiatives such as SEEPAD (South East Europe Program for Accountancy Development).
3. This should concern companies listed on official and non-official markets, as well as companies which are not listed but do have a large number of shareholders, usually due to the voucher privatisation. The threshold regarding the number of shareholders should be decided depending on national circumstances.
4. Small and medium-sized companies should be able to apply simplified accounting standards, provided that these are consistent with IFRS and do not give any discretion on consolidation rules. The work carried out on the elaboration of accounting standards for small and medium-sized enterprises by international organisations such as UNCTAD should be taken into consideration in order to avoid duplication and also to ensure compatibility with IFRS.
5. These guidelines should also include the development of tax reconciliation procedures. This would allow a clear separation of financial reporting from profit tax calculation, as a lack of such separation leads to lower and distorted disclosure and could hamper the whole accounting reform process. Moreover, without such separation, companies will continue to have more than one set of books, which is costly and reduce the overall transparency of business practices.
6. To this end they could refer to the "Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities", a statement issued by the Technical Committee of the IOSCO (International Organization of Securities Commissions) in October 2002.
7. Disclosure could even be required ahead of certain types of events, such as the expected purchase of block shares by an already significant shareholder.
8. The European practice regarding omission of information is described in Part II, Section XIV of the IOSCO Non-Financial Disclosure Requirements for Cross Border Offerings and Initial Listings by Foreign Issuers.
9. These procedures could require that, in case information is provided to the stock exchange, it could be disclosed to the public directly, provided that the content of the information is the same and it is released at the same time or after notification to the stock exchange. These procedures could also require that, in the case of rumours, companies should confirm or deny them as rapidly as possible in order to discourage market manipulation.
10. The standards of materiality cannot be the familiar financial ones because the scope of disclosure should extend beyond the financial accounts.
11. Here again, companies should be permitted not to disclose information which the board members judge to be so sensitive or confidential that disclosure would materially damage the company's commercial interests.
12. These matters are discussed at length in Turnbull, R., "Internal Control: Guidance for Directors on the Combined Code" (The Institute of Chartered Accountants in England and Wales, London, 1999).
13. Such as notice of meetings, circulars and proposals.
14. This could take the form of a two-tier regulatory system, including self-regulatory organisations on the one hand and securities regulators on the other hand.

15. In this regard SEE countries could refer to the IOSCO « Principles for Auditor Oversight » (October 2002), stating the most important features in developing and enhancing regulatory structures for auditor oversight.
16. Careful consideration should be given to the development of such redress mechanisms, as they may easily give rise to abuse. For example investors could lay the blame for poor investment decisions on failures by the auditors rather than on their own judgement.
17. They could consider the IFAC Code of Ethics as a basis for elaborating their own requirements regarding auditing and accounting professions.
18. By auditor we mean the statutory auditor, the audit firm, or an individual of this firm, and its network member firms.
19. This criterion should be sufficiently clear and reasonable to be enforceable, but be robust and comprehensive enough to encompass the various types of links that may compromise the auditors' independence. In this regard, an approach based on principles would be preferable to one based on precise and rigid rules, as it would avoid formal compliance that might still betray the overall objective of independence
20. Recommendation by the Commission on « Statutory Auditors' Independence in the EU : A Set of Fundamental Principles » / IOSCO "Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence" (October 2002).
21. In developing these standards, the costs incurred by their effective enforcement should be considered and balanced with the expected benefits in the SEE countries' particular circumstances.
22. While some other company bodies traditionally fulfil the role of external auditors, such as the Censors in Romania, they do not have to be composed only of certified accountants and generally, they are not trained to perform an audit for purposes of determining whether financial statements are presented in accordance with accepted accounting principles.
23. These regional programmes could be developed under the umbrella of regional initiatives such as SEEPAD (South East Europe Program for Accountancy Development).
24. This is encompassed in the Article 6, paragraph 4, of the EU Market Abuse Directive, "Directive of the European Parliament and of the Council on Insider Dealing and Market Manipulation".

THE RESPONSIBILITIES OF THE BOARD

226. Efficient boards have a critical impact on the success of a corporation. The board is at the centre of the corporate governance system of a company, as it is both the link between the shareholders, stakeholders and managers and between the company and the outside world. The key task of the board is to seek to ensure the company's prosperity. It therefore sets the company's aims and objectives by providing strategic orientation and ensures that these objectives are achieved by appointing and overseeing management. Finally, the board should supervise information disclosure and monitor risk as it is accountable to the company and the shareholders and has a duty to address stakeholders concerns.

227. Establishing efficient boards lies at the core of corporate governance reform. Indeed, in socialist economies, line ministries or worker collectives were in charge of strategic orientation and oversight of management. These two functions now have to be fulfilled by the boards. In SEE countries, boards are also an essential tool in monitoring management in an environment where managers have acquired significant power over companies and are repeatedly accused of abuse and expropriation of corporate assets. Boards should play a crucial role in monitoring conflicts of interest, which have given rise to the most severe and widespread abuse in the transition period. The role of boards as a device for protecting the rights of minority investors is thus crucial. Finally, being ultimately responsible for disclosure, boards materialise and put into practice the new accountability of enterprises toward their shareholders. By making sure that the enterprise provides the market and the public at large with the relevant information on companies' operations and results, boards contribute to the development of market transparency and thus efficiency.

228. Different models of board structure are represented in the SEE region, sometimes in the same country, reflecting the diversity of historical and legal heritage as well as choices made during the transition period. Board structures are in evolution and often are variants of the usual one-tier or two-tier models. The following recommendations should be applied and adapted in light of the specific board structures which are prevalent in the countries concerned.

229. The legal and regulatory provisions concerning boards are not evenly developed in SEE countries. In some countries there is not much concerning the boards in the company law nor in regulatory acts and listing requirements, except for the requirement for companies above a certain size to have a board, the choice of a board structure and how the board should be elected. Few countries have laws or regulations specifying in much detail board structure, composition or functioning, or legal requirements regarding the presence of independent board members or specialised committees. Some provisions do exist but may be not mandatory, leaving some important characteristics of the boards to be specified in company charters or by-laws. Furthermore, provisions regarding the board are not very developed in voluntary codes of best practice.

230. In practice, boards do not yet play a central and strategic role, as their functions are not clearly distinguished from those of management. They may perform only procedural tasks or be mere representatives of controlling shareholders. They most often lack independence from major or controlling shareholders and from management. The presence of truly independent board members is still an exception. Boards are in general weak in terms of authority, resources and actual responsibility.

231. Empowering the boards in SEE so that they fulfil their essential functions will first require developing the general understanding of their functions and duties by the business community and board members

themselves. It will also necessitate improving their structure by increasing their independence and developing efficient forms for performing their most critical functions. Meanwhile, boards have to be provided with the necessary means to perform these functions, i.e. effective access to information, extensive training as well as adequate remuneration. Finally, board members should be asked to devote sufficient time to their board functions while boards should collectively establish and implement transparent and relevant procedures to professionalize and improve the fulfilment of these functions.

232. 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.

233. Boards of a large number of widely held companies in SEE have been captured by particular interests, which raises serious questions about their loyalty to the companies. Because of the generally concentrated ownership structure and the close links to major owners or, on the contrary, of an extremely wide distribution of shares, board members may in fact represent specific shareholders and may even be paid directly by these shareholders.

234. It is fundamental for board members to understand that their individual and collective loyalty should be to the company and to all shareholders collectively. They should not represent specific shareholders within the board. Notwithstanding who nominated, elected or influenced their election, board members have a duty to represent the interests of all the shareholders collectively and to act with diligence and care.

235. It should be clearly specified in company law or other relevant regulatory acts that the boards have a duty of loyalty to the company itself and to all shareholders. This can be formulated in various ways on a purely legal basis, but should always articulate where the board member's loyalty should lie. If it is not spelled out in law, companies should do so in their by-laws.

236. One of the board's overriding duties is to abide by the company's articles of incorporation or by-laws and to do nothing that is outside the capacity of the company as laid down in its articles of incorporation, or to exceed limitations placed upon the powers of the board itself. In principle, any action of a company outside these limits should be void and the board members made liable. Companies in SEE should be encouraged to seek redress from board members who exceed their individual authority.

237. The business community in general, through Institutes of Directors for example, together with regulatory bodies and judicial authorities might contribute the improvement board members' awareness of their duties. It could do so through building up a data base of references to authentic cases illustrating the meaning of this duty of loyalty, or of the essential aspects of the duties of care and diligence. As this has already been done in some countries, a "Directors' Guide" could also be developed and distributed to existing as well as newly appointed board members (see Recommendations 277 to 282). Such guides should recall the main legal provisions concerning board members' duties, including sanctions for breach of duty. They should also discuss proper conduct to be adopted by board members in concrete and typical situations¹.

238. 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 regularise the fulfilment of these functions.

239. The actual functioning and effective role of the boards depends to a large extent on the qualities of their individual members as well as on the respective CEOs. The role and functions of the board are not always understood and implemented in many cases in SEE. There is not always a clear distinction between the role of the board and the role of management and some boards only perform primarily procedural or representative tasks. The law usually remains quite general regarding the board's functions. Similarly, the functioning of the board is not regulated in much detail, regarding procedures for deliberation or decision making, or disclosure of information on its members and activities. This leaves a great deal of room for flexibility in practice.

240. Firstly, the role of the board should be clearly distinguished from that of management². It is important that there is neither confusion nor ambiguity regarding their respective responsibilities, whatever the board members' background or other functions within the company itself or with affiliated companies. The board decides on the strategy of the company, while management decides on the implementation of this strategy and is monitored in doing so by the board. To help this clarification, it could be useful for the boards to draft a statement defining its reserved powers, where this is not done in the law or the company by-laws.

241. Key functions of the board are to ensure the strategic guidance of the company, the appointment and effective monitoring of management and the accountability to the shareholders. These three functions relate both to direction and control. They may just be distributed and structured differently, depending on the type of board structure. The ability to perform these tasks is facilitated if the board has a well-documented work-plan or reference document defining its main functions and describing which procedures will be applied to carry out these functions. This document should be reviewed periodically. Main elements of these board procedures should be also disclosed to shareholders.

242. Ensuring the strategic guidance of the company implies providing it with a sense of vision and direction, thus determining the long and short-term goals of the company. It concretely requires elaborating and agreeing the company's strategy with management. In this regard, the board should be considered as an essential resource for the management team, providing it with a wide range of knowledge and experience.

243. Monitoring management implies hiring and firing senior management, and most importantly the CEO. Managers' appointments have to be decided based on merit and criteria for selection have to be known to shareholders. The CEO's and other senior managers' remuneration should also be adequately disclosed. Shareholders should be informed of the principles of board and senior managers' remuneration and where performance related schemes may have a dilutive effect on their holdings, shareholders should be called on to give their approval. To perform these tasks, the board should review management performance on a continuous basis and following specifically defined procedures.

244. Boards have a specific duty to monitor and manage conflicts of interest, and should put in place relevant procedures, especially regarding related party transactions. Such procedures should include specific and clear disclosure requirements as well as rules regarding decision making. Independent board members, given their inherent characteristics, have an important role to play in the process (see Recommendations 94 to 99 and 106 to 110 of Chapter 1 on Shareholders Rights and Equitable Treatment).

245. Finally, the board is responsible for reporting to the shareholders and for ensuring compliance with the law. The board is elected by the shareholders and is accountable to the shareholders and the company itself. To fulfil this reporting responsibility, the board should ensure the integrity and effectiveness of the accounting and financial reporting system. This requires checking that adequate internal control systems are in place and overseeing the disclosure and communication system. This function of risk management and oversight is becoming increasingly important and requires financial literacy as well as personal integrity. Once again, the contribution of non-executive, independent board members is critical in performing this reporting and risk management function. To fulfil this responsibility more adequately, the board might also seek outside expert advice (See Recommendation 270).

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

247. The exact content and extent of board members' liability is not always specified in relevant legal documents of all SEE countries. In some countries, company law provides for sanctions that are inadequate and weak, thus appearing purely symbolic. Other countries are much more stringent, allowing for severe criminal sanctions. But whatever the level and characteristics of sanctions provided by the legal framework, these sanctions have never been enforced and legal cases involving board members' liabilities are still almost non-existent.

248. Collective and personal liability of board members should be clearly defined in company law or other relevant regulatory acts. Legislators should decide on the most suitable options and design proper sanction schemes, which should encompass civil and administrative as well as criminal sanctions where appropriate³.

249. In their capacity as board members, the same legal duties and liabilities should be applied to executive and non-executive board members. Equal responsibility would put pressure on non-executive board members to inform themselves and act diligently. However, as their access to information is not comparable and their degree of involvement may vary, different degrees of liability could well be adjudicated in court if the board is sued.

250. Sanctions should be high enough for board members to take their responsibilities seriously. However, the need for stringent rules should be balanced in a way that does not unduly deter able candidates. Clear statements about board duties and liabilities in law, company by-laws or board procedures would also help in raising this awareness. Moreover, the notion of business judgement or an equivalent provision in the respective legal systems should be introduced in order to protect board members from being held liable for wrong business decisions⁴.

251. Sanctions should be effectively enforced in order to deter wrongdoing. Strict and consistent enforcement of sanctions may help in increasing board members' awareness of their real responsibility. Making it clear that board members may be personally liable is likely to be especially effective in this regard. Improvements in the training of board members and clarity about their duties laid down by laws and regulations should also help in raising this awareness.

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

253. There is usually no legal requirement in SEE for non-executive or independent board members, and there are still very few truly independent board members on companies' boards. As for non-executive board members, they often represent persons related to the company, controlling shareholders or political parties. Thus, the composition of the boards usually reflects the concentrated ownership structure of companies, with representatives of controlling shareholders *de facto* dominating the boards. Minority shareholders are rarely in a position to influence the nomination and election of board members. Finally, the State may be over represented on boards, and a number of non-executive board members be mere political appointees, regularly changed following parliamentary elections. However, recent regulatory amendments are now requiring a minimum number of independent board members in some SEE countries, some of them even providing a precise definition of independence. There is also a more general trend towards an effective increase in the number of independent board members, as well as a growing separation between the function of chairman of the board and that of executive board member.

254. It is essential to understand the spirit of independence. It requires the capacity to exercise objective judgement on corporate affairs and not to be subordinate to any particular interest, especially that of management, controlling shareholders or political parties. Being independent is more a question of individual character and personal attitude, which cannot easily be prescribed by law. Consequently, in addition to the general skills and experience required for all board members, the foremost personal qualities and attitudes that should be sought for in independent board members are integrity and strength of character. Certain criteria that can facilitate such an independent mindset may however be clarified in the law or in regulations. This criterion⁵ should address situations that could preclude or tint independence, for example being a current or former executive of the company or its affiliates, parents, partners or connected companies, being a close relative of senior management and representatives of controlling shareholders, having a contract with the company or the group, as service provider, supplier or client, or finally being a political appointee. Along the same line, board members should not be prevented in any direct or indirect way from questioning executive board members' views, raising specific concerns and challenging the board's decisions as long as they have any doubt about the relevance, veracity or adequacy of a transaction, an evaluation or any information disclosed.

255. Independent board members have the same general legal duties to the company as other board members, but they play a specific and significant role in allowing the board to carry out some of its key functions. Firstly, independent board members may be instrumental in providing an external view to help develop the company's strategy, bringing in fresh perspectives and unfettered judgment. Secondly, having a significant number of independent board members is crucial for monitoring management. This is even more the case in the SEE context where managers are often connected to the controlling shareholders and/or political parties. Independent board members will thus have a special role in reviewing management performance and in deciding or proposing remuneration schemes. They will also have a primary role in monitoring and managing conflicts of interest, allowing the board collectively to fulfil its duty of loyalty to all shareholders and not only to the significant shareholders. Consequently, independent board members will have an important role in the composition of specialised committees, as mentioned in the following Recommendation 258-264.

256. Company laws, regulatory provisions or voluntary codes should encourage a sufficient number of independent board members in order for the boards to perform their main functions properly. The concept of independence should also be defined as clearly as possible in national regulations, along the lines described above. As these legal changes may take time, companies should be encouraged by stock exchanges to voluntarily increase the number of independent board members. The exact proportion may depend on national circumstances as well as on the availability of suitable candidates.

257. In addition, legislations should grant the possibility for companies to voluntarily adopt cumulative voting for the election of their board members. Cumulative voting could also be encouraged by listing requirements. It opens up the possibility for a greater voice for minority shareholders in the nomination and election process of board members. In some SEE countries, recent legal amendments already allow or even require cumulative voting. However, cumulative voting should not be mistaken for the adoption of a representative concept of boards. The board members elected through cumulative voting should not be perceived as representatives of minority shareholders. Like other board members, they should represent all shareholders.

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

259. Most company boards in SEE do not have specialised committees. Such committees are in most cases not mandated by the law, other regulatory acts or listing requirements. The usual functions carried out by specialised committees are precisely those that are poorly developed in SEE board practice. Moreover, the typically small size of boards is in itself a limit to the constitution of specialised committees. Finally, boards currently have little recourse to outside experts, which hampers their capacity to contribute substantially to the elaboration of the company's strategy or to effectively monitor management.

260. The main advantage of having specialised committees is to clearly single out the importance of some specific board functions. This is particularly relevant in the SEE context where these committees can emphasise the importance of the boards' very functions that have been underdeveloped until now. Another advantage is to clearly structure the functions of boards involving conflict of interest and to identify board members that have the skills and experience to carry them out. Finally, it also helps these board members devote sufficient time to ensuring these functions. To help them be able to focus on these specific duties they could receive a special remuneration as committee members. Thus, the existence of specialised committees ensures that key board functions are more adequately discharged, even if it is the board as a whole that legally retains the full responsibility.

261. The setting up of specialised committees for boards of companies should be encouraged either through regulation or through stock exchanges rules. These specialised committees should more particularly concern the key responsibilities of the boards involving conflicts of interest, notably audit and remuneration. When companies establish specialised committees, it is important that their duties, procedures and composition are clearly defined and documented.

262. Specialised committees should be comprised of a majority of non-executive board members, and if possible of independent board members. This is a necessary requirement for their effective functioning as they are particularly tasked with monitoring conflicts of interest.

263. Given the complexity of disclosure in the transition context and the poor performance of many SEE companies in this regard, the audit committee should be given special attention⁶. It should draw on the non-executive and independent board members with the most relevant skills and experience in financial and auditing matters. The roles of the audit committee are to review the financial reporting process, the internal control systems and to liaise with the company's internal and external auditors. The extent to which the "censors" or "financial revisors" could play the role of the audit committees in some SEE countries should be reviewed in the light of their past performance, the competence of their members and their independence and authority. Most probably the presence of such special bodies should not preclude setting up audit committees within the board, as the former do not have the same functions or responsibilities as board committees.

264. The remuneration committee should be in charge of working out the framework and policy related to the CEO and other remuneration of executive management. They should also be responsible for determining the remuneration of executive board members in their roles as board members. The remuneration committee should be explicitly responsible for proposing objectives and targets used for performance-based compensation, as well as the total remuneration package for each executive board member, including any kind of incentive payments. It should also appoint and monitor remuneration consultants.

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

266. Being a board member, and especially a non-executive one, is an increasingly complex and demanding role. One main obstacle that prevents boards in SEE from adequately performing their functions independently is the difficulty of obtaining reliable, sufficient and timely information on the company's business and situation. The extent and quality of materials presented to board members often fall short of what should normally be available. Non-executive and particularly independent board members are usually limited in their capacity to require specific information from executive board members as well as to check its veracity. They are also limited in their access to independent information.

267. The quality of information provided to board members is key for them to be able to carry out their mandate in a professional manner. Boards should have access to all the necessary information to evaluate and decide on all matters related to the company ahead of their meeting. They should rely on management and on executive board members to provide them with relevant and accurate information in an orderly and timely manner.

268. It is the chairman's and the CEO's responsibility that the non-executive board members receive proper information. They should regularly assess and determine which kind of information is necessary or relevant for non-executive board members to perform their task more efficiently. Nevertheless, non-executive members of the board should also be proactive in requiring the information they judge necessary to be in effective control of the company and its management. They should look for complementary information or clarification when they deem it necessary. Companies should provide them with the effective capacity to access this information and to check its quality through executive board members. Thus, there should be a constant dialogue between executive and non-executive members regarding the information provided to the board. This should constitute a clear element of the evaluation process for the overall board as well as individual board members' performance.

269. A procedure should be put in place to allow board members to have direct access to employees at all levels as an independent check on information reported to the board by senior management. It should also be stated clearly in the mandate of executive board members and in the duties of other managers that they should provide non-executive board members with all the information they require.

270. Boards and especially committees should also have access to outside professional advice in order to perform more adequately their functions when they judge this as necessary. Boards should thus have the necessary financial resources to seek independent expertise.

271. The remuneration of board members should be adequate and transparent.

272. Remuneration of board members is rarely published and the decision making process is not transparent, even though a formal approval by the AGM is usually required. Remuneration packages linking board remuneration to the performance of the firms are very rare and sometimes hampered by legal restrictions regarding remuneration in the form of shares. The latter may also be limited in practice by recent provisions regarding independence criteria. More generally, the very low level of stock retention by board members indicates that the alignment of board members' interest with shareholders' interest via ownership is not widespread. But individual board members are sometimes directly paid by the significant shareholders that have elected them, and in this case it is often based on confidential agreements.

273. The remuneration of board members should be adequate and correspond to their workload and responsibilities. Remuneration of board members should be high enough to recruit competent and experienced professionals and to allow them to devote sufficient time and energy to fulfil their tasks in an independent manner. It will obviously depend on the scale and complexity of the business, as well as on the general wage level in each country for professionals with the equivalent skills and background.

274. Board members' remuneration could include not only annual fees and meeting attendance fees, but also additional fees for special expertise or responsibilities in committees. The distribution of shares could also be part of the remuneration package, as this may help in aligning the interests of board members with those of shareholders⁷.

275. An interested party should not remunerate board members directly for their work as board members, as this could obviously affect their independence.

276. Whatever its form and level, the remuneration of board members should be transparent and published in annual reports.

277. 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.

278. Boards in SEE do not always perform their function adequately since board members generally do not devote enough time to fulfil their demanding role. The effective attendance by board members may be poor and preparation for the board meetings limited. Last but not least, in some companies participation in board meetings might be formal instead of an active, critical and questioning one.

279. As experience cumulates and individual companies develop their board practice, the business community would be well served by gathering these experiences in a systematic fashion. Practical guidelines or "how to do" manuals for boards could be developed at the national or regional level, as this has already been done in some individual countries. These guidelines should be disseminated, discussed and reviewed by the private sector over time as the board practice evolves. They would clarify board responsibilities and encourage professionalism.

280. These guidelines should specify the minimum procedures consistent with the effective performance of board duties. It could for example give indications on the number of board meetings and provide specific procedures to guide the board's monitoring and supervisory work. It could also limit the number of board membership that is appropriate for one person. Specific attention should be paid to procedures regarding

the approval of related party and major transactions, as well as any decision involving conflicts of interest with managers or board members. These guidelines should also insist on the collegiality of board practice and recommend that board members' contracts specify their duty of loyalty to all shareholders, their main functions as board members as well as minimum time commitments⁸.

281. These guidelines might also give further indication on the specific and special role of the board's chairman. The board chairman has the onerous task of leading the board, managing its business and developing its effectiveness as a working group. The chair is responsible for setting up, in co-operation with the board, board procedures distinguishing between the powers and responsibilities of board and management respectively. He/she also has the ultimate responsibility for conducting the board meeting in an orderly and timely fashion, for presiding over this meeting, and for the information provided to the board members. He/she should make sure that board members, and particularly non-executive board members, have sufficient time and information to prepare and discuss all agenda items.

282. Finally, these practical guidelines should underline the necessity and utility for the boards to carry out annual performance reviews and give indications on minimum disclosure related to board practice and board members. Companies should report on the number of board and committee meetings, the attendance of each board member to these meetings, and provide minimum information on each board member. They should also indicate if an annual review of the board's performance has been done.

283. 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.

284. The lack of a sufficient number of competent and qualified board members is a major obstacle to improving board practice in SEE. The existing board members reflect the prevalent technical profile in the management structure of the previous economic system, i.e. the dominance of engineers. Board members need to gather a wider range of skills and increasingly complex expertise, especially in accounting and financial reporting, but also in strategic planning, human resources, risk management etc. Despite significant progress in the recent years, there is still a relative shortage of adequate profiles in terms of business background. Moreover, specific skills and qualities related directly to board members' roles have to be developed for existing as well as incoming board members.

285. Supporting board member training is the main avenue for enlarging the pool of qualified board members. Training should encompass three different aspects: the role of board members, personal development and technical skills. Firstly, board members should be provided with practical guidance and training on the meaning of their fiduciary duties and on how they should perform their main functions. Secondly, training programmes should encourage and reinforce the capacity of board members to work together. They should also emphasize the most essential personal qualities key to the effective functioning of boards, i.e. integrity, scepticism and courage to question management. Finally, specific technical and substantive training could be provided to complete and bring board members up-to-date in the various and increasingly complex domains of expertise necessary to the adequate performance of their functions.

286. Companies are encouraged to develop induction programmes to make new non-executive board members familiar with the company's business, operations and markets. They should also make sure that the new board members are fully aware of their role and responsibilities as board members.

287. In order to provide companies with expertise centres to train board members, Directors' Institutes could be set up, developed and reinforced at the country level. These Institutes of Directors should be developed with the co-operation of business and professional associations, stock exchanges, chambers of commerce and companies themselves. These Institutes are instrumental in providing adequate training for existing as well as new board members. By giving board members the opportunity to exchange experience and thus create networks, these Institutes would contribute significantly to the development of a new board

culture. They could also develop a database of qualified board members and thus facilitate the recruitment process for companies. Institutes of Directors could greatly benefit from bilateral co-operation with other Institutes of Directors from OECD or transition countries.

288. A priority for multilateral assistance could be to develop a network of national Institutes of Directors. This network could help its members to develop and disseminate guidelines for board members as mentioned above. It could also develop training programmes and materials for national Institutes of Directors, as well as provide training for individual board members from the region. This network of Institutes of Directors could also develop qualification programmes⁹ that would be recognised in the different SEE countries. Developing such a regional network, in addition to pooling assistance and expertise resources, could alleviate the shortage issue by further enlarging the pool of qualified candidates and encouraging the nomination of board members from the region.

NOTES

1. They could refer as an example to the « Standards for the Board » published by the British Institute of Directors (IoD, London, 2001). A more detailed discussion of directors' duties, potential liabilities and good practice is "The Company Director's Guide" (IoD, London, 2002).
2. This distinction is clearly described and discussed in Chapter 3 of "Corporate Governance and Chairmanship, a personal view", by Sir Adrian Cadbury, Oxford University Press, 2002.
3. Sanctions should be adapted to the different breaches of duties, taking into account the severity of the offence and the degree to which the company should answer for the misdeeds of its board members. Finally, on deciding on the type and level of sanctions, authorities should consider their deterrence value, which will depend on their severity and the way they are actually enforced. The effective enforceability of sanctions should be the most critical criterion and it would depend on the features and strength of the institutional framework in general and of the judicial system in particular.
4. The business judgment rule aims at granting board members and senior management wide latitude in deciding the business affairs of the company. They should not be held liable for the consequences of their exercise of business judgment – even for obvious mistakes – unless certain exceptions apply. These exceptions include fraud, conflicts of interest, acting outside the corporate purpose and failure to be sufficiently diligent and exercise due care in the basic activities of the board member's role (such as attending meetings, seeking to inform oneself and deliberating meaningfully before making important decisions).
5. Regulators may find numerous examples of such lists of criteria, such as in the "Review of the role and effectiveness of non-executive board members" of the "Higgs Report" (2003), or in "Towards better corporate governance" of the British National Association of Pension Funds (2000).
6. Best practices for the audit committee are provided in the IOSCO "Principles of Auditors Independence and the Role of Corporate Governance in Monitoring and Auditor's Independence", Statement of the Technical Committee, October 2002.
7. However, given the current state of stock market development in SEE, this could not realistically provide a real incentive in the near term. Moreover, too large holdings by board members could detract from independence.
8. These time commitments should cover both board and committee meetings, preparation for these meetings as well as interaction with employees and outside professionals. Although it is quite difficult to codify and quantify the necessary time required by a board member to fulfil his/her duties in an informed way, such contracts could encourage a greater involvement by board members, especially non-executive ones. The assessment of time devoted by each board member should be part of the regular evaluation process.
9. The qualification of Chartered Director in the UK is a recent example.

IMPLEMENTATION AND ENFORCEMENT

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

290. In many SEE countries, the judiciary has had difficulty in dealing with the rapid growth of commercial litigation that has occurred over the transition period. Insufficient opportunities for training, lack of experience and precedent and a shortage of resources have all been problems in various SEE countries, leading to long delays and sometimes questionable judgements. Strengthening the judicial system's capacity in terms of commercial disputes should be an essential element of corporate governance reform. The judicial system underpins not only many of the recommendations listed in this White Paper, but the whole commercial and contractual system.

291. Resources, capacity and authority of the judicial system should be strengthened in order for the courts to be able to investigate wrongdoings and design suitable remedies or deterrents regarding violations of shareholders' rights. These remedies should include injunctive relief.

292. Successful reform of the judiciary will require a number of steps in most SEE countries. Priority should be given to the following: (a) guarantees for its independence; (b) the training of lawyers and judges in commercial law and procedures, especially with respect to company and securities law, as well as bankruptcy law. Multilateral and bilateral assistance could play an important role in achieving this; (c) the compensation of judges and other court personnel should be adequate to ensure the education, experience and integrity required for the position; (d) greater specialisation of the judiciary in matters of commercial and company law should be encouraged; (e) court written opinions and decisions should be made public to increase public awareness, facilitate interpretation of the law and enhance the accountability of the legal system; (f) effective mechanisms to counter corruption in the judiciary should be put in place.

293. Securities regulators in SEE countries should have the independence, resources, remedies and accountability necessary to oversee financial markets and self-regulatory organisations effectively¹.

294. In most countries in SEE, the national securities regulator is the first, and in many cases, last line of defence for shareholders' rights. They also normally oversee the self-regulatory organisations like stock exchanges that can also play an important role in protecting shareholder rights and promoting corporate governance. Consequently, they play an important role for the investment climate and for the overall credibility of the market. Unfortunately, a shortage of resources; a sometimes unclear division of responsibilities with other parts of government; a seeming lack of transparency and accountability; and a lack of appropriate remedies have all prevented the relevant regulators from being fully efficient in carrying out their mandate.

295. Effective enforcement requires that the securities regulators of SEE countries have adequate budgetary resources, regular staff training, including international exchange of expertise with similar institutions, and competitive salaries. Reinforcing the capacities of securities regulators in terms of financial and human resources should be a priority for technical assistance.

296. Securities regulators should be operationally independent, while having sufficient authority to perform their monitoring function. Personnel at all levels should be appointed on the basis of professional merit

and their respectability in financial markets. To enhance regulators' independence, their mandate should be of adequate duration and staggered². They should not be removed except in strictly defined circumstances.

297. The functions of the securities regulators should be clearly defined, and they should operate in a transparent and accountable manner. For example, their members should disclose their own transactions in shares of companies under their authority. In turn, securities regulators should demand that relevant self-regulatory organisations observe the highest ethical and professional standards.

298. The securities regulators should have access to, and take advantage of, remedies other than suspending trading and de-listing a company's stock, such as fines or public notice. Suspensions may not be the most suitable sanctions as they penalise primarily market participants.

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

300. Shareholders who seek legal redress through the judicial system often experience delays and costs that in the vast majority of cases exceed the value of their shares. This discourages shareholders from seeking redress when their rights are abused.

301. Shareholders should have an easy access to the ordinary court system and be able to obtain redress at reasonable cost and without excessive delay. It should be possible to file derivative suits, i.e. to sue on behalf of the company against board members to recover losses.

302. As a remedy, it might also prove useful if stock exchanges or other relevant bodies provided for professional arbitration mechanisms to settle disputes between companies and shareholders. Such private arbitration may sometimes offer greater resources and speed than litigation in state courts. However, arbitration cannot be a substitute for court enforcement, as successful arbitration still requires the prevailing party to have the arbitral award recognised and enforced by court systems.

303. Improving the legal redress mechanisms for shareholders could also include allowing low cost collective efforts through shareholders' associations or other institutions. In the same vein and when this is not yet the case, securities regulators should be allowed to file lawsuits on behalf of shareholders, provided that sufficient resources are made available for this function.

304. Active regional co-operation should be developed further between all the main actors in the corporate governance institutional framework. This regional co-operation should be initiated regionally and supported by international organisations.

305. The setting up of the whole necessary institutional framework dealing with corporate governance issues and market integrity is a complex and costly process. Some small countries in the SEE region may not have the necessary resources to build up such a complete framework. This may result in an incomplete institutional framework and weak individual institutions unable to effectively carry out their mandate. Moreover, a number of small stock exchanges in SEE are probably unable to pursue development unless they co-operate or even integrate at the regional level. Some initiatives have already been taken regarding co-operation among securities regulators, the integration of trading platforms between some stock exchanges in the region, or training of market professionals³.

306. Regional co-operation should be undertaken or reinforced between stock exchanges, securities regulators, as well as all relevant professional associations such as associations of accountants and auditors, brokers-dealers, minority shareholders, etc. This regional co-operation could focus on two priorities. It should first concentrate on training by developing common curricula, training institutions and licensing process. The objective could be at least to achieve mutual recognition of standards and licences. The second priority

should be the co-operation between stock exchanges. To achieve this aim, regulatory authorities should also work on regulatory convergence.

307. National or international donors should encourage this regional co-operation.

308. The Roundtable should continue its work and review and support progress in the area of corporate governance and other related corporate sector issues.

309. There is now a growing recognition of the importance of having good corporate governance practices to attract investment, develop sound secondary financial markets and restructure the industry. A number of countries in SEE are now in the process of reforming their legislative and institutional framework related to corporate governance issues. The Roundtable has created a regional network of corporate governance experts, including policy makers, regulators and representatives of the private sector. The Roundtable has allowed these experts to support their reform activities at the national level and to strengthen their knowledge about corporate governance issues. This network of regional experts forms an important coalition for reform at the regional and national level, which is essential for the next phase of policy design and implementation. This White Paper could be a useful tool for regional experts and policy makers to follow on their reform activities, as well as to inform and shape the reform process itself.

310. This White Paper should first be translated, disseminated and publicised in respective countries, especially amongst the business sector and national authorities. This whole process should be carried out on the basis of national initiatives, supported by the OECD secretariat.

311. The Roundtable should continue its work using the White Paper as a basis for supporting the process of designing, implementing and enforcing reforms. This second phase of the Roundtable would aim at monitoring the implementation of the White Paper, providing further expertise on corporate governance issues and maintain regional policy dialogue on specific issues and priorities for reforms. These priorities would encompass enforcement, procedures and rules for changes in corporate control, and procedures to monitor conflicts of interest.

NOTES

1. Regulators could refer to the Objectives and Principles of Securities Regulation drafted by the IOSCO in February 2002, particularly the first five Principles related to the Regulator.
2. If the term is three years, only one third of the board should be up for election per year.
3. A regional initiative for setting up a center for education and training of market participants, including brokers, and analysts, and for developing cross licensing is presently developed by the East-West Institute. Participants will be all stock exchanges, securities regulators and market actors in the region.

A COMPARATIVE OVERVIEW OF THE CORPORATE GOVERNANCE FRAMEWORK IN SOUTH EAST EUROPE

312. This landscape chapter serves as an annex to the White Paper on Corporate Governance in SEE. The main purpose of this paper is to illustrate the main common characteristics as well as the main differences among SEE countries regarding their corporate governance framework.

313. The first part of the paper draws a broad landscape of the current economic situation of SEE countries. It highlights the main common or specific characteristics regarding the macroeconomic climate and recent progresses in privatisation. It shows how, for the first time since the beginning of the transition, SEE countries are enjoying a favourable macroeconomic climate, with macro-stabilisation and a return to growth, though these achievements are still fragile, especially concerning budget balances and external positions. Finally, it briefly indicates how large privatisation is still an ongoing process in all SEE countries.

314. In its second part, this paper focuses more closely on the corporate governance framework. To do so, it gives an overview of the ownership structures of enterprises, showing how these derive mainly from the privatisation programme and how they are still characterised by the significant control exercised both by insiders and by the State. The paper then briefly describes the state of the financial sector, showing how the banking sectors are only now recovering from acute crisis and how they have been largely privatised to foreign banks. As for the stock exchanges, they are mainly underdeveloped, with low liquidity and low transparency, in spite of usually well-functioning infrastructures. The current or upcoming pension reforms are one potential source for their development. Finally, this paper makes a preliminary assessment of the legal framework regarding corporate governance, highlighting main discrepancies between relevant laws in respective countries, as well as recent legal evolution and reforms. The paper also makes a general observation regarding obvious shortcomings in implementation.

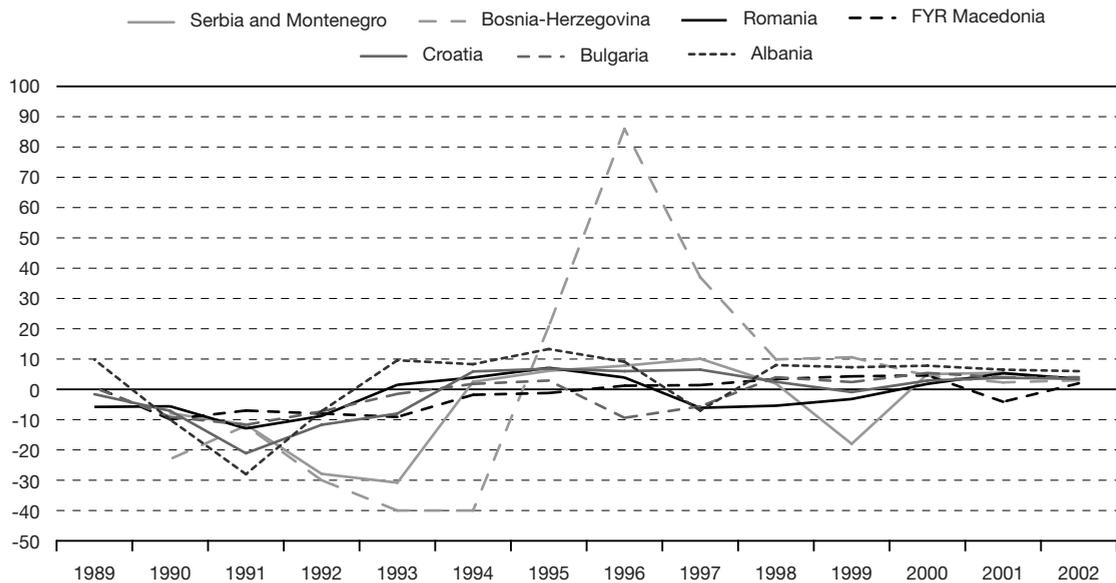
315. An improved macroeconomic climate

316. While in Central Europe the average *per capita* GNP of transition countries have reached about 20 to 30 percent of that in the European Union and are tending to converge, the situation is bleaker in SEE. Average GNP per capita is less than 10 percent of the EU's and the gap is widening. If SEE countries have experienced clearly diverse trajectories since the beginning of the transition, some common and obvious factors explain their lagging transition, among which are adverse initial conditions, armed conflicts as well as hesitant reforms and restructuring.

317. Nevertheless, most SEE countries are now and for the first time since the beginning of the transition enjoying a stabilised macroeconomic situation as well as positive growth rates.

318. In terms of growth patterns, SEE countries have undergone various trajectories but growth rates have turned positive throughout the region since 2000. In face of the economic slowdown witnessed first in the US and the EU as well as increased uncertainty in the world economy, SEE growth continues to be robust, though slightly slowing down in 2002 (around 3.5% on average) in comparison with 2001 (around 4.5% on average).

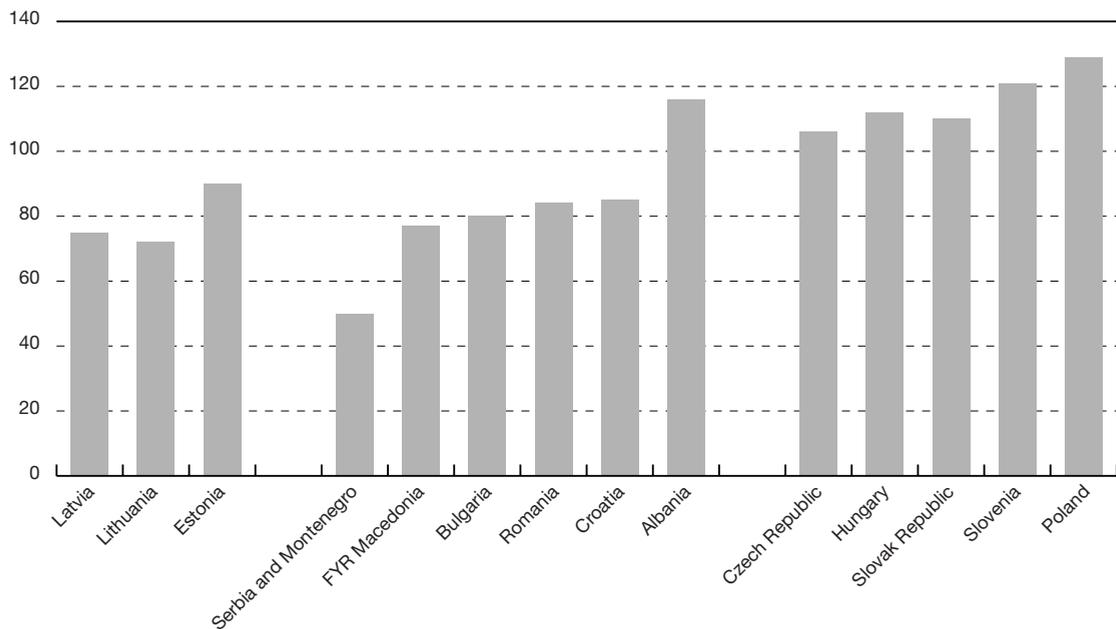
Graph 1. GDP Growth 1989 – 2002 (%)



Source: EBRD Transition Report 2002.

319. In spite of this recently renewed growth, and contrary to most other European transition countries, most SEE countries have not yet caught up to pre-transition GDP levels. The present growth rates would need to remain large enough for awhile yet in order to compensate for the initial drop in output. This is even more the case when considering industrial output.

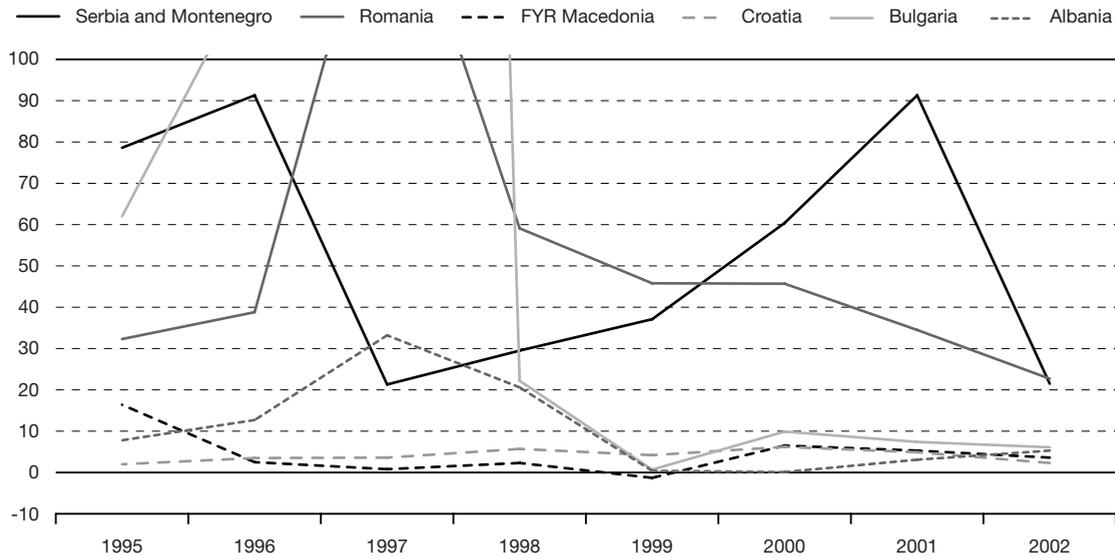
Graph 2. GDP 2001 / 1989 (%)



Source: EBRD Transition Report 2002.

320. As for macroeconomic stability, stabilisation occurred in almost all countries. Inflation has steadily declined to reach average levels of 6% in 2002. Only Romania and Serbia and Montenegro still suffered from double digit inflation levels in 2002.

Graph 3. Inflation 1995 – 2002
(change in annual average retail/consumer price level, %)

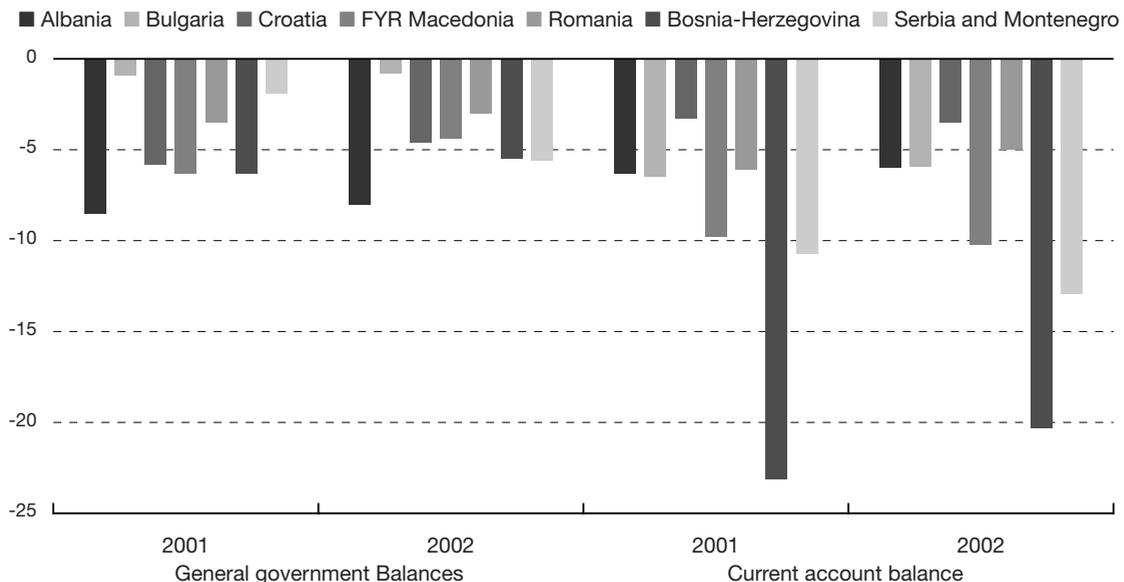


Source: EBRD Transition Report 2002.

321. Nevertheless, large government budget deficits still hang over this newly achieved stability, while the sustainability of external positions often remains fragile with weak export performances.

322. The structure of the GNP has typically evolved with a declining contribution of industry and agriculture, and an increasing significance of services. Nevertheless, this structural change cannot be considered as a sign of modernisation of SEE economies as it was brought about by a decline in industrial output combined with a rise in prices in the service sector. Indeed, enterprise restructuring has been quite low and slow, especially in large enterprises.

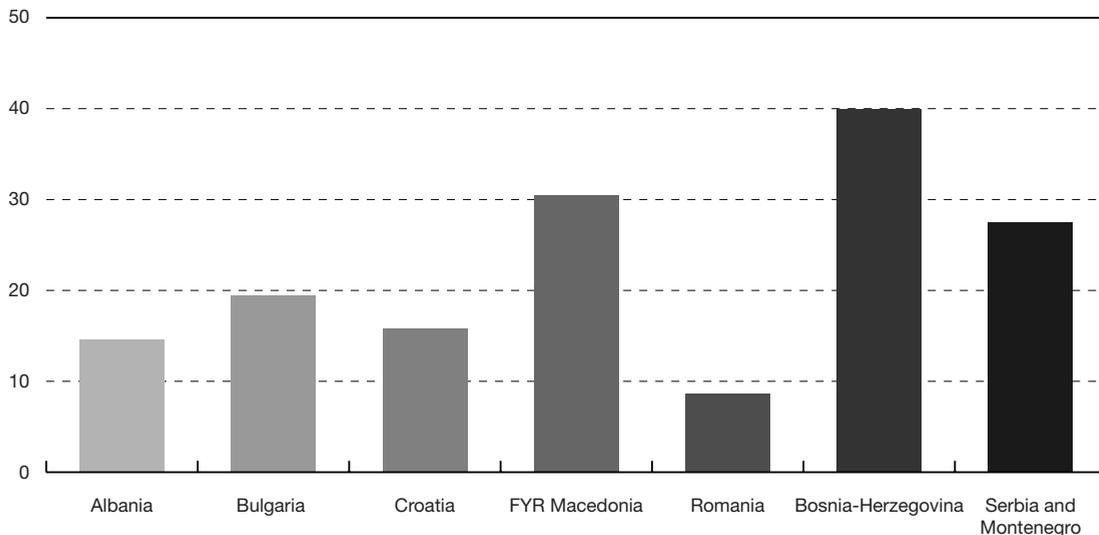
Graph 4. General government and current account balances, 2001 – 2002 (in % of GDP)



Source: EBRD Transition Report 2002

323. This resulted in a rise in unemployment that reached high and even dramatic levels (between 12 and 40%) and a sharp decrease in living standards, accompanied by increasing inequality. SEE countries have the lowest GDP per capita levels and the highest unemployment levels of European transition countries.

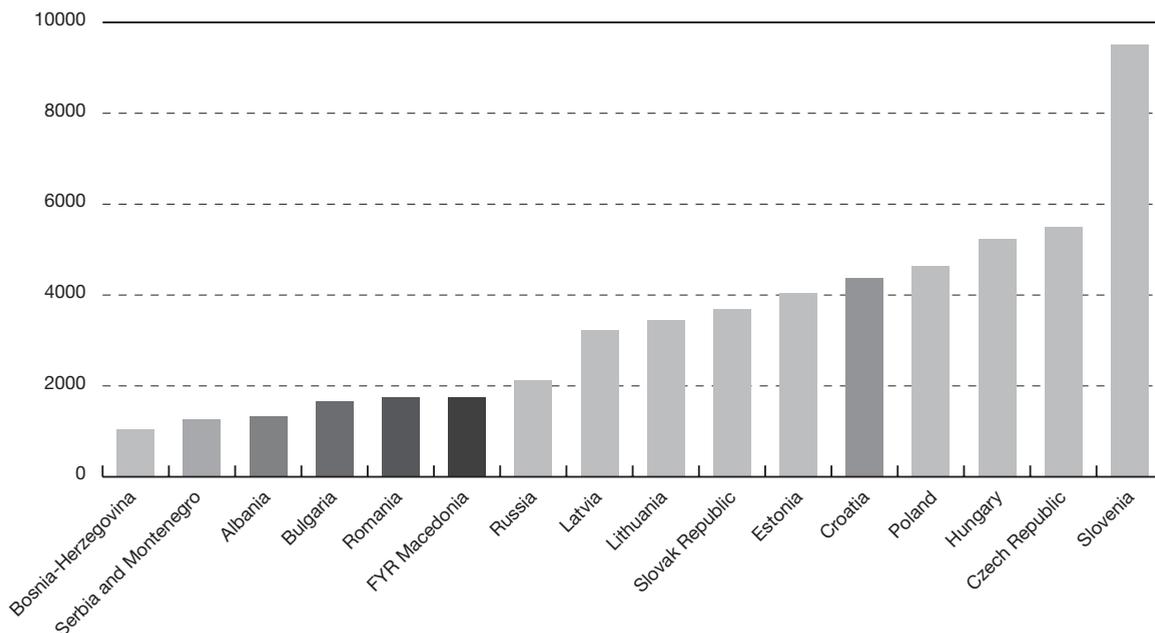
Graph 5. 2001 Unemployment Levels (% of labour force)



Source: EBRD Transition Report 2002

324. Thus, SEE countries are finally enjoying a stabilised, though fragile, macroeconomic climate and new growth. But the bulk of industrial restructuring remains to be done.

Graph 6. GDP per Capita in 2002 (in US \$ PPP)



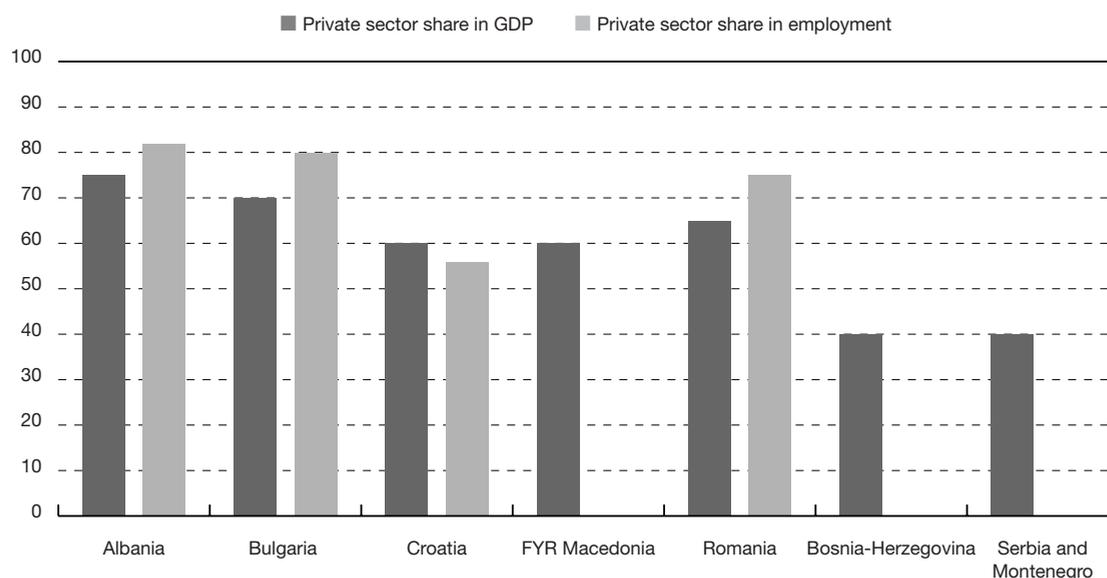
Source: EBRD Transition Report 2002

Recent progress in privatisation of large enterprises and FDI

324. The progress in privatisation as well as in the methods used to privatise formerly state or socially owned enterprises have a significant impact on corporate governance practices in transition countries. MEBOs (Management and Employees Buy-Outs) and voucher privatisations are usually considered to be less favourable to the emergence of active private owners aiming at improving efficiency or maximising profits than direct sales to private investors

325. Privatisation programmes have taken various forms but have often begun late and are still in progress in most SEE countries, particularly in the case of large enterprises. Consequently, while the private sector now accounts for around 60% of GDP in most SEE countries, this is far from being the case regarding industrial production.

Graph 7. Share of the Private sector in GDP and Employment, 2002 (%)

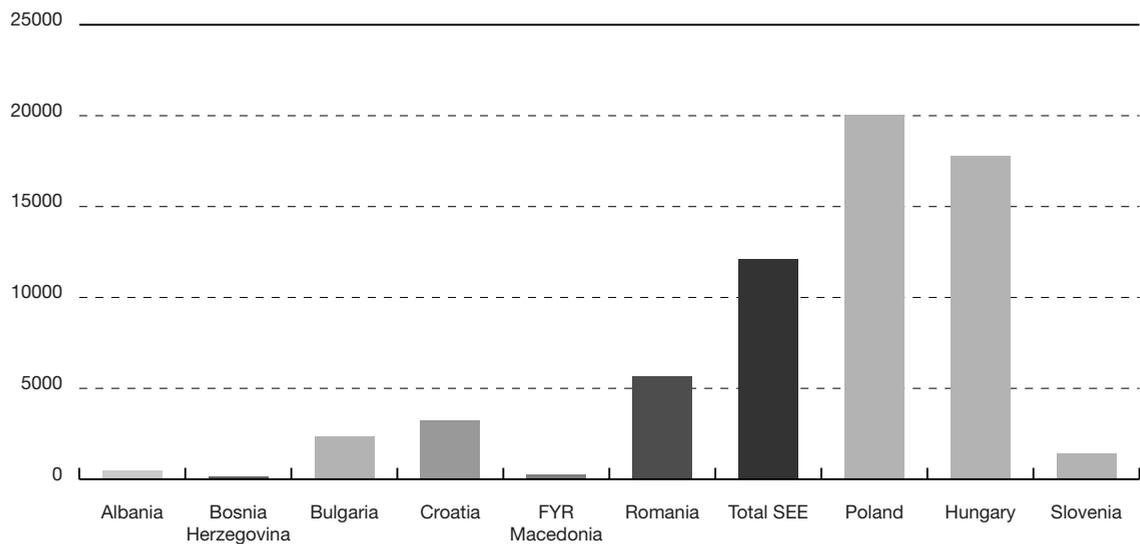


Source: EBRD Transition Report 2002

326. A further improvement in macroeconomic performances as well as a continuation or an acceleration of the privatisation programmes could simultaneously trigger and be facilitated by foreign investment in the region. Until now, the SEE region has attracted relatively low foreign investment, especially FDI.

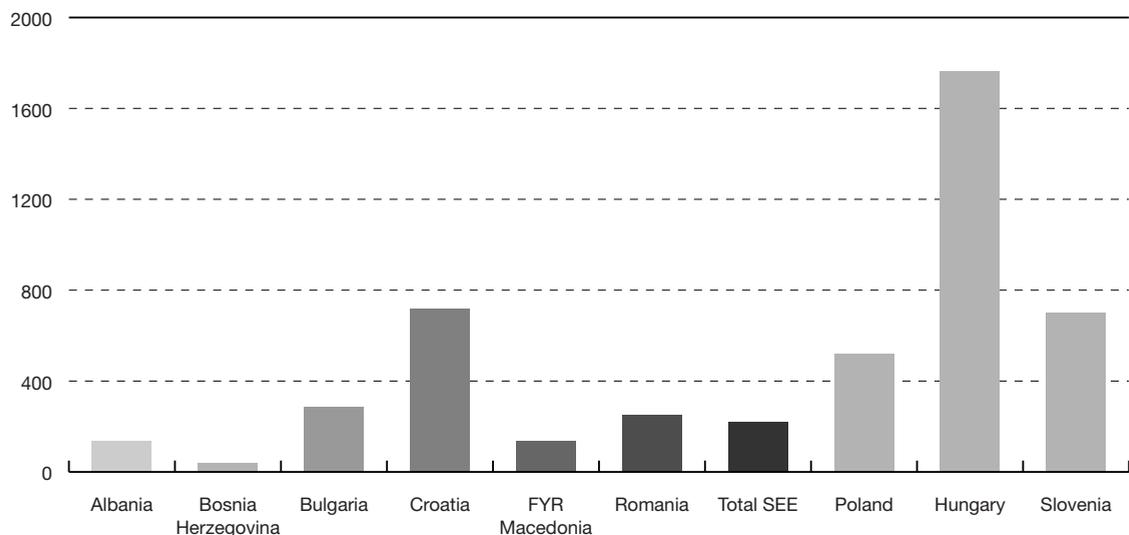
327. But a significant improvement/acceleration in industrial restructuring and an effective increase in foreign investment requires a second stage of reforms. This second stage of reforms builds on the institutional foundations of a market economy, of which corporate governance is a key element. Indeed, it has been now widely recognised that improved corporate governance practices are necessary in order to trigger restructuring and achieve efficiency gains. Improved corporate governance is also a prerequisite for attracting foreign investment that would allow restructuring to be extensive. Such investments and restructuring make up the only path towards sustainable growth.

Graph 8. Cumulative FDI, 1989 – 1999, in US \$



Source: EBRD Transition Report 2001.

Graph 9. Cumulative FDI per Capita, 1989 – 1999, in US \$



Source: EBRD Transition Report 2001.

Common characteristics of the ownership structures

328. The present ownership structures of JSC in SEE countries show some common characteristics and reflect the history of the privatisation programmes. Ownership structures are characterised by: (i) a significant control by insiders and more precisely by managers, who have secured control either through direct ownership or indirectly by *de facto* control over employee shares; (ii) the importance of remaining state ownership and control, especially in large firms and utilities that are still to be privatised; (iii) the emergence of

various forms of institutional investors, mainly former privatisation funds, that play a significant role in the ownership structure of enterprises.

329. These common characteristics (significance of ownership by insiders, remaining state ownership and control, and the emergence of various forms of institutional investors, mainly former privatisation funds), engender a series of specific problems and difficulties regarding corporate governance practices.

- Insider domination easily leads to abuse of minority investors, asset stripping and problematic handling of conflicts of interest
- Remaining state ownership and control may be an impediment to restructuring if the State does not really exercise its role as shareholder or if management of state shares is dominated by political concerns rather than business judgement.
- Emerging institutional investors may have a significant impact on corporate governance practices. As they are at the centre of corporate ownership as the majority shareholder, the controlling minority shareholder or at least significant shareholders, privatisation funds or holding companies are in a privileged position to influence corporate governance practices of companies they invest in. But their own behaviour towards their shareholders should also be improved. The problem is really “who guards the guardians”.

330. While the ownership structures in SEE countries show certain common characteristics, they are also changing. Strong and common trends are visible and include an increased concentration of ownership in individual companies, the transformation of JSC into Limited Liabilities Companies (LLC), the de-listing of public companies and the formation of holding companies on the basis of former privatisation funds.

331. The tendency towards ownership concentration takes various forms and may be more or less marked in the different countries. It is particularly marked in countries where privatisation programmes have been well advanced. Indeed, the concentration constitutes a sort of second stage reaction to the outcome of the early privatisation programmes. This tendency towards ownership concentration derives jointly from the excessive ownership dispersion that results from voucher privatisation, and more generally and fundamentally from the inability or great difficulty for minority investors to have their rights respected.

332. Parallel to this concentration tendency, a lot of JSC are being transformed into LLC. This tendency to de-listing should be encouraged regarding small and medium-sized enterprises. Indeed, these firms do not have the means to access outside capital, and the legal structure of JSC is not appropriate for them. It is too burdensome and costly in terms of administration and legal obligations. Sophisticated mechanisms to carry out shareholder meetings and even more so, to protect minority investors can be quite costly for SMEs. Certainly, concerns about transparency and disclosure are also relevant for SMEs, the more so as they are a critical part of transition economies, especially as they include most of the new private enterprises.

A weak banking sector.....

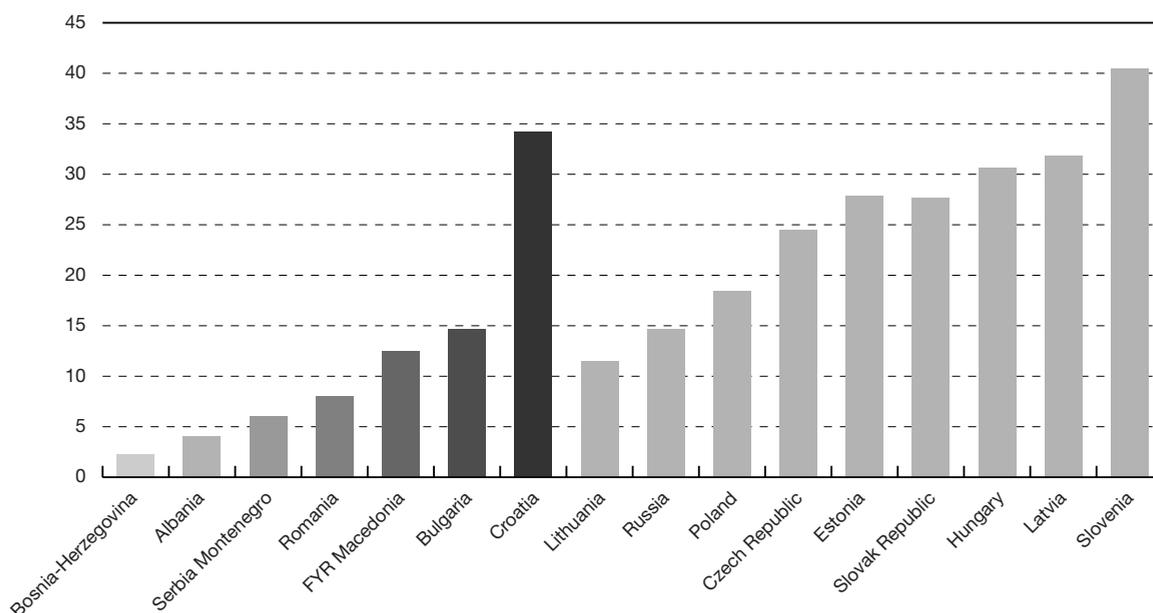
333. As in most transition economies, the financial sector is a strategic but often weak sector in the SEE region. Indeed, most SEE countries underwent a major banking crisis in the second half of the 1990's. These crises have been very costly and have resulted in very small outside financing of enterprises, while financial markets are still quite underdeveloped.

334. The bank crisis resulted from poor banking supervision and mounting bad debts granted by state-owned banks to not yet restructured state-owned enterprises. The cost of solving the banking crisis has been significant in all SEE countries, estimates ranging from around 8% of GDP in Romania, 30 % of GDP in Croatia, up to 75% of GDP in Bulgaria between 1991 and 1998, some of the highest figures among transition economies.

335. Fundamental remedies to these banking crises have been the changes in the regulatory frameworks and the privatisation of the banking sector. Regulatory changes mainly consisted in improved banking supervision, while the privatisation of the banking sector was carried out mainly through sales to foreign banks. Foreign capital now dominates the banking sector in most SEE countries. Finally, the banking sector remains highly concentrated, with expected further concentration in view of EU accession.

336. Despite an improvement in soundness and profitability, one main characteristic of SEE economies remains the low level of banking intermediation, even taking into account their low development stages. Loans to the private sector usually represent less than 15% of GDP. These levels are quite low, not only with respect to international standards (from around 50% for the US to around 120% for Germany on average from 1989 to 1998), but also in comparison with other European transition countries.

Graph 10. Domestic credit to enterprises (in % of GDP)



Source: EBRD Transition Report 2002

337. The reasons for this weak intermediation are at once numerous and obvious:

- First of all, lending to the private sector is *de facto* very risky, as old customers are restructuring or are now clearly not creditworthy, while new ones have neither a credit history nor collateral. Consequently, banks prefer low risk liquid assets, mainly government securities and deposits in financial institutions.
- This fundamental obstacle to lending to the real sector is magnified by the low level of transparency and the weak legal environment, which greatly lessen the probability of recovering losses in case of default.
- Moreover, the tighter regulation and supervision of banking activities that were imposed after the banking crisis make lending to loss-making enterprises much more difficult. Thus, for the moment, banks' sizes together with both cautious depositors and cautious banks make the potential financing of investment by the banks quite modest.

338. The restructuring of the banking sector throughout SEE and the increasing involvement of foreign banks should lead to increased bank financing for the restructuring of enterprises. Banks are currently

more interested in investing abroad or in government securities. But in the medium-term, especially with the growing involvement of foreign banks, banks may have more financial resources to grant credit to enterprises. They will also be more able and prone to discriminate between risks, and thus to exercise their intermediation role.

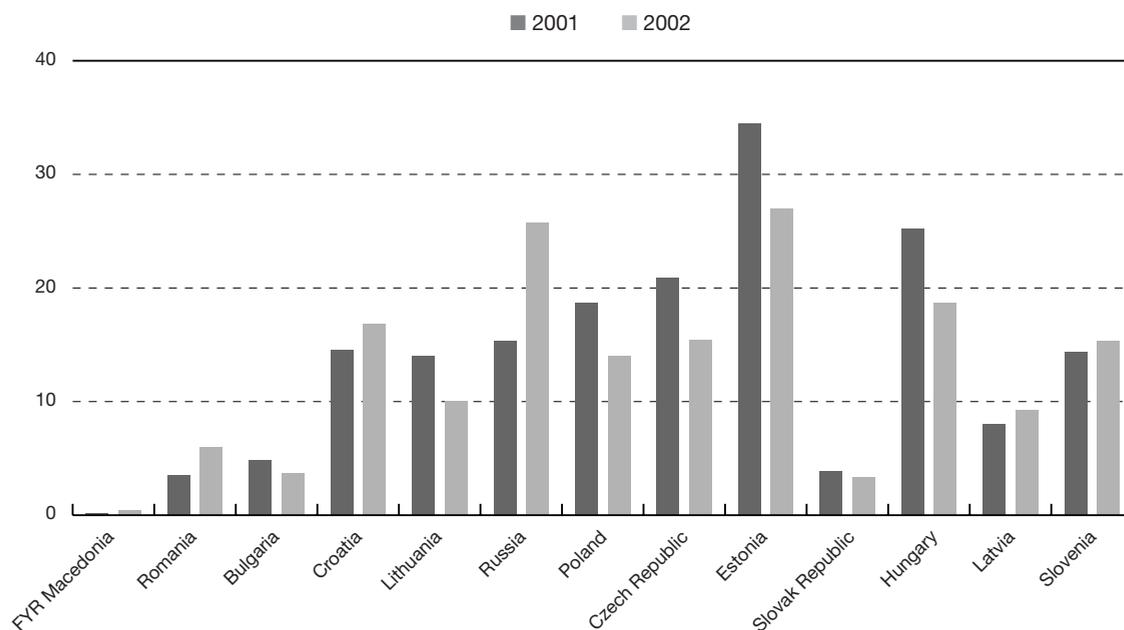
339. Consequently, banks in SEE will probably become more prudent and demanding creditors for industrial enterprises. They may be able to play an increasing role as stakeholder, demanding more transparency and disclosure. Moreover, they will probably exert more pressure in order to tighten the budgetary constraint of enterprises through the threat of bankruptcy. A prerequisite for these developments is obviously a significant improvement in their own governance and supervision. Finally, the degree to which banks will be willing and able to become significant shareholders as well as creditors is not yet clear.

...and underdeveloped stock markets

340. Most SEE countries created stock exchanges early on in the transition, but they really became operational and regulated by securities commissions in the second half of the 1990's. These securities markets usually enjoy good technical and legal infrastructures.

341. SEE stock exchanges usually have two or more tiers, gradually offering more flexible listing requirements. The bulk of market capitalisation and trade volumes derives from the most flexible segments of the markets. The existence of these different market tiers in terms of disclosure requirements renders comparisons between market statistics difficult.

Graph 11. **Stock Market Capitalisation (in % of GDP)**



Source: EBRD Transition Report 2002

342. SEE stock exchanges remain quite underdeveloped, with low capitalisation and little liquidity. With such limited liquidity, the viability of market intermediaries is problematic and data on capitalisation may be very misleading.

343. It is important to recall that the SEE stock exchanges have been created as privatisation devices and initial trading was linked to redistribution of property. They remain mainly secondary markets dedicated to these functions. In some stock exchanges, there is still a majority of block deals. Moreover, a lot of deals are still off-exchange, based on inside information, which creates transparency problems for market pricing.

344. This underdevelopment of SEE stock markets results first of all from a supply problem. SEE stock exchanges lack large companies with substantial free-floating shares. In some cases, the listed stocks resulting from voucher privatisation programmes are *de facto* government residual stocks in non-attractive companies. The most attractive and largest companies have either not been privatised yet, or have been privatised through cash sales.

345. There are several reasons why companies are sometimes reluctant to be listed. First, listing requirements are often perceived as unnecessary and costly constraints. Companies are afraid of “bureaucratic hurdles” and in some countries refer to high fees and slow processing of documents as obstacles to getting listed. Secondly, as there is no liquidity, the cost of capital is higher than with private placements. Then, companies may be reluctant to disclose information on the market. Finally, when privatised to foreign companies, they may have access to lower cost financial resources from their foreign mother company. Moreover, they do not want to be exposed to the risk of large stock price fluctuations or even manipulations caused by the low development of local stock markets.

346. The limited supply of good stocks is reinforced by a lack of demand. Indeed, there are very few new investors on these markets, and stocks are mainly traded between existing participants. SEE stock exchanges are sometimes described as being only inside games between brokers.

347. Besides the current general slowdown in world markets which accentuate problems in SEE markets, investors are reluctant to invest on SEE stock exchanges because of low liquidity, lack of confidence and lack of legal protection for minority shareholders. Foreign investors may initially have invested indiscriminately in these emerging markets, and then been trapped in their investments. Some of them are now trying to exit these markets without losing too much money. They sometimes achieve this by sending their minority shares to majority investors that would be willing to de-list.

348. For these reasons, there is a current trend towards the de-listing of companies. Indeed, as explained above, the underdevelopment of securities markets makes the listing unattractive. An excessive number of JSC have been created and listed through the privatisation programmes. They have somehow been made public “by force” without any good rationale for their being listed.

349. Consequently, SEE stock exchanges are having a hard time fulfilling their traditional roles in terms of funding and disciplining through the threat of take-overs. Nor do they serve as a reliable source of information or corporate evaluation. Indeed, SEE stock exchanges may be considered inefficient, in the sense that market prices do not reflect any true or even reasonable value of the companies. Market prices are highly volatile and usually well below accounting net asset value.

350. In order to overcome these structural development difficulties, SEE stock exchanges will have to gradually attract and select companies well-suited to be listed. In order to increase liquidity, some exchanges have turned to cooperation with more developed stock exchanges. Given the common characteristics of the SEE stock exchanges, regional co-operation may indeed be the appropriate solution. Such cooperation could help in harmonising rules and regulations, enhance possibilities for dual listings, provide direct links between the exchanges to their respective databases or develop common trading platforms.

351. Pension reforms may contribute to the development of stock markets. By late 1990, the pension (as well as health insurance) systems in the whole region became financially unsustainable with large unfunded pension liabilities. Difficulties derived from structural imbalances. Pension reforms have thus been undertaken in a number of SEE countries. A common feature of these reforms is the introduction of pension funds which potentially may become important owners of equity.

352. This pension reform may constitute the impulse necessary to boost the market. As pension funds start to accumulate money, companies may have more incentives to be listed, in order to profit from this potential demand for equity and to be able to make IPO within the next two years.

353. Nevertheless, there is a great divergence of opinion regarding pension funds' likely effective potential impact on the development of the regional financial markets. Stock exchanges tend to consider this as their "last-chance" for development. The World Bank underlines the low contribution levels but still believes that it could constitute a source of capital for industry, growing gradually from 0.5% to 2% of GDP in the next 20 years. However, many players remain sceptical concerning this new industry. The new pension funds are either considered as being the possible first movers in breaking the self-strengthening vicious circle of no-demand – no offer of securities, or much too weak in the short run to break the standstill.

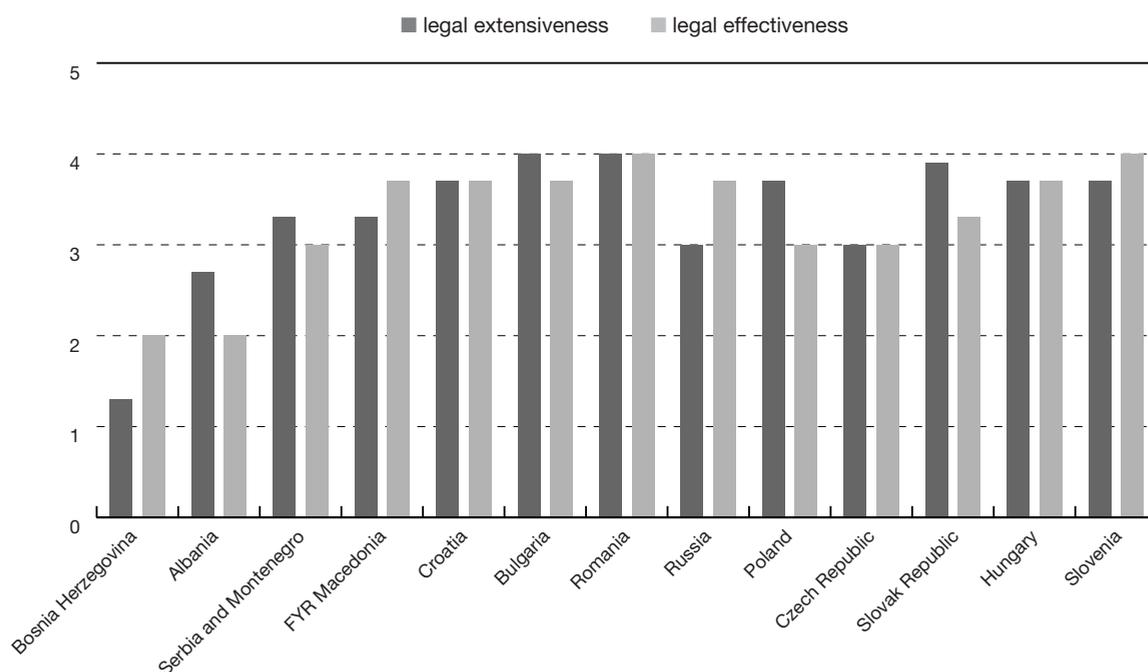
The legal framework

354. Issues of corporate governance are usually regulated mainly by two sets of laws, company law and securities law. In addition, the bankruptcy law and labour law have also an impact on the corporate governance framework.

355. In almost all SEE countries, company laws have been adopted at an early stage of the transition, as they provided the legal framework for the transformation of SOE. Securities laws have been adopted later on in conjunction with developments of the financial markets. Bankruptcy laws have been adopted or significantly amended quite recently.

356. The company and securities laws adopted have been both largely copied from or inspired by foreign models and drafted from scratch. Resulting company or securities laws are for the most advanced SEE countries of good quality. This is especially the case after the adoption of a number of amendments and adjustments over the last two years to remedy drawbacks or loopholes in the legal framework. Nevertheless, depending

Graph 12. **EBRD ratings of legal extensiveness and effectiveness (company law)**



Source: EBRD Transition Report 2002

on respective legal traditions and also on the origin of technical assistance provided for drafting securities laws, in a few cases there are still discrepancies between company law, based on continental models of civil law, and securities law based on Anglo-Saxon models of common law.

357. The good quality of the legal framework is reflected in EBRD “extensiveness” legal indicators, which in most cases compare favourably with more advanced transition countries.

358. Nevertheless, the main legal difficulty lies in implementation and not in unsatisfactory legislation, as is usual in transition countries. As a typical example, current amendments to the laws are trying to address specific abuse that could have been dealt with within the existing legal framework, had it been correctly applied.

359. The underlying fundamental legal difficulty is the weakness of the judicial and administrative systems unable to enforce shareholders’ rights or, more generally, commercial law. Consequently, regulatory frameworks may be considered as satisfactory or even good, while *de facto* corporate governance practice remains quite poor. This discrepancy is reflected in turn in the difference between SEE country scores in EBRD “extensiveness” and “effectiveness” legal indicators.

360. Courts usually lack sufficient human and financial resources, resulting in very slow settlements of disputes. More particularly, there is an acute lack of trained and impartial judges in commercial and company law.

361. Given this very poor legal implementation, companies and managers may continue to behave as they wish and to breach even elementary rules with relative impunity. Absence of law enforcement creates unfair competition and general distrust among trading partners. Arbitration procedures which were generally accepted and enforced could greatly improve the situation.

362. The weaknesses of legal enforcement will not be solved in the short term. More generally, enforcement and implementation are among the major obstacles and challenges to corporate governance reforms. Indeed, there is a great discrepancy between the corporate governance framework, i.e. legal provisions regarding corporate governance, and actual corporate governance practice. This underlines the crucial roles that have to be played by administrative authorities, regulators and self-regulatory organisations to develop sound corporate governance practices by ensuring a minimum level of enforcement of shareholders’ rights.

GLOSSARY

STAKEHOLDERS

Individuals or groups, in addition to shareholders, to whom the board judges on occasion have an appropriate interest in, and/or influence over, the company's operations and the achievement of the company's goals. Such groups include mainly creditors, employees, suppliers, customers, the community and the environment

CHAIRMAN

The person (of either sex) who heads the board and leads its business.

EXECUTIVE BOARD MEMBER

A board member who has a senior management position as well as being a member of the board. As managers or executives, they are paid employees of the company. In addition they have full board responsibilities.

NON-EXECUTIVE BOARD MEMBER

A board member who, broadly speaking, does not take part in the day-to-day operations of the company, and is not an employee of the company.

INDEPENDENT BOARD MEMBER

A non-executive board member who, by virtue of his position *vis-à-vis* the company, its shareholders and its management, brings great impartiality and objectivity to the board's deliberations. It is generally felt that in order to qualify as independent a board member should not have (or be perceived to have) an inherent conflict of interest with the company or those close to it. He/she should have no business or contractual relationship (other than a service agreement as a board member) with the company and should not be under the undue influence of any other board member or group of shareholders. Various groups of institutional investors have suggested types of connection which in their view compromise independence.

Annex C

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Annex D

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WHITE PAPER ON CORPORATE GOVERNANCE IN SOUTH EAST EUROPE

This White Paper was developed by the participants to the South East Europe Corporate Governance Roundtable and contains recommendations and priorities for reform. The Corporate Affairs Division of the OECD served as the Secretariat for this work which was carried out under South East Europe Regional Programme of the Centre for Co-operation with Non-Members (CCNM). The South East Europe Corporate Governance Roundtable was launched in 2001 in co-operation with the World Bank and is a Regional Flagship Initiative of the Investment Compact, under Working Table II of the Stability Pact for South East Europe. The Roundtable also received financial support from the Global Corporate Governance Forum. This report is part of the OECD's ongoing co-operation with non-member economies around the world.



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