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SHAREHOLDER RIGHTS, EQUITABLE TREATMENT AND THE ROLE OF THE STATE

*Shareholder Rights, Equitable Treatment and the Role of the State
in Georgia*

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**The Global
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INTRODUCTION

Corporate ownership structures

Current corporate patterns in Georgia are only in part shaped by the local projections of the global or regional powerful trends - democratization, market-oriented legal and institutional reforms, privatization, enforcement of the rule of law, etc. The new values and nominal transformations in most cases serve only as a drapery for old power patterns, as strong and operational as before. In other words, actual social and economic relationships are determined by long established informal ties between financial/political groups, while formal institutionalized relationships play predominantly the role of façade. Redistribution of forces, based on new system, new structures, and new laws will need much more time and significant efforts.

The major corporate patterns serving the interests of the above financial/political groups are presented in the Table 1.

Table 1. Major Corporate Patterns

Type of Company	Legal Form	Newly Est-ed	Gov. Ownership %	Gov. Shares controlled by	Foreign Partner	West. mgmt	Stock Exch Flootation		Example	% of production
							Potent	Actual restr.		
Strategic	Ltd	N	100	Branch Min	No	N	High	Yes	Poti Port Railroad	15
	JSC	N	95-100	Branch Min	Yes	N	High	No	Madneuli Copper Rustavi Metal Power Stations	14
	JSC	N	95-100	Foreign Partn	Yes	Y	High	Yes	Power Stations	10
Semi-strategic	JSC	N	50-100	Branch Min	No	N	High	No	Kutaisi Auto	5
	Ltd	N	51	Branch Min	Yes	N	High	Yes	Georgian Telecom	3
	JSC	N	51	Foreign/Geo Partner	Yes	N	High	No	Zestaponi Ferrous Alloys	3
Large / Medium (excl. banks)	JSC	N	20-25	Branch Min	75%	Y	High	No	Tbilisi Power Distribution, ChiaturManganese	10
	JSC	N	0-10	Branch Min	>50%	Y	High	No	Ksani Glass Tea/Wine Factories	5
	JSC	N	0-10	Branch Min	N/portf	N	Low	No	Kutaisi Mill	5
	Ltd	Y	0	-	Yes	Y	High	Yes	GGMW, GWS, Magti, Geocel	10
	Ltd	Y	0	-	No	N	Low	Yes	Iveria +, Omega	5
Banks	JSC	N	0	-	Y (portf)	Y	High	No	UGB, GEB	3
	Ltd	Y	0	-	Y/N	Y/N	High	Yes	TBC, Kartu	6
Small	Ltd	Y	0	-	N/Y	N/Y	Law	Yes		6

Official data on the ownership structure in the large Georgian companies is absent. From publicly available sources (i.e. Ministry of State Property Management) only some fractions of the data (i.e. size of government holdings) can be obtained.

One of the best sources may perhaps become the National Securities Commission of Georgia (NSCG). According to the Law on Securities Markets, all owners of at least 5% of so-called 'Reporting Companies' (e.g. companies having 100 or more shareholders or traded at the stock exchange) must provide reports about such holdings to the NSCG. Hopefully, in the near future, NSCG will fully enforce this requirement.

Profiles of shareholders

The major shareholders in large and medium Georgian companies are the government, foreign companies or funds, local holding companies, banks and individual investors.

The role of corporate/financial groups (FG) is significant. However, as it was mentioned above, few of such groups are formally established. Hence it is not easy to trace all the arrangements they employ to exercise their control.

In different cases given in the Table 1 FGs exercise different forms of control:

- A. Where government has more than 50%, there are three options: a) these shares are controlled by branch ministry; b) via contract are given into management (nominee holding) to foreign operator; or c) via contract are given into management (nominee holding) to local company. In the case (a) control by FG is maintained by appointing directors/managers and by influencing branch ministries. In the case (b) – by establishing certain relationships with the foreign operator (in many cases these foreign operators are brought in the country by FGs and are lobbied by them). In the case (c) they maintain control more directly.
- B. Where government has less than 50 percent of shares, as a rule there exists a major shareholder controlling more than 50 percent. In most cases, these are former (or acting) managers allied with some FG and/or foreign investor. Often, the privatization pattern of the company is lobbied by such FG.
- C. In the newly established companies FGs exercise direct control (often together with foreign partners).
- D. Companies established as joint ventures of the government and foreign/local partners is very interesting form of indirect (opaque) privatization. In such cases government officials (adhering to the interests of FGs) are able to pump significant amount of state assets into privately owned (and controlled) companies. As a rule such companies enjoy various kinds of monopolistic benefits granted to them by government.

Unfortunately, most frequently, in cases A and B interests of the minority shareholders are practically ignored. Official profit is hardly ever reported by such companies. Only insiders benefit from the company operations. Even in cases when company generates tremendous losses, the insiders still may enjoy significant unreported profits. No surprise, attraction of outside investments is possible only via special arrangements between controlling FGs and investors.

In case C the interests of all shareholders are usually treated equitably. There are more chances to generate official profit. However, the proportion of reported activities varies depending on the presence of foreign partners and degree of westernizing of the local partners/management.

In case D private partners enjoy all the benefits generated by their monopolistic positions.

1. PROTECTION OF SHAREHOLDER RIGHTS

It may be admitted that in Georgia the core legal, regulatory and institutional corporate governance framework is in place. Protection of shareholders rights is the essential part of this framework.

Legislation. The Law On Entrepreneurs (LOE) adopted in 1994 became the legal foundation for corporate governance in Georgia. The Law regulates all types of companies from sole proprietorship to joint-stock companies. Based on German corporate legislation it reflected classical concepts of continental law. Though quite progressive for the time, it contained number of deficiencies related, first of all, to the regulation of joint stock companies. In 1999, with the aim to develop the capital market in Georgia and increase shareholder protection, Georgian Parliament significantly amended the Law. These amendments were based on the suggestions by US, German and Georgian experts and reflected current international best practices in corporate governance. Another law serving the cause of shareholder protection is the Law on Securities Market (LOSM) drafted with the assistance of US experts and adopted in December 1998.

Regulation. Since 1999, when the National Securities Commission of Georgia (NSCG) was established, there is a state institution with the major mission to protect investors – and first of all – shareholders. Using its rights to issue regulations, to license, to control and enforce, NSCG gradually becomes an important and effective agency for protecting shareholders rights.

a) Ownership registration and transfer of shares

The LOE and LOSM define the basic procedures of share ownership registration. According to the Article 51 of the LOE, the record in the share register certifies shareholder's ownership title. Under the LOSM, shares of JSCs with 100 or more shareholders or of those traded at a stock exchange (Publicly Held Securities) shall be dematerialized and the share registers be maintained by an independent securities registrar. Such securities registrars are subject to licensing and supervision by NSCG in accordance with the LOSM and NSCG Temporary Regulation on The Maintenance of Share Registers. Issuers of shares that are not Publicly Held Securities may either maintain the register by themselves or use the services of independent share registrar. The companies maintaining in-house registers, however, must comply with the above Regulation.

In addition, according to the Article 10.3 of the LOSM, the proof of ownership of Publicly Held Securities, where a nominee owner holds such securities, are the records of such nominee owner.

The key weakness in ownership registration lies with the companies that have fewer than 100 shareholders and maintain the share register themselves. The Temporary Regulation covers companies with in-house share registers, but the NSCG has no authority to supervise such companies.

Under the Article 52 of the LOE, the company charter may limit share transfers by requiring the consent of the company for the transfer to be implemented. The 1999 Amendments to the LOE reduced the ability of company managers to restrict the transfer of shares. The amended Law requires the restrictions on share transfers be specified in the company charter and written approval of the restrictions be given by all shareholders. Furthermore, the company is obliged to approve any transfer unless such would endanger the essential interests of the company. Also, in the Parliament Decision, which approved the Amendments, there was a transitional provision by which all share transfer restrictions existing in a company charters prior to the adoption of the Amendments were automatically declared void unless supported by the written consent of all shareholders. Prior to the 1999 Amendments, the NSCG received numerous complaints

from shareholders about company management refusing to honor their request to transfer shares. However, following the implementation of the amendments, NSCG has received no further complaints regarding such cases.

According to the LOSM, trading of Publicly Held Securities shall be conducted only via licensed brokerage companies. Besides, shares admitted for trading at the stock exchange may not be traded outside it. The Georgian Central Securities Depository (GCSD) conducts the clearing and settlement of securities trades at the stock exchange, where GCSD acts as a nominee holder of the shares. Transfer of ownership takes place upon recording of such transfers at the level of GCSD.

Due to the small size of the Georgian securities market and the low capitalization of the clearing and settlement infrastructure the GCSD works on a pre-payment basis, allowing for the same-day DVP (Delivery Versus Payment) settlement of trades. The GCSD plays a vital role in the efficient and transparent operation of the securities market.

b) Dividends

According to the LOE, to participate in the company profits is a generic right of a shareholder. Common shareholders can receive dividends proportional to their share in equity, upon the satisfaction of claims by preferred shareholders. The Law also states that in the case where shareholder have not yet paid in full for the shares purchased through initial public offering, such shareholder may claim only the respective portion of dividends. However, no such cases been registered yet.

Based on the annual report and the proposal from the managing directors, the Supervisory Board submits to the general meeting of shareholders a proposal for the distribution of profits. If the Supervisory Board and the directors do not agree on the proposal, two separate proposals are presented to the shareholders' meeting. However, the poor state of financial reporting in Georgia means that the annual report provides little reliable indication of company profits, thus reducing the ability of shareholders to judge whether they are treated fairly.

Today, against the background of 60 to 80 % of Georgian economy being in shadow, significant part of joint stock companies' profit remains unrecorded, thus available to be shared by a small group of insiders. This is one of the major reasons for which most of such companies are of little attraction to outside shareholders/investors.

c) Participation in major corporate changes

According to the Article 54 of the LOE, the general meeting of shareholders has the exclusive authority to:

- 1) amend the company charter (in particular, to change the charter capital, company name, the type of activity, and to take decision on the company liquidation);
- 2) decide on mergers and transformations;
- 3) approve the purchase, disposal or exchange of assets in excess of 50% of company's total assets book value (unless otherwise envisaged by the company charter);
- 4) cancel the preferential treatment of existing shareholders when increasing charter capital or issuing convertible bonds;
- 5) approve the company's annual report;
- 6) decide on the proposals by the Supervisory Board or directors concerning the use of profits;
- 7) elect and recall the members of the Supervisory Board that represent shareholders;
- 8) approve the Supervisory Board member salaries;
- 9) elect the auditor and special controller;
- 10) make decisions regarding court actions against the directors and members of the Supervisory Board; and
- 11) make decisions on other issues under the LOE.

According to the LOE, the authority of the general meeting of shareholders is limited to the areas specifically defined under the Law. Also, it should be noted that there is no provision to allow the general meeting of shareholders to invalidate the decisions of the directors or the Supervisory Board, apart from decisions within the specific authority of the general meeting of shareholders.

At least 3/4 of the shareholder votes present are required for the approval of mergers or transformations and cancellation of shareholders pre-emptive rights. Decisions to amend company statutes (in particular, change the authorised capital, company's name, the authorised subject of activity, and to take decision on its liquidation), or on the use of company profits may be made by at least 2/3 of votes present. Other decisions may be made by 1/2 of votes present.

Under Article 59 of the LOE, the shareholders' meeting must approve all authorisations of new capital, although the Law does allow company directors to determine the timing of the share issuance. Under Article 59.2, the shareholders' meeting may set the upper "permitted" limit of the authorised capital, whereby for a period of five years the directors are authorized to issue new shares up to the limit thus set. Each issue must be approved by the supervisory board. Under the NSCG regulation, the private or public sale of a significant amount of additional securities is considered to be a material event and must be disclosed to the NSCG and the relevant stock exchange within 15 days.

In addition, Article 59.4 allows the shareholders' meeting to increase the company's capital in the form of "conditional capital" (which may include convertible shares) to provide shares to employees or "fulfil the measures of acquiring capital". The article also requires that the shareholders' meeting define the period and the conditions under which the conditional capital may be issued so that the decision of the issuance of capital is not subject to a decision of the managing directors or the supervisory board.

However, the pre-emptive rights of existing shareholders are clearly maintained, even in conversion of debt to equity. Such conversion would increase the company's charter capital, which requires the approval of a shareholders' meeting in which 2/3 of the voting capital participating in the meeting approves the increase. Under Article 59.7 the new shares must first be issued to existing shareholders. Only in the case that shareholders refuse to exercise their pre-emptive rights are creditors permitted to exchange their debt for shares. Note also that the conversion of debt to equity also requires an independent valuation under Article 59.1 of the Law.

The LOE does not specifically discuss the voting for extraordinary transactions that result in the sale of the company. As for the decisions on the opening or cessation of specific business lines, within the limits of general framework defined by the company charter (see above), – these are the responsibility of a Supervisory Board.

d) Access to information

The basic information about the companies is registered in enterprise registers maintained by 60 district courts. Under the LOE, enterprises must file the key information with the enterprise registers in the district where they legally reside. This includes the amount of authorized capital, names of the directors and supervisory board members, and the distribution of capital among founders. Names of new shareholders (changes in ownership) for joint-stock companies are not included in such registers. In principle, under LOE, the information in the enterprise registers is publicly available and key legal information about companies is accessible. However the system suffers from two weaknesses: 1) the administrative practices of the enterprise registers vary among districts, with some court clerks arguing that the information is confidential and cannot be disclosed to third parties while other clerks allow unknown visitors to borrow the files and make their own photocopies; and 2) the system is neither centralized nor available online,

reducing the ability of shareholders or other interested parties to gain easy access to the key information on Georgian companies. The Supreme Court is developing a plan to set up a centralized electronic network within the judiciary. This would include a website that would provide online access to the court information such as that in the enterprise registers.

As mentioned above, the reporting companies maintain shareholder registers with independent share registrars. In such companies shareholders have the right to get information about the amount of shares in their possession in the form of abstract from such registers.

Under the Article 11 of the LOSM, all reporting companies shall prepare and submit to the NSCG and the stock exchange where such companies are traded, as well as to publish or distribute to the registered owners: a) annual reports; b) semi-annual reports; and c) current reports.

The annual report shall be prepared for each fiscal year of the company and contain data about the issuer, its activities, directors and members of supervisory board, persons who hold or control more than 5% of the votes in the general meeting, financial statements certified by an auditor, and other information and in such form, as may be specified in NSCG regulations. Semi-annual reports shall contain financial statements of the reporting company, information about material events that occurred during the accounting period, and such other information and in such form, as may be specified in NSCG regulations.

A current report shall be filed following any material event, as defined in NSCG regulations, which occurs after a company becomes a reporting company. The current report shall be filed within 15 days of the event that is the subject of the report. The form and content of such a report is also stipulated by NSCG.

Under Article 12 of the LOSM, directors and members of supervisory board of a reporting company shall file with the NSCG a report specifying the percentage of the company's securities, of which he/she is a beneficial owner. If the securities of such company are traded on a stock exchange, the report shall also be filed with the stock exchange. Any changes in the information filed shall also be filed with the NSCG (stock exchange). The form and content of the report is determined by NSCG regulations. The report shall be filed within 10 days after: a) such company becomes a reporting company; or b) such person becomes a member of the managing body.

Under Article 14 of the LOSM, a person, acting independently or together with other persons (a "group"), shall inform 1) the NSCG about the substantial acquisition of securities in the manner prescribed in regulations adopted by the NSCG, 2) the issuer whose securities are being acquired, and 3) any stock exchange where the securities are traded. Substantial acquisition of securities means beneficial ownership of securities, which provide 5% or more of the voting rights in a reporting company and also when level of beneficial ownership changes by more than five percent from that originally reported. Notification about substantial acquisition of securities shall be submitted to the NSCG within 15 days, or such shorter time period as may be prescribed in NSCG regulations, from the date the level of beneficial ownership is changed. A person who fails to inform the NSCG, the issuer, or the relevant stock exchange about substantial acquisition of securities, shall, upon the discovery of such failure by NSCG or stock exchange, lose at the next general shareholders meeting all the voting rights associated to such securities.

After the inception of the LOSM, the NSCG commenced the awareness campaign among reporting companies to clarify their reporting obligations under the law. Only after this awareness campaign, including 'open houses', conferences and training courses, NSCG started the gradual enforcement of the provisions above. As a result, today about 2/3 of the reporting companies providing such reports and about half of them satisfy to a degree the NSCG requirements regarding the form and timeliness of such reporting. As for the reporting of substantial acquisitions, due to the efforts of the brokerage community and NSCG, both Georgian Stock Exchange and NSCG regularly receive appropriate reports. No cases of violation of this requirement have been registered yet.

As it was mentioned, the reports are filed with the NSCG and the stock exchange, though practically none of them have been published or distributed to the shareholders, as required by the Law. Reporting companies may provide excuse referring to high costs of publication or distribution of the reports to the shareholders, which in most cases may be true. If NSCG would start penalizing reporting companies for such formal non-compliance with the letter of law, most of the reporting companies would exert substantial efforts to reduce the number of shareholders below 100 and thus become non-reporting companies. The result will be detrimental for the shareholders, which, in such cases, will have even lower access to the relevant information. Constructive solution of the problem will be publishing of the reports on the websites of the NSCG and/or Georgian Stock Exchange. However, though these organizations have such plans, currently their financial resources are insufficient for the implementation of such project, especially if the reports are to be published both in Georgian and English. Today any shareholder may come and read the reports at NSCG or the Georgian Stock Exchange or copy them at his/her expense.

Another issue of concern is the quality of financial information provided in the reports. Though, under Georgian legislation all joint stock companies shall follow International Accounting Standards and have all financial reports audited by an independent auditor, the quality of the audit in most cases is questionable. Although some regulations do, the Law on Audit Activities does not require auditors to adhere to the International Audit Standards, what, in practice, makes auditors liability quite symbolic.

e) Shareholder meetings

Under the LOE, two classes of shares may be issued: preferred and common. All common shares have voting rights. Preferred shares are non-voting, but the company statutes may permit voting in cases of non-payment of dividends.

Regular general meeting of shareholders must be held once a year, within two months after the financial statements have been prepared. Extraordinary general meetings may be convened by the company directors or the Supervisory Board, or at the written request of the holders of at least 5% of the authorized capital of the company. However, practice shows that many joint stock companies in Georgia fail to hold regular shareholder meetings. Though, lack of accurate statistics makes it difficult to assess the exact scale of the non-compliance with this legal requirement.

Under the LOE, the Supervisory Board shall define the Record Date for the determination of the shareholders eligible for participation in shareholders' meeting. The shareholders' meeting must be announced at least 20 days in advance. The notice must include the agenda, recommendations of the directors and Supervisory Board regarding proposed decisions, and any possible changes to the company statutes. There are no legal provisions stating where the shareholders' meeting should be held, such as in the city of the company's headquarters. Description of the procedure enabling a shareholder to verify his/her right to participate in the meeting, within 10 days before the meeting, should be attached to such notice.

Notification is to be given by registered mail to all shareholders owning 1% or more of the shares. Besides, the announcement must be published in the mass media. For reporting companies, the NSCG will need to determine the requirements for notification of shareholders with less than 1% of shares and the selection of media for the published notice.

However, unreliable postal system and the presence of some 400 thousand small shareholders (or almost 10% of the total population) increase the difficulties of distributing routine notices of shareholders' meetings. Tracking the dates and locations for shareholders' meetings through media is also very difficult due to the large number of publications in which the announcement could be made. Determining by NSCG of media for publishing of the notices would greatly simplify this process.

Under the LOE, up to ten days before a shareholders' meeting, shareholders have a right to present written questions to the directors and the Supervisory Board seeking to clarify the items on the agenda. In case of no answers have been given to the questions, these should then be regarded as a part of the agenda. Refusal to answer the questions must be in writing and can only be justified as being required to protect the essential interests of the company.

Participation (representation) via proxies is allowed, but the LOE provides little detailed guidance on the procedure. For example, the Law does not require that a nominee holding a proxy cast the vote in accordance with instructions from the shareholder. Nevertheless there appear to be few cases of abuse of proxy votes. Article 17 of the Law on Securities Market regulates proxy solicitation for Publicly Held Securities. However, it is largely referring to the NSCG regulations, which are not in place yet.

A general meeting of shareholders is authorized to take decisions if the owners of at least 50% of the authorized capital are present. If the quorum is not met, a second meeting may be held at which 25% of the capital owners must be present. If a quorum is not achieved for the second time, a third meeting may be held at which there is no minimum level of shareholders needed. Voting procedures are not clearly specified by law or regulation.

2. EQUITABLE TREATMENT OF SHAREHOLDERS

Georgian corporate legislation (LOE and LOSM) ensures equitable treatment of all shareholders, including minority ones. However, there are no special provisions regulating foreign shareholders or the state as a shareholder.

a) Treatment of minority shareholders

Special attention is paid to the protection of minority shareholder rights.

Under Article 53.3.2 of the LOE, shareholders with 5% or more of the authorized capital may demand a special inspection of the company's economic activity and annual balance, if they suppose there are violations. In case the general meeting does not satisfy their demands, the regional court in the territory where the company is located may make the decision on the special inspection.

Under Article 53.3.3 of the LOE, shareholders - owners of at least 5% of the authorized capital, have the right to call for a special meeting if the interests of the company so require. The demand is to be presented and motivated in written. If the directors do not hold the meeting within 20 days from the date the demand is made, the shareholders may appeal to the court of the district where the company is registered

Article 53.4 of the LOE requires that a dominant shareholder who knowingly uses his/her/its position to cause damage to the company's interests must compensate the other shareholders. A dominant shareholder is defined as a shareholder, or group of shareholders acting in concert, which has the ability to control the outcome of voting in a shareholders' meeting.

A shareholder or group of shareholders having 20% or more of the company shares can have at least one representative in the Supervisory Board. Under Article 54.8 of the LOE general meeting of shareholders may agree on cumulative voting for election of the members of Supervisory Board. However, since this is not mandatory requirement, practically there are no cases of using it. For better protection of shareholder rights it is desirable to introduce mandatory cumulative voting.

b) Treatment of foreign shareholders

There are no specific corporate governance provisions relating to foreign shareholders. In practice, there are cases of both preferential and detrimental treatment of foreign shareholders, depending of the nature of informal relationships within a specific company. However, as a rule, foreign shareholders (even minority ones) have deeper pockets to defend their rights and/or better access to the international media or even political tools, which makes the prospects of legal redress more likely.

c) The state as a shareholder

There are no specific corporate governance provisions regulating state as a shareholder. However, in practice one can notice number of peculiarities related to the companies where the state has a stake:

- i. Companies where state has controlling shares, as a rule, are far from being transparent. This, first of all, is achieved though organizing them in the form of a limited liability company (LLC) instead of a joint-stock company (JSC). Level of transparency in LLCs is much less than in JSCs. The largest and most attractive Georgian companies, such as Georgian Railway, Poti Port, Georgian Telecom are limited liability companies.
- ii. Even in cases of JSCs, the level of corporate governance in such companies is very low and the management style practically is still in the command economy era.
- iii. As a rule, corporate decisions, including profit distribution, are made in violation of legal requirements, though there are few cases when such violations were revealed or properly redressed.

3. VIOLATION AND ABUSE OF SHAREHOLDER RIGHTS

a) Asset stripping and self-dealing.

Asset stripping and self-dealing is one of the frequent shareholder right violations in Georgia. This common practice originates from Soviet period, then flourished during pre-privatisation period and now, if control is under the same group of "Red Directors" is still ongoing.

LOE defines fiduciary duties of company managing directors and of the members of supervisory boards. Under Article 9 of the LOE they should take all the efforts in conducting company activities in good faith, with the care that a person of ordinary prudence would exercise in similar circumstances, and in a manner that they believe to be in the best interests of the company. If they do not fulfil their obligations, they are jointly and severally responsible for the damages incurred. Abovementioned persons must prove that they did not infringe their obligations.

Article 16 of LOSM restates the above requirement of the LOE and, in addition, empowers NSCG to adopt regulations clarifying the rights of shareholders and duties to shareholders under this Article. Also, according to this Article, upon a finding by the NSCG that a member of the managing body has engaged in conduct prohibited by NSCG regulations and from which he gained a benefit at the expense of the reporting company's shareholders, the NSCG may: a) bar such person from being a member of the managing body of a reporting company for a stated period of time; b) petition the court to invalidate any related transaction/s; c) where such conduct has resulted in monetary damages to the company or its shareholders, require such person to compensate the company and its shareholders for such losses.

b) Related party transactions

There is no specific provision in corporate legislation regulating related party transactions for the managing directors or members of supervisory board. However, there is a provision in the Article 53.4 of the LOE limiting the right of shareholders to vote in cases where the decision relates to the transactions with them or the approval of their report.

c) Insider trading

Article 45 of the LOSM prohibits using insider information to: 1) acquire or dispose of shares of reporting companies, 2) disclose it to any third party unless the disclosure is made in the normal course of professional duties, or 3) recommend or procure a third party to acquire or dispose of the shares.

In addition, Article 14 of the Georgian Stock Exchange Code of Ethics prohibits member-brokerage companies from using information regarding the ownership of securities to create, increase or decrease purchases, sales, or exchanges of securities except when approved by the beneficial owner of the security.

Under the Code on Administrative Violations NSCG has the right to impose a GEL10,000 (about \$5,000) for abusive use of insider information.

It should be noted, however, that the effectiveness of any regulations on insider trading and self-dealing currently are limited by the low levels of liquidity of the Georgian Stock Exchange.

4. ENFORCEMENT AND LEGAL REDRESS

The NSCG may investigate violations of laws and regulations related to companies issuing Publicly Held Securities. Also, NSCG may impose administrative penalties for violation of securities market laws under the Code of Administrative Violations of Georgia. Decisions by the NSCG may be appealed to the court.

Decisions of the general meeting of shareholders, directors or Supervisory Boards may be appealed to the court when the procedures of taking such decisions have violated the law or the company charter.

Under the Article 53.5, shareholders can initiate derivative lawsuits in their own name. In particular, if a joint-stock company failed to pursue the claim against the third person the shareholder, on behalf and in the interests of the joint-stock company, may bring the claim to court. The shareholder will be considered as appropriate claimant if the company, within 90 days after written notification from the shareholder, has failed to bring the claim to court on its own or to provide a proof that such a claim is against the interests of

the company. In case the court rules in favour of the shareholder the joint-stock company is obliged, within the reasonable limits, to compensate the shareholder for the court expenses, including attorney fees, related to this claim. The company is discharged from such compensation if the company can prove that satisfaction of the claim is damaging for the company. If the shareholder is not accepted as an appropriate claimant or the claim is not satisfied, the shareholder has to compensate reasonable expenses the company incurs in connection with the claim. The court, taking into account shareholder's financial condition, may postpone the payment of the court expenses.

Also Article 53¹ of the LOE, unless otherwise is provided by the company charter, allows a shareholder to demand that the company redeem his/her/its shares if he/she/it did not vote in favor of: 1) a charter amendment that substantially violates his/her rights; 2) mergers, divisions or transformations; or 3) purchase, disposal or exchange of assets comprising more than half of the company assets book value. This provides some protection for shareholders who oppose decisions made by the shareholders' meeting on the issues above. Redemption of the shares shall not be permitted if: a) due to this redemption company's shareholders' equity becomes less than the minimum authorized capital required by LOE, or b) the amount required for the share redemption exceeds 25% of the shareholders' equity.

As was mentioned above, Article 53.4 of the LOE requires that a dominant shareholder who knowingly uses his/her/its position to cause damage to the company's interests must compensate the other shareholders. However, yet there were no cases of minority shareholders using this kind of redress. This is not only due to the low level of shareholders' awareness but due the low level of awareness of corporate lawyers as well. It should be mentioned that there are cases when this article could be used against the state as a dominant shareholder.

The LOE appears to provide for adequate protection and the equitable treatment of shareholders and adequate opportunity for shareholders to obtain effective redress in the court system. However, enforcement of these rights appears to be difficult due to the weaknesses of the court system, i.e. large case backlogs, lack of judges familiar with the issues presented in shareholder rights cases, and, occasionally, improper influences affecting the judicial process. Besides, Georgian legislation does not provide for class action lawsuits. Introducing class actions will significantly reduce litigation costs and will in practice simplify protection of minority shareholders rights.

Theoretically, self-regulatory enforcement for a shareholder is available in case a member of a self-regulatory organization (SRO) violates the shareholder's rights. At present, there are two self-regulatory organizations in Georgia - the Georgian Stock Exchange (GSE) and the Georgian Central Securities Depository (GCSD). Only brokerage companies may become the members of GSE. Members of the GCSD may be stock exchanges, brokerage companies, insurance and investment companies, banks and issuers of securities. In practice, however, only the violations of the rights of present or potential shareholders as of the clients of SRO member *brokerage companies* could be currently considered as a subject for self-regulatory redress, e.g. when such company violates the GSE Code of Ethics.

5. SHAREHOLDER AWARENESS AND SHAREHOLDER ASSOCIATIONS

It should be admitted that the awareness of shareholders about their rights is very low in Georgia. Most of existing shareholders emerged in the process of so-called mass-privatization, when all Georgian citizens were given an opportunity to invest their vouchers into privatized companies (or sell these at the market) and/or to receive the shares of such companies for free, as their employees. According to the Ministry of State Property Management of Georgia, there were about half a million shareholders at the initial stage of privatization. Now, through the consolidation process their number is reduced twice, as a rough estimate.

Most of these shareholders hardly have any idea about their rights. Only very small number of (more or less) sophisticated investors including institutional ones had full information about their rights.

Since 1998, due to the efforts of USAID Capital Market Development Project in Georgia, NSCG, Georgian Securities Industry Association and of all capital market institutions, the shareholders awareness has slightly improved, though it's still far from being satisfactory. There is no shareholders association in Georgia yet. Though there are initiative groups, which, hopefully, in the near future will found such association.

CONCLUSION

In conclusion, it could be stated that in Georgia basic legal and regulatory framework for the protection of shareholder rights is in place. Though, the above analysis suggests that the following recommendations (see Table 2) could be made for further improvement in this area:

Table 2. Recommendations for Improving Shareholder rights Protection in Georgia

#	Recommendations	Legislative	Regulatory
1.	Protection of shareholder rights		
a)	<u>Ownership rights.</u> The LOSM needs amendment for eliminating the two weaknesses below. The NSCG has no, control over private placements as well as companies with fewer than 100 shareholders. For companies that are publicly traded, the NSCG should have the authority over issuance of all securities, including placements to a small group of investors, since such placements affect the preemptive rights of existing shareholders. The lowering of the 100-shareholder threshold may also be considered, since there are many relatively large companies, able to impact the capital market considerably, but with the number of shareholders slightly less than a hundred.	*	
b)	<u>Dividends.</u> The current Law on Audit Activities should make mandatory International Standards on Auditing and set a minimum liability for auditing companies. International best practices suggest that the minimum liability should be set at a multiple of the authorized capital of the auditing company. This will improve quality of financial reports and increase shareholders chances for participation in real profits.	*	
d/e	<u>Access to information and shareholder meetings</u> <i>Information about enterprise registers.</i> The Supreme Court of Georgia is developing a plan to provide an electronic network within the judiciary. This would include a website that would provide online access to the enterprise registers maintained by district courts. <i>Information contained in the reports of reporting companies.</i> Publishing the reports of reporting companies, as well as the information on substantial acquisitions, on the websites of the NSCG and/or Georgian Stock Exchange (GSE) <i>Notification about shareholder meetings.</i> Tracking the dates and locations for shareholders' meetings through media is very difficult due to the large number of publications in which the announcement could be made. Determining by the NSCG in its regulations (envisaged by the LOE) of the media for publishing of the notices will greatly simplify the task.		*
2.	Equitable treatment of shareholders		
	<u>Treatment of minority shareholders.</u> Mandatory cumulative voting for members of the supervisory board should be introduced in the LOE. This will allow shareholders with small stakes to vote at least one member of the supervisory board.	*	

3.	Violation and abuse of shareholder rights			
a/b	<u>Asset stripping, self dealing and related party transactions.</u> In Georgian legislation there is no provision regulating the conflicts of interest of the members of supervisory board or directors in the specific transactions of the company. NSCG may consider preparing a regulation to require disclosure, for example, of any direct or indirect interests in a transaction, covering the extension of credits or sales (or pledges) of assets or securities above a certain limit.		*	
4.	Enforcement and legal redress			
c)	<u>Access to legal redress and its impact.</u> Introduction in the LOE of the class action concept might be very helpful. It will provide sufficient economies of scale to allow an individual shareholder to assume the high legal costs of litigation. With frequent changes in corporate and securities legislation, it is particularly difficult for lower-court judges and court administrators to stay current with the laws and their implementation. It is highly desirable to organize special training courses for judges on the corporate and securities legislation.	*		*
5.	Shareholder awareness and shareholder associations. Increasing of the shareholder awareness should become one of the priorities in practical protection of shareholder rights. Conferences, training courses, educational programs and materials for secondary and high schools – this is a small part of the focus area in this regard. Creation of shareholder associations will significantly assist in this process.			*

ANNEX

The Normative Acts Establishing and Protecting the Rights of Shareholders in Georgia.

1. **The Law on Entrepreneurs.** Adopted by the Parliament of Georgia in October 1994 and amended in June 1999.
2. **The Law on Securities Market.** Adopted by the Parliament of Georgia in December 1998.
3. **The Temporary Regulation on Maintenance of Share Registers.** Adopted by the NSCG in June 1998.