

Report by the South East Europe Corporate Governance Roundtable to the Preparatory Meeting of the Investment Compact Ministerial

Introduction

The South East Europe Corporate Governance Roundtable (“Roundtable”) was launched by the OECD in partnership with the World Bank Group as part of the South East Europe Compact for Reform, Investment, Integrity and Growth within the Stability Pact (“Investment Compact”) in 2001. The last meeting of the Roundtable, which took place in Istanbul on 16 and 17 February 2006, focused on the issues of enforcement of corporate governance rules and corporate governance of state-owned enterprises, as well as on a stock-taking exercise regarding the recent developments and future priorities in the field of corporate governance in the region. In addition, the Roundtable discussed priorities for its work programme and the organisation of its future work so as to maximise its impact in participating countries.

Many legislative and regulatory reforms have been undertaken in all participating countries over the last years. Corporate governance codes have been developed with the support of the business sector and stock exchanges have introduced good corporate governance tiers. The Roundtable was crucial for much of this progress, which has led to substantial improvements in the investment climate in SEE. In general, SEE capital markets have often outperformed those in other regions over the last years and, in particular, in 2005. A recent concrete example of the positive effects of the corporate governance reform process for companies in SEE is the successful privatisation of Banca Commerciala Romana, which could increase its book value from 1 billion Euro to some 6 billion Euro in less than three years after a complete reorganisation of its governance structures. In addition, companies, such as Pliva and Podravka in Croatia, adapted their internal corporate governance rules to comply with international best standards, in particular the OECD Principles of Corporate Governance and the recommendations in the Roundtable’s White Paper on Corporate Governance in South East Europe (“White Paper”), and have become internationally successful businesses. To capitalise on these positive developments at companies’ level, one of the Roundtable’s key partners, the International Finance Corporation (“IFC”) of the World Bank Group, has started a programme in four countries of the region aimed at supporting companies willing to enhance their corporate governance structures.

Despite the progress, further concrete work has to be undertaken to advance the reforms in the field of corporate governance in order to enhance the overall business climate in the countries of the region and to attract more investment, as set out in the recommendations of the Roundtable’s White Paper. A survey among Roundtable participants suggested that major shortcomings still exist across a range of priorities (see Annex 2 for a full summary of the findings), with a particular need to promote further progress in the areas of:

- Effective enforcement of corporate governance rules;
- Commitment of the private sector, and in particular of boards, to the corporate governance reform process;
- Effective application and enforcement of International Financial Reporting Standards and International Standards on Auditing

The SEE Roundtable is a recognised vehicle for corporate governance dialogue and sharing of experience in the region, and a reference point for policy-makers, legislators and market participants in their efforts to address corporate governance topics. The Roundtable is, therefore,

best suited to develop concrete policy recommendations of high quality on those reform priorities, so that the reform process in SEE will be further advanced. As set out in detail in the action plan below, the results of the work of task forces within the Roundtable framework and detailed reviews of the implementation of the White Paper recommendations on a cross-country basis can feed into the Investment Compact's work. In addition, the establishment of a so-called "Companies Circle" by the Roundtable (in co-operation with the Global Corporate Governance Forum and the IFC) will give greater visibility to SEE companies having benefited from an improved corporate governance framework, thereby serving as success stories for other companies in the region to follow.

For the SEE Roundtable to continue its successful work in improving the investment climate in SEE, and to accomplish these ambitious, but necessary and feasible tasks, it is crucial to have the support of Ministers of the Investment Compact (including the availability of sufficient funding for the Roundtable to continue).

Level of Progress in the Corporate Governance Reform Process

In the second half of 2005, the OECD Secretariat circulated a questionnaire among participants of the Roundtable in order to gather information on the status-quo and future projects in the field of corporate governance in SEE. The questionnaire focused on the six key priorities for reform identified in the White Paper:

- Strengthening of regulatory authorities to improve implementation and enforcement;
- Developing training for all parties and professions critical to good corporate governance practices;
- Increasing the commitment of the private sector to corporate governance reforms;
- Protecting minority shareholders against abuse by insiders and controlling shareholders;
- Reinforcing boards;
- Full convergence with international standards and practices for accounting, audit and non-financial disclosure.

Though the questionnaire was aimed at providing a more general overview without any ranking of countries, its results serve as a good indicator of progress, or lack of progress, and a means for identifying possible priorities for follow-up work of the Roundtable. Some 20 responses to the questionnaire were received prior to the meeting. In addition, detailed research and the discussions in the last Roundtable meeting provided further information that has fed into the following assessment. As to the overall results for the region, it can be noted:

- i. The White Paper and the OECD Corporate Governance Principles form benchmarks in the reform process both for regulatory and private-sector initiatives;
- ii. The legal framework is rather advanced, but, implementation and enforcement are still weak;
- iii. Governments are overwhelmed by the extent of reforms required, but are frequently hesitant to rely on self-regulatory efforts as a possible complimentary route in the reform process;

- iv. Stakeholders would still benefit from increased awareness of good corporate governance; and finally
- v. National and international entities working in the area of corporate governance should improve co-ordination, on the one hand, and ensure that companies they invest in become role models for good corporate governance in the region, on the other hand.

Respondents to the questionnaire also provided detailed information as to the key developments, the main obstacles and the future priorities in participating countries for each of the six key priority areas. A summary of the results can be found in Annex 2 to this report, so that here it suffices to say that progress in most of the countries is limited and more efforts are necessary in the future.

Action Plan for Future Work of the Roundtable

The actions set out in the following will generate tangible results for the region in the short and medium term, in particular, by developing concrete policy recommendations that support the formulation of policy priorities and reform of the corporate governance framework.

The Roundtable is a recognised vehicle for corporate governance dialogue and sharing of experience in the region and a reference point for policy makers, legislators and market participants in their efforts to address corporate governance topics. In Phase II of its work, which is focused on implementation and enforcement, the Roundtable's activities will become more concrete and result in more detailed policy recommendations, prioritised and adapted to the specific situation in SEE. This can be best achieved by the creation of small task forces of experts with a mandate from the Roundtable.

Increased participation from the business sector in the work of the Roundtable is a priority for the future. A first step in this direction will be the establishment of a group of companies, either having already a good record regarding corporate governance or taking concrete steps in this direction, that would serve as models for other companies in the region and share with each other and the public their experiences in putting principles of good corporate governance into practice (so-called "Companies Circle"). Moreover, the Roundtable and task forces will invite a greater number of private-sector representatives to participate in their work and use other ways of involving businesses even more closely (eg, public consultations of draft recommendations of task forces).

Finally, continuing participation of high-level officials from all participating countries, which are responsible for corporate governance reforms at the policy and legislative level (eg, government officials, members of parliament, heads of regulatory authorities), in Roundtable meetings will be an important objective, also as a means to ensure that the Roundtable's policy recommendations are applied in participating countries.

Taking into account the discussions in the last and previous Roundtable meetings and the results of the questionnaire mentioned above, the Roundtable considers the following issues as a priority for its concrete policy work in the future:

- o Effective enforcement of corporate governance rules:

The most significant improvements in the area of corporate governance in SEE could come from effective enforcement of existing laws and regulations. This not only concerns regulatory authorities and courts, but all mechanisms of enforcement, including alternative dispute resolution. The results of the questionnaire and additional research show that progress in this area has been limited so far, with several major obstacles remaining (lack of sanctioning powers and independence of regulators, limited co-operation and trust between authorities and private sector, etc.). It was the general view of Roundtable participants that enforcement should be a top priority in its work programme, particularly, in order to enhance the capacity, authority and resources of the regulatory authorities and to strengthen the expertise and capacity of the judiciary in relation to commercial disputes. The task force would not only gather representatives from authorities and the judiciary, but also experts from the private sector, and take account of projects already in place in the region (eg, reforms of the judiciary). The task force would also look at how to create incentives for better compliance with corporate governance requirements (eg, more comprehensive consultation practices of regulatory authorities, work undertaken by self-regulatory organisations).

- Commitment of the private sector, in particular of boards, to the corporate governance reform process:

The private sector, and here in particular boards, play a crucial role in improving the corporate governance of companies. However, too often, boards are not aware of the (economic) benefits of good corporate governance and their functions and duties, including their duties owed to the company and all shareholders. Most of the responses to the questionnaire and further analysis of the situation in SEE confirm that there has only been little progress in the reinforcement of boards: all board members, whether or not decided by controlling shareholders, should be aware of their fiduciary duties towards the company. Given the importance of boards for good corporate governance, both policy-makers and companies need to act rapidly to tackle this problematic area, for which the Roundtable should provide concrete recommendations.

- Disclosure of financial and non-financial information:

According to the White Paper, convergence with International Financial Reporting Standards (“IFRS”) has to be pursued, as it is indispensable for ensuring adequate quality, credibility and comparability of financial statements. Although a number of participating countries have adopted laws that implement IFRS and International Standards of Auditing, according to the review undertaken actual implementation and enforcement of those standards is not adequate in many cases, in particular, because of the lack of qualified accountants and auditors as well as of shortcomings in the implementation process (language, delays, etc). Therefore, further action by the Roundtable on these issues is considered a priority, which can include concrete recommendations as to training of the accounting and auditing profession, effective enforcement mechanisms and ways facilitating the transposition of IFRS and ISA in domestic law, which would be undertaken in close co-ordination with stakeholders in this field in the region.

An additional area of work, which the Roundtable will undertake, concerns information-gathering and data-collection exercises in specific areas of interest. A concrete example is the issue of de-listings of companies, which have been increasing in many participating countries. A survey would help to gather information on the extent, reasons and effects of de-listing to financial

markets in SEE, in order to help the Roundtable and decision-makers in the region understand better what actions may be necessary to promote more vibrant and active capital markets.

The Roundtable participants consider it important to conduct more detailed reviews of the level of progress in the region, on a cross-country basis (focused on areas requiring special attention, such as enforcement or the role of the board), in particular, on the basis of the recommendations of the White Paper, taking also into consideration World Bank Reports on the Observance of Standards and Codes regarding participating countries. This will enable policy-makers, especially, to identify remaining shortcomings, to compare and contrast their own situation with developments in other countries in the region, as well as to observe (positive) trends in the area of corporate governance. Moreover, such reviews will be of great use for the Roundtable, when undertaking concrete work in such an area. In addition, the results of those surveys will regularly be brought to the attention of Meetings of the Investment Compact.

Finally, the Roundtable is of the view that the need for awareness-raising, in particular, among small shareholders, is still great, and that the Roundtable should regularly discuss the different policy approaches taken in participating countries in this area in order to identify and promote good practices for achieving this objective.

Annex 1

Background Information on the South East Europe Corporate Governance Roundtable

The OECD Principles of Corporate Governance are one of the Financial Stability Forum's twelve key standards for the promotion of a sound international financial architecture. One of the primary vehicles for raising awareness and promoting the Principles' use in developing and emerging market economies are regional corporate governance roundtables organised by the OECD in partnership with the World Bank Group, including the South East Europe Corporate Governance Roundtable, launched in 2001 as part of the Investment Compact. Participating countries of the Roundtable are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Romania, as well as Serbia and Montenegro. The main objectives of the Roundtable are to serve as a forum for policy dialogue, to raise awareness in South East Europe as to the importance of good corporate governance, and to formulate best practices for the region.

Each meeting of the Roundtable has gathered some 70 core participants from eight countries in the region, including representatives from all stock exchanges and securities commissions, market participants, experts from several OECD countries, as well as representatives from multinational organisations and bilateral agencies. Roundtable participants are the most prominent, active and influential corporate governance players in the region, and form a peer group that can press for regulatory as well as private-sector action in the respective countries.

In Phase I of its activities, the Roundtable, in a participatory approach, developed the White Paper, setting out a series of recommendations and key priorities for reform in the corporate governance area. The Roundtable has had impact in several areas, including, legislative and regulatory changes in company law in each participating country, adoption of corporate governance codes, introduction of special corporate governance tiers on stock exchanges, and creation of corporate governance institutes and associations.

The Roundtable has now begun Phase II with the main emphasis on actual implementation and enforcement of the recommendations and key priorities of its White Paper. Even though countries in SEE have made significant progress in corporate governance over the last years, which can be concluded from Roundtable participants' input to the stock-taking exercise and related research undertaken by the OECD Secretariat, it is important to maintain the momentum for reforms and to put in place credible enforcement mechanisms, so that markets are reassured that corporate governance reforms in SEE are shifting towards global standards, thereby improving the investment climate and business development in the countries concerned.

Annex 2

Results of Questionnaire as to the Progress in the Corporate Governance Reforms in SEE

Key Priority I – Strengthening of Regulatory Authorities

- **Little/some progress**
- **Key developments**
 - Reform strategy on the judiciary (FYROM)
 - On-line access to case law (Romania)
- **Obstacles**
 - Limited or no (financial) sanctioning powers of regulators in corporate governance (“CG”) field
 - Lack of qualified staff
 - Resistance to reforms from within the judiciary
 - Lack of trust in effectiveness of enforcement
- **Priorities for future**
 - Safeguards for independence of regulators and judiciary
 - Better co-operation between regulators and courts
 - Build trust between authorities and private sector
 - Improve consultation practices of regulators
 - Need for arbitration and other ADR mechanisms for cost-effective enforcement

Key Priority II – Commitment of the Private Sector

- **Little/some progress**
- **Key developments**
 - CG codes (Croatia, FYROM, Serbia) and requirement of CG programmes of listed companies (Bulgaria)
 - Launch of CG Institute (Romania) and CG Forum (Albania)
 - CG award (Bulgaria)
- **Obstacles**
 - Many companies not voluntarily public, but because of mass-privatisation
 - Lack of institutional investors for driving reforms in companies
 - “Good CG” tiers of stock exchanges not increasing investors’ interest
- **Priorities for future**
 - “Cleaning-up” of markets
 - Explain benefits of good CG to companies in a better way
 - Support efforts to create CG code

Key Priority III – Better Training

- **Little/some progress**
- **Key developments**

- Increased number of training programmes for key stakeholders (Albania, FYROM, Montenegro)
- Launch of CG Institute (Romania)
- Lawyers’ and accountants’ associations advanced in their training programmes
- **Obstacles**
 - Lack of interest of the private sector in taking part in training (“I know it anyway”-attitude)
 - Lack of training programmes taking into account local characteristics
 - Limited number of courses at universities specifically dealing with CG issues
- **Priorities for future**
 - Better co-ordination by entities providing training
 - Enhance local capacities for training
 - Raise awareness as to need for better training

Key Priority IV – Minority-Shareholder Protection

- **Some progress**
- **Key developments**
 - Company Act fully or largely in line with White Paper (FYROM, Bulgaria)
 - Takeover Acts in place with protection of minority shareholders (FYROM, Croatia, Bosnia-Herzegovina)
 - Out-of-court redress mechanism for small shareholders (Serbia)
- **Obstacles**
 - Unclear rules on related-party transactions and insider transactions making enforcement difficult
 - Effects of mass-privatisation
 - Protection of shareholders of non-listed companies considerably reduced compared with listed companies
- **Priorities for future**
 - Educational efforts targeted at small shareholders
 - Establishment of effective shareholders’ associations and low-cost redress mechanisms
 - Sufficient investigatory and sanctioning powers for regulatory authorities

Key Priority V – Reinforcing Boards

- **Little progress**
- **Key developments**
 - Requirement of independent directors and criteria for independence (Bulgaria, Serbia)
- **Obstacles**
 - Majority shareholders regard board members as their “delegates”
 - Lack of understanding of function and role of boards
 - Specialised committees exceptional
 - Concentration of ownership
 - Board members rarely taken to court for breach of fiduciary duties
 - State-ownership

- **Priorities for future**
 - More training
 - Raise awareness among boards and shareholders

Key Priority VI – Convergence with International Standards and Practices for Accounting, Audit and Non-Financial Disclosure

- **Some progress**
- **Key developments**
 - Applicability of IFRS (Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FYROM, Romania)
- **Obstacles**
 - Shortage of qualified accountants and auditors as in impediment to correct application and enforcement of rules
 - Disclosure of non-financial information not satisfactory
 - Translation of international standards often not by experts in this field
 - Different accounting standards for financial institutions and listed companies result in inconsistencies
- **Priorities for future**
 - Increase number of qualified accountants and auditors
 - More effective financial reporting supervision and enforcement
 - More effective auditor oversight mechanisms