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SHAREHOLDER RIGHTS, EQUITABLE TREATMENT AND THE ROLE OF THE STATE

Shareholder Rights: in Mongolia

by **Econsulting**

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SHAREHOLDERS' RIGHTS IN MONGOLIA

Background: development of joint stock companies

The first corporations, or according to Mongolian laws, joint-stock companies¹, were established in Mongolia in 1992 by corporatisation of state-owned enterprises and their privatisation. Initially ownership of shares was highly dispersed with about 86% of Mongolian population becoming owners of nearly 500 companies. The natural result was little power and interest of shareholders to control corporations' affairs.

Since the launch of secondary market trading in 1995, some shareholders started to buy up shares of others. The government also sold several additional companies through the stock market. As a result, concentration of shares increased. As the process approached its end result – maximum concentration of shares in hands of a few shareholders – share trading activity slowed down, powers of a few shareholders increased, but powers of most shareholders remained the same or even deteriorated.

Basically, it has been the government who nourished and continues to nourish the stock market by setting the stock market infrastructure, by selling its companies through the stock exchange, by regulating them, by launching government bonds, etc. The government is currently contemplating the issue of selling the remaining, most valuable state-owned companies through the stock exchange.

Despite these efforts, the number of listed companies decreased to 400, de-listing being one of the major reasons. The value of transactions on the stock exchange has done from 10.8 billion togrog² in 1998 to under 2 billion togrog in 2001. Market capitalisation in US\$ at end-2001 was only 7% higher than at end-1998. However, the TOP-75 index increased by over 3 times, suggesting that while the market in general has become less active, shares of the leading companies were traded actively. The number of companies whose shares were traded was about three-quarters of listed companies on average in 1998, while by 2001 this number rapidly decreased to one-quarter of companies.

Compared with a few years earlier, in 2002 the Mongolian Stock Market is in much worse shape. The reasons for this include:

- Small number and limited profitability of companies
- Poorly enforced shareholders' rights and weak awareness of shareholders' rights
- Limited interest of the majority of shareholders and absence of institutional shareholders
- Stock market infrastructure geared towards scrupulous recording and reporting, but not towards enhancing the speed and functionality of the market
- A culture of cronyism
- Absence of recognition by both companies and potential shareholders of benefits of being listed

¹ By definition of the Company Law, a company listed on the Stock Exchange

² Mongolian currency, currently at Tg 1100 per US\$.

- A large tax burden that compels most companies to evade them, an option more difficult to pursue if a company is a publicly listed company.

While these issues are intricately interrelated to each other and all deserve attention, in this paper we will discuss shareholder rights as facilitators or deterrents to the stock market activity.

In many cases it had been very difficult to find information and often we used estimates and anecdotal evidence in preparing this report.

Introduction: who are they?

The first companies in Mongolia emerged since 1990. Before that, economic value was created mainly by state-owned enterprises, cooperatives and collective farms.

Corporations were initially established by incorporating state-owned enterprises and issue of shares equal to their state-owned capital. None of the privately companies raised any funding through IPOs.

Since shares of these companies were exchanged for vouchers that were issued to Mongolian citizens, the initial shareholders were only Mongolian individuals. No foreign or domestic company or organisation owned other companies' shares. A total 470 joint stock companies were created in this way, with their owned by 1.3 million Mongolians.

Establishment of the Securities Committee and creation of the legal and regulatory framework for opening of secondary market trading during 1994-1995 allowed trading of shares of these 470 companies on the stock exchange.

It was then when numerous small shareholders started to sell their shares. During 1995-1998 shares of companies the process of share concentration was very intensive. By 2000, controlling packages of shares of about 95% of companies were owned by 1 or 2 persons on average. Altogether, over 500 people owned controlling shares of these 470 companies.

Partly due to the history of creation of corporate companies, and partly due to illiquidity of the stock market, institutional investors have not actively invested in shares. Another reason is strict regulation of banks that does not allow them to hold shares in excess of 20% of their capital. Given ample demand for loans, banks had been at best slow to invest in shares. Thus, there has been almost no occurrence of shares owned by banks or financial institutions, with the exception of limited cases when banks had to do foreclosure on some corporations that defaulted on their loans.

Insurance companies are prohibited by law to invest in assets as risky as shares.

As in all post-communist countries, pensions were the prerogative of the government in Mongolia. Still, pension funds do not exist, although the government is planning to enable creation of private pension funds.

About 30 securities companies that buy and sell shares for profit are another type of institutional investors. Their shareholding is, however, not very constructive for improvement of shareholders' rights.

Corporate groups are more characteristic of limited liability, or closed, companies. One can say that in Mongolia it is the other way round: there are many limited liability

companies that are larger than corporations. While in the strict legal sense these are not corporations, they are closest to definition of corporate groups. They operate in the financial sector, mining, education, services, trading, etc.

The government, through the Stock Exchange, is by far the largest institutional shareholders. But most of its remaining valuable enterprises are not listed companies. Presence of the government rapidly shrunk in the past 5 years and currently, there are 56 companies, of which 39 companies with over 50% of state ownership.

Protection of shareholder rights: design, but not enforcement

Shareholder rights are ensured, protected and regulated by the Company Law, the Law on Securities, the Law on Accounting, the Law on Auditing, and the Civil Code, as well as regulations and rules issued by the Stock Exchange and the Securities Committee. The major and the most detailed legal document is the new Company Law issued in 1999 replacing the old Law on Companies and Partnerships. The Company Law specifies core shareholder rights and forms of their enforcement.

The legal framework is generally in place and in dealing with many aspects of shareholders' rights it is quite elaborate. But the problem is of the rule of law: in many cases provisions of laws are 'imported' and have little applicability in the case of Mongolian listed companies; in others, they exist, but given wide-spread reluctance to follow them and small, uncertain or erratically imposed sanctions, they do not have sufficient power; sometimes they simply entail too large costs to justify the benefits of compliance.

Ownership rights

Registration. The law stipulates that joint-stock companies must keep their records of shareholders, or they may outsource this function to an authorised institution, in our case, the Stock Exchange.

In practice, registration of shareholders is the domain of the Stock Exchange, to whom most companies 'outsource' their registration. It maintains a register of all shareholders of all companies whose shares are listed on it. Since most of trading of shares takes place on the Stock Exchange, the system automatically records transactions, thus resulting in relatively little disputes regarding share ownership.

It is a convenient arrangement, because trading of shares of most shareholders (small shareholders), many of whom are located outside Ulaanbaatar (where the stock exchange is located), takes place through securities companies that deal directly with the Stock Exchange.

However, the negative side is inadequate security of transactions. Although share transactions require shareholders' signatures, specimens of signatures are not kept and this creates a potential for forging the signatures by securities companies. Such incidences occurred several times.

Transfer of shares. While serving to protect shareholders' rights, registration requirements inhibit prompt trading of shares when they are excessive. The existing Securities Law creates just this. It has not been amended since 1996, and strongly reduces the ease of share trading. According to the law, any investor willing to buy 20 or

more percent of shares of a joint-stock company have to submit a tender offering to the Securities Commission. The ensuing bureaucratic procedures inhibit the speed of transactions.

The law also provides for the right of shareholders to give and receive shares, in addition to buying and selling them.

Dividends

The right to receive dividends is explicitly acknowledged as the basic right of a shareholder in the Company Law. The law also requires dividends to be paid within a certain period after their announcement, and obliges the company to pay a fine to the shareholder if the deadline for payment was exceeded.

However, less than 10 listed companies regularly pay dividends, while about 70 companies pay dividends erratically and about 100 companies haven't paid dividends at all.

Business is underdeveloped in Mongolia and there is little scope for companies to earn profits. In addition, limited financing possibilities compel companies to generate finance internally.

The law requires the board to report to shareholders why dividends have not been paid.

As in many other cases, companies often pay their dividends through the Stock Exchange and securities companies. As a result, announced dividends paid by the companies are accumulated at the Stock Exchange. In some cases shareholders themselves do not bother to pick up their dividends, as they are too small.

A case of a money recently lost by the Stock Exchange as its correspondent banks went bankrupt has received a widespread attention. Although the loss of dividends (of about \$300 thousand) was not large, it involved the rights of many small shareholders.

The Securities Commission reports that not announcing dividends is the most frequent complaint by shareholders.

Participation in decisions on major corporate changes

Decisions on some forms of reorganisation of a company (mergers and acquisitions, demergers and changing the status of the company) and changes to the Charter require approval of general shareholders' meetings. Specifically, these issues need approval by two-thirds of the participating shareholders.

Decisions on major and conflict-of-interest transactions are made by the Board of Directors. In case of major transactions, if at least one of the board members disagrees, the issue must be decided by the shareholders' meeting. In case of conflict-of-interest transactions, if its value exceeds 2% of assets or shares, the decision is made by the shareholders' meeting. Generally, there have not been reported cases of bringing such transactions to the shareholders' meeting for approval.

Shareholder meetings and access to information

Shareholders' meetings. Participation and voting in shareholders' meetings is recognised as one of the fundamental rights of shareholders. The quorum for

shareholders' meeting is set at 50% by the law. This is one of the several cases when companies may set a larger quorum in their Charter.

The law specifies elaborate procedures of convening meetings, counting votes, determining voting shareholders, etc. However, most of these provisions do not find application: only over a quarter of 400 listed companies are reported to regularly hold their shareholders' meetings.

Even where shareholder meetings are convened, only large shareholders, shareholders who live nearby, or employee-owners participate in shareholder meetings and vote on the raised issues.

The law also provides for 'external voting', when ballots may be collected by means other than in person. While external voting is allowed only for irregular meetings, companies tend to do external voting for regular meetings as well.

Access to information. The law requires joint-stock companies to prepare and deliver annual reports, and information on decisions of general meetings, which must be delivered to shareholders. In addition, shareholders may request and obtain from the company information on related parties. Regulations of the Stock Exchange offer a detailed list of information companies must submit. For the most part, the list includes standard company-to-shareholder information, such as interim and annual reports, decisions on dividends, decisions and minutes of shareholders' meetings, decisions on reorganisation, changes in management, etc. But some other requirements are excessive and burdensome: information about cases filed against the company, information on new products and services, etc.

The Securities Commission, jointly with the Mongolian stock exchange, started to publish consolidated financial reports of 50 leading companies in a Stock market publication.

In addition, while authorities report about little practical implementation of information requirements, it might be the case that companies deliver information to directly to shareholders.

Equitable treatment of shareholders: where the power is

The laws of Mongolia provide for equal treatment of shareholders in accordance with the number and type of shares they own.

The new Company Law contains a number of provisions on the rights of minority shareholders, such as selection of board members by cumulative vote in order to enable representation of minority shareholders on the board, the obligation of the company to redeem shares of small shareholders if they disagree with reorganisation of the company, setting a wider approval on important issues (2/3 of the voters), etc.

As well, some provisions allow companies to determine the quorum of shareholders meetings and the percentage of approvals to make some decisions effective, in their Charters

While these provisions intend to protect the rights of minority shareholders, its enforcement is fraught with difficulties.

The ongoing case of APU company, the major distillery, is illustrative in this respect. A private shareholder owned about 40% of the company. When the government decided to

sell its 51% of shares, all of them were bought by another company. Since the charter of the company set a quorum of 2/3 of shareholders, higher than 50% specified in the Company Law APU's shareholders are now unable to come to an agreement on fundamental issues.

The law does not offer a definition of a minority shareholder, leading to differing interpretations of the concept.

In reality the majority of small shareholders deal with their companies through securities companies in receiving shareholder information, notifications to convene general shareholder meetings, ballot sheets, etc. In some cases, shareholders may vote through securities companies. This creates a potential for abuse of their rights.

The law provides a possibility to shareholders disagreeing with decisions of the general meeting to request redemption of his/her shares by the company. But there are two caveats: 1) because the market is illiquid, sometimes it is not clear at what price should the shares be redeemed, 2) the general shareholders' meeting may decide to waive the redemption right.

Both in law and in practice, foreign shareholders are treated equally with Mongolian individuals or companies. At least there is not much complaint about this issue. Currently, about 30 foreign shareholders are registered on the stock exchange. This includes foreign shareholders who own the controlling package of shares.

In early 1990, shares of most companies were owned by the government. As a result of the waves of privatisation, currently shares of only 56 listed companies are owned by the state. The government plans to privatise all of them in the next two years.

According to the law, government representatives to the board (in accordance with the share owned by government) is not elected, but directly appointed. Also, the government does not have the right to vote for selection of non-government representatives to the board.

In practice, deficit of the state budget pushes the government to force the companies to pay the government's share of dividends. After elections the government embarks on a process of replacing its representatives to companies' boards, thus disrupting continuity and sustainability of governance.

The new Company Law also provided for a new concept of shares – Golden shares. These are not shares in the strict sense, but the right of the government to have a say in the matters of the company if it sells over 50% of its shares at once and if the company can have effects on social and economic issues on a large scale. While this provision has not been exercised so far, it will be, during the upcoming privatisation of most valued companies. When and if it is enforced, it will be a very binding provision on new shareholders.

Violation and abuse of shareholder rights: leveraging power for personal gains

Asset stripping and self dealing

In early 1990s ownership of shares was highly dispersed, as was mentioned above, leading to a natural consequence: limited oversight of shareholders of dealings of the

executive management of companies and the resulting asset stripping phenomenon. Abuse of powers by executive management was especially strong during 1993-1994.

But since opening of secondary market trading in 1995, shares were increasingly concentrated in hand of a few. As a result, the executive management of companies during 1998-1999 was mostly replaced. Nowadays it is more often the case that the controlling shareholders serve as managers. However, the rights of majority of shareholders – minority shareholders remain frequently violated, and it has become a problem on its own.

According to the law, the shareholders' meeting appoints a Supervisory Body, which may consist of one person.

Related party transactions

The Company Law includes the following persons in the definition of related persons: 1) governing persons – executive management and board; 2) shareholders owning 20 or more percent of shares of the company; 3) and family members of the above.

The law requires that transactions with related parties are approved by the board or shareholder meetings, but hardly any transactions go beyond the board. Naturally, most such transactions are of little, if any, value to the company.

Shareholders owning in excess of 1% of shares of a company may appeal to court if he/she considers that a related party transaction infringed his/her rights.

Since sanctions for such dealings are uncertain, there is little chance that a shareholder challenging such transaction would win the case should he/she appeal to court.

It appears that in Mongolia related party transactions are more of a problem, as is characteristic of small communities.

Insider trading and share dilution

Dilution of shares is not very common, but occurred several times. In this case small shareholders have a preferential right to buy, on a pro-rata basis, the new shares. But this legal requirement is seldom enforced. Often it is the case that the persons who would buy newly issued shares are identified first and the new issue is sold to them directly. This practice of untransparent dealings is not punished by certain sanctions, a situation which encourages such incidences.

Enforcement and legal redress: the weakest part

Shareholders have the right to initiate for a legal redress for damages caused by them, to be compensated for damages by applying to relevant authorities.

There are several agencies that deal with shareholder complaints: the stock exchange, the securities commission, courts and the state property committee (with regard to the government as a shareholder)

However, the phenomenon of shareholding emerged in Mongolian less than 10 years ago, and often employees of the authorities often do not have the skills, competence or time to address shareholders' complaints. In addition, the complaint process often requires lots of time and energy to go through all the bureaucratic procedures, and most complainees leave the futile effort.

Similar is situation with the judicial system. While the court decision is final and irreversible, most employees in the judicial branch of the government have limited, if any, experience, expertise and skills in dealing with this kind of cases and few shareholders seek for justice in courts.

Another channel to obtain a legal redress is the Securities Commission The Securities Commission monitors operations of not only shareholding companies, but also securities companies and the Stock Exchange.

The Securities Commission carries out routine and special investigations, identifies and sanctions incompliances and responds to shareholders' complaints. Since recently, the Commission started to appoint its experts to assist the courts and law enforcement agencies in cases related to shareholders rights.

Still, understaffed organisation result in slow response and focus on mechanical, rather than fundamental resolution of an issue.

Another body is an arbitration body under the Chamber of Commerce and Industry; however, this body only deals with disputes of companies with companies. There has not been a history of dealing with shareholders's cases, and the Law on Arbitration does not provide for this.

The Stock Exchange is a 100% state-owned company. State ownership prevents effective implementation of a concept of self-regulation. The government is, however, planning to privatise the Stock Exchange, separate the depository and the payments system from the Stock Exchange, and establish an arbitration body that deals exclusively with shareholders' rights.

Shareholder awareness and shareholder associations: knowledge is power

The rights of shareholders are quite adequately protected by the law. However, the majority of shareholders are poorly educated regarding their rights as shareholders specifically and about corporate governance in general; many are not interested to know more about these rights. Privatisation of state-owned enterprises for vouchers distributed to the people is the strongest reason for this indifference. Where shareholders invested in shares by cash, the situation is entirely different.

While legal provisions for protection of shareholders' rights are quite adequate, the law is silent on the issue of punishment for violation of these rights, creating difficulties for law enforcement authorities. Where sanctions are specified, they are too small to discourage misdealings.

A widespread solution is to adopt regulations that set stricter sanctions, but law are superior to regulations when it comes to courts.

No official association to protect shareholders' rights had been established so far. There have been individual occurrences of small shareholders getting together and taking an approach opposing the large shareholders.

There had been several attempts to establish a shareholders' association. They invariably encountered an obstacle – who should be the shareholders whose interests they represent and protect – would it be large, or small, or all shareholders? An association of all shareholders is too large an issue and as such, these initiatives had always failed.

Conclusion: solutions lie broader

Strengthening shareholder rights requires a concerted effort on the part different government bodies, including the high-level bodies, companies and shareholders. A much stronger effort is needed on enforcement of existing laws and regulations, supported by more enabling legislation.

- Reorganisation
- Public education targeted at new, existing shareholders and management of joint-stock companies
- Encouragement of institutional shareholders
- More liberal bank regulation
- Strengthening regulation by the Stock Exchange
- Better use of information collected on joint-stock companies
- Strengthening of the judicial system
- Create an arbitration body that deals with shareholders' rights

Annex: The legal and Regulatory Framework providing for shareholder rights

Existing:

The Civil Code of Mongolia, revised in 2000

The Constitution of Mongolia, 1992

The Company Law of Mongolia, 1999

The Securities Law of Mongolia, 1994

Rules and regulations of the Securities Commission:

- Regulation on delivering notifications of shareholders meetings and obtaining votes
- Regulation on receiving and implementing tender bids and offers
- A list of information considered insider information
- A list of persons considered insiders
- Regulation on detailed register of securities
- Regulation on trading of shares, their payments and deposits
- Regulation on registration
- Regulation on securing powers of shareholders

Rules and regulations of the Stock Exchange:

- Regulation on trading of securities
- Rules on information to be supplied to listed companies

The Law on the Property of the Central and Local Governments

Pending:

Revised version of the Securities Law

Amendments to the Company Law

Publishing of the OECD principles of corporate governance