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**"Institutional Investors And Corporate Governance Reform in a Transitional Context: The Case of Bulgaria"**

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**INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE REFORM IN A  
TRANSITIONAL CONTEXT: THE CASE OF BULGARIA<sup>1</sup>**

Institutional investors have a special role to play in corporate governance reform: they can mobilize a wide constituency of supporters or strengthen existing public fears of participation in transactions involving securities. This role is based on their dual status: on the one hand, they can be the major proponents of sound corporate governance as owners of stock, most often of a minority share, in publicly traded companies; in this respect, maximizing shareholder value constitutes their primary objective. On the other hand, the majority of these investors have multiple owners themselves, i.e. even if they are not publicly traded they can provide clear examples of good or bad corporate governance. It can be argued that good corporate governance on the part of the institutional investors themselves can go hand in hand with good corporate governance of the companies whose stock they own, and vice versa – disregard for corporate governance within the institutional investors can raise questions about their ability to promote it at these companies. One could predict the future of corporate governance reform nationwide by monitoring corporate governance practices within the institutional investors themselves. With regard to countries with economies in transition when thinking about this future it was expected that the entrenched interests against sound corporate governance would not be strong: if the appropriate pro-reform institutions were set up early enough, then the ultimate goal of maximizing shareholder value would not be hard to achieve. Institutional investors have been regarded in this context as a critical element of the general institutional

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<sup>1</sup> The work on this paper is part of a larger effort by experts from Bulgaria, Romania and the US on a comparative study of the role of institutional investors in Bulgaria and Romania in corporate governance reform, which is being carried out through the IREX Collaborative Research Program for the Black and Caspian Sea Countries in 2002/2003. The team includes Cristina Ioana Hodea of the Bucharest Equity Research Group, Ellen Greenberg of the American University in Bulgaria and Boyan Belev of the Center for the Study of Democracy in Sofia. Funding for this paper was provided by OECD; an earlier version was presented at the Third Southeast Europe Corporate Governance Roundtable, organized by OECD in November, 2002 in Zagreb, Croatia. The author would like to thank Dimana Rankova, Stefan Petranov, Tsanko Peevski, Ralitsa Againe and Ellen Greenberg for their help as well as Emanuela Ivanova for her valuable research assistance.

setup; moreover, one could say that success or failure of corporate governance reform in general is largely dependent on the involvement and performance of institutional investors.

I would argue, however, that if proper institutional safeguards are not in place in a transitional context, rather than promoting good corporate governance, institutional investors can turn into an obstacle to it. Newly created institutional investors can take advantage of the liberal regulatory environment; absence of strict enforcement and existing loopholes in the legislation to serve particularistic interests rather than maximize shareholder value. In a case of delayed reform (such as that in Bulgaria, for instance, which started 5-6 years after the start of the democratic transition), institutional investors can be captured from the very beginning by status-quo interests and pursue illiberal or anti-competitive policies as these interests have been strong enough to shape the newly adopted rules for their conduct. On the basis of the experience of the Bulgarian institutional investors I hypothesize that inappropriate legislative framework can cause a mutation in the emerging institutional investors, which, by the logic of their own genotype, have no chance to play a positive role in corporate governance reform and to help build healthy capital markets. My research has led me to believe that the majority of the emerging institutional investors in Bulgaria have effectively turned into a pillar of crony capitalism supporting the *status quo* rather than reform aimed at building competitive markets. The current state of corporate governance at or with the involvement of these investors can hardly make them a factor for the growth of capital markets, offer opportunities for mobilization of savings nationwide, add to the sophistication of the financial sector as a whole and ultimately foster economic growth and stimulate the competitiveness of the national economy.

The practices of Bulgarian institutional investors both as subjects and objects of corporate governance that have been analyzed in this paper provide ample evidence in support of my argument. I have given an assessment of the current state of affairs and tried to formulate predictions both on the progress of corporate governance reform in the country and the future of these investors as a whole; I have stopped short of making specific policy recommendations with regard to the regulatory environment and corporate practices because of the pessimistic conclusions I reached and with the hope that these conclusions may be wrong.

In Bulgaria, just as in most of the countries in Central and Eastern Europe, the universe of institutional investors consists of the former *privatization funds* (investment and holding

companies created as a result of mass privatization through vouchers or other instruments), *pension funds* (created as a result of the transition from a state-sponsored to a market-driven pension system), *investment funds* owned by foreign investors, as well as *banks* and *insurance* companies which invest in equity. Although any company which makes an investment could be technically called "an institutional investor", for the purpose of this study I define the term as a company with multiple owners, which is interested primarily in portfolio investments and derives its investment income from dividends on the shares owned and/or realized capital gains from asset sales. As a rule, an institutional investor holds minority shares; the corporate control exercised by such an investor is usually indirect – like the control exercised by individual investors who have pooled their assets with the institutional investor.

For the purpose of the analysis it makes sense to narrow the universe of institutional investors under consideration. First, the presence of foreign investment funds in Bulgaria is really limited – these are usually funds which invest in private equity and their investments in publicly traded companies are negligible. Bulgarian capital markets are underdeveloped and with a very low degree of liquidity; the volume of shares traded on the stock exchange is low.<sup>2</sup> In this situation, publicly traded companies are barely on the radar screen of foreign investment funds, so their corporate governance practices are not considered. Second, after the collapse of the banking system in 1996-1997, banks in Bulgaria were placed under very tight regulations. A number of them went bankrupt; the remaining ones have had to work under very strict limitations, so they were less in the business of financing companies through credit than holding these companies' current accounts and providing non-credit services. Investment in equity in the limited space permitted by law is not of serious interest for them. With regard to insurance companies, in addition to the tight government regulations we need to keep in mind the nature of the insurance business in the country: they don't have the size and analytical capacity to successfully participate in the equity markets. A large portion of these companies have a criminal origin (protection racket), so they came to this business for different reasons and if they really want to stay in it and gain legitimacy in addition to their legal status they need first to learn to survive in

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<sup>2</sup> The Bulgarian Stock Exchange – Sofia has provided the following statistics for year 2002: official trading of equities in market segment A: number of shares traded – 76,416; traded volume – 997,222 leva, number of trades – 45; official trading of equities in market segment B: number of shares traded – 436,948; traded volume – 2,124,737 leva, number of trades – 701; official trading of equities in market segment C: number of shares traded – 4,136,555; traded volume – 11,424,393 leva, number of trades – 5,754; unofficial trading of equities: number of shares traded – 15,428,564; traded volume – 69,547,312 leva, number of trades – 9,543. See (<http://www.bse-sofia.bg/index.php?page=Statistical+reports>).

the core business activities. Thus, portfolio diversification toward equity to the very limited extent permitted by the law is not among their objectives for the foreseeable future. For these reasons my analysis focuses only on the relevant institutional investors, namely, the former privatization funds and the pension funds.

### **1. Theoretical and Methodological Background**

The drive toward corporate governance reform has its theoretical justification in the literature on institutions and institutional change in general<sup>3</sup>, economics of property rights<sup>4</sup>, transaction cost economics<sup>5</sup> and positive theory of agency<sup>6</sup> in particular.<sup>7</sup> Thus, property rights have a major impact on the distribution of the costs and benefits of economic activity; transaction costs may hurt the ability of shareholders to exercise their property rights; different organizational forms evolve to deal with the agency problems, which arise from the attenuation of property rights. From this theoretical perspective one can observe variations in the models of corporate governance with two possible ends of the continuum – the “outsider” model, often called Anglo-American (known for dispersed ownership, separation of ownership and control, low debt/equity ratio and low ratio of bank credit to total liabilities, highly sophisticated and diversified financial markets, little incentive for outside investors to participate in corporate control, costly and

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<sup>3</sup> See, for instance, Douglas North, *Structure and Change in Economic History*, New York: Norton, 1981, James Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan*, Chicago: The University of Chicago Press, 1975, Friedrich von Hayek, *The Constitution of Liberty*, Chicago: The University of Chicago Press, 1971, Friedrich von Hayek, *Law, Legislation and Liberty*, Chicago: The University of Chicago Press, 1971-I, 1973-II, 1979-III.

<sup>4</sup> See, for instance, Armen Alchian and Harold Demsetz. Production, Information Costs and Economic Organization // *American Economic Review*, 62/1972, Louis De Alessi. The Economics of Property Rights: A Review of the Evidence // *Research in Law and Economics*, 2/1980.

<sup>5</sup> See, for instance, Ronald Coase. The Nature of the Firm // *Economica* 4/1937, Herbert Simon. *Models of Man: Social and Rational. Mathematical Essays on Rational Human Behavior in Society Setting*. New York: Wiley, 1957, Oliver Williamson. *Markets and Hierarchies, Analysis and Antitrust Implications: A Study in the Economics of Internal Organization*. New York: Free Press, 1975, Oliver Williamson. *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. New York: Free Press, 1985.

<sup>6</sup> Michael Jensen. *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms*. Cambridge, MA: Harvard University Press, 2000; Michael Jensen and William Meckling. Theory of the Firm, Managerial Behavior, Agency Cost and Ownership Structure // *Journal of Financial Economics* 3/1976; Eugene Fama and Michael Jensen. Separation of Ownership and Control, and Agency Problems and Residual Claims // *Journal of Law and Economics* 26/1983.

<sup>7</sup> For a detailed discussion of this theoretical justification, see Jurgen G. Backhaus and Frank Stephen. Mass Privatization, Governance Structures and the Appropriate Legal and Economic Environment: A Theoretical and Empirical Investigation, p.p. 3-76 // Plamen D. Tchipev, Jurgen G. Backhaus and Frank H. Stephen, eds. *Mass Privatization Schemes in Central and Eastern European Countries: Implications for Corporate Governance*. Sofia: Gorex Press, 1998.

antagonistic hostile takeovers, insignificant representation of stakeholders, low commitment of outside investors to long-term strategies of the firm, possibility of creation of monopolies as a result of takeovers), and the "insider" model, often called German-Japanese (known for concentrated ownership, association of ownership and control, high debt/equity ratio and high ratio of bank credit to total liabilities, low level of sophistication and insignificant opportunities for diversification of financial markets, control by stakeholders, such as banks, related firms and employees, absence of hostile takeovers, representation of many stakeholders, intervention of outside investors limited to periods of clear financial failure). There has been a debate on what model should countries with economies in transition follow in the design of the market institutions – initially, it seemed that the Anglo-American model was the one to adopt but later the lack of consistency in applying its major features led to certain preferences for the German-Japanese model. Ultimately, the new corporate governance frameworks adopted by most of these countries turned out to be blends of features of these two models which did not always fit very well together. Almost fifteen years after the start of market-oriented reforms in Central and Eastern Europe it is becoming increasingly evident that the problem is not simply the decision which of these two major models of corporate governance is more appropriate in general but to what extent a country has the institutional prerequisites for successful application of the chosen model.

The body of literature on the experience of institutional investors in some of the countries in Central and Eastern Europe and Russia is focused mainly on the implications of mass privatization. Most relevant for this study has been the literature on the countries in which market-oriented reforms have brought clear-cut success or failure in setting up this kind of non-banking financial institutions – for instance, the Czech Republic, which is known for probably the most successful mass privatization after the democratic transition, and Russia, where after a series of scandals with pyramid schemes and the crisis of 1998 institutional investors are considered to be practically dead.<sup>8</sup> The relevant literature on Bulgaria includes a few studies of the mass privatization as well as studies of corporate governance practices<sup>9</sup>; nevertheless, unlike

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<sup>8</sup> See, for instance, Roman Frydman, Cheryl W. Gray, Andrzej Rapaczynski (eds.). *Corporate Governance in Central Europe and Russia*. Central European University Press, 1996; Evzen Kocenda. *Development of Ownership Structure and its Effects on Performance: Czech Firms from Mass Privatization*. Working Paper Series 188. CERGE-EI, Prague, 2001; Jan Hanousek and Randall Filer. *Lange and Hayek Revisited: Lessons from Czech Voucher Privatization*. Working Paper 166, CERGE-EI, Prague, 2000.

<sup>9</sup> See, for instance, Plamen Tchipev and Rilka Dragneva. Mass Privatisation Funds – The New Institutional Investors in Central and Eastern Europe? // *Ikonomicheska Misa*, 2/1999, p.p. 56-72 [in Bulgarian – Пламен Чипев, Рилка

the work done on other countries (for instance, the analysis of corporate governance practices in Czech investment privatization funds by John Coffee<sup>10</sup>), there has not been any systematic study of the role of institutional investors in corporate governance reform, although their practices both as subjects and objects of corporate governance have been widely discussed in mass media.

With regard to the research strategy used in the preparation of the study there was an initial intent to rely primarily on a survey of institutional investors in Bulgaria. Two questionnaires, one for studying the behaviour of institutional investors as subjects of corporate governance and one for studying the behaviour of institutional investors as objects of corporate governance, were prepared. The former was circulated among managers of former privatization funds and pension funds; the latter – among investors in the former privatization funds. In general, managers at the institutional investors were reluctant to provide answers – obviously, there is still a lack of culture to talk openly about one's own business although the respondents were supposed to remain anonymous and the questions covered issues, which were supposed to be disclosed in their periodic reports to the regulatory bodies.<sup>11</sup> The answers from individuals who placed their privatization investment vouchers in privatization funds showed two things: first, very low interest in the subject (roughly 5 percent among individual investors and 15 percent among institutional investors) reflecting minimal expectations from their invested vouchers, and second,

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Драгнева. Институционални инвеститори ли са приватизационните фондове в Централна и Източна Европа // *ИКОНОМИЧЕСКА МИСЪЛ*, 2/1999, с.с. 56-72]; Plamen Tchipev. Bulgarian Mass Privatization Scheme. Implications on Corporate Governance // Plamen Tchipev et al. (eds.), op. cit.; *Corporate Governance and Control in Bulgaria: Summary Report*. Center for the Study of Democracy, Sofia, 1999 (<http://www.csd.bg/economic/actplan.html>); *Corporate Governance Assessment Report, 2000*. Corporate Governance Initiative in Bulgaria, 2001 ([http://www.csd.bg/economic/reports\\_e.html](http://www.csd.bg/economic/reports_e.html)); *Corporate Governance Guidelines*. Corporate Governance Initiative in Bulgaria, Sofia, 2001 (<http://www.csd.bg/economic/initiative.html>); Evgeni Peev. Ownership and Control Structures in Transition to "Crony" Capitalism: The Case of Bulgaria // *Eastern European Economics*, 5/2002, p.p. 73-91; Bistra Boeva. *Corporate Governance. From the Powerful Corporations to the Economies in Transition*. Sofia: Princeps, 2001 [in Bulgarian - Бистра Боева. *Корпоративно управление. От мощните корпорации към икономиките в преход*. Princeps, София, 2001].

<sup>10</sup> John Coffee. Institutional Investors in Transitional Economies: Lessons from the Czech Experience // Frydman et al., eds., op. cit., p.p. 111-186.

<sup>11</sup> Out of 58 HCs that were not stricken from the register of the SSEC, 30 could not be reached over the phone (either the phone numbers they had submitted to the SSEC was wrong or nobody answered multiple calls over a period of one month); 2 of those reached over the phone replied that they could not give the information contained in their annual reports; one of the largest HCs answered that this information could be obtained only from the SSEC, another one – from the stock exchange; in a couple of HCs were referred to the CEO as he was "the only person who could authorize the disclosure of such information"; in another HC the CEO asked to receive a call from somebody he personally knew in order to answer the questionnaire. I would like to thank the management of the following former privatization funds which helped us in our work and provided answers to the questionnaire: *Sveta Sofia*, *AKB Fores*, *MM Invest*, *SB Holding*, *Stara Planina*, *Razvitie*, *Industrialen Fund* and *Zlaten Lev* as well as one of the pension fund company – *Newton-Sila*. Unfortunately, we could not do a meaningful analysis of the answers, as the low response rate could not guarantee representativeness of the data.

similar investment approaches and attitudes relevant for the assessment of corporate governance practices of the institutional investors among those who answered the questionnaire. Thus, the results of the survey turned out to provide little insight into the corporate governance practices of the institutional investors; fortunately, however, the information which most of the managers were reluctant to share in the survey was available in the narrative parts of their annual reports as well as in their financial statements filed with the State Securities and Exchanges Commission (SSEC). In fact, some of the information voluntarily disclosed in these documents was much more telling than any of the answers to the questions in the survey could be. Some of the disclosed details as well as certain statements on specific corporate governance practices may raise concerns about the state of corporate governance at these companies; in countries with a more or less developed equity culture among the citizens, some of these statements might cast doubts about the integrity of the management and even drive the company out of business, although technically no laws and regulations may have been violated. In addition to the research methods mentioned above, in-depth interviews with selected representatives of the management of institutional investors and the regulating bodies as well as individuals who have small shares in the former privatization funds were carried out.

The frame of reference for the assessment of the corporate governance practices at or with the involvement of Bulgarian institutional investors have been the OECD principles of corporate governance<sup>12</sup>, the White Paper on Corporate Governance in Southeast Europe<sup>13</sup> and the corporate governance practices in countries with mature capital markets and strong institutional investors – for instance, those of major US mutual and pension funds. Thus, the standards by which these practices have been judged are rather high and go beyond the requirements of the national regulations - a number of these practices, which according to this paper compromise good corporate governance, do not technically constitute violations of the existing regulations. Still, success in corporate governance reform requires remedial action in this regard, which is likely to be more effective if it comes from a pro-reform constituency in business and civil society rather than law enforcement and regulatory agencies – a constituency which can hardly be mobilized through a minimalist legalistic approach only. The goal of this paper is not to serve as

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<sup>12</sup> OECD Principles of Corporate Governance. Organisation of Economic Co-operation and Development. Paris, 1999 (<http://www.oecd.org/pdf/M00008000/M00008299.pdf>).

<sup>13</sup> In fact, the full text of White Paper on Corporate Governance in South-Eastern Europe has not been published yet. The author of this paper participated at the OECD roundtables for South-Eastern Europe in 2002-2003, at which drafts of the White Paper were discussed and adopted.

an indictment for violations of corporate governance principles but to show in what direction pro-reform actors should focus their efforts.

## 2. Former Privatization Funds

The former privatization funds have so far been the most significant element in the universe of Bulgarian institutional investors. According to the legislation adopted in the mid-1990s, including the Law on Privatization Funds (1996), all citizens of age 18 and older received investment vouchers of 25,000 leva nominal value to use in the acquisition of shares in the auctions of mass privatization or alternatively to pool together in privatization funds where professionals would have the responsibility for the investment decisions. The majority of the participants in the mass privatization (about 80 percent of the 3 million people who acquired vouchers)<sup>14</sup> chose the second option – in addition to professional investment management these funds were supposed to offer the advantages of economies of scale and lower risk through greater asset diversification. These funds were to be traded on the stock exchange subject to the regulations for all publicly traded companies. The legislation enacted in the mid-1990s intended that these funds should be transformed into investment companies regulated according to the provisions of the Securities Law or into holding companies functioning according to the provisions of the Commercial Code.<sup>15</sup> This is how the possibility of mutation of institutional investors appeared – the opportunity to function as a holding company under the Commercial Code subjected to a minimum of regulations in spite of certain disclosure requirements (not always consistently enforced) was taken by most of the privatization funds and led to a change of genotype which determined their future corporate governance practices.

### ***a) Investment Holding Companies (HCs)***

Following the provisions of the law, most of the privatization funds were transformed into holding companies after the first wave of mass privatization. Their initial number in 1997 was 75, all of which were listed on the Bulgarian Stock Exchange as publicly traded companies. By August 2002 their number had shrunk to 45 – the rest were either closed by their own decision

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<sup>14</sup> Plamen Tchipev, Bulgarian Mass Privatization Scheme. Implications on Corporate Governance // Tchipev et al. (eds.), op. cit., p.p. 82-83.

<sup>15</sup> For a detailed analysis of mass privatization in Bulgaria as well as the legal provisions for the future of the privatization funds, see Plamen Tchipev, op. cit.

or delisted because they failed to submit the necessary periodic documentation to the SSEC. A large part of the remaining holding companies are currently facing difficulties and less than 20 can be considered as serious players on this segment of the market. In the course of the research we tried to study the behaviour of the largest possible number of the currently registered holding companies. The survey was intended for all; however, a significant number of them could not be found at the addresses provided by them to the regulating body. Those, which could be contacted, were asked to provide answers to the institutional investor managers' questionnaire; responses were obtained from only 12. After consultation with representatives of SSEC, we focused in detail on the prospectuses and annual reports of 18 HCs that could be considered as not just formally registered but effectively functioning companies.<sup>16</sup>

### *HC strategy*

The general strategy of these HCs includes acquisition, holding and trade of shares of stock and bonds of other companies as well as acquisition, holding and trade in patents, which is less common for institutional investors. The major field of their activity, however, is management and financing of the companies in their portfolios, including raising investment capital from foreign countries. The statutes of most of the HCs allow them to do any kind of business which is not prohibited by law – a provision which lets them easily get involved in what comes handy, regardless of the initial goals of the company and its shareholders.

At the mass privatization auctions the privatization funds acquired small portions of the stock of multiple state-owned enterprises. The declared goal of Bulgarian policy makers of that time was to create a business-friendly environment in which institutional investors pooling the resources of a large number of individuals should hold small shares of stock of publicly traded companies in various industries. Pluralism in investment and governance was seen as an alternative to managing the economy from a single center, i.e. as a remedy against a monopoly position of one

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<sup>16</sup> The list of these former privatization funds (HCs and investment companies) includes: *Mel Invest, Albena Invest, Slunchev Briag, Orel Invest, Assenova Krepost, Petrol* (later renamed as *Sinergon*), *Aktsioner-Favorit, AKB Fores, Republica, Razvitie-Industria, Doverie-Obedinen, MG Elite, Severokoop-Gumza, Industrialen Holding Bulgaria, Sveta Sofia, Trud & Kapital, Bulgarian Holding Company, Stara Planina, Zlaten Lev, Industrialen Fund and Koop Yug*. The data provided on these HCs further in this paper comes from their latest annual reports and prospectuses, available at the SSEC as of October 2002. Further in this paper for the names of the individual companies two or three letter combinations have been used in the specific examples illustrating specific corporate governance practices.

or another state-owned enterprise in entire sectors of the economy. The transactions which took place after the mass privatization auctions, however, led in the opposite direction – privatization funds/HCs swapped stock from their portfolios with the purpose of consolidating their holdings and acquiring such a number of shares which would allow them to effectively control their companies. Today all HCs state that **their objective is portfolio optimization through acquisition of majority/controlling shares and sale of the shares in the companies in which they do not want or do not have the capacity or the opportunity to acquire a controlling share**. At this point it is fair to ask the question to what extent this objective is generally appropriate for an institutional investor as it is generally not consistent with the working definition of such investors mentioned earlier in this paper. The most important feature of the genotype of the holding companies in terms of their corporate structure is that the individual companies in their portfolios are, in fact, their subsidiaries. The purpose of holding a majority stake in the capital of a company is to be able to directly control it, to take charge of all of its managerial and operational decisions. Direct control of a manageable number of subsidiaries is the name of the game for these former privatization funds.

The following examples illustrate the HCs' own perspective on what they should be doing. *EE* sees its activities as a mission – to participate in the recovery the Bulgarian industry. *GG* clearly states that it is not in the business of trade of any kind – transactions with shares of stock of the companies in its portfolio are "an exception". *KK*, on the other hand, states that its activities include mainly transactions with securities (a more careful look into its annual report leads us to the conclusion that this is not true – it is in the business of direct management of the companies held in the portfolio); it has mentioned R&D as a sphere of activity but later notes that it does not do any R&D. *FF* sees its role as a kind of R&D body – it "develops strategies" for creating new companies and participating in existing ones, assists in laying out the strategies for the development of the companies in its portfolio and plans to build a unified information system for these companies on the basis of which new products will be developed. This is in fact the only company, which openly states its intention to achieve a monopoly position in the sectors with its involvement. *RR* admits that "transactions on the stock exchange are risky" and the only safe way for them to operate is through direct control. *TT* states that part of its activities is "accepting cash deposits from the subsidiaries" and management of these funds – apparently, the distinction between "deposits" and "investments" is not considered an issue. One might wonder what the reaction of the individuals who put their voucher in these privatization funds would

have been if these statements were made at the initial stage of raising capital for the privatization funds. It is curious to know that one of the few, if not the only, holding company more or less focused in its sphere of activity is *AA*, an affiliate of a company (*AAA*) which is perceived as the prototype for a private business entity originating from the symbiosis of organized crime and the secret police of before 1989.

### *Portfolio composition*

An analysis of the portfolios of the HCs can clarify strategy and the results they have been trying to achieve. After the auctions of SOE shares in the course of the mass privatization after 1996-97, the privatization funds found themselves holding less than a third of the shares of dozens of companies - in fact, the law did not allow them to acquire more than 34 percent at these auctions. After the transformation of the privatization funds into HCs they had the right to acquire more than 34 percent; all of them tried to do so. HCs swapped packages of shares; as a result, they remained with a smaller number of companies in their portfolios but with larger portions of the company stock. If there was no opportunity to amass a controlling share, then they didn't need the shares - they were realistic enough not to expect equitable treatment as minority shareholders as they themselves did not intend to do so in the companies in which they had acquired a controlling share. As a result, the HCs started to sell their small packages of shares privately or on the stock exchange; some of them were willing to wait in hope for better share prices but it turned out that those who sold the earliest gained the most. The strategy of accumulating companies in which a majority stake is owned and at the same time reducing the number of companies in which a minority stake was the most that could be hoped for, is explicitly spelled out by virtually all the HCs. The following examples illustrate the results of this strategy for the first years of their existence:

*OO*'s portfolio included 52 companies at the end of year 1999: in 7 it owned over 50 percent of the shares, in 11 - between 25 and 50 percent, in 4 - between 5 and 25 percent, and in 30 - less than 5 percent of the shares. Two years later (end of year 2001) the number of companies owned was down to 43: 10 with over 50 percent share ownership, 8 with ownership between 25 and 50 percent, 3 - between 5 and 25 percent, and 22 - less than 10 percent.

*In 1999 BB* had 5 companies with over 50 percent share ownership in its portfolio, 19 with share ownership between 25 and 50 percent, and 9 - between 10 and 25 percent. In 2002 the number of companies owned at more than 50 percent was 10, in another 10 the shares held were between 25 and 50 percent, and in 7 - between 10 and 25 percent.

*QQ Holdings* portfolio included in April 1999 1 company with over 50 percent ownership, 1 with ownership between 25 and 50 percent, and 4 - between 5 and 25 percent. At the end of year 2001 there were already 4 companies with over 50 percent of the shares owned, 1 with ownership between 25 and 50 percent, and 4 - between 5 and 25 percent.

*EE's* portfolio included in 2001 25 companies in which it owned over 50 percent of the shares, 16 companies with 25-50 percent of the shares, 4 with 10-25 percent. In previous years the number of companies in which it owned over 50 percent was much smaller and the number of companies in which it held minority shares was much greater.

*KK* owned in October 1999 over 50 percent of the shares in 6 companies, between 25 and 50 percent in another 6, between 10 and 25 percent in 5, and less than 5 percent in 9. Toward the end of year 2001 it owned over 50 percent of the shares in 19 companies, between 25 and 50 percent in 8, between 5 and 25 percent in 4, and less than 5 percent in only 5.

Some of the more mature HCs have already achieved a degree of comfort in which they practically have no dependence on financial markers: *JJ*, one of the largest HCs, has dozens of companies with 51 percent of the shares owned and only a few with a minority share. In almost all of the companies of its portfolio, *CC* owns more than 50 percent of the shares. This is the ultimate goal of all HCs but still it has been achieved by a very limited number of them.

A slightly different strategy was followed by the more sophisticated HCs. The goal of direct management of a company's operation can be achieved through holding a controlling share of the equity, which does not have to be over 50 percent. From this perspective some of the seemingly minority share holdings in the portfolios of the HCs are, in fact, controlling packages. Some of the HCs state explicitly that they want to have a minority stake in companies in which the state still has a significant residual share, thus having to own about 20-30 percent of the equity only (*EE*). This is a very efficient strategy as their own investment in the companies doesn't have to be too large. The state as the owner of residual shares is not known for exercising its property rights judiciously when it comes to making decisions or exercising control; in addition, sooner or later it is going to sell its residual packages, so it is expected to be much cheaper to purchase these shares of stock from the state directly than from another private party.

It is worth saying a few words about the companies included in the portfolios of the HCs. As the risks borne by the individuals who invested their assets in an institutional investor depend on the portfolio composition regulators, HCs are obliged to include a special section in their prospectuses and annual reports explaining the risks investors could face. Some of the HCs

provide detailed theoretical explanations of the difference between general market (systemic) risks, risks coming from currency exchange rate fluctuations (as if they invested in foreign assets in the course of the mass privatization), political risks or specific risks coming from stock selection. For 99 percent of the individual investors these explanations sound like academic exercises with little relevance in practice. Even if a great deal of information is offered in the annual reports and prospectuses, their relevance, as a rule, is doubtful – there is no operationalization of the concept of risk for the portfolio in question; standard deviations of portfolio returns are not mentioned or not very well explained; there is practically no reference to the riskiness of the stock (*beta*).

There are other measures of general portfolio risk specific for less efficient markets that may be more appropriate for Bulgaria. A portfolio including privately held companies with very low liquidity is much more risky than a portfolio including only publicly traded companies. Most of the HC portfolios include such privately held companies; in most of these companies either the 100 percent of the shares or a majority stake is owned. Explanation of this kind of risk, however, is missing. Thus, a large number of individuals who pooled their vouchers in the privatization funds in order to participate in the stock market and at the same time minimize risks found themselves investing, in fact, in private equity which involves much higher risks. It is unclear if they would have given their vouchers to the privatization funds if they had any idea of the future investments of the fund; it is clearer, however, what the reaction of the regulators would be if this were happening in the US, for example.

There are multiple instances in which people were invited to join a privatization fund which was supposed to follow a specific strategy; later, however, when privatization vouchers were already collected, this strategy radically changed. Thus, for instance, one of the HCs totally reoriented its investment policies when a former minister of the chemical industry joined the management – its acquisition efforts were redirected to companies in this sector. Another one (*UU*) gradually turned into a private equity operation – now it invests in SMEs, mainly “operating under the auspices of the Ministry of Agriculture and the Ministry of the Industry”. In a few cases, HCs have off-shore companies in their portfolios – the logic of mass privatization definitely did not include acquisition of such entities.

*Corporate disclosure*

A review of the reporting practices of the HCs shows a varied degree of compliance with the requirements. On the one hand, a very small number of HCs, including, for instance, *DD*, have provided most of the necessary details, even though some of the information might be sensitive or even embarrassing. The disclosure by *DD* provides the best possible illustration of the genotype of the former privatization funds, as this HC does not try to conceal activities, which might be considered inconsistent with sound corporate governance. On the other hand, the smaller the HCs, the less likely to fully comply with the reporting requirements, although some of the largest HCs may represent exception to this rule (*KK* and *FF*). Most of the HCs disclose a fair amount of information, omitting in their reports mainly data on board members' income and involvement with other companies; the mandatory consolidated financial statements are usually very detailed as prescribed by law.

#### *HC governing bodies*

Corporate governance practices to a great extent depend on, and are reflected in, the choice of people sitting on the governing bodies of companies. The legislation in Bulgaria sets strict requirements for disclosure of information regarding board members – significant details which in many countries are considered as private, including educational and professional background, all additional positions held, remuneration received for board membership and other professional commitments, number of shares owned, and even the person's social security number, have to be made public. Unfortunately, failure to fully and correctly disclose such details is not penalized, so the completeness of disclosure depends on the good will of the companies and their management.

With regard to the membership in HCs governing bodies, first, individual board members may sit on the boards of many other companies. Thus, two board members of *OO* participate in the boards of six more companies. The CEO of *CC* is at the same time the CEO of three more companies and a board member in seven companies. The chairman of the board of *DD* is also member of fourteen boards; another board member sits on nine more boards. In *SS* a board member is also on seven other companies' boards. These practices raise serious questions about the effectiveness of these people's participation in the governing bodies of the companies as well

as the role of the boards vis-à-vis the management, given the limited amount of real work which can be done as a very part-time effort by the directors.

A second issue is an appearance of conflict of interest. Thus, in *MM* the chairman of the board of directors is at the same time the CEO of affiliated privately held companies (in finance and insurance), which might be competitors in some of their spheres of activities. In *SS* a board member sits on the board of a company that is one of the owners of a competitor HC (*KK AD – KK HC*); two board members are also members of the board of a pension fund company (owned by a major European universal bank), which competes with *SS*'s own pension fund. In *GG* HC a company holding a seat on the board of directors could be a direct competitor. Among the board members of *DD* we find two public officials - the deputy mayor of a large city and the managing director of the local privatization agency. Two of the *QQ* board members are reported as current members of the Parliament. These are just a few facts are explicitly stated in the filings of these HCs with the SSEC.

A third issue is that of insiders versus outsiders sitting on the governing boards. It is hardly a secret that even if there are outsiders in these bodies, they have been appointed to serve the interests of the majority owners. It is logical that the holders of controlling shares in the HCs should have the right to appoint board members; nevertheless, these board members should be coming from different backgrounds and, at least formally, create an appearance of pluralism. Most of the HCs, in fact, have such people in the boards. Still, some of the big HCs or ones, which have gained notoriety for some reason do not even try to create the appearance that board members are there to serve the interests of all shareholders. In *AA* only executives from its parent company (*AAA*) and two off-shore companies belonging to the same parent company are members of the boards; of course, no information is provided about the other professional commitments or the income of these people. The same holds true for the largest HC - *SS*. The situation is not very different in another large HC - *KK*: although little information has been disclosed about the board members' additional professional commitments or income, it is clear that all of them are involved in affiliated companies having the word *KK* in their names.

A related issue is that of the professional board membership. Generally, board members are lawyers, experts in business administration or other areas related to the specific field(s) of activity of the HC. Nevertheless, it is not uncommon to see on the boards people who do not

have sufficient expertise for the specific business – e.g. most of the board members of *PP* (one of the largest HCs) are not experts in the business of investments or company management and have background in other fields, such as linguistics or child care. Alternatively, the people in charge of *KK*, who claim to be experts mainly in tourism and related industries, are not afraid to venture into very different fields, such as machine building.

*Corporate control*

The most important issue with regard to corporate control is who effectively owns the HCs. To an outsider or a small investor there is no easy answer to this question – sometimes it is clear from the company documents who the controlling shareholder is (for instance, a company or a person holding more than 50 percent of the shares); sometimes it is not, like in the case of *SS*, in which there are no owners holding more than 10 percent of the equity. Very often it is groups of people from different fields or occupations but with similar business interests and opportunities to achieve complementarity of their efforts. In a number of HCs there are affiliated companies with similar names, most often privately held, which effectively control the HCs - e.g. *TT HC* and *TT AD*, *PP HC*, *PP Industry AD*<sup>17</sup> and *PP Investment and Securities Company*. In *OO* there is a company in the portfolio called *OO Brokerage*, in which the HC has only a minority share (20 percent), but whose declared activities are practically the same as those of the HC, i.e. as it is a direct competitor, it may be used as an instrument to siphon off funds through various forms of financing of the subsidiary by the parent company. Very often it is the subsidiaries who effectively own the HC and not vice versa, as one would consider logical. Thus, the controlling shareholder of *KK HK* is *KK AD*, whose share which grew from 22 percent in 1999 to 44 percent in 2001. In *UU* there is a subsidiary called *UU Consulting*, which has received substantial financing from the parent company and may be considered as an entity with corporate control in the HC.

In many cases the controlling shareholder(s) are companies that are 100 percent owned by the HC, but at the same time have large portions of stock (over 10 percent) of the HC itself. This cross-holding can block any attempt for takeover. The best example of such an arrangement is given by *DD*, which represents the quintessential HC (multiple capital increases, goals of concentration achieved, clear structure) with 4 major subsidiaries with similar names (*DDA*, *DDB*, *DDC*, *DDE*), all of them privately held, owning chunks of capital in the parent HC (9.5, 9.5, 8.5 and 8.5 percent respectively); these companies, however, are 100 percent owned by the HC. With regard to *SS* there are serious doubts that some of the subsidiaries are, in fact, controlling shareholders with less than 10 percent of the shares owned – these are other HCs with the same

name (*SSA Holding* and *SSB Investments*) which are owned at more than 50 percent by the parent HC. The situation at *JJ* is similar.

A combination of these two approaches is present at *NN*: on the one hand, it is partly owned by *NVA* (13 percent of the equity) but at the same time it owns 81 percent of *NVA*. On the other hand, *NNB AD*, a company which provides most of the people for the board of directors, is an important minority holding of the HC. Other interesting details include registration of multiple subsidiaries at the same address (*NN*, *FF*). In *RR* more than 10 percent of the equity (not mentioned how much exactly) is owned by *RRA Holding* (same name, but different owners – there are no small investors in the latter). In *JJ* 46 percent of the equity is controlled, although not directly, by 5 firms, among which it is not too hard to guess that another holding company with practically the same name, but not publicly traded and not a former privatization fund (*JJA Holding*), as well as an insurance company (*JJB Insurance*), are probably the major players. It is curious to know that two of the owners of *FF* are companies with similar names operating in the same field of activity.

A major issue for the HCs in general is their corporate structure, including a very complex web of cross-holdings – for instance, *SS* has a multi-layered structure with separate HCs within the parent HC; in *JJ* the corporate structure is so complicated (cross-holding, subsidiaries-competitors, etc.) that there is no way even the controlling shareholders can achieve a decent degree of efficiency in their management efforts. This state of affairs can be explained with the need to provide effectively some share of the business to most of the people whose cooperation was needed to start and run it in post-socialist times, to go through the bureaucratic routine and somehow neutralize everybody who might have been able to create obstacles.

We should note that some of the HCs-former privatization funds are partly owned by off-shore companies – e.g. *CC* (24 percent), *GG* (17 percent); in *BB* and *AA* there are offshore firms on the board. It is interesting that it is the HCs associated in people's minds with the former communist secret police in particular are not afraid to advertise their offshore ownership or management. In other instances HCs are believed to be effectively controlled by prominent personalities (for instance, former government ministers) who prefer not to be on the governing bodies. Another

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<sup>17</sup> AD at the end of the name is an abbreviation for joint-stock company in Bulgarian (акционерно дружество).

interesting detail is that a major labour union is on the board of one of the largest HCs together with an obscure private company – one can just wonder why this union would need such a company for a partner.

### *Increase of capital*

Increase of equity capital can be an act against shareholder interests due to dilution of equity - most often it is minority and small shareholders who stand on the losing side. Holding companies that appeared as a result of the transformation of the privatization funds in Bulgaria had little chance to avoid capital increases as mass privatization was carried out in three waves: citizens could acquire privatization vouchers more than once and the state offered shares of SOEs for sale at three separate auctions. Thus, from the very beginning privatization funds were expected to increase their equity capital in order to acquire additional privatization vouchers and participate in the auctions. This, however, resulted in dilution of the initial equity acquired by small investors; what is worse, however, is that the door was opened for subsequent equity increases in which cash was raised – increases in which most of the shareholding public could not participate.

Most of the HCs raised thus their equity capital three, four or five times after the start of mass privatization. Technically, this was done fully in compliance with the law; it is clear, however, that the existing regulations could hardly serve to protect the interests of shareholders. All owners of stock received rights to acquire new shares proportionally to the capital owned before the increase. What is interesting here is that most of these decisions were made not by the general assemblies of the HCs, but by their boards of directors. Only a very limited number of people could in general participate in this increase – there may be multiple reasons but the major one is that hyperinflation in 1996/1997 and the subsequent stabilization measures left the majority of the population below the poverty line, so when survival is an issue investing is not an option. As a result, it was the HC management or related people or companies or the controlling shareholders, who ended up purchasing these newly issued shares. If participation in the first wave of mass privatization was really wide, participation in the second and third waves was very narrow. Theoretically, the rights to acquire additional shares could be traded or exchanged but the regulations did not provide for the organization of such a market; these rights expired too early (within a month), so to small and minority investors they were worth too little. As a result,

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the ownership of the new cash issues was really concentrated – thus, for instance, only one company and 47 individuals bought the entire fifth issue of additional shares by *OO* in 1998.

### *Dividend policies*

Small shareholders are interested in receiving dividends. Some of them have been lucky – their HCs have paid dividends every year (e.g. *KK, EE*). Others have been less lucky – after paying out dividends for one or two years their HCs stopped doing this (e.g. *OO, TT, MM*). A third group of small shareholders had no luck at all – they saw no dividends, even if their HCs managed to finish every year in the black (e.g. *CC*). Even if no dividends were paid, these people could theoretically cash in their capital gains by selling their shares. Something like this happened, in fact, when shares of the former privatization funds started trading on the stock exchange but the process looked more like liquidation of shares than taking profits. With or without dividends, the returns for small investors were negligible: they had received their privatization vouchers before the hyperinflation of 1996-97; they could not acquire serious real assets soon enough, so one year later their investment vouchers were worth 1000 times less. Getting 1 or 2 percent dividend yield on their depreciated investment in the best-case scenario is not much by any measure. Again, even in this situation some HCs tried to play tricks on their shareholders - *UU*, for instance, declared that rather than paying a larger dividend it would use part of the profit for “increase of the nominal value of the shares” which, not surprisingly, raised no objections among the shareholders; *KK* also raised the nominal value of its stock - apparently, for the investing public in Bulgaria there is no difference between reinvesting profit and increasing the nominal value of the shares.

### *HCs as subjects of corporate governance*

In order to assess the role of institutional investors as subjects of corporate governance it is necessary to consider their behaviour as owners of equity in other publicly traded companies. For this purpose it is important to see how HCs, or their representatives, behave in the governing bodies in which they participate. As a rule, the former privatization funds in Bulgaria have seats on the boards of directors of only those companies in which they have a controlling interest. This is the reason why HCs swapped small packages of shares in the early months of their existence; this is the reason why they try to sell the minority stakes in companies which they had acquired one way or another. As a rule, the HCs do not allow any of the small or minority investors in the companies in which they have controlling interest to have any board seats - they just don't need

that and for as long as the law does not prevent them from appointing all board members they have no reason to worry. Minority shareholders can be activist if they perceive that their rights have somehow been violated and if they have the capacity to formulate grievances and take action. A minority shareholder with a seat on the board can have in addition a lot of information, i.e. a significant resource for activism – why should then a majority owner give him/her this resource? Basically, this is the kind of thinking characteristic for the HCs with regard to the need for pluralism on the boards and giving opportunities for voice to minority investors. This is the reason why almost all of the privatization funds from the very beginning opted for this form of reorganization once they collected small investors' privatization vouchers and started practicing direct control of the companies in their portfolios, no matter if they had the expertise for the specific sector or not. HCs are not in this business for holding and trading in small or minority shares of publicly traded companies, they are not portfolio investors *per se*. HCs set the rules of the game, so that their authority over the companies in their portfolio will not be contested. This state of affairs makes their lives much easier - they don't have to worry about takeovers, no matter how inefficient their work is.

Again, it is worth noting that for a controlling interest, i.e. opportunity to appoint all board members, there is no need to own more than 50 percent of the stock of a company – first, the small investors can be taken out of the equation from the very beginning; then, there was a residual state ownership (sometimes over 30 percent of the equity) in most of the companies offered for sale in the process of mass privatization. That is why the strategy adopted by a number of HCs (e.g. *MM*, *AA*, *UU*) to focus on owning between 25 and 50 percent of the stock is the most efficient form of corporate control, although there is no guarantee that the best companies would be acquired at these terms.

The following details from the annual reports and prospectuses may sound really paradoxical in another setting. Thus, some HCs don't have employees at all (e.g. *TT*); a couple of HCs consider it an accomplishment that they have a good relationship with the regulatory body (SSEC) and comply with its requirements (i.e. they sound proud about not breaking the law). *OO* effectively borrowed somebody else's brand name, that of the foreign automobile manufacturer *OOZ*, in its initial advertising campaign in order to attract investment vouchers. *OOZ* was never a shareholder in this privatization fund/HC – it was the auto dealer for *OOZ* in Bulgaria who registered the fund. There are multiple car dealers in the world but few of them can leverage –

legally or not – the brand names of the cars they sell in order to get into a different sphere of business activity. A similar trick was played by the *FF* – at the beginning it was called Bulgarian-European Privatization Fund and the brand name of a major European universal bank as a co-founder was used to attract investment vouchers (people treated the presence of this bank as a guarantee of decent standards of corporate governance). Later, however, when the fund was transformed into a HC, the bank sold its stake and the European presence in the name of the fund disappeared together with the hopes for equitable treatment of small shareholders. Another HC - *KK* - which has special expertise in tourism, claims that its investments in the wood-processing industry are motivated by the need “to restructure and modernize its hotels and raise their ratings”.

To conclude, our analysis does not let us claim that the HCs in Bulgaria which came into being as a result of the transformation of the mass privatization funds qualify as institutional investors in the strictest sense. Such investors may provide examples of good or bad corporate governance and even abuse of shareholder rights but the analysis of the HCs’ own periodic reports and prospectuses shows that these HCs are in fact industrial conglomerates. As any other publicly traded company they can have multiple small investors, whether or not these investors acquired their shares on the stock exchange or in exchange for their privatization vouchers. A few years after the start of the mass privatization in Bulgaria there is absolutely no difference for a small investor if he/she got shares of one of the companies that were directly auctioned in the course of the mass privatization or ended up with shares of a HC which represents a conglomerate of other companies. As stated above, these HCs are in the business of direct control of the companies in their portfolio, which are correctly considered as subsidiaries, and not in the business of portfolio management on the basis of the financial performance of the individual stocks. No matter that HCs are obliged to disclose financial data, discuss risks, expected return on their portfolio and track financial performance, this kind of information is practically useless to individual shareholders as portfolio management is different from direct management and control of subsidiaries. Bottom line, even people involved in HC management but conscious about issues of corporate governance admit that HCs are lost for the cause of good governance; expecting these companies to play the special role which, in theory, institutional investors could play in corporate governance reform, is like being blinded by an illusion.

### ***b) Investment Companies***

Investment companies emerged as a result of the second type of transformation which privatization funds could undergo after they collected privatization vouchers and acquired a portfolio of companies in the mass privatization auctions. Initially there were four such companies; today, there are just two of them left: *HH* as an open-end investment company (similar to regular mutual funds) and *II* as a closed-end investment company (similar to closed-end funds).

The general goal of these investment companies is investing in securities of publicly traded companies and sharing the risks by the individual investors. *HH* in particular aims at increase of its share price for the benefit of its shareholders through a portfolio with a stable structure of the basic asset classes; it seeks both significant income as well as stock appreciation. In fact, this investment company represents the latest stage of the evolution of the former privatization fund with the same name: initially, it was transformed into a closed investment company (closed-end fund) with a portfolio, including large share packages – 2 companies in which over 50 percent of the equity was owned, 5 companies with equity between 25 and 50 percent, 6 companies with equity between 10 and 25 percent and a large number of companies owned at below 10 percent. In 1999 it split into two parts – *HH Investment Company* (a mutual fund) and *HH Holding* (like the dozens of HCs whose genotype we analyzed earlier). The HC took over companies in which more than 10 percent of the stock was owned but which were less liquid and direct control seemed to be the optimal strategy as shown by the example of the other former privatization funds. The open-end investment company kept the rest of the assets – packages of below 10 percent of large company stock with decent liquidity (by Bulgarian standards), opportunities for more active trading on the stock market, i.e. stocks of Bulgarian blue chips. The *HH Investment Company* tries to achieve good asset diversification – it currently owns 13 stocks while there are only 9 in the major stock exchange index.

The other investment company, the *II*, appeared in its current form in 1999 after its merger with another closed investment company – the *IV*. It aims at receiving income from dividends and

realized capital gains from the sale of securities acquired on the capital market and at auctions of the mass privatization.

With regard to corporate control we need to mention that initially (1988) *HH* had two controlling shareholders - two off-shore companies registered in Cyprus, respectively holding 24 and 25 percent of the equity. The members of its boards are highly qualified professionals in this sphere of activity and information about them is disclosed and in the prospectus and the annual reports. It is interesting that after the split in 1999 the two offshore companies are not mentioned any more in the annual reports – apparently, foreign capital is not interested in significant mutual-type of investments in Bulgarian blue chips. As to the *II* its management and board members are also experts in investments or specific industrial fields. This fund, however, does not provide full disclosure – for instance, with regard to board members' compensation.

The two investment companies operate under significant restrictions coming from the existing legislation or their own statutes. Thus, *II* can put no more than 25 percent of its assets in the shares of a single company or no more than 30 percent of a treasury bond issue. It has very limited borrowing capabilities – it is not allowed to borrow and/or trading on margin; it cannot lend or pledge its assets as collateral for third parties lending which is a standard practice for Bulgarian HCs; it is not allowed to purchase private equity or securities before they have been offered publicly on a regulated market, to participate in short selling or purchase illiquid long-term assets, such as non-securitized real estate or other property, etc. Restrictions for *HH* are a little more relaxed – it can buy securities which are not listed on a stock exchange for up to 10 percent of its capital (for investment in private equity this is a serious percentage), up to 5 percent (or 10 percent with a special permission from SSEC) of its capital can be invested in the same stock. The fund cannot have a controlling interest in another company; neither can it give or take any loans, issue bonds, buy securities before their initial public offering, carry out operations on margin or sell short, etc. For both funds there is a requirement to keep at least 10 percent of their assets in cash or equivalents in order to guarantee liquidity of the shares and an ability to buy them back.

The two funds have different investment strategies. On the one hand, *II* invests in "liquid, low and middle risk level securities" which can bring optimal profitability in the long run (including corporate and municipal bonds, short- or medium-term treasuries, other debt instruments plus

deposits in cash); it has no plans to invest in equity as "it involves a high degree of risk and doesn't bring significant income to the company". On the other hand, *HH* invests primarily in equity, which has a potential to grow in terms of share price as well as with potential for dividend income. The fund maintains a balanced portfolio of assets which are expected to bring relatively high yield and at the same time allow it to maintain a sufficient degree of liquidity, so that it could constantly buy back shares. *HH* has the ambition to explore more actively the market for municipal and corporate bonds when it matures. Yet, it admits that it is possible to face liquidity problems in cases of massive withdrawals by the shareholders and consequently to delay payments on bought back shares. Fortunately, so far this hasn't happened although there was a period of massive withdrawals – the time when people were allowed to cash in their investments in privatization vouchers right after the transformation of the privatization fund into an investment company. The current environment in Bulgaria has posed another problem – due to the underdevelopment of the capital markets and the difficulties in buying and selling large packages of stock on the stock exchange the fund couldn't follow its strategy and reach the desired targets with regard to the proportions of the individual asset classes in year 2000. That is why in 2001 the company started decreasing the share of equity in its portfolio and increasing the share of fixed income instruments, including debt issued by solid companies.

The strategy of these investment companies can be illustrated by the review of their portfolio composition. *II* tries to maintain the following distribution of its assets among different asset classes: equity - 0.1-0.5 percent of the portfolio, corporate bonds - 20-25 percent, municipal bonds - 15-20 percent, treasuries - 5-10 percent, other debt - 5-10 percent, short term deposits - 25-30 percent, cash in current accounts - 1-2 percent, non-financial assets - 7-8 percent, and short-term receivables - 3-5 percent. This distribution makes it clear that the fund is not just income oriented - given the level of diversification, its portfolio strategy allows for a degree of risk as large as that of a fund investing generally in treasuries. There is an obvious eclectic approach, which makes sense given the fact that this is the only investment fund in Bulgaria targeting income producing securities. With this degree of risk, however, it is practically impossible that the fund can ever be a factor in corporate governance for the companies whose securities it buys. Theoretically, it could be a significant stakeholder relevant for corporate governance, but if the companies, whose debt it holds, are in distress; such a situation, however, does not fit in its investment strategy, i.e. it is extremely unlikely that the funds will find itself in such a situation.

*HH* has a different portfolio strategy – in 1998 it aimed at maintaining the following distribution among assets classes: equity - 25-45 percent of its portfolio, treasuries - 35-55 percent, other securities - 2.5-4 percent, cash 13-17 percent; in 2001 (after the split) it was a little more aggressive aiming at investment in equity - 50-60 percent, Bulgarian treasuries - 8-12 percent, foreign treasuries and sovereign debt - 7-10 percent, municipal and corporate bonds - 8-12 percent, other securities - 2-4 percent, and cash - 15-18 percent. The major stocks in the portfolio were *Lukoil-Neftochim* - up to 15 percent of its total asset value, *Solvey-Sodi* – about 10 percent, *Bulgartabac* – about 10 percent, etc., i.e. some of the most liquid stocks on the stock exchange.

As of 31.12.2001 *II's* assets included: cash – 56.12 percent, short-term receivables – 4.01 percent, equity – 0.07 percent, other long-term debt – 33.50 percent, non-financial long-term assets – 6.23 percent, and provision for expenses for future periods – 0.07 percent. This portfolio composition, however, raises another question – what are these long-term non-financial assets mentioned above – after all, their percentage is not insignificant. Most likely, this is real estate and other property (buildings, cars, etc.), which the fund has bought in order to use in its day-to-day operations. The value of the assets held by the fund is given in the table below - it shows that over the last three years there has been an increase of the share of cash in the investment portfolio and decrease of the long-term debt, i.e. a tendency for the assets to get more liquid and for the risk to decrease.

#### **Distribution of *II's* assets among asset classes.**

<b><i>Investment vehicle</i></b>	<b><i>31.12.1999</i></b> <b><i>г.</i></b> <b><i>(BGN)</i></b>	<b><i>31.12.2000</i></b> <b><i>г.</i></b> <b><i>(BGN)</i></b>	<b><i>31.12.2001</i></b> <b><i>г.</i></b> <b><i>(BGN)</i></b>
Cash	<b>533 688</b>	<b>640 380</b>	<b>676 586</b>
Short-term receivables	<b>19 794</b>	<b>42 087</b>	<b>48 280</b>
Long-term investments	<b>243 361</b>	<b>404 838</b>	<b>404 717</b>
Non-financial assets	<b>65 976</b>	<b>83 905</b>	<b>75 099</b>
Provision for future expenses	<b>3 016</b>	<b>888</b>	<b>869</b>

As to *HH's* portfolio at the end of year 2001 it included: cash - 22.82 percent, short-term receivables - 0.26 percent, stocks - 60.93 percent, other long term financial assets - 15.47

percent (including Bulgarian and foreign treasuries, municipal, corporate, mortgage bonds and sovereign debt). Its total assets under management amounted in 1999 to 9,402,803 leva (NAV – 2.89 leva), in 2000 to 5,899,570 leva (NAV 2.49 leva) and in 2001 to 5,532,202 leva (NAV – 2.62 leva).

Increase of capital is usually considered as a major event with implications for preserving shareholder value. As it was mentioned earlier, former privatization funds which were transformed into HCs did this multiple times as a result of which thousands of small investors had their share of capital diluted. Investment companies, however, didn't go along this path. In *Industrial Fund* there was just one increase of capital since its inception and it was done for the purpose of raising additional investment vouchers in 1997. The management has had little incentive to go for further capital increases because given the fund's profile there would be little to gain from it. Following this increase and the merger with the similar *VV* the number of shares reached 805,951 trading on the Sofia Stock Exchange at a price between 0.85 and 1 lev with a total volume of 5150 for year 2001. Increase of capital is not an issue for the shareholders of *HH* as it is an open-end investment company.

Although *II* has practically no opportunity for activism in the companies whose securities it holds, it may give an example of good or bad corporate governance as a company with multiple shareholders. The major and probably the only issue worth raising is the administration costs which shareholders have to bear. According to the existing regulations in Bulgaria which investment companies are allowed to charge is up to 5 percent of the total assets. *II* has had the following expenses for year 2001: 19,098 leva for remuneration of the board members, 1,800 for auditors, 34,449 leva for other expenses, all totaling 55, 347 leva, or 4.59 percent of the fund's total assets (48,778 leva or 4.16 percent in year 2000). The numbers seem to be well within the limits prescribed by the law. In fact, these expenses may be reasonable for Bulgaria as transaction costs for maintaining an investment fund are considerable and as the fund's assets are not large enough, fund administration may be really expensive due to large fixed costs. Nevertheless, by the standards of developed market economies this number is prohibitively high, especially for a fixed income fund. The increase of NAV was 2.86 percent for year 2001 which means that investors had to pay almost twice as much for this gain; in addition, for this modest return on their investment they had to take much higher risks which would otherwise match a return of over 7 percent - from this perspective one might have a different view on its risk

aversion strategy. There is one additional problem, however – the fund management does not offer in their 2002 annual report any analysis of the financial results which seems at least strange given the fact that many HCs do this. At *HH* the expense ratio for year 2001 was 4.80 percent of its assets under management and 4.10 percent for year 2000. Managing this fund is not getting more expensive in absolute terms - the reason for the increase of the expense ratio is the shrinking asset prices and NAV over the last couple of years. Still, these numbers are quite high by international standards – funds with similar profiles in the US, for instance, charge administration fees of about 1 percent of their assets; in off-shore locations these fees are about 2-3 percent.

As a subject of corporate governance *HH* has had little opportunity to influence the practices at the companies whose stock it holds in its portfolio. Theoretically the opportunity for exit could play the role of a lever for exerting influence; this option, however, is not very realistic for a thinly traded market in a transition economy – the fund invests primarily in the blue chips of the Bulgarian stock market and can hardly find other companies which would satisfy its investment objectives and requirements for liquidity and traded volume. What is more important, however, is the fact that *HH* is just a portfolio investor in these companies and “exit” is the only available option of external control. It wouldn't mind sitting on boards of directors in companies, in which it has a significant minority interest, but so far it has been unable to achieve this as none of the controlling investors in these companies has been willing to offer board seats to a minority investor.

To conclude the discussion of the possible role of investment companies in corporate governance reform one should keep in mind that *II* participates only in the fixed income market and has practically no opportunities for an activist role as a subject of corporate governance. With regard to *HH* we need to keep in mind, first, that as a minority investor it has no access to corporate boards; it makes efforts to influence corporate decision making, for instance, by sending letters to the controlling shareholders with demands for greater transparency, discussion of the changes of corporate strategy by the general assemblies, etc, but this is hardly sufficient to produce any serious impact. Second, the Bulgarian stock market can be really unpredictable and in case of a continued downturn (which is easy to imagine) the fund may have to radically alter its investment strategy toward fixed income instruments; in such a case, however, its role as an agent of corporate governance reform is not likely to grow.

### 3. Pension Funds

In developed market economies pension funds are among the most important institutional investors – they are active buyers and sellers of stocks on the market. People's retirement money stands behind serious decisions of the management of publicly traded companies as these funds account for large numbers of votes in the general assemblies and provide presence in corporate boards. Through pension funds multiple unsuspecting individuals can participate in the governance of a company and vice versa – if a company is successful in its field of business, provided it is properly run, it can bring significant benefits to these unsuspecting individuals. Policy makers who launched the pension reform in Bulgaria had these considerations in their minds. Since 2000 the major institutions of a market-based pension system have been set up; private pension funds started operating in addition to the state social security system. In general, the pension reform aimed at providing guarantees in the long run for decent income of millions of citizens who sooner or later will reach retirement age; in a medium term perspective, among other things it aimed at the consolidation of financial markets. I am not going to elaborate further on the pension reform in general but focus only on one of its pillars – the private pension funds, which can be relevant for corporate governance reform.

Currently there are eight licensed pension fund companies in the country with three funds in each of them – one professional, one supplemental universal and one voluntary pension fund which receive respectively mandatory contributions from employers, mandatory contributions from employees born after 1959 and voluntary contributions regardless of the investment preferences, time horizons and risk tolerance of individual contributors.<sup>18</sup> At the end of year 2001 the capitalization of all pension fund companies amounted to 40.275 million leva (US\$1 was equal to about 2 Bulgarian leva in November 2002), which was 59.82 percent more than that at the end of year 2000. At the end of year 2001 only the assets under management of the voluntary and professional pension funds reached almost 187 million leva (respectively 72.5 and 27.5 percent of the total); the assets of the supplemental universal pension funds represent 0.66

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<sup>18</sup> According to the existing regulations every employer and employee in a given proportion should make mandatory contributions to a pension fund for the benefit of the employee. If the employee was born after 1959 he/she should make supplemental contributions from his/her regular income. Everybody can make additional voluntary contributions – the incentive for this is the opportunity to defer taxes until the time of withdrawal when supposedly he/she will be in a lower tax bracket.

percent of GDP and 3.71 percent of the total deposits in commercial and savings banks (versus respectively 0.34 and 2.41 percent one year before).<sup>19</sup>

The mandatory nature of a large part of the contributions makes this process look like taxation and guarantees significant cash flow to the pension funds for the future; at the same time the state has taken special measures to guarantee the safety of people's investments by strictly regulating the investment options. According to the legislation on professional and supplemental universal funds (the Code on Mandatory Social Insurance of 1999 and Law on Supplemental Voluntary Pension Insurance of 1999) at least half of the investments should be in treasuries or other instruments guaranteed by the state or in bank deposits; not more than 5 percent of the assets can be invested in real estate (by the way, this requirement shows a certain lack of understanding on behalf of the regulators as real estate can be very risky and illiquid); there is a limit of 5 percent of the fund's assets for investment in a single stock and a limit of 10 percent for the purchase of shares of the same company; at most 5 percent of the fund's assets can be invested in foreign treasuries, sovereign debt and municipal bonds and the same percentage - in listed foreign securities. Voluntary pension funds should invest at least half of their assets in cash and equivalents, up to 10 percent in real estate and mortgage bonds and up to 5 percent in other investment vehicles. Pension fund companies may borrow money but only with the sanction of the regulators and up to an amount equal to 10 percent of their own capital. There are special regulations with regard to investments abroad limiting the scope of securities for purchase to debt rated at least BBB+ (S&P) and shares of stocks included in major stock exchange indices.

There are also special capital adequacy requirements; detailed information on the structure of the investment portfolio should be reported to the regulators every 3 months. Every year pension fund companies have to present annual reports to their general assemblies. Surprisingly, contributors to the pension funds don't participate in these general assemblies. What is more, these reports are not submitted to the regulators – what the regulators should receive is just financial statements with no narrative explanation by the management. What is most interesting is that individual contributors are not considered as investors or shareholders but rather as clients. Pension funds are practically owned by the pension fund companies. These companies

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<sup>19</sup> Annual report of the State Agency on Social Security Supervision for 2001, Sofia, p. 40.

are required to create reserve funds for their professional and supplementary universal funds from which they are supposed to provide pensions for people who live longer than actuaries' estimations, i.e. these funds work more like insurance companies than mutual funds. In the voluntary pension funds there is a period of time, specified in the contract with the individual contributor, within which the balance in the individual account can be taken out once the contributor retires. Once the reserve requirements have been satisfied, then the pension fund companies can pay dividends to their shareholders – it makes sense to reiterate that these are not the contributors to the pension funds. From a corporate governance perspective this is important – individual contributors can have only one option of effective control – the “exit” option; their “voice” option is limited only to reporting instances of clear breach of the regulations by the pension funds to the regulatory authorities; otherwise, the “voice” option is reserved for the shareholders of the pension fund company. As pension fund companies are not publicly traded, issues of corporate governance in them have different dimensions and little relevance to the current reform efforts.

Still, individual contributors have to pay fees. The existing legislation sets the upper limits – 5 percent for fund administration plus 1 percent investment fee for professional and supplementary universal funds and 7 percent total for voluntary pension funds (strangely enough, investing the assets is not considered by the legislators as an element of the administration of these assets). As a result of this generosity pension funds do not effectively compete for people's contributions on the basis of fees, although this would be logical for a market-based pension system – practically all of them charge a little below the maximum allowed by the law. In their advertising campaigns funds focus on yields, which can go up to double digits – they are not allowed to make promises about expected returns but use historical data from the first years of their operations. Thus, individual contributors have to pay a percentage-based fee as if they were hiring somebody to handle their investments for them although they do not get the benefits of being investors *per se*. The law also provides that in the professional and supplementary universal funds 90 percent and in the voluntary pension funds 80 percent of the investment income is supposed to be distributed among the individual accounts proportionally to their weight in the fund's assets. This means, in fact, that additional charges are imposed on the contributors, i.e. the remaining percentages from the total investment income. In addition, in order to achieve double-digit yields pension funds should have a really high profit margin (equal to the yield plus the administration fee); such margins (15

percent and over) can hardly be accounted for on the basis of the stated very conservative approach to the choice of instruments they invest in. If the risk-free rate in Bulgaria is equal to the yield on national treasuries (about 5 percent for those with maturity of one year) the difference represents a significant risk premium which is obviously inconsistency with the conservative investment strategy stated by the pension fund companies, which calls for an explanation by the management.

As the opportunities for control by the individual contributors are limited the control functions of the state have to be strong – this is why these functions have been very clearly spelled out in the legislation. Governing and supervisory board membership of the pension fund companies is very strictly regulated. People who owned or worked in the management or governing bodies of companies which went bankrupt or defaulted on their financial obligations are not allowed to take such positions; there is a special prohibition for people who have worked in companies providing security or similar services (since the beginning of the transition process in Bulgaria such companies have been legal forms of the presence of organized crime in business); people with record of employment for security companies are not allowed to work as pension fund agents. Control in general is exercised by the State Agency for Social Security Supervision, which oversees the activities of pension funds companies, reacts upon violations of the regulations, imposes measures for financial restructuring if necessary, approves biometric tables for use by the pension fund companies in their actuaries, etc. With regard to investing the assets of the pension funds SSEC has the regulatory and controlling functions as in all investment activities in general.

As the pension reform was designed a few years after the mass privatization a number of the lessons learned were taken into account. One of these lessons involved conflict of interests. The pension reform legislation prohibited a person to be at the same time a shareholder and/or a board member and work in the management of companies-potential competitors and/or investment intermediaries. Other restrictions on pension fund management include prohibition to be affiliated with companies with which the pension fund company does business and prohibition to be a pension fund agent for more than one pension fund. In addition, pension funds are not allowed to be shareholders in other businesses or non-profit organizations.

With regard to the current portfolios of pension funds we should admit that the current investment policies are even more conservative than the regulatory requirements. As of 31.12.2001 voluntary pension funds as a whole have 38.18 percent of their assets in cash deposits, 44.38 percent in treasuries or other securities guaranteed by the state, 6.70 percent in municipal bonds, 4.50 percent in mortgage bonds, 4.41 percent in real estate, 1.02 percent in other securities traded on regulated markets (including equity but not exclusively) and 0.81 in other investment vehicles. As of the same date professional pension funds had the following distribution of investments among asset classes: 37.28 percent in cash deposits, 58.60 percent in treasuries and other securities guaranteed by the state, 2.75 percent in mortgage bonds, 0.85 percent in municipal bonds and 0.52 percent in securities listed on regulated markets. It is worth noting that individual funds do not disclose generally the exact composition to their portfolio – they report it only to the regulators and, as a rule, individual contributors do not have access to this information. As of today, it is very likely that their investments in equity are close to zero; the role of pension funds as a factor of corporate governance reform is therefore insignificant as they are not interested in equity investments.

The State Agency on Social Security Supervision expects that in year 2002 the number of individual contributors to voluntary private pension funds will reach 537 thousand, 1.256 million in universal pension funds, and 157 thousand in professional pension funds, which is really a lot for a country with a population of about 8 million. The assets of these funds in general are expected to reach 366.410 million leva, i.e. about 0.7 percent of GDP and 6.2 percent of the savings held in commercial and savings banks in the country. Given the high rates of growth of pension fund assets it is likely that a significant part of them may be invested in equity in the future, no matter that this will be a small portion of their total portfolios. When this happens they will face the issue of equitable treatment as shareholders and most likely at that time they will try to get some say in the companies' management through seats on corporate boards. If the current legislation is not changed, then they will not be able to hold majority stakes and directly manage the companies in their portfolio. This will be the time when Bulgarian pension funds may become active proponents of corporate governance reform – unfortunately, this is unlikely to happen in the near future (at least in the next 5 years or so); in addition, given the track record of Bulgarian private business behaviour over the last decade or so, they may start lobbying for legislative changes which will allow for an accommodation in the existing situation with publicly traded companies and somehow share the benefits with the majority holders, or become

majority holders themselves, rather than trying to push for comprehensive reform of corporate governance practices – at least, they will have the resources to do so.

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In most of the developed economies institutional investors and financial markets are subject to special regulations, much tougher than the general rules for commercial activities; the absence of strict (but not restrictive) government regulation or private self regulation and reliable enforcement goes hand in hand with poor corporate governance record. The analysis of the regulatory framework and the corporate governance practices at the former privatization funds and the private pension funds in Bulgaria leads us to generally pessimistic conclusions – the private sector entities in Bulgaria, whose counterparts in developed market economies have been at the centre of the drive toward sound corporate governance, will hardly rise to the challenge they face. First, most of the privatization funds which accumulated people's investment vouchers in the course of the mass privatization wouldn't qualify as institutional investors as they turned, in fact, into industrial/financial conglomerates: these HCs have become some of the major abusers of shareholder rights; they are already entrenched in the status quo and are likely to strongly resist efforts to reform corporate governance. In a few years when Bulgaria joins the European Union free float of capital and goods across the national borders will put these HCs, or more accurately, their subsidiaries, under serious competitive pressures and given their general lack of inefficiency and lack of capacity to function in a competitive environment it is very likely that we will witness massive business failures, including bankruptcy of most of the HCs. This is going to be, in fact, the end of the story, called Bulgarian mass privatization.

Second, the investment companies which emerged from the transformation of the privatization funds are currently just two: the one which invests in fixed income instruments may have some future in general but it is not likely to become a player in the field of corporate governance reform. The other one, which invests in equity, will need a consistent stock growth in the coming years in order to be able to pursue its current strategy given its high management fees. Whether this is possible or not given the general economic situation in the country as well as the global market trends is a big question. Thus, significant support for corporate governance reform is unlikely to come from these two investment companies. Third, pension funds have the potential to gain strength in the future but they are not active and unlikely to be in a short- and mid-term

perspective; individual contributors to these funds are not shareholders; the share of equity in their portfolio is insignificant; in general, they have not been conceived as strong participants in capital markets in the future. In this situation they are more likely to be passive observers of the efforts to achieve (or prevent) corporate governance reform.

The bottom line is that the counterparts of major private business proponents of corporate governance reform in developed markets are missing in Bulgaria. We can make two further conclusions. First, the model of corporate governance which policy makers have been trying, although inconsistently, to bring to Bulgaria may not be the most appropriate. The experience of most of the countries in Central and Eastern Europe as well as that of Russia shows that "outsiders" have little chance to get equitable treatment as shareholders; no matter what the regulations are, "insiders" have a disproportionately large amount of power. A number of analysts have observed the gap between the goals and the provisions of the laws and regulations, on the one hand, and the existing practices, on the other hand; in this case, some people argue that further efforts toward corporate governance reform may be more successful if they focus to a greater extent on the interests of "insiders" and offers them greater opportunities for pursuit of their interests rather than trying to promote measures which are totally out of place in the current business environment of the countries with economies in transition.<sup>20</sup> Although I am sceptical on this, efforts to come up with specific proposals in this direction should be welcomed – they will represent a test of the viability of corporate governance principles in general. And second, in an environment, in which pro-status quo actors dominate, the prospects of reform are really bleak. External shocks may be necessary to bring life to the reform - the accession to the EU may represent the source of such shocks; the question is, however, if it is not going to be too late.

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<sup>20</sup> See, for instance, Andrei Yakovlev. Demand for Legal Regulation in Corporate Governance: Evolution of the Strategies of Economic Agents // *Voprosy ekonomiki*, 4/2003 [in Russian – Андрей Яковлев. Спрос на право в сфере корпоративного управления // *Вопросы экономики*, 4/2003]; Dolgopiatova T. D. *Corporate Control in the Russian Companies: Models and Mechanisms*. Working Paper 1. Institutional Issues in the Russian Economy. Moscow: State University – Higher School of Economics, 2002 [also available in Russian - Т.Долгопятова. Модели и механизмы корпоративного контроля в российской промышленности (опыт эмпирического исследования). // *Вопросы экономики*, 5/2001]; Eric Berglof and Ernst-Ludwig von Thadden. The Changing Corporate Governance Paradigm: Implications for Transition and Development Countries. Mimeo. 1999, etc.