

Eurasian Roundtable on Corporate Governance
Kiev, October 19-20 /2000

Synthesis note

Summary

Faced with the need to press ahead with privatisation and the restructuring of enterprises, corporate governance has become a topical issue in transition economies of the former Soviet Union. In response to the growing awareness of the impact of corporate governance among public and private decision-makers and donors in the region, the OECD and the World Bank Group have decided to launch **a regional policy dialogue forum** - the Eurasian Corporate Governance Roundtable - to encourage improvement both in the regulatory domain and in private practices.

Hosted by the Ukrainian Cabinet of Ministers, the first meeting of the Eurasian Corporate Governance Roundtable took place in Kiev, Ukraine on 19-20 October 2000. It has been organised with the support of the International Finance Corporation and the US Agency for International Development and sponsored by the Japanese Government, the World Bank-OECD Global Corporate Governance Forum, and the Canadian International Development Agency. Attended by over a 120 leading government and private sector representatives from Eurasia, selected international counterparts, academics, international financial institutions and OECD member countries the meeting primarily served as an overview of current corporate governance trends in the region with a focus on Ukraine.

Participating Eurasian countries included Ukraine, Moldova, Kazakhstan, Uzbekistan, Kyrgyzstan, Georgia and Mongolia. While these countries are at different stages of economic development, they are all undertaking steps to establish their corporate governance regimes and their legal and institutional framework in order to support long-term economic growth.

The meeting achieved its main objectives through a lively and frank discussion yielding important insights into the corporate governance framework in the region. The first objective was to present international trends in corporate governance and further raise the awareness of local public and private decision makers in order to create a better understanding of the fundamental role of corporate governance. Second to review the regional corporate governance landscape and framework in order to discuss areas for improvement. The roundtable also highlighted ongoing reform initiatives and had a first general discussion of key areas of corporate governance following the framework of the OECD principles. The Roundtable helped gain a greater appreciation of the challenges that lay ahead and ways to face them. Participants expressed their appreciation for the high quality expertise and acknowledged that:

- While the countries of the region have specific identities and perspectives due to their geographical, cultural and economical potential, they also face common problems due to the soviet legacy and need to share their experience to overcome these problems.
- The enforcement of good corporate governance practices in the region is closely linked with corporate restructuring efforts.
- From a policy perspective, adequate laws and regulations need to be adopted and enforced, by strengthening the institutional capacity of the judiciary and regulatory authorities.

- From a private perspective, business culture needs to be improved by raising awareness of how good corporate governance can be beneficial at the enterprise level. Business rules and ethics also need to be developed in order for an accountable and transparent corporate sector to emerge.

The following note attempts to summarise the key policy issues that were raised during the roundtable and outlines some of the main conclusions. It was drafted under the responsibility of the OECD Secretariat.

Corporate governance and its relevance to transition countries

The roundtable started with recalling the importance of Corporate Governance and its relevance to transition countries.

Corporate Governance has a two-fold meaning: It is a set of relationships between corporate agents through which enterprises are directed and controlled. It is also a structure, a set of public and private rules that specify the distribution of rights and responsibilities among different participants of a company such as its management, its board, its shareholders and other stakeholders. Participants agreed that corporate governance is part of the larger economic and social development picture that directly supports restructuring and development programmes in transition economies. It contributes to the establishment of the rule of law and the building of well-functioning institutions in a market economy.

International experts stressed that establishing good corporate governance is essential to create a competitive corporate sector that serves as a locomotive for economic development. In the context of more integrated and globalised financial markets and economies, effective corporate governance serves both the efficient use of domestic financial resources and the attraction of foreign investment. This is especially important for Eurasian transition economies where domestic savings remain relatively limited.

Except for a limited number of companies in the energy and telecommunication sectors, investment is scarce for enterprises in the region. Investment needs are being financed eventually from the corporations own revenues but mostly from sustained government subsidies and through accrued debts, which has increased overdue payable and receivables in the economy as a whole.

Countries of the region could benefit from a better access to international capital both in the forms of portfolio and foreign direct investments but they have to face international competition in attracting this capital.

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| <p>Corporate governance is important in the economic transition process in order to:</p> <ul style="list-style-type: none"> • Built well-functioning corporations and key private institutions for economic growth; • Efficiently allocate capital and contribute to the development of financial markets; • Attract investment to companies; • Enhance the rule of law. |
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At this stage weak corporate governance has emerged through out the region as a serious obstacle to the development of a sound private sector able to attract domestic and international investors. In order to participate in the global competition for capital, countries of the region need urgently to establish better corporate governance. Eurasian participants agreed that *corporate governance is a public policy concern* critical to economic growth. Good corporate governance practices cannot develop without appropriate public policy, without an adequate legal and regulatory framework. In most Eurasian countries such a framework is yet to be defined. For example, Ukraine has not put a joint stock company law in place yet. In other countries as Kyrgyzstan and Georgia, adequate legal frameworks have been set up but their enforcement still remains weak.

To begin with participants stressed that it is critical to establish credible and enforceable provisions for property protection, secure methods of ownership registration and the opportunity to obtain effective legal redress. These are pre-requisites for the mobilisation of capital. Reliable and transparent accounts are essential for making informed decisions about the allocation of financial resources among alternative uses. Proper procedures for internal corporate decision-making, the distribution of authority among company organs, proper incentives and established lines of accountability are important for effective monitoring. But without strong institutions that can uphold the rule of law, companies whether domestic or foreign will have trouble with enforcing contracts, collecting debts, and resolving disputes.

The weak regulatory and institutional infrastructure in the region makes corporate governance at the company level often the most important factor in establishing investor's confidence. Government initiatives are not enough. **Private sector action** is essential if good governance is to take hold. For private sector action to take place, managers need to be educated and persuaded that good corporate governance is vital for the monitoring and expansion of their business. Companies that adopt high standards on their own are able to attract investors even in a difficult context.

Participants agreed that corporate governance reform is driven by a multitude of public and private actions, from the adoption of legislation in the parliament and its implementation by the courts, to regulatory action, to professional codes and requirements, to individual company policies. While good corporate governance cannot exist without an adequate level of public governance, it will never take off unless the private sphere of the economy and its main players, the companies, become transparent, law – abiding corporate citizens. Awareness of this mutual interdependence should be at the centre of any reform effort.

Corporate ownership and control structures

During the last decade, essential structural reforms have been completed throughout the Eurasian region. They have resulted in substantial trade and price liberalisation and in a large shift in ownership from the public to the private sector. Privatisation is one of the most important reform efforts. Differences in ownership structure in Eurasian countries have developed from diverse approaches to privatisation. The roundtable examined the main characteristics of the changing Eurasian corporate ownership and control structures through selected country specific presentations.

While Ukraine and Moldova are trying to shift to exclusively cash-based sales, after years of voucher privatisation, other countries have introduced tender privatisation earlier as Kazakhstan. As a result Corporate ownership is still dispersed in Ukraine, while more concentrated in countries where the privatisation method led to significant ownership by strategic investors. In countries like Georgia and Moldova, mass privatisation has led to extremely dispersed ownership, since even small and medium size enterprises were privatised that way.

Mass privatisation programs were especially designed to create a broad ownership and thereby ensure public support for reform. However in most countries, privatised corporations have not yet performed in an efficient manner. A lot of the **old management patterns** have stubbornly persisted across the region. The roundtable referred to particularities of the Eurasian corporate environment related to the soviet legacy and its direct influence on corporate behaviour. Problems related to weak financial discipline and to the restructuring of social assets in privatised companies were quoted in particular.

Despite variations in the shareholder structure, control of the companies remains often in the hands of old style managers who continue to run companies with the wrong incentives. Shares acquired by employees or citizens have not been accompanied by a transfer of control, while strategic investors who obtained controlling packages in attractive firms have to deal with **strong resistance from insiders** in the restructuring process. Dispersed ownership leaves enterprise managers unchecked and able to use company

assets for their own means. Lacking the right incentives in most Eurasian countries, managers haven often, against the interests of shareholders and other stakeholders, diverted cash flows for personal gain instead of maximising company value. Shareholders have often seen their shares diluted by insiders' manipulations. Enterprises have been stripped of their assets by various means of transfer pricing and other insider transactions.

Enterprise performance can not be directly linked with the corporate ownership structure. All types of companies can demonstrate good governance and performance regardless of their corporate ownership structures. Conversely, under persistently unpredictable macroeconomic conditions and a weak legal institutional framework, even a 100% owner of a company might have more incentives to move assets safely offshore rather than leave them within their company.

Participants however stressed that **ownership and control rights need to be aligned** in order to avoid situations that encourage expropriation by insiders.

The corporate governance framework

Shareholder rights and equitable treatment

What is perceived as the region's unfavourable investment climate is, to a considerable extent, due to the **lack of credible investor protection**. Regional corporate laws do not establish sufficient legal rights for shareholders, as in Ukraine, and even when they do, as in Georgia or Kyrgyzstan, enforcement mechanisms and remedies against violation of shareholder rights are inadequate or non-existent. Share dilution was quoted as one of the most widespread violations in the region, notably in Ukraine. Mostly the laws do not provide a mechanism to guarantee the preemptive right to purchase shares of additional issues. A variety of creative ways have also been developed to deprive shareholders of the right to participate meaningfully in the general shareholder meeting. It was also reported that in many countries in the region, registration of shares is not very effective. It sometimes takes months or even years to register a change in the share ownership, which casts a doubt in the accuracy of the registration. Prompt registration of share ownership is one of the fundamental rights of shareholders. The registry system is an example of the institutional support for effective implementation of legal protection of shareholders.

In order to improve investor confidence and ultimately enable companies to have access to external capital, it is a priority to enhance the protection of shareholders and to strictly prohibit self-dealing and market manipulation. Protection of shareholder rights could be strengthened through the emergence of a set of intermediary market institutions that help keep shareholders informed and assist them in exercising their control rights. Professional associations and stock exchanges could notably contribute by raising public awareness.

In addition to protection of shareholder rights, fair and equitable treatment of all shareholders is one of the key principles of effective corporate governance. Protection of minority shareholders is generally very weak under the Eurasian laws. The interests of minority shareholders are often neglected by corporate managers and controlling shareholders, which do not hesitate to seek their own interests at the expense of minority owners. In particular information on related party transactions are not disclosed although it could effectively prevent abuses of power by managers and major owners in pursuit of their personal interests at the expense of other shareholders. Participants from Georgia and Kyrgyzstan stated that the basic problem remains that minority shareholders are often not fully aware of their rights or willing to exercise them.

The state as a shareholder

Privatisation has at this stage left a considerable degree of ownership and control in the hands of the State. It remains a majority shareholder in many large industrial enterprises and a minority shareholder in a number of other firms. Even though most countries of the region plan to continue their privatisation efforts, the process may remain slow due to political and social considerations. The roundtable therefore recognised the importance of discussing the role of the state as a shareholder in otherwise privatised enterprises and the need of setting up good Corporate Governance mechanisms in enterprises yet to be privatised.

Participants stressed that the state is often not a good owner of profit seeking corporations as decisions by the state are influenced by various policy considerations and political constraints. The state cannot sufficiently finance investments needed for company growth. Many stated that the state as shareholder and as regulator of corporate activity faces a conflict of interest difficult to resolve and might act in ways that violate the right of other investors. Evidence from Ukraine suggests that growth in 1999-2000 is due to the activity of private companies, while the state owned sector is still generating substantial losses. Hence, privatisation is still the priority in some countries of the region.

Some participants stressed that the state as shareholder can play a positive role in improving corporate governance. Participants considered that the state could be used to improve board structures. The government and its asset management institutions, i.e. State Property Funds, could adopt property management policies that force companies to have independent boards that take their monitoring role seriously. Directors could be trained to this effect. Important positive spill-over effects could be generated for private companies and the market as a whole, if the government were to become **a corporate governance pioneer** in a limited number of large companies in which it will keep stakes in the long term.

Transparency and disclosure

Disclosure and transparency issues are at the core of investor concerns. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to make informed decisions about the acquisition, ownership and sale of shares. Better disclosure also helps to improve public understanding of the structure, activities and policies of enterprises. With more transparency and accountability major shareholders or management will have less of an opportunity to strip assets at the expense of all the other stakeholders, and society as a whole. Good disclosure and transparency mean:

- better auditing of financial accounts;
- clarity of ownership and control
- better explanations of corporate performance
- The discussion highlighted that good corporate governance requires credible disclosure not only of the financial results, but also on non-financial issues such as ownership structures and ownership arrangements. For better corporate governance, disclosure of non-financial information is of critical importance. Management, often in alliance with controlling shareholders, has superior access to information and can manipulate the decision making process of the company to the disadvantage of minority shareholders.

Eurasian Securities commissions and stock exchanges should promote good governance practices and take the lead in introducing international standards and practices, both in terms of regulation and enforcement. They should take an active role in promoting disclosure by introducing more stringent listing rules. However, their influence is still limited as the markets are still in their infancy and enforcement is not always effective.

While some countries have moved towards the adoption of International Accounting Standards, practical implementation and enforcement of these standards has been difficult for the following reasons:

- contradictions with existing regulations;
- local accountants are unfamiliar with the new requirement;
- managers are concerned about the possible tax implications;
- enforcement by regulatory authorities is slow.

It was suggested that countries around the region should directly adopt International Accounting and Audit Standards, at least for the larger companies. The institutional infrastructure needs to ensure that auditors are independent and belong to strong professional organisations with high standards.

Responsibilities of the boards

The board is an important mechanism for monitoring management and providing strategic guidance. Members of the board are expected to act in good faith, with due diligence and in the best interest of the company and all shareholders. At the same time, the board must ensure the compliance of the company with applicable laws and take into account the interests of stakeholders. While primarily acting in the long-term interest of the shareholders, the board should also be responsible for ensuring the fair treatment of other stakeholders. The way a company is managed is not only of importance to shareholders but to all persons who may have a stake in the company. Corporate governance is concerned with finding ways to encourage the various stakeholders to undertake socially efficient levels of investment in human and physical capital. It is important that the corporate governance framework recognise that the interests of the corporation are served by recognising the interests of stakeholders and their contribution to the long-term success of the corporation.

Board structures of corporations in Eurasian countries differ depending on the legal framework. However, the role and responsibility of boards are in general vaguely defined in legislation and poorly understood in practice. Management is often unwilling to recognise the body which supervises its activities and many established joint stock companies don't have operating boards of directors. Hence, another challenge for the countries of the region is to establish effective corporate boards and to constitute a pool of qualified independent directors who can effectively carry out their responsibilities. Professional education and **training of corporate directors** is of particular importance for the establishment of good corporate governance.

The role of stakeholders

To enhance long-term success of a company, the role of stakeholders in corporate governance has been given increasing recognition in the international arena. Identifying ways to encourage the various stakeholders in the company to invest firm-specific human and physical capital is a dominant trend.

The roundtable recognised that the competitiveness and ultimate success of any business corporation is the result of the combined contributions from a range of different constituents, including employees and local communities. In relation to the role of stakeholders in corporate governance the roundtable engaged in discussions on how corporations can reach out and build long term relationships with employees, local communities and others affected by their operations. It was nevertheless pointed out that stakeholders do not constitute a homogenous group with a common agenda as they may sometimes have conflicting interests.

In Eurasia, stakeholders --especially employees-- receive little information and have little voice in corporate governance, despite the fact that they are also shareholders of their company. Employee presence could potentially be a powerful force for monitoring the fiduciary functions of managers and limiting self-dealing. However, at present, employee stakes are often manipulated through threats and strategic behaviour to consolidate the power of management and create bigger divergence between control and cash flow rights. Even though employees have the interest and incentives to play a full role in corporate governance, there are barriers that limit their effective contribution. In many companies, employees cannot in practical terms vote their shares. They have their shares voted en bloc by management.

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Sustaining the momentum for corporate governance reform

In the last session, the future works of the Roundtable were discussed. There was a large consensus over the need for the Eurasian Corporate Governance Roundtable to sustain the momentum for corporate governance reform. Further developments of the roundtable will contribute to raising the awareness of decision-makers on the issues that need to be tackled. Participants from Kyrgyzstan and Georgia have expressed their wish to host a future roundtable meeting. Many participants noted that tremendous challenges lay ahead, but pointed out that there is reason to be optimistic. There are examples of successes despite the daunting circumstances. Various companies are making the right choices and moving ahead; securities commissions each year are improving; new institutions such as shareholder protection organisations are forming; and, professional bodies such as those of accountants and auditor are actively training their large memberships in international standards.

Participants agreed that the overarching objective of the roundtable would further be:

- to serve as a central vehicle in the process of identifying key areas for improvement both in the regulatory domain and in private practice;
- to assist the countries of the region in developing public policy responses to perceived shortcomings, using the OECD Corporate Governance Principles as a conceptual framework;
- to set up of a regional comparative corporate governance progress review based on country specific input in order to compare legal frameworks, implementation policies, institutions and corporate practice in the region.

Given the significant differences in the regional corporate environment, the Roundtable activities will also pay due attention to country specific issues. Over the next 24-30 month, the Roundtable will meet periodically to discuss various aspects of corporate governance more in details. The issues to be covered should include: improved protection of shareholder rights (e.g. need for an effective registration system), stronger transparency and disclosure (e.g. improved accounting and auditing practices and information disclosure) and the establishment of clear responsibility and accountability of the boards as well as better understanding of the role of stakeholders.