

A comparative overview
of the corporate governance framework
in South East Europe

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Summary

This paper illustrates the main common characteristics as well as the main differences among SEE countries regarding their corporate governance framework, and identifies the main issues and difficulties currently encountered in corporate governance practices in SEE. The first part of the paper draws a broad landscape of the present political and economic situation of SEE countries. It shows how South East Europe has recently entered a new political era, hopefully putting an end to devastating conflicts and international isolation for some countries. It then examines how, for the first time since the beginning of the transition, SEE countries are enjoying a favourable macro-economic climate, with macro-stabilisation and a return to growth, though these achievements are still fragile, especially concerning budget balances and external positions. Finally, it analyses how large privatisation is still an on-going process in all SEE countries. The paper focuses then more closely on the corporate governance framework in its second part, giving an overview of the ownership structures of enterprises, showing how these derive mainly from the privatisation program and how they are still characterised by the significant control both by insiders and by the State. It then briefly describes the state of the financial sector, showing how the banking sectors are only now recovering from acute crisis and how they have been largely privatised to foreign banks. As for the stock exchanges, they are mainly under-developed, with low liquidity and low transparency, in spite of usually good working infrastructure. The current or up-coming pension reforms are one potential source for their development. Finally, the makes a preliminary assessment of the legal framework regarding corporate governance, highlighting main discrepancies between relevant laws in respective countries, as well as recent legal evolution and reforms and underlying obvious shortcomings in implementation. The third part of the paper identifies the main current issues concerning corporate governance practices in SEE, following the five chapters of the OECD Principles of Corporate Governance.

Introduction.....	3
Part I: The background landscape	4
I. A new political era	4
II. An improved macroeconomic climate	5
III. Recent progress in privatisation of large enterprises and FDI	9
Part II: The Corporate governance framework	12
I. Ownership structures	12
1. Main characteristics	12
2. Current trends	14
II. The financial sector.....	16
1. The Banking sector	16
2. The stock exchanges	19
3. Pension reforms	22
III. The legal framework	23
Part III: Main issues in corporate governance	26
I. Shareholders' rights	26
II. Equitable treatments.....	29
III. Transparency and disclosure.....	32
IV. Boards	35

Introduction

Objective of this paper

1. The main purpose of this paper is to illustrate the main common characteristics as well as the main differences among SEE countries. The description of this “landscape” will have to be completed, refined, detailed and even corrected by this session’s discussants, and more broadly by the work of the Roundtable.
2. The second objective of this paper is to identify the main issues and difficulties currently encountered in the field of corporate governance in SEE. This will once again have to be refined during the roundtable. Indeed, the determination of these main issues will help to orientate the future work of the roundtable.
3. Finally, this paper will also serve to clarify the areas for which we do not have much information and where the process of the Roundtable should solicit additional empirical and analytical input.
4. The major challenge in this exercise is its comparative nature. I will try as much as possible to cover the whole set of countries included in the Roundtable. Nevertheless, for some of them we have not been able to collect much information, or else they have only recently embarked on a real transition process, for reasons that are well known. Consequently, parts of this paper may focus more on a limited set of countries for which more information is available. We hope that the Roundtable will enable us to achieve to broaden our perspective and we will need your cooperation in nourishing this roundtable with information from your respective countries.

Structure of the paper

5. This paper is divided in three parts. The first draws the background landscape. The second part describes the institutional framework for corporate governance in South East Europe. The third part identifies the main issues regarding corporate governance practices.
6. The first part of the paper will draw a broad landscape of the present political and economic situation of SEE countries. This will necessarily be quite general. But as we are at the beginning of the first Roundtable, it is worth highlighting the main common or specific characteristics regarding the present political background, the macroeconomic climate as well as recent progresses in privatisation. We will show how South East Europe has recently entered a new political era, hopefully putting an end to devastating conflicts and international isolation for some countries. We will then examine how, for the first time since the beginning of the transition, SEE countries are enjoying a favourable macroeconomic climate, with macro-stabilisation and a return to growth, though these achievements are still fragile, especially concerning budget balances and external positions. Finally, we will analyse how large privatisation is still an on-going process in all SEE countries.
7. In the second part, we will focus more closely on the corporate governance framework. To do so, we will give an overview of the ownership structures of enterprises, showing how these derive mainly from the privatisation program and how they are still characterised by the significant control both by insiders and by the State. We will then briefly describe the state of the financial sector, showing how the banking sectors are only now recovering from acute crisis and how they have been largely privatised to foreign banks. As for the stock exchanges, they are mainly under-developed, with low liquidity and low transparency, in spite of usually good working infrastructure. The current or upcoming pension reforms are one potential source for their development. Finally, we will make a

preliminary assessment of the legal framework regarding corporate governance, highlighting main discrepancies between relevant laws in respective countries, as well as recent legal evolution and reforms. We will then make a general observation regarding obvious shortcomings in implementation, as this point will be discussed in depth in session 7.

8. The third part of the paper will identify the main current issues concerning corporate governance practices in SEE. It will follow the five chapters of the OECD Principles of Corporate Governance. It is still a preliminary assessment, as it will be one of the roundtable's aims to carry a more in-depth and detailed investigation of the difficulties and shortcomings in these five areas. The purpose is to stimulate a structured discussion and Roundtables participants are encouraged to provide further input regarding their respective countries. The Roundtable's ultimate aim will be to come up with informed and relevant recommendations in the White Paper, as this will be the end-product of this whole exercise.

Part I: The background landscape

I. A new political era

9. South-East Europe has entered a new political era, with fundamental changes in Croatia and, more recently in Yugoslavia, that have broken their international isolation.
10. Since the January 2000 parliamentary elections that brought to power a coalition of six moderate parties, and the February 2001 election of Stipe Mesic as President. Croatia has joined the NATO Partnership for Peace, has acquired WTO Membership, participates in the CEI, SECI, Stability Pact, Adriatic Ionian Initiative. It obtained unilateral trade concessions from the EU and, in November 2000, negotiations were launched for a Stabilisation and Association Agreement with the EU.
11. The most dramatic changes obviously occurred in Yugoslavia, where the October 2000 and January 2001 elections brought to power the DOS coalition. The new government(s) have launched a substantial economic reform program and renewed contacts with the international community. FRY became a full member of the Stability Pact in October 2000 and received 1,3 bn USD in aid in a donors' conference at the beginning of July.
12. These very positive evolutions must of course not hide the remaining acute and potentially destabilising tensions in Bosnia-Herzegovina, the recent and persisting unrest in Macedonia, as well as the Kosovo situation.
13. Some less radical political changes also affected the remaining SEE countries last year with democratic elections that brought to power new parties or coalitions that do not question the reform path. In Romania, the PSDR minority government led by Mr Nastase seems to be more stable than the previous ones, while President Iliescu's party has evolved towards more investor friendly positions. In Bulgaria, the National Movement King Simeon II won the legislative elections in June 2001. It formed an "investor-friendly" government and announced a continuation of market reforms launched by the previous government. Finally, Albania is the only country that has not witnessed a political change this year. The ruling Socialist Party of Albania won a landslide victory in the last June parliamentary elections. This has been welcome by some as a proof of political stability, although the election results are being contested by the five-party coalition "Union for Victory".
14. With these political evolutions, most SEE countries are now targeting EU integration in a more or less medium term. According to the 1999 Helsinki Council, Bulgaria and Romania are to join the EU in 2007, even if at present they seem like "laggards", especially Romania, which received the worst

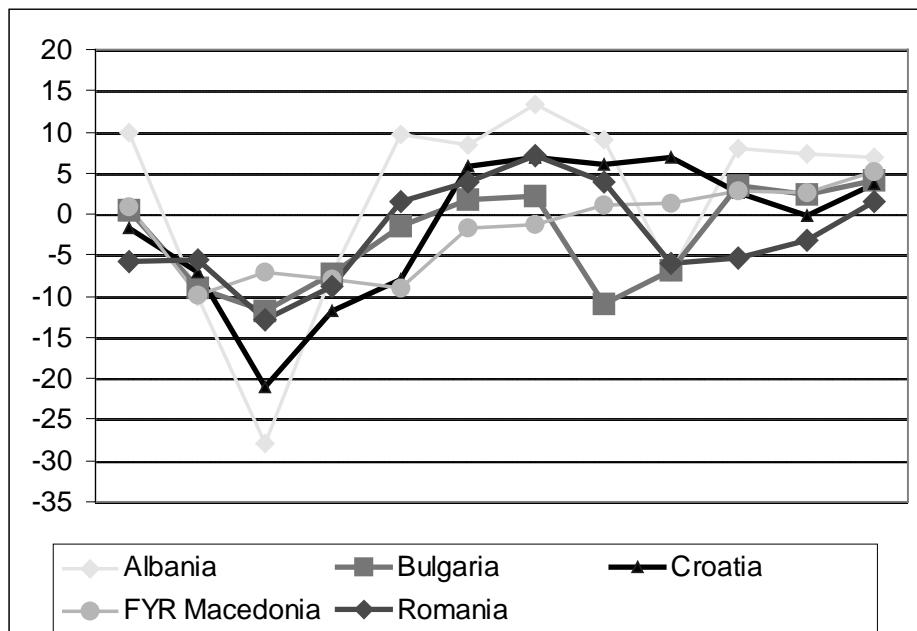
progress report in November 2000. Macedonia has signed a Stabilisation and Association Agreement with the EU in May 2001, Croatia should do the same this autumn, while Albania should start negotiations by the end of 2001. Finally, Yugoslavia officially declared its willingness to join the EU and has launched initial negotiations towards an SAA agreement in July.

15. These political evolutions may bring a relative stability to the SEE region and for the first time allow (some) regional cooperation on economic issues. Moreover, this favourable political climate is reinforced by a sound macroeconomic environment.

II. An improved macroeconomic climate

16. While in Central Europe transition countries average per capita GNP have reached about 20 to 30 percent of that in the European Union and tend to converge, the situation is more bleak in South East Europe. Indeed, average GNP per capita is less than 10 percent of the EU's and the gap is widening. If SEE countries have experienced clearly diverse trajectories since the beginning of the transition, some common and obvious factors explain their lagging transition, among which are adverse initial conditions, armed conflicts as well as hesitant reforms and restructuring.
17. Nevertheless, most SEE countries are now and for the first time since the beginning of the transition enjoying a stabilised macroeconomic situation as well as positive growth rates.
18. In terms of growth patterns, SEE countries have undergone various trajectories but growth rates have nowadays turned positive throughout the region.

Graph 2: GDP Growth 1989 - 2000



Sources: EBRD Transition Report 2000 and Investment Profiles 2001

- **Croatia** had enjoyed a relatively high level of growth up to 1998, as the 5 year average growth was 5 % between 1994-1998. But this growth pattern turned out to be unsustainable, as wages increased more than productivity and increasing public consumption crowded out private investment. High interest rates and low FDI also contributed to the low level of investment. Consequently, Croatia lost its competitiveness. Industrial production in 2000 was at 60 % of its 1989 level and exports

stagnated. All this resulted in a mounting fiscal deficit and external debt, increasing arrears (19 % of GDP at the end of 1999) and a recession in 1998-1999. Croatian economy took off again in 2000 with a 3,8% growth in GDP. It still enjoyed a 4,2% growth in the first quarter of 2001. Moreover, this growth was boosted by industrial output (+ 6%) and investments in fixed assets that grew for the first time by 11,6%.

- In **Bulgaria** with the currency board, the growth rate became positive as soon as in 1998 (+3,5% in real output in 1998 and +2,5% in 1999), in spite of unfavourable international events and trends in commodity prices. The growth has continued with a 5% increase in output in 2000, and a 1,7 % and 3,3 % increase respectively in industrial output and exports in the first half of 2001. Bulgaria now enjoys one of the highest growth rates among accession countries. Meanwhile, the government budget remained broadly balanced. Investment has recovered from its lowest level in 1996 (8,4 % of GDP), but is still insufficient for sustained growth.

- **Romania** appears as the late comer in terms of growth rate. Romania however had already enjoyed 4 years of growth with a peak at +7 % in 1995, after three years of the initial “transformational recession”. It entered a new phase of recession in 1997 and was renewed with a timid growth only in 2000 (+1,6%), mainly driven by exports. It remains however one of the lowest growth rates in accession countries and in the SEE region. But this situation may be changing as the GDP is expected to grow by 4% in 2001, largely driven by domestic factors. Indeed, industrial production rose by 12,4% in the first half of 2001.

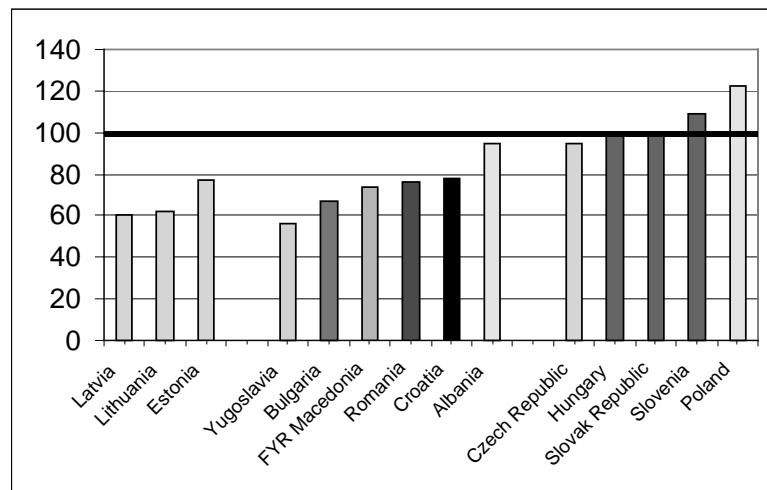
- **Albania** is the only SEE country that has been renewed with growth early in transition after a massive initial decline. Indeed, it has enjoyed constant growth since 1993, except in the crisis year of 1997, and presently enjoys a strong growth propelled by construction and services.

- **Bosnia-Herzegovina** enjoys a declining but still strong growth of 8,5%.

- Growth rates have been positive in **Former Yugoslav Republic of Macedonia** since 1996, but at low levels. While 2000 had been the best year in terms of growth since the beginning of the transition, with a GDP growth of 5%, the outlook for 2001 is obviously grim. The growth may come to a complete halt in the event of continuing conflicts.

19. Thus, SEE has not yet been hit by the economic slowdown witnessed first in the US and already in the EU. More especially, the looming German recession may hit European transition countries hardly given the importance of Germany in their exports. However, this share is not as significant for SEE countries, ranging from 9 % for Bulgaria to 16 and 17 % respectively for Croatia and Romania. But Bulgaria and Romania are relying heavily on capital and labour intensive exports, making them more vulnerable on the short term to a slow down.
20. In spite of this recently renewed growth, and contrary to most other European transition countries, SEE countries have not yet caught up to pre-transition GDP levels. The present growth rates would need to remain large enough for a while in order to compensate for the initial drop in output. This is even more the case when considering industrial output.

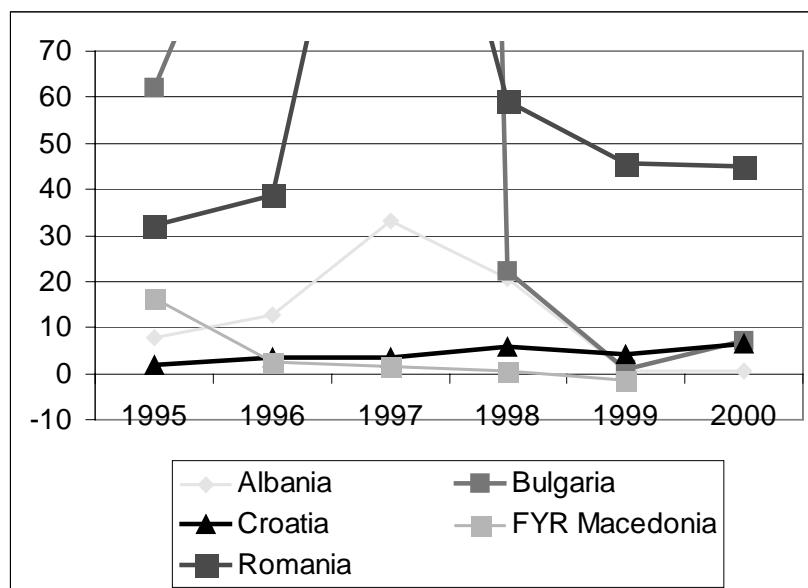
Graph 3: GDP 1999 / 1989



*Source : EBRD Transition Report 2000
(Except for Yugoslavia, it is industrial output, from Alpha Bank Monthly Economic Update)*

21. As for macroeconomic stability, stabilisation occurred in almost all countries. Nevertheless, large government budget deficits still hang over this newly achieved stability, while the sustainability of external positions often remains fragile:

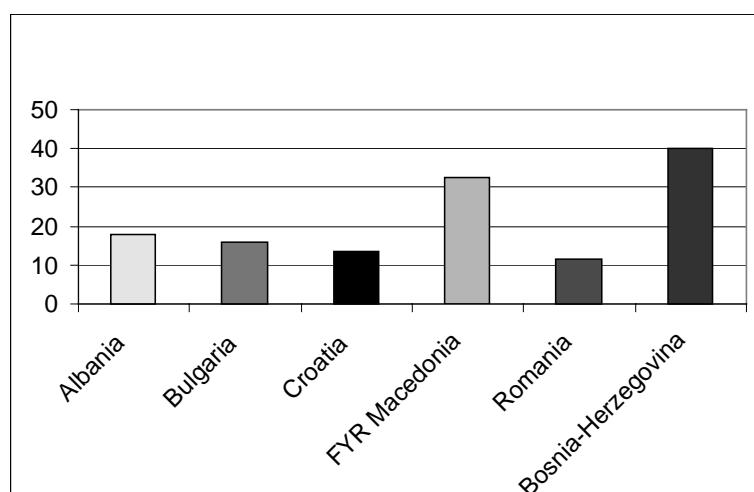
Graph 1: CPI Inflation 1995 - 2000



Sources: EBRD Transition Report 2000 and Investment Profiles 2001

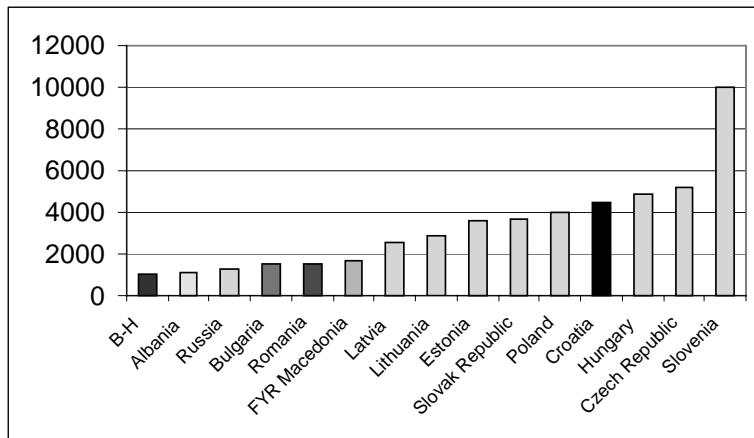
- **Croatia** has been the first to achieve a stable currency as well as a low and stable inflation rate (always below 6% since 1994). It more recently achieved reductions in current account deficits from 7,4% of GDP in 1999 to 6,5% in 2000, based on impressive cuts in government spending (by 4,2% of GDP). Yet this decrease is fragile given this current year's severe shortfalls in projected privatisation revenues, due to some delays in high profile privatisations.

- It took almost ten years of stop-and-go stabilisation policies and a currency board triggered by drastic banking and foreign exchange crisis for **Bulgaria** to catch up with macro stability. The currency board was underpinned by conservative fiscal policies and resulted in a rapid decrease of inflation and a solid fiscal position. Since the record level of 1058 in 1997, consumer price inflation dropped to 18 % in 1998 and to around 10 % in 2000. The budget is broadly balanced. The main problem is now the sustainability of Bulgaria's external position, with a widening current account deficit, a low ability to accommodate fiscal risk (due to currency board) and a problematic structure of the debt. However, the new Economic Minister announced a Eurobond issue in the second half of 2001 of Euro 200 to 400 million, precisely in order to restructure the foreign debt, by reducing the ratio of debt to GDP from 75% to 60%.
 - Macro stabilisation remains quite problematic in **Romania**. While Romania had initially succeeded in significantly decreasing its inflation with the 1993-1994 stabilisation program, it underwent a new up-burst in 1996-1997. Since 1998, Romania is still fighting with a vulnerable fiscal position and with significant levels of inflation (above 40%), the highest ones among Central and Eastern European countries. These macro imbalances resulted in an accumulated foreign debt becoming increasingly difficult to finance. Nevertheless, Romania enjoyed recent improvements in its current account balance, in external as well as liquidity indicators, ranking now around the middle in transition countries. However, a recent and renewed step increase in current account deficit in the first half of 2001 is again worrisome. A new stand-by agreement is currently being negotiated with the IMF. The recently announced economic program focuses on a gradual reduction of inflation to single digit levels over the next four years. Nevertheless, there has been step increase in current account deficit in the first five months of 2001 and year-to-year inflation is still expected to reach 30%.
 - In **Albania**, inflation has decreased steadily from its 1998 peak and has stabilised to a very low level since mid 1999. It was 4,6% in 2000 and the targets for 2001 are between 2% and 4%.
 - In **Former Yugoslav Republic of Macedonia**, macro stabilisation has been achieved earlier in transition, as inflation has been at very low levels (under 3%) since 1996 and the currency was pegged to the DM. The present instability and uncertainty may jeopardise these achievements.
22. The structure of the GNP evolved with a declining contribution of industry and agriculture, and an increasing significance of services. Nevertheless, this structural change can not be considered as a sign of modernisation of SEE economies as it was driven by the declining industrial output and the rise in prices in the service sector. Indeed, enterprise restructuration has been quite low and slow, especially in big enterprises.
23. This resulted in a rise in unemployment that reached high and even dramatic levels (between 12 and 40 %) and a sharp decrease in living standards, accompanied by increasing inequality. SEE countries have the lowest GDP per capita levels and the highest unemployment levels of European transition countries.



Graph 4: 1999 Unemployment Levels
 Source : EBRD Transition Report 2000

Graph 5: GDP per Capita in 1999 in US D



Source: EBRD Transition Report 2000

24. Thus, SEE countries are finally enjoying a stabilised, though fragile, macro-economic climate and a new growth. But the bulk of industrial restructuration remains to be done.

III. Recent progress in privatisation of large enterprises and FDI

25. The progress in privatisation as well as in methods used to privatise formerly state or socially owned enterprises have a significant impact on corporate governance practices in transition countries¹.
26. Privatisation programs have taken various forms but have often begun late and are still in progress in most SEE countries, particularly in the case of large enterprises. Consequently, while the private sector now accounts for around 60% of GDP in most SEE countries², this is far from being the case regarding industrial production (in Romania, for example, the SOE still account for 75% of industrial production).

- In **Croatia**, three waves of privatisation have already occurred.

- The first wave was undertaken under the 1991 Law on Transformation of Socially Owned Enterprises and the second under the 1996 Privatisation Act. The privatisation process set aside shares for employees at preferential rates payable with instalments. Unsold shares were transferred to two state funds, the Croatian Pension Fund and the Croatian Privatisation Fund.
- The third and final privatisation scheme was opened for veterans and displaced persons (200 000 participants). They could auction for shares or transfer them to Privatisation Funds. The Croatian Fund for Privatisation is supposed to sell 80 % of its portfolio by the end of the year. It is now allowed to sell its stakes at their market rate (under nominal value) which had not previously been the case, and consequently, the privatisation was slowed down. It is also allowed to apply several privatisation options (including tenders for strategic investors).

¹ MEOBs (Management and Employees Buy-Outs) and voucher privatisations are usually considered to be less favourable to the emergence of active private owners aiming at improving efficiency or maximizing profits than direct sales to private investors

² 75 % in Albania, 70 % in Bulgaria, 60 % in Romania and Croatia, 55 % in FYROM and 35 % in Bosnia-Herzegovina (EBRD Transition Report, 2000).

- Largest firms, mainly utilities, had been put aside from the very beginning of the privatisation process. The privatisation program was thus expected to accelerate in 2001 as the new government planned to privatise 11 major public enterprises, including strategic utilities, through selling big stakes to strategic investors³. But big deals have been postponed and it is not sure now that the targets set up in the 14-Month Program signed in March will be met.

- In **Bulgaria**, privatisation was undertaken quite late in the transition, as the first wave of privatisation was launched only in 1997.

- The first wave concerned all sectors except for energy, transport and infrastructure and was initially scheduled to be completed by the end of 1999. 70 % of these assets have already been sold, while 10 % have been liquidated. This first wave was characterised by a complex mix of privatisation methods and approaches, including direct cash sales, cash sales through auctions and tenders, MEBOs, mass privatisation through voucher distribution and direct IPOs (Initial Public Offerings) on the stock exchange. During the first wave of privatisation, people were given vouchers that they could invest either in privatisation funds or else directly in companies to be privatised. Nearly 3 millions citizens participated in the process, mostly through privatisation funds.
- The second wave of mass privatisation began in 1998 and is an on-going process. It gave the possibility to all citizens over 18 of acquiring a new voucher book containing 250 “investment Leva” (with a value of approximately USD 130). Tenders are organised every 6 weeks, with new offers and residuals from previous tenders. Presently, minority stakes are offered (only in ten companies out of 300 to 400). These tenders are a good way to get rid of residual government shares. Some of the residuals are also kept for the restitution process.
- The privatisation in remaining sectors (energy, transport and infrastructure) still remains to be carried out. The new government priorities regarding privatisation will be to try to sell BTC (the Telecom monopoly) and Bulgartabak holding, whose previous attempts had failed in 1999-2000, as well as Varna Shipyard.

- In **Romania**, the privatisation process has been very slow.

- The SOF (State Ownership Fund) received 70% of the stocks of commercialised companies, while the remaining 30% went to 5 SIFs (privatisation funds). The SOF has successfully privatised small and medium sized enterprises but only half of the large companies have been privatised. The SOF retains stakes in more than 1000 companies.
- Until 1999, the biggest enterprises, the so-called “régies autonomes”⁴ had even been excluded from privatisation programs and remain to be restructured (they account for 20% of total employment and for 45 %, of productive assets). In 1999, these corporatised “national companies” were transferred to line ministries to be privatised, with very modest results. The WB had put together an accelerated privatisation program under its PSAL 1 (Private Sector Adjustment Loan) for 63 big enterprises. In 1999-2000 only RomTelecom was sold.
- Thus privatisation of large enterprises is still pending. The SOF was transformed into APAPS (Authority for Privatisation and Administration of State Property) under the direct supervision of the government. In February 2000, the new government agreed to initiate the privatisation of 17 enterprises which had been included in the PSAL 1 program, and some other major ones have also been launched (Petrom, Alro, Tarom, Galati, ...). Besides the

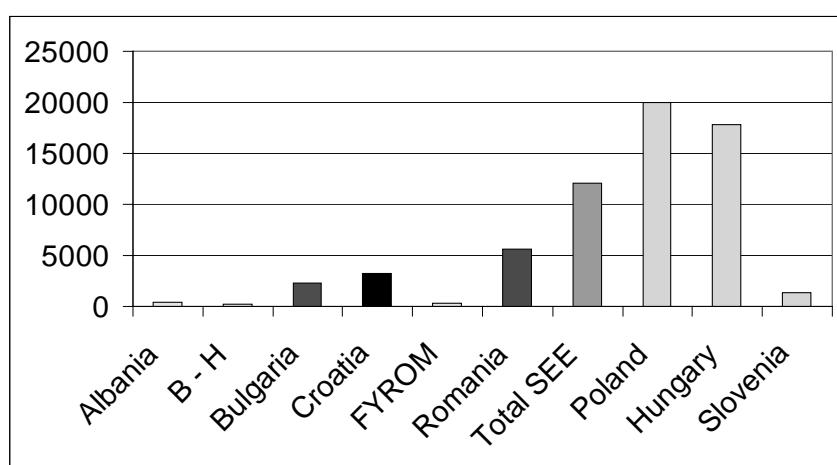
³ 35 % of the telecom company, HT, have been sold to Deutsche Telekom in 1999 and an additional 16% stake has been sold in July, at a 100% premium over the first deal price. The Parliament is currently revising the privatisation law to accommodate this latest transaction that would give DT a 51% stake in HT

⁴ These “régies autonomes” had been created at the very beginning of the transition by the Law n°15/1990 making them non-privatizable entities. They were successively excluded from the bankruptcy law subjects. These “régies autonomes” only reintegrated the privatization process in 1997 1995 (Negrescu, 1999).

privatisation of Banca Agricola that we will refer to below, major achievement has been the privatisation of the steel mill Sidex, the biggest Romanian company, accounting for 4% of its GDP, and having accumulated a debt of USD 1.2 billion. Finally, the government is also working towards a PSAL-2 programme, including an additional 30 major companies.

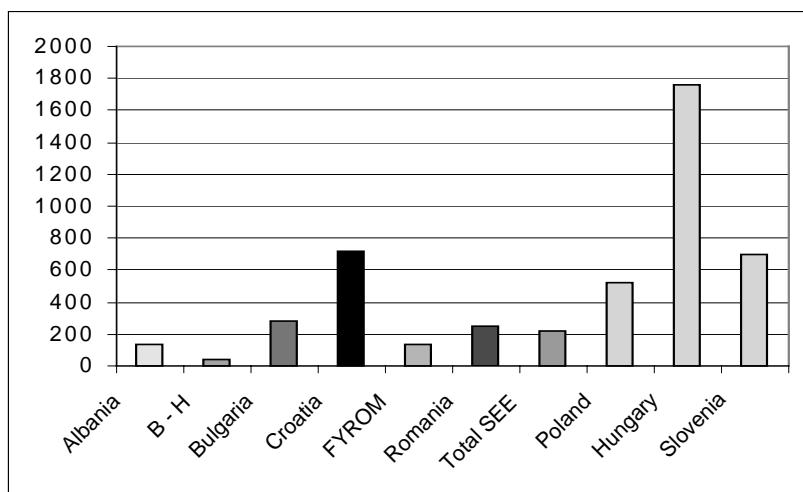
- In **Former Yugoslav Republic of Macedonia**, a large privatisation program began in 1994. A case by case commercial approach was taken with a large domination of MEBOs. Today privatised enterprises dominate the formal enterprise sector in terms of output and employment. Only 10% of the companies remain socially or state owned. However, the largest enterprises still remain to be privatised, mainly loss-making utilities and primary sector.
 - In **Bosnia-Herzegovina**, a number of privatisation deals have recently been made or are on the verge of being made (Mostar-based TKM, Banja Luka and Uniline breweries, Aluminij Mostar, a car assembly line in joint-venture with VW).
 - In **Albania**, a mass voucher privatisation program began in 1995 but was interrupted by the 1997 unrest. Privatisation of big enterprises was re-launched in 1999 but is still at an early stage. This time the strategy is to find strategic investors or long-term concessionaires. Accordingly, the telecom monopoly should be sold through an international tender by the end of this year. However, 75 % of the GDP is still generated by private firms, as only 2% of firms employ more than 10 employees.
 - In **Federal Republic of Yugoslavia**, a New Law on Privatisation has been approved in July. This law provides for (or forecasts) the privatisation of all state-owned enterprises within 4 years. This new law does not favour the insiders, as has been the case for most privatisation programs in the region. Indeed, up to 70% of the shares may be sold to foreign strategic investors. A Privatisation Agency is being established. An initial list of 16 companies has been prepared for international tenders (including Mobtel and Beocin, the largest cement factory). Even the Zastava group, the biggest in the region, whose largest companies should be privatised via tenders with the help of the WB in the second half of 2001.
27. A further improvement in macro economic performances as well as a continuation or an acceleration of the privatisation programs could simultaneously trigger and be facilitated by foreign investment. Until now, the SEE region ranked badly in terms of foreign investment, especially FDI.

Graph 6: Cumulated FDI, 1989 – 1999, in US D



Source: EBRD Transition Report 2000

Graph 7: Cumulated FDI per Capita, 1989 – 1999, in US D



Source: EBRD Transition Report 2000

28. But a significant improvement/acceleration in industrial restructuring and an effective increase in foreign investment requires the second stage set of reforms. This second stage set of reforms build on the institutional foundations of a market economy, of which corporate governance is a key element. Indeed, it has been now widely recognised that improved corporate governance practices are indeed necessary in order to trigger restructuring and achieve efficiency gains (EBRD, 1999, p. 92; Roland, 2000). Improved corporate governance is also a pre-requisite for attracting foreign investment that would allow these restructurations to be carried on. Such investments and restructuring make up the only path towards a sustainable growth.

Part II: The Corporate governance framework

I. Ownership structures

1. Main characteristics

29. The present ownership structures of JSC (Joint Stock Companies) in SEE countries show some common characteristics and reflect the history of the privatisation programs. Ownership structures are characterised by the significance of ownership by insiders (managers and employees), the importance of remaining state ownership and control, especially in big firms and utilities that are still to be privatised, and the emergence of various forms of institutional investors, mainly former privatisation funds.
30. The current ownership structure is characterised by significant control by insiders and more precisely by managers, who have secured control either through direct ownership or indirectly by *de facto* control over employee shares.
- In **Croatia**, the privatisation process somehow perpetuated the main features of the hybrid Yugoslav model of enterprise management, with high employee involvement as well as share ownership.

- In **Bulgaria**, the first wave of privatisation (until 1994) was dominated by MEBOs. Altogether 38% of privatisations have taken place through MEBOs. Consequently, 17 companies listed on the BSE-Sofia (Bulgaria Stock Exchange – Sofia) are still majority controlled by PAS (employees associations). At the end of 1998, a survey showed that for 52 privatised enterprises with more than 100 employees, managers and employees detained on average 24% of capital and that employees and managers have a dominant participation in 21% of enterprises.
 - In **Romania**, the employees associations have majority stakes or minority but controlling stakes in many traded companies, while millions of individual employees have acquired shares in the vast majority of RASDAQ companies through the voucher privatisation.
31. SEE ownership structures are also characterised by significant remaining state ownership and control, especially in big firms and utilities that are still to be privatised. This may be problematic for restructuring if the State does not really exercise its role as shareholder or if the management of state shares is dominated by political concerns rather than business judgement.
- In **Croatia**, a typical ownership structure for a privatised company is the following:

20 % held by Croatia Pension Fund
10 % local banks
15 % employees
10 % war veterans
45 % privatisation funds

 Thus, 40 % is controlled more or less directly by the State (Croatia Pension Fund, local banks⁵ and war veterans). All these stakes should be put under the supervision of the Croatian Privatisation Fund, which has started to become more involved and active as a shareholder.
 - In **Romania**, the APAPS (former SOF) still has majority stakes in 16 listed companies and minority stakes in many enterprises (in 2001 it still has 1135 companies in its portfolio). Nevertheless, given the very dispersed ownership of the remaining stakes, the State has retained control over most companies in APAPS's portfolio after the Mass Privatisation Program. This is especially the case for the vast majority of non-traded companies on the RASDAQ where the ownership structure "was petrified at the post-privatisation stage", divided between the State with a minority stake and "tens of thousands of voiceless minority shareholders" (OECD, 2001).
 - In **Bulgaria**, in the above mentioned survey, the State holds on average 18% of capital.

32. Finally, various forms of institutional investors, mainly former privatisation funds, have emerged and play a significant role in the ownership structure of enterprises.
- In **Bulgaria**, 81 licensed privatisation funds participated in the privatisation auctions and acquired 60 over the 90 million shares offered from 1060 enterprises. Almost all the Privatisation Funds transformed into holding companies (about 80 holding companies). But only 4 or 5 holding companies are really active (good, well known and significant in size). Presently, about 30 ex-privatisation funds are traded on the BSE, half of them on the official market. The price of their shares is at their nominal level⁶. Holding companies usually do not act as brokers. They are not financial investors but majority shareholders. A regulation of these holding companies as financial institutions is still lacking. The holding companies are not controlled by their shareholders. The

⁵ The 10 % held by private banks may be considered as controlled by the state as bank were until recently all state-owned. When privatised, shares were bought back by the DAB (Bank Rehabilitation Agency), as for PBZ (Privredna Bank Zagreb). PBZ had a portfolio of 100 M D book value. Prior to selling PBZ, the DAB bought out these shares.

⁶ Bulgar Tabac Holding, Albena and Petrol Holding Group, for example, are traded and do not perform so bad.

managers of these funds or holdings are the real owners and controllers. Holding companies have consolidated their stakes. There is a trend towards concentration within the holding companies ownership structure. Significant reorganising of these holdings has been going on, through non-transparent block deals and raising of capital, resulting in complex structures with holdings and sub-holdings. This reorganisation was usually done using legal methods, but nevertheless resulted in a *de facto* dilution of public shares and in a full control by managers.

- In **Romania**, the 5 SIFs (Financial Investment Companies) are the biggest institutional investors. They result from privatisation as COs (Certificates of Ownership) were distributed to citizens under the first privatisation program as well as privatisation coupons under the Mass Privatisation Program. Both could be used to acquire shares in SIFs. The whole (and complex) process resulted in between 30 % and 60 % of commercial enterprises' capital being shared between the 5 SIFs. The SIFs were eventually transformed into mutual funds after 1996. The capital structure of these SIFs is extremely dispersed. Since 1999 they have been listed and are the major players on the BSE as they are the most liquid (22% of the total turnover) stocks, they pay dividends and are themselves significant shareholders in the other listed companies.

- In **Croatia**, 7 Privatisation Funds were created and they control big stakes in privatised enterprises. These Privatisation Funds are closed-end companies, traded far below the nominal value of their shares, which reflects their bad and illiquid portfolio.

33. As they have become major players, privatisation funds or holding companies are a good target for action (for the roundtable). Indeed,

- They are at the centre of corporate ownership (In Bulgaria the biggest 10 holdings are said to control most of the big public companies. In Romania, the SIFs are the most important corporate governance agents).
- As majority shareholder, controlling minority shareholder or at least significant shareholders, they are in a privileged position to influence corporate governance practices.
- Their own behaviour towards their shareholders should also be improved. The problem is really "who guards the guardians".

34. Consequently, SEE countries present very common characteristics among transition countries regarding post-privatisation ownership structures. These three characteristics (significance of ownership by insiders, remaining state ownership and control, and the emergence of various forms of institutional investors, mainly former privatisation funds), engender a series of specific problems and difficulties regarding corporate governance practices:

- This first Roundtable will devote one special session to the State as a shareholder and corporate governance agent in to address one of these three characteristics.
- Problems related to insiders' shares will also be addressed in many sessions of the First Roundtable. Sessions 3, 4 and 6 will consider employees as minority shareholders. Session 5 will focus on one of the consequences of managers' control, e.g. related parties transactions. Finally, a future Roundtable will deal with the role of stakeholders. In such a Roundtable the role of employees as both shareholders and stakeholders will be studied in more depth.
- As for the role of institutional investors, it will probably become gradually more significant, as we will explain below. Many aspects of corporate governance are impacted by the presence of such investors, as has been the case in western countries since the beginning of the 80's. We will thus and most certainly deal with the various aspects linked to their ownership in privatised firms in many sessions of the Roundtables.

2. Current trends

35. While the ownership structures in SEE countries show certain common characteristics, they are also changing. Strong and common trends are visible.
36. Common trends regarding ownership structures include: an increased concentration of ownership in individual companies, the transformation of Joint Stock Companies (JSC) into Limited Liabilities Companies (LLC), the de-listing of public companies and the formation of holding companies on the basis of former privatisation funds.
37. The tendency towards ownership concentration takes various forms and may be more or less marked in the different countries. It is particularly marked in countries where privatisation programs have been well advanced. Indeed, the concentration constitutes a sort of second stage reaction to the outcome of the early privatisation programs.
- In **Romania**, the Mass Privatisation Program resulted in an extremely dispersed ownership structure. On the BSE, the vast majority of companies, except for mainly financial ones now (mostly SIFs), have a concentrated ownership structure, with a >50% owner, or are controlled by a minority owner. Majority shareholders are foreign investors who want to further increase their capital shares (15 companies), employees associations (17 companies), foreign investor funds (4 companies) or holdings (9). Minority but controlling owners are also employees associations or institutional investors (mainly SIFs). Indeed, SIFs are concentrating their portfolio by reducing the number of companies in their portfolio and increasing their individual stakes (with various strategies, some choosing to acquire majority positions and others preferring to remain minority but significant owners). Consequently, SIFs tend to behave like strategic investors. On the RASDAQ there is a similar trend towards concentration and the RASDAQ is considered as a take-over market. More than half of top 100 companies listed on the RASDAQ are majority controlled by strategic or institutional investors. This trend towards concentration may also be understood in the light of the fact that the majority of the biggest companies are closely held, i.e. owned by one or a few investors.
- In **Bulgaria**, the already concentrated structure of ownership is being reinforced.
 - In **Croatia**, the most probable evolution would be towards an increase in management ownership, as well as in PIF (Privatisation Funds) shares, while State and employee shares are likely to decrease.
 - In **Albania**, concentration of ownership has been observed in half of the privatised enterprises.
38. The tendency towards ownership concentration derives jointly from the excessive ownership dispersion that results from voucher privatisation, especially in Romania, and more generally and fundamentally from the inability or great difficulty for minority investors to have their rights respected.
39. Parallel to this concentration tendency, a lot of JSC are being transformed into LLC.
- In **Croatia**, 2500 to 3000 JSC have been created through the privatisation process. This is too large a number given the average size of companies. Consequently, the current trend is towards the transformation of numerous JSC into LLC⁷.
 - In **Bulgaria**, most companies are currently single proprietorship or one person LLC. In the case when LLCs has several shareholders, they are often related (family connections or close friends). As

⁷ 100 000 LLC are currently registered, a pattern similar to the German one, with the predominance of LLC, considered as more simple and flexible than JSC.

for JSC, a lot of them have only two shareholders (one with 99% and the other one with 1%). There is no rationale for these companies to remain JSC.

- In **Romania**, there were 23 000 JSC, as of December 2000, of which 12 500 were active. Only 2500 had more than 250 employees. Only a small portion of JSC are real “corporations” in the legal sense given their size, ownership patterns and organisational model.

40. This tendency to de-listing should be encouraged regarding small and medium size enterprises. Indeed, these firms do not have the means to access outside capital, and the legal structure of JSC is not appropriate for them. It is too burdensome and costly in terms of administration and legal obligations. Indeed, sophisticated mechanisms to carry out shareholder meetings and even more so, to protect minority investors can be quite costly for SMEs. Of course, concerns about transparency and disclosure are also quite relevant for SMEs. Furthermore, SMEs are a critical part of transition economies, especially as they include most of the new private enterprises. These are even more significant in some SEE countries, like Albania.

II. The financial sector

41. Like in most transition economies, the financial sector is a strategic but often weak sector in the SEE region. Indeed, most SEE countries underwent a major banking crisis in the second half of the 90's. These crises have been very costly and have resulted in very low outside financing of enterprises, while financial markets are still quite underdeveloped.

1. The Banking sector

42. The bank crisis resulted from poor banking supervision and mounting bad debts that state-owned banks granted to not yet restructured state-owned enterprises. The cost of solving the banking crisis has been significant in all SEE countries. It has been estimated at around 8% of GDP in Romania, at 75% of the GDP in Bulgaria between 1991 and 1998, and at 30 % of the annual GDP in Croatia; some of the highest figures among transition economies.

- In **Bulgaria**, the acute banking and foreign exchange crisis in 1996-1997 triggered the introduction of a currency board. In 1996, nine out of the ten state-owned banks had a negative capital while half of the private banks were technically bankrupt. First restructuring measures, including mainly closures and recapitalisations, revealed themselves insufficient, lacking significant regulatory changes and privatisation measures. It was only after bank runs and the closing of about one-third of the total banking system that effective measures were taken.

- **Croatia** underwent a major banking crisis in 1998 after the collapse of the 5th largest bank, Dubrovacka Bank and a series of other scandals involving small private banks, provoking runs on deposits. While numerous banks have been rehabilitated under the supervision of the BRH (Bank Rehabilitation Agency, DAB in Croatian), more than 11 banks were went bankrupt and several were put under temporary administration.

- In **Romania**, the first problems arose in 1995 with some of the largest private banks, Dacia Felix and Credit Bank, and in 1996 with Columna Bank. They were (slowly) isolated and finally went bankrupt. The crisis peaked in 1999 firstly with the insolvency of two small banks, Banca Albina and Bankcoop, then with problems at two large banks, Bancorex and Banca Agricola accounting respectively for 25% and 20% of the banking assets. The rescue efforts consisted in transfers of bad loans, with the establishment of AVAB (Asset Recovery Agency) transformed into ORCB (Office for the Recovery of Bank Assets) to manage bad loans portfolio of large state banks, recapitalisations (for Banca Agricola in February 2001), state guarantee and privatisation through

sale to a foreign bank. The crisis is still not over, due to the 2000 problems with Banca Turco Romana.

- In **FYROM**, a large scale recapitalisation operation transferred the non-performing loans of the 25 largest enterprises to the “Bank Rehabilitation Agency”, replacing them with government bonds. This bail-out costs 2 % of the yearly GDP.

- In **Albania**, the underdevelopment of financial services has been one of the main obstacles to the reforms. The collapse of fraudulent pyramid deposit saving schemes in 1996-1997 caused social riots, political backlash and an international military intervention, as the majority of the population lost its life savings. These schemes were unregulated and served as substitutes for underdeveloped banks.

43. One ultimate remedy to these banking crises has been the changes in the regulatory frameworks and the privatisation of the banking sector.

44. Regulatory changes mainly consisted in an improved banking supervision:

- In **Bulgaria**, legislative reforms in 1999-2000 concerned the issuing of permits for banking activities, as well as consolidated supervision.

- In **Romania**, reforms included a speeding up of bankruptcy procedures, an improved supervision with an early warning system and the establishment of a credit information system at the NBR. More strict regulation of mutual financial intermediaries (after the collapse of FNI in May 2000) as well as credit co-operatives was also adopted.

- In **FYROM** minimum equity capital has been significantly increased in order to limit the number of banks. A Deposit Insurance Fund was established, with all banks and savings institutions as mandatory shareholders.

- In **Albania**, after the Banking Law of February 1996, bad loans of the three previous state owned commercial banks were transferred to a recovery agency and two of them were merged. The Bank of Albania increased capital adequacy ratio as well as other prudential standards.

45. The privatisation of the banking sector is carried out mainly through sales to foreign banks, resulting in a significant increase in foreign capital.

- In **Romania**, 52.6 % of banking assets are now controlled by foreign banks (of which 8 % are subsidiaries of foreign banks). State ownership is nevertheless still prevalent in the banking sector, as the State still controls 43% of banking capital and 47 % of assets. In 1998, Société Générale acquired 51 % (sale and capital increase) in Romanian Bank for Development. In 1999, 45% of Banc Post was sold to GE Capital and Banco Portugues de Investimento. Raiffeisen expressed interest in Banca Agricola in March 2001 and the Romanian Commercial Bank (the biggest bank) is to be privatised in 2001.

- In **Croatia**, 85 % of banking assets are now controlled by foreign investors. The six largest banks have foreign participation, and the two largest banks are now majority owned by foreigners. Zagrebacka Banka, the largest bank with a 30 % market share and the only one that survived the 1998-99 crisis unscathed, is 63 % owned by foreign portfolio investors (through an IPO on the LSE)⁸. Privredna Banca Zagreb is 66 % owned by Banca Commerciale Italiana. Slavonska Banka was sold to EBRD and Kartner Landes-und Hypothekenbank of Austria, which will raise its stakes to 81% through an IPO and a buy back from minority shareholders. Rijecka Banka (4th) and Splitska (3rd) were sold to Bayerisches Landesbank and UniCredito in 2000.

⁸ In May Unicredito allied with Allianz made an offer for 55% of ZB, but withdrew their bid as the HNB (Croatian National Bank) could have rejected it, being concerned about potential Italian domination of the banking sector.

- In **Bulgaria**, the banking sector is now also largely privately-owned (80% of assets). Moreover, 72% of banking assets are foreign or majority foreign ownership. The two largest banks, Bulbank and UBB, have been sold to foreign investors in 2000 (to Unicredito and Allianz and to National Bank of Greece, respectively). The third largest bank, the former savings bank DSK Bank, and the fourth largest, Biochim, should be privatised in 2001-2002.

- In **Albania**, the third state-owned commercial bank, the National Commercial Bank, was sold up to 60% to a Turkish bank (Kent Bank of Turkey). The process is now catching up, with the forecast privatisation in September of the Saving Bank. It is the largest of the 13 existing banks, with 87% of the domestic deposits and 37% of foreign-currency deposits. This will be done possibly through tender for a 35 % share to a consortium of foreign banks, with another 49 % tranche available to institutional investors, and IFC participation.

- In **FYROM**, the biggest bank Stopanska Banka has been privatised, with 65% sold to the Hellenic Bank, 10 % to the EBRD and 10% to IFC. Another Greek bank, the Credit Bank, has purchased Kreditna Banka.

- In **Bosnia-Herzegovina**, Bank Austria Creditanstalt is presently trying to buy Union Bank.

46. Banking sectors remain highly concentrated in the SEE region, with expected further concentration in view of EU accession :

- In **Bulgaria**, the three largest banks hold 50 % of assets, 51% of deposits and 36 % of loans to non-financial institutions, 83 % of net interest revenues
- In **Romania**, the four majority state-owned banks representing 32 % of credits and 49 % of deposits.
- In **Croatia**, the 10 largest banks have an 80% market share and the consolidation of the banking sector is in progress through mergers and acquisitions.
- In **Albania**, the three largest banks have a 60 % market share.
- In **FYROM**, the Stopanska Banka has a 65 % market share and an even higher proportion of branches. However, some consolidation is already going on.

47. Despite an improvement in soundness and profitability, one main characteristic of SEE economies remains the low level of banking intermediation, even taking into account their low development stages. Loans to the private sector usually represent less than 15 % of GDP (12% in Bulgaria in 1999 and about the same in Romania). These levels are quite low, not only regarding international standards (from around 50 % for the US to around 120 % for Germany on average from 1989 to 1998), but also in comparison with other European transition countries. Indeed, loans to the private sector in these latter countries were in 1998 between 20 % of GDP for Poland and almost 60 % for the Czech Republic.

48. The reason for this weak intermediation are at once numerous and obvious :

- First of all, lending to the private sector is *de facto* very risky, as old customers are restructuring or are now clearly not creditworthy, while new ones don't have credit history, nor collateral. Consequently, banks prefer low risk liquid assets, mainly government securities and deposits in financial institutions, especially in Bulgaria with the liquidity requirements deriving from the currency board.
- This fundamental obstacle to lending to the real sector is magnified by the low level of transparency and the weak legal environment, which result in a very low probability of recovering losses in case of default.
- Moreover, the tighter regulation and supervision of banking activities that were imposed after the banking crisis make lending to loss-making enterprises much more difficult. Thus, for the moment,

banks' sizes (for example, in Bulgaria, banking assets represent only 36 % of GDP), both cautious depositors and cautious banks make the potential financing of investment by the banks quite modest.

49. The restructuring of the banking sector throughout SEE and the increasing involvement of foreign banks gives better perspectives to bank financing for the restructuring of enterprises. Right now banks are more interested in investing abroad or in government securities. But in the medium term, especially with the growing involvement of foreign banks, banks may have more financial resources to grant credit to enterprises. They will also be more able and prone to discriminate between risks, and thus to exercise their real intermediation role.
50. Consequently, banks in SEE could become more prudent and demanding creditors for industrial enterprises. They may be able to play an increasing role as stakeholder, asking for more transparency and disclosure. Moreover, they will probably put on more pressure in order to tighten the budgetary constraint of enterprises through bankruptcy threat. A prerequisite for these evolutions is obviously a significant improvement in their own governance and supervision.
51. The degree to which banks will be willing and able to become significant shareholders as well as creditors is not yet clear.

2. The stock exchanges

52. Most SEE countries created stock exchanges early on in the transition, but they really became operational and regulated by Securities Commission in the second half of the 90's.
 - In **Bulgaria**, an equity market was re-established in 1991. It was unregulated until 1995 and the SSEC was established in 1996. The present BSE-Sofia was founded in 1996.
 - In **Croatia**, the Zagreb Stock Exchange opened in 1992 but has developed after 1995. The securities commission, the CROSEC, has been in place since 1996.
 - In **Romania**, the Bucharest Stock Exchange became operational in 1995 and the RASDAQ was launched in 1996 to trade stocks distributed through the mass privatisation program. The National Securities Commission had been created in 1994 but only became active in 1996. However, a 2000 scandal has seriously questioned its willingness and ability to effectively regulate the market. It was held responsible for the collapse of an investment fund (NFI) and some commissioners, including the President, were even arrested.
 - In **Albania**, both the Tirana Stock Exchange and the Albanian Securities Commission were founded in 1996. But it does not really function as a stock exchange. It is in fact a money market as only Treasury bills are traded. Trade in privatised company shares is done out of the market.
 - In **FYROM**, the Macedonian Stock Exchange was founded in late 1995. Trading volumes have been low and are currently plummeting.
53. The securities markets that function, usually have a good technical and legal infrastructures.
 - The Zagreb Stock Exchange (ZSE) is considered to be functioning well with a PC based real time, on line, order driven electronic trading system.
 - The BSE-Sofia is also considered to have a good working trading infrastructure.
 - The BSE and the RASDAQ have an electronic trading system, which fulfils the three functions of trading, clearing and settlements as well as registration in a dematerialised environment. It is cost-effective and is able to handle large volumes. The RASDAQ uses the same information technology as the US NASDAQ.
54. SEE stock exchanges usually have two or more tiers, gradually offering more flexible listing requirements. The bulk of market capitalisation and trade volumes usually derive from the most flexible segments of the markets. The obvious exception is the ZSE where the two most traded stocks

are on the first tier and represent 75% of trading volumes. The existence of these very diversified market tiers in terms of disclosure requirements render comparison between market statistics difficult.

- There are three segments on the BSE-Sofia (A, B, C) and a free-market where the only listing requirement is a prospectus and free transferability of shares. The free market has 89 % of market capitalisation and 69 % of the volume (Ulgenerk and Zlaoui, p.20).
- ZSE has two segments with different reporting requirements. While the overall number of companies is 57, only 4 companies are listed on the first segment. Of the 4 listed companies, 3 are also listed on the LSE. The four listed companies are Zagreb Banca (LSE); Pliva (pharmaceutical) (LSE); Prodavka (agro-food business) (GDR on the LES) and Viktor Lenac (ship building). Two shares (ZB and Pliva) account for 75% of turnover.
- There are two market segments on the BSE, plus an “unlisted” sector. 23 companies are listed on the first market segment and 91 on the second one. The market is very concentrated as 10 companies represent 80% of the market capitalisation.
- The Macedonian Stock Exchange has three market segments, the third being de facto an unofficial OTC market, where most activity takes place. Moreover, only one stock is traded on the first and second market segments. The market is largely restricted to government bonds, with the forecast of an initial offering for 10 % of Mak-Tel (51% was sold in 2000 to an international consortium led by Matav).

55. SEE stock exchanges remain quite under-developed, with low capitalisation and little liquidity. With such limited liquidity, the viability of market intermediaries is problematic and data on capitalisation may be very misleading.

- On the BSE-Sofia, the capitalisation is presently estimated at around USD 526 million. But only about half of this capitalisation, i.e. 300 million US D, concerns traded non-state owned shares, thus representing grossly 35% of the GDP. The yearly turnover reaches USD 64 million. Turnover dropped by 40 % between 1998 and 1999 and remained stable in 1999 and 2000. However, with the new impetus in privatisation, which should go partially through the stock market, the BSE could develop in the coming year and reach a capitalisation of 2 to 3 Bn USD.
- The capitalisation on the ZSE was about USD 2,7 Bn at the end of 2000, representing 13,4 % of GNP. The yearly turnover in stocks was USD 187 million (a 190 % increase from 1999). The Varazdin market had a capitalisation of about 650 m US D, almost 4% of the GNP.
- The BSE Market capitalisation was 400 million US D end of 2000, down from 630 million in 1997, or 1,4 % of GDP (2,9% if the newly listed Romanian Bank for Development is included). The RASDAQ's market capitalisation was 1 billion US D, with a daily turnover around USD 500 000, significantly over the BSE.

56. It is important to recall that the SEE Stock Exchanges have been created as privatisation devices and initial trading was linked to re-distribution of property. They remain mainly secondary markets dedicated to these functions.

- The BSE and the RASDAQ are often described as only being inside games between brokers.
- This is especially the case on the BSE-Sofia, where only 10 to 15 companies are regularly traded. Moreover, there is a majority of block deals (close to 70 % of the volume in 2000). These block deals are registered on the exchange but the terms of the deals are set outside of the market. Moreover, a lot of deals are still off-exchange (according to estimations, there is 30 % more off market than on the market), based on inside information, which creates transparency problems for market pricing.

57. This underdevelopment of SEE stock markets results first of all from a supply problem. SEE Stock Exchange lack large companies with substantial free-floating shares. In the Bulgarian case, the listed stocks resulting from the second voucher privatisation program are *de facto* government residual stocks in non-attractive companies. As for the most attractive and largest companies, either they have

not been privatised yet, or else they have been privatised preferably through cash sales. There are several reasons why companies are not interested in being listed:

- First of all, they may be too small to be listed. The best example is obviously the RASDAQ with its 5700 listed companies and 16 millions shareholders.
- Secondly, as there is no liquidity, the cost of capital is higher than with private placements.
- Thirdly, given the usually small size of companies, listing requirements are perceived as unnecessary and costly constraints. Companies are afraid of “bureaucratic hurdles” and in some countries refer to high fees and slow processing of documents as obstacles to getting listed.
- Finally, companies may be reluctant to disclose information on the market.

58. The limited supply of good stocks is reinforced by the lack of demand. Indeed, there are very few new investors on these markets, and stocks are traded between existing participants. Foreign investors may initially have invested without discrimination in these emerging markets, and then got trapped in their investments. Some of them are now trying to exist these markets without losing too much money. They sometimes achieve this by sending their minority shares to majority investors that would be willing to de-list.
59. Besides the current general slowdown in world markets which accentuate problems in SEE markets, investors are reluctant to invest on SEE stock exchanges because of low liquidity, lack of confidence and lack of legal protection for minority shareholders.
60. Consequently, there is a current trend towards the de-listing of companies. Indeed, as developed above, the under-development of securities markets makes the listing unattractive. An excessive number of JSC have been created and listed through the privatisation programs. They have somehow been made public “by force” without any rationale for their being listed.
 - In **Bulgaria**, as a result of the first mass privatisation in 1996-97, 1052 companies became public. At the beginning of 2000, the number of companies listed on the Official Market was 33. Now, only 24 companies are listed on the first segment of the market, and 600 are left on the free market (it used to be 1000). This number is decreasing, as even the most serious and solid companies with foreign investors tend to de-list. Some foreign companies became 100% private, such as Union Minière. The new Law makes it possible to close a company if its capital is less than 200 000 DM. Moreover, the majority shareholder and the management are often the same, and they would prefer to close the company. Consequently, even good and big companies have been closed.
 - In **Romania**, many listed companies are dominated by strategic investors who are trapped in the ownership structure inherited from the privatisation process. These big companies are listed but with a majority investor who prefers to become private in order to avoid dealing with too many minority investors. They would like in fact to de-list, but this is very difficult as they have thousands of individual shareholders. They need to decrease the number of these shareholders down to less than 500 to de-list, and the cost of these transactions may well be higher than the value of the respective shares. On the RASDAQ, some experts estimate that 80% of companies should de-list, (at least) as they do not fulfil disclosure requirements.
61. Consequently, SEE Stock Exchanges are having a hard time fulfilling their traditional roles in terms of funding and disciplining mechanism through the take-over threat. Nor do they serve as a reliable source of information or corporate evaluation. Indeed, SEE stock exchanges may be considered as inefficient, in the sense that market prices do not reveal any true or even reasonable value of the companies. Market prices are highly volatile and usually well below accounting value.

62. In order to face these structural development difficulties, SEE stock exchanges will have to gradually develop by attracting and selecting companies well suited to be listed. Consequently, mandatory listing does not seem to be an appropriate solution for building a strong equity market⁹.
63. In order to increase liquidity, some exchanges have turned to cooperation with more developed stock exchanges. Given the common characteristics of the SEE stock exchanges, regional cooperation may indeed be the appropriate solution. Such cooperation could help in harmonising rules and regulations, enhance possibilities for dual listings, provide direct links between the exchanges to their respective databases or develop common trading platforms.

3. Pension reforms

64. By late 1990, the pension (as well as health) systems in the whole region became financially unsustainable with large unfunded pension liabilities. The difficulties derived from structural unbalances.
65. Pension reforms have been undertaken in Croatia, Bulgaria and more recently in Romania. A common feature is the introduction of pension funds which potentially may become important owners of equity.

- **Bulgaria** is the most advanced country in the region regarding pension reform. A Pension Law and a Law for Supplementary Voluntary Pension Insurance have been adopted in 2000. 9 pension funds have been licensed for managing mandatory contributions of occupational employees as well as 9 universal pension funds. Pension funds are in their infancy and still in the process of collecting money. They are by law allowed to invest, by law, up to 50% in government securities, 10% in equity market and 10% abroad.

- In **Croatia** the pension reform has been constantly delayed, but the Parliament has finally accepted the principle of a three-pillar pension system, and is currently adopting legislation concerning the second pillar, i.e. mandatory funded pensions for those under the age of 40 and optional for those between 40 and 60. The resulting Pension Funds will have to invest at least 50 % of their assets in government bonds, and may invest up to 25 % in domestic equities (and up to 20 % in OECD equities).

- Finally, pension reform has just begun in **Romania**, with the legislation on “universal pension funds” adopted in 2000 (Emergency Ordinance 230/2000).

66. This pension reform may be the impulse necessary to boost the market. In Croatia for example, some banks as well foreign funds have already expressed their willingness to participate in the new pension fund industry. As pension funds will start to accumulate money, companies are told to list now, in order to profit by this potential demand for equity and be able to make IPO within the next two years.
67. Nevertheless, forecasts and opinions greatly diverge regarding pension funds’ effective potential impact on the development of the regional financial markets. Stock Exchanges tend to consider this as their “last-chance” for development. The World Bank underlines the low contribution level set in Croatia for example, but still believes that it could constitute a source of capital for industry, growing gradually from 0.5% to 2% of GDP in the next 20 years. However, many players remain sceptical concerning this new industry. The new pension funds are either considered as being the possible first

⁹ Apparently, the new Securities Law drafted by the CROSEC in Croatia apparently includes criticised provisions concerning the mandatory listing for certain big companies (according to capital or number of shareholders).

mover in breaking the vicious circle of mutually strengthening no demand - no offer of securities, or much too weak in the short run to break the standstill.

III. The legal framework

68. Issues of corporate governance are usually regulated mainly by two sets of laws, company law and securities law. In addition, also the bankruptcy law has an impact on the corporate governance framework. In almost all SEE countries, company laws have been adopted at an early stage of the transition, as they provided the legal framework for the transformation of SOE. Securities laws have been adopted later on in conjunction with developments of the financial markets. Bankruptcy laws have been adopted or significantly amended quite recently.
- In **Romania**, the Commercial Company Law (n° 31/1990) was adopted early on in the transition, between the Law on the Reorganisation of State Enterprises (n°15/1990) and the Privatisation Law (n°58/1991). It has been amended in 1997 (ordinance n°32). The Securities and Stock Exchange Law (n° 52/1994) was adopted later and is in the process of being amended (cf. below the discussion about the ordinance n° 332/2000).
 - In **Bulgaria**, main points usually included in Company Laws are dealt with in the Law on Commerce, while JSC using public offering had been regulated by the Law on Securities, Stock-Exchange and Investment Companies which applied from July 1995 until the beginning of 2000.
 - In **Croatia**, the Company Law was passed in December 1993, while the Law on Issuance and Sale of Securities was passed at the end of 1995 and amended in 1998. Finally, the Law for Takeover of JSC was adopted in 1997.
69. The adopted Company Law and Securities Laws have been either largely copied from or inspired by foreign models, or else drafted from scratch. Resulting Company or Securities Laws are for the most advanced SEE countries of good quality, as reflected in EBRD “extensiveness” legal indicators, which have reached 4- for Romania, Croatia and Bulgaria. Nevertheless, these laws did present many drawbacks or loopholes that have been debated and sometimes solved.
70. The debate over the Company Law and the Law on Issuance and Sale of Securities has been especially vivid in **Croatia**, including the following arguments:
- A much criticised provision of the Company Act enables the Company to insert a clause relative to restrictions on the transfer of shares into the article of association. This provision has been widely used, making all the companies concerned non eligible for listing.
 - Another example of a widely criticised provision of the same Company Act is the necessity for a shareholder to be physically present in the AGM in order to cast a vote. Moreover, as the agenda may be changed during the meeting, this discards any vote by custodians. Even if these loopholes of the Company Law may be compensated by listing requirements, these later requirements concern only very few companies.
 - Meanwhile, the Law on Issuance and Sale of Securities is considered to be incomplete and full of mistakes. A lot of provisions were adopted only to answer the specific problems of given companies. The drafting process has been criticised as having mainly consisted in harmonising different texts from different ministries, without enough legal specialists involved. According to these critics, the deficiencies in the final law would result from deficiencies in the drafting process.
 - Finally, the Law for Take-over of JSC is criticised for over-regulating and specifying very detailed procedures, while it misses some important principles, such as the pro-rata treatment of shares, or else it does not regulate voluntary bids, only mandatory ones.

71. Moreover, depending on respective legal traditions and also on the origin of technical assistance provided for drafting securities laws, there are in few case discrepancies between the Company Law, based on continental models of Civil Law, and the securities laws based on Anglo-Saxon models of Common Laws.

- The strongest and most vividly debated discrepancy seems to happen in **Croatia**. The Company Law is based on the German model and is sometimes described as a more or less up-to-date straight translation of the German Company Law. Meanwhile, the Securities Law has not been copied directly from a foreign model but was fully re-written. It is dominated by the US model. In any cases, it is somehow non-compatible with the German legal model that prevailed in the Company Law. An example of such discrepancies is the fact that securities are dematerialised in the Securities Law, while materialised in the Company Law. Consequently, there is an on-going discussion regarding which law should be more amended and adapted to the other.

- **Romania** encounters the same issue of discrepancy between the more civil and continental oriented Company Law (this time more on the French / Italian model) and the Securities Law, though to a much lesser degree.

72. Recent or current legal evolutions have improved or have tried to face these legal drawbacks.

- In **Bulgaria**, the Law on Securities, Stock-Exchange and Investment Companies has been replaced by a new Law on Public Offering of Securities (LPOS), which was adopted in December 1999, taking effect in February 2000. The previous Law was considered as being too fragmented. This completely new law better regulates corporate governance issues, especially concerning minority shareholders' rights. Numerous changes in the commercial code have also been adopted in September 2000 (concerning more than 600 articles). Some legal loopholes remain concerning specific points, as for related parties transactions or conflict of interest, which remain unregulated. The LPOS only regulates the case where there is a property transfer. Moreover, a violation is only sanctioned with administrative-penal liabilities.

- In **Croatia**, a new Securities Law is being drafted by the CROSEC. This draft law apparently includes the already referred to criticised provisions concerning the mandatory listing for certain big companies. This new Securities Law should more closely regulate all entities engaged in trading, as the present legislation does not give enough nor explicit power to the CROSEC to supervise the market, according to the CROSEC.

- In **Romania**, an intense public debate has arisen concerning an amendment to the Securities Law (Ordinance N°229/2000), adopted the last day of the former legislature. This ordinance was pushed by minority investors in response to alleged abuse by majority investors, including strategic foreign investors. It was repelled in February 2000 by the new government. It had been indeed under strong criticism especially from foreign strategic investors. While aiming initially at protecting the rights of minority investors, it *de facto* allowed them to micro-manage the company. Following this episode, the Company Law is now under revision. This process is co-ordinated by the APAPS, and major players, such as the Foreign Investor Council, are contributing to the discussion.

73. Nevertheless, the main legal difficulty lies in implementation and not in default in current legal acts, as this is usually the case in all transition countries. A typical situation is for example that some current amendments to the Laws are trying to deal with specific cases of abuse that did occur, but that also could have been dealt with within the existing legal framework, provided that this had been correctly applied. This seems to be the case for the ordinance N°229 in Romania.

74. The underlying fundamental legal difficulty is that there is no judicial or administrative system able to enforce shareholders' rights or, more generally, commercial law. Consequently, regulatory frameworks may be considered as satisfactory or even good, while *de facto* corporate governance practice remains quite poor. This discrepancy is reflected in turn in the difference between SEE country scores in EBRD "extensiveness" and "effectiveness" legal indicators.
75. Courts are usually very weak and poor, resulting in very slow settlements of disputes. There is an acute lack of trained judges in Commercial and Company Law. Judges are often considered as being incompetent in the best case, easily influenced or even corrupted in the worst.
- This has been widely recognised for **Bulgaria** and reported in the EU Review Report on Copenhagen Criteria or in the above mentioned Corporate Governance Assessment. There are no specialised (commercial) courts. The judicial system is rather unpredictable, with very surprising rulings. Cases need five years to be settled in first instance. Consequently, people prefer to settle things outside of the court system.
- In **Croatia**, there are too many commercial courts (officially 13 but only 9 are really opened and working). Sometimes there are only 4 judges in one court. 4 courts should be enough for Croatia, and this should allow for specialised centres. Judges are young and inexperienced. Commercial courts are overburdened, very slow (loss of time in postal and written procedures, no e-mail connection). They are not computerised nor centralised. There is neither literature nor systematic information. There are not enough copies of official gazettes. Presently, a selection of sentences is published only once in two years. No more than 100 sentences have been published for 6 years. Consequently, it is very difficult to establish a steady core practice. In July 2001, the World Bank granted a 5 million USD loan for a "Court and Bankruptcy Administration Project". This should significantly improve the working of commercial courts and their access to legal information.
- Problems with the judicial system in **Romania** have been widely underlined in the process of EU accession, though it was also recently recognised that "important progress" has been made (EU 2000 Regular Report on Progress Towards Accession). For example, a special ordinance enforced in January 2001 established a specific procedure for commercial cases involving "substantial value". However, the overall assessment does not differ from that of other countries regarding settlements of commercial cases.
76. Given this very poor legal implementation, companies and managers may continue to behave as they wish and to breach even elementary rules with relative impunity. This absence of law enforcement creates unfair competition and general distrust among trading partners. Arbitration procedures could greatly improve the situation.
77. This implementation weakness is a main obstacle to corporate governance reforms. Indeed, as we will come across at many points in the following pages, there is a great discrepancy between corporate governance framework, i.e. legal provisions regarding corporate governance, and corporate governance actual practices. This is probably one of the main challenges that we will encounter in this Roundtable process.
78. Finally, the legal enforcement weaknesses will not be solved in the short term. This only underlines the crucial roles that have to be played by administrative authorities and self-regulatory organisations to develop sound corporate governance practices by ensuring a minimum level of shareholders rights enforcement.

Part III: Main issues in corporate governance

I. Shareholders' rights

83. Basic shareholders' rights such as ownership registration and transfers of shares seem to be relatively secure in most SEE countries.
84. This positive situation is nevertheless quite recent and mostly concerns traded securities. Indeed, it is only recently that most depositories have been organised, which is late in comparison with stock market development. These depositories are now working satisfactorily:
- In **Bulgaria**, a Central Depository was established as a Joint Stock Company in 1996. All operations on the BSE-Sofia are recorded and cleared through the Central Depository. This is the case even when transactions are carried out off the exchange. All public companies have dematerialised shares and share registries are kept by the CD. The CD is regarded as being efficient and received the highest score in the Corporate Governance Assessment conducted by the Initiative for Corporate Governance). Nevertheless, shareholders do not have easy access to information on ownership structure detained by the CD, as administrative procedures are heavy and expensive.
 - In **Romania**, registry is integrated into the clearing and settlement system. Quoted companies have to keep a registry of ownership at an independent registry. Registry and depository activities (as well as compensation) are regulated by the Securities and Stock Exchange Law (Law 52/ 1994) and have to be carried out by legal entities authorised by and under the supervision of the Securities Commission. This latter has issued detailed regulations concerning these activities.
 - In **Croatia**, the Securities Depository Agency, set up in April 1999 and financed through a WB loan, is presented as a successful story. It works satisfactorily, according to the CROSEC, although brokers complain about overly high prices. It provides efficient and effective electronic clearing, settlements and depository services. But this Securities Depository Agency has up to now completed registration for only 150 of the most-traded companies, out of the 1500 initially expected. It nevertheless represents a significant improvement in the quality of share registration.
 - In Albania, the Equity Registration Agency was founded in 1996 to register shares of privatised companies with more than 50 shareholders. Only 52 out of the 97 enterprises privatised during the MPP in 1995-1996 are actually registered. It is almost impossible to get information on the ownership structure of other companies.
85. The situation is less transparent concerning registration of shares from companies not quoted on the exchanges.
- In **Romania**, companies are required by law to maintain a register of shareholders, by themselves or else through delegation to an independent specialised registry. Every shareholder should be able to obtain information on its own stake, but also on other shareholders' ownership.
 - The situation is similar in **Croatia**, where ownership registers may be maintained by the company itself or by another company. Nevertheless, there is no specific regulation concerning this activity. As for enterprise registers, they are maintained in the local commercial courts, but they do not include information on company ownership structure. Moreover, access to these registers is costly, difficult and time consuming.

86. The free transferability of shares is usually granted for all companies, as is the case in Romania, or just for traded companies as part of the listing requirements. However, this is not the case for all markets (such as the Croatian Verazdin Market) nor for non-traded companies in all countries. More specifically, the Croatian Company Law allowed Joint Stock Company to restrict transferability (“vinkulation”), through requiring in the statutes management approval prior to such a transfer. In the same vein, a company may cancel a share registration provided that this would be “in the company’s interest” or that the shareholder has been unjustifiably entered in the share register.
87. Participation and voting in general shareholder meetings are formally granted, but the effective capacity of shareholders to influence the decision making process is much more tenuous. Indeed, widespread practices prevent shareholders, and especially minority shareholders, from really participating and voting in general shareholder meetings. These practices are related to information about the shareholders meeting, its location and voting procedures.
88. One such obstacle is that shareholders are informed about general shareholder meetings too late. The Law may require publication of the AGM announcement in newspapers, but without always specifying which kind of newspaper. This is the case in Croatia, where information will typically be published in internal and obscure company newspapers, even if the law requires the agenda to be published 30 days beforehand in the official gazette. In Romania, the agenda has to be published in the official gazette as well as in a local newspaper at least two weeks in advance.
89. Shareholder meetings are sometimes held in remote locations in order to prevent many minority shareholders from attending. Nevertheless, widely publicised abuse has recently triggered regulatory changes. This is the case for example in Bulgaria where the new LPOS (Law on Public Offerings of Securities) regulates more precise provisions regarding the AGM and requires that it takes place in the town of the company headquarters. In Croatia, the AGM must be held either at the company headquarters, or at the stock exchange.
90. The agenda may be provided ahead of the meeting, but it remains quite general and vague. There are not always provisions allowing shareholders to add items on the agenda. This is the case for Croatia, although shareholders may make decisions on issues not on the agenda, provided that there is a unanimous agreement among shareholders to do so. Given the ownership structure, this practically prevents shareholders other than management from putting an issue on the agenda.
91. Clear provisions preventing companies from setting up procedures that impede shareholder voting are not always provided for in the Law or in Stock Exchanges or Securities Commissions’ regulations. This is the case in Croatia, but the Zagreb Stock Exchange has taken firm actions discouraging such behaviour. Indeed, it halted the trading of a company that required the payment of fees, the physical presence of shareholders and the presentation of documents difficult to obtain in order to participate in the vote.
92. However, preventing minority shareholders from voting in the AGM does not seem to be a major issue in most countries. Indeed, ownership concentration ensures majority owners with an almost automatic approval at the AGM.
93. The capacity to vote in absentia is usually granted in all countries theoretically. But the actual use of proxy-voting may *de facto* be much more limited, as practical provisions for proxy voting may be an obstacle:
 - In **Bulgaria**, this results from the restrictive nature of the Law on Public Offering of Securities regarding proxy-voting, as the Law initially aimed at avoiding abuse of such proxy-voting.
 - In **Croatia**, the law grants shareholders with the right to vote by proxy. However, these proxies must be notarised and the proxy must be appointed in writing and the proxy card delivered to the company. Consequently, the process is really cumbersome.

- In **Romania**, the law allows shareholders to be represented by proxies, but these are not used very often in practice.
94. The right to receive dividend remains quite theoretical in all SEE countries, as the vast majority of large and even listed companies have not distributed dividends in the last few years. This absence of dividend payments is a major impediment to the development of capital markets, especially as it prevents portfolio investors from entering such markets.
- Very few companies have a dividend policy that clearly relates paid dividends to profits.
 - Many of them have systematically transformed profits in accrued capital.
 - Whenever dividends are voted for during the AGMs, they are effectively paid with long delays. In Croatia for example, the Law does not specify guidelines for dividend payments. Usually, the announcements of such payments do not specify who has the right to apply for dividend payment, neither at which date.
 - Finally, some tax regimes penalise the payment of dividends, as has been the case in Bulgaria until now (15% profit taxation). However, the new government has planned to eliminate this tax.

95. Given the concentrated ownership structures, the low liquidity of stock markets and the low level of shares actually traded, markets for corporate control are *de facto* almost non existent.
- In **Croatia**, procedures for acquisitions and mergers are clearly stated in the Securities Law and in the Law on Takeovers. These procedures require a public tender offer when one acquires a 25 % stake in a company. Nevertheless there are some major exceptions, for banks or insurance companies as well as for stakes acquired from the State. For banks, the bank regulator's approval is needed for every 10 % acquired. This provision has been used as an excuse to leave the banks out of the take-over legislation, but the Central Bank who is the supposed supervisor does not actually supervise the market. Given the overall low transparency of the privatisation process, a lot of abuse, especially regarding dilution of minority rights, has taken place.
 - In **Bulgaria** there have not been any hostile take-overs. Some take-overs did occur, but not through the market, rather through the exercise of a pledge.
 - In **Romania**, the take-over market is still in its infancy as far as large companies are concerned. The first battle occurred in 2000. Nevertheless, the RASDAQ has been a very volatile and speculative market, animated by supposed take-over attempts. However, although take-over as such (and in due forms) has not yet developed, a take-over bid has recently occurred (SIF Oltenia over Lacta Giurgiu, of which it already controls 46,5%).

Main Issues Concerning Shareholders Rights (to be discussed)

- Access to information on shareholders' structure
- Information on shareholder meetings
- Clear provisions concerning voting procedures during AGMs
- Capacity for shareholders to vote in absentia, by proxy or mail
- Rights to receive dividends

II. Equitable treatments

96. Given the concentrated ownership structure, the most critical issue in the SEE region is probably that of protecting minority shareholders. This is underlined by the fact that managers are often identified with the controlling shareholders.
97. In SEE, the issue of minority shareholders protection is obviously valid in a theoretical perspective, and has actually proven to be a real and quite practical one. Indeed, existing evaluations regard this as being the most serious issue. It has given rise to intense and endless public debates in many SEE countries.
98. The main issue concerning the protection of minority shareholders' rights has been the dilution of minority stakes. These dilutions especially occurred during the process of or following cash privatisation to strategic investors. Moreover, these dilutions do occur in spite of existing provisions in the respective laws concerning pre-emptive rights.
 - This has definitely been the case in **Bulgaria**, where privatisation contracts with strategic investors often involved subsequent capital increases lacking transparency. These often resulted in dilution at the expense of minority investors.
 - In **Romania**, the dilution issue has generated an intense public debate. Indeed, in spite of usual pre-emption rights granted to all shareholders in case of capital increases, dilution was made easier given specific features of the Romanian economic or legal environment. Firstly, with the high level of inflation, minority shareholder stakes could be automatically diluted if capital was not properly re-evaluated prior to the issuance of new shares. Some major foreign strategic investors have been accused of such dilution practices and brought to court. Secondly, in cases of capital increase with in-kind contributions, existing shareholders do not enjoy pre-emptive rights, while suffering the potential abuse of over-evaluation of these in-kind contributions.
 - In **Croatia**, the Company Law contains several provisions providing the management board with the possibility of increasing capital without the explicit approval of the shareholder meeting. Indeed, subject to a 75 % approval in a shareholder meeting, company statutes may allow the management board to increase the company's share capital by up to 50 % for a period of up to 5 years. Moreover, according to the Company Law, the management board may also exchange the company's bonds for shares up to the amount of share capital. Finally, the company's by-laws or a shareholders' meeting may deny an existing shareholder the right to participate in a new share issue or may even waive all existing shareholders pre-emptive rights on new share issues.
99. However, recent progress or attempts have been made to improve the legal provision protecting minority investors from such dilutions.
 - In **Bulgaria**, following the adoption of the Law on Public Offering and Securities, the practice of non-proportionate capital increases has strongly decreased. Nevertheless, abuse of minority rights is still a major concern, especially regarding the "technical aspects" of capital increases.
 - In **Romania**, the later abrogated ordinance n°229/2000 provided for some preventive measures against dilution. It prescribed an approval by the Securities Commission before any capital increase, allowing this Commission to check the effectiveness of shareholders' ability to exercise their pre-emptive rights. It also obliged a re-evaluation of fix-assets in case of inflation higher than 10% since the last valuation. Finally, an independent expert nominated by the shareholders' meeting had to appraise any in-kind contribution. Thus, this ordinance had attempted to provide remedies for the most obvious problems regarding dilution.

100. Moreover, as noted in the first part of this paper, there is a general tendency for small and even large companies to de-list. This should indeed be facilitated in case there is no rationale for such companies to be public. Nevertheless, provisions for protecting minority shareholders during these de-listing are not always granted by the law, or have not yet been tested. Given the scale and relevance of this issue, such protections should be elaborated further and up-graded if needed. In Bulgaria for example, the possibility to de-list has been granted by the new LPOS and seems to present another major threat for minority investors.
101. The representation of minority investors into management bodies is also problematic. They are either under-represented or else not at all. This may result from either a lack of activism from minority investors or a lack of access to the nomination process. Indeed, cumulative voting is not always possible. This question will be dealt with in the section on Boards below.
102. Similarly, minority shareholders seem to be barely involved in discussing strategy during the AGM. This may also result from the already referred to low use of proxy voting. Moreover, some legal provisions may limit the equitable treatment of shareholders regarding their voting rights. This is the case in Croatia where the Company Law allows for limitation of voting rights for some designated shareholders.
103. The low involvement of minority shareholders in the AGM is generally the result of the ownership structure previously described. With a concentrated ownership and significant or majority shareholders often linked to the management, minority shareholders have little incentive to participate and take pains to “vote smartly” than in the traditional Berles and Means dilemma with dispersed ownership.
104. However, due to this widespread issue of equitable treatment of minority shareholders, the already referred to ordinance n° 229/2000 in Romania included provisions giving somewhat disproportionate power to shareholder meetings. Indeed, according to this ordinance, any transaction involving assets whose value exceeds 10 % of the share capital had to be approved by an extraordinary general meeting of shareholders. Should such an approval not be obtained, any shareholder could make the courts annul the transaction. This provision is considered to be excessive by many commentators in Romania, as this would decrease flexibility. Nevertheless, this constitutes a good example of how abuse regarding minority shareholders rights may lead to over reaction on the legislation side. Moreover, as already underlined, existing provisions already allow minority shareholders to defend themselves in case they are suspicious about a specific transaction. Indeed, shareholders representing more than 10% of the shares may appoint experts, paid by the company, to investigate specific transaction. In such case, the experts’ report will be sent to the claimants and to the censors.
105. Another major issue related to equitable treatment is the widespread practice of transferring assets or profits outside the company, to related companies including companies related to major shareholders. These abusive related parties transactions have plagued restructuring reforms in most transition countries and have been widely described in the literature. Needless to say, SEE countries did not avoid this general and acute phenomenon, with their dragging reforms, less advanced judicial systems and in some cases the highly corrupt and incestuous relationship between the political and the economic elite.
106. This issue of related parties transactions has to be solved with provisions requiring:
- disclosure of interest,
 - fair and independent evaluation of assets,
 - board responsibilities,
 - qualified majority requirements

Current legislation in most SEE countries has increased the majority requirements for the approval of such related parties transactions. However, these provisions may only be efficient if a minimum standards of disclosure and transparency are reached, which is far from being the case. Without proper

and reliable auditing, and without well-functioning boards and managers, individuals can always hide their material interests in transactions or matters affecting the corporation. In such a case, whatever provisions are taken in the law to prevent abusive related parties transactions would be ineffective.

107. Insider trading and self-dealing are prohibited by Securities Laws. Nevertheless, adequate enforcement of such legal provisions requires institutional capacity, human and budgetary resources that local stock exchanges and securities commissions do not always have. For example, in Croatia, the ZSE has a total staff of 12, from which very few can devote time to market surveillance. It has nevertheless referred to the CROSEC three cases for review in 2000. The CROSEC has a total staff of 24 people, among which 4 are involved in enforcement issues. Two cases of price manipulation and five cases of insider trading have been referred to the courts.

108. Moreover, abuse of self-dealing and insider trading are difficult to track down and even harder to prove. Indeed, such cases eventually have to be dealt with by the courts, which may be unable to render adequate and timely judgements to the often very complex cases. For example, the CROSEC has no power to impose fines and has to refer the cases to the commercial courts. Up to now, no judgement has yet been rendered on the 120 cases that the CROSEC has submitted to the courts.

109. Shareholders usually have the right to sue for violation of their rights, though few cases have been brought to court until now and even fewer have been ruled in favour of shareholders. In Romania, shareholders have the right to sue under the courts the decisions of the general shareholders meeting. This right is nevertheless difficult to enforce in practice, given the already referred to difficulties in the judicial system. In Croatia, shareholders may sue under Commercial Courts regarding decisions made by the Management Board. This latter may theoretically incur severe civil and criminal liabilities in case it fails to act in the interests of the company. A shareholder won in 1999 in a "vinkulation" case, and was even allowed to sue the company for damages. Thus, the capacity for shareholders to seek redress for violation of their rights still remains to be tested in all SEE countries.

110. With the current trend towards further concentration of ownership, the efficient protection of minority shareholders' rights may become even more difficult. In addition, minority shareholders rights may only be secured if two other pillars of the corporate governance framework have been secured, at least to a minimum level; that is efficient disclosure and transparency as well as Board practices.

Main Issues Concerning Equitable Treatment (to be discussed)

- Dilution of the minority stake during capital increases
- Fair treatment of minority shareholders in case of de-listing of a JSC
- Related parties transactions
- Insider dealing and self-trading
- Possibility of legal redress

III. Transparency and disclosure

111. Transparency and disclosure are perhaps the areas that show the widest discrepancy between legal requirements and actual practice in SEE countries. Access to information is *de facto* very limited, especially for outside shareholders, but even for minority inside shareholders (employees).
112. Indeed, in many countries, even the most basic requirements such as the publication of Annual Reports may not be fulfilled. If it is formally done, their reliability still remains a central issue. Indeed, at the most basic level, even published turnovers may be misleading, should a significant part of the activity not be declared. In this regard, the significance of the black and grey economy does not concern only SMEs, but has an overall and utterly negative impact on the level of transparency that may be reached in all sectors, whatever the size of the firms concerned.
113. The fundamental difficulty regarding transparency and disclosure is one of incentive. Companies are not interested in publishing such information, as there is no articulated demand from actual or potential shareholders. As a matter of fact, without primary markets, there are very few incentives to make information available. Administrative and legal pressures are not sufficient in order to ensure a satisfactory level of disclosure, while fiscal threat remains a strong negative incentive. Finally, the legacy of the past system, where information manipulation was a major power tool in the central planning bargaining process still has an impact in the average behaviour of managers towards disclosure of information.
114. As a reflection of this general lack of interest and even reluctance towards information disclosure, enterprises do not consider that they should look after, inform and more generally develop their relationships with investors, actual or potential. Accordingly, having an investor relation department is still a very rare practice, even for large companies with many shareholders. In Bulgaria, only 20 % of companies surveyed in the Corporate Governance Assessment declare that they have such a department, which still seems like a rather optimistic evaluation.
115. Indeed, Securities Commissions disclosure requirements are usually high but not evenly respected. When information is published or filled into the self-regulatory bodies, its quality, reliability and accessibility are often quite poor.
- In **Bulgaria**, the LPOS requires that companies file into the SSC the annual, semi-annual and quarterly financial reports and that they also disclose “material information”.
 - In **Croatia**, the Company Law, the Securities Law and the Accounting Law require the publication of an annual report including a directors review. This report has to be audited only for medium and large companies.
 - In **Romania**, a Directors’ Report as well as a Censors’ Report have to be approved by the AGM. The content of these reports is not specified in much detail and their quality varies significantly. Financial statements are submitted to the tax authorities and to the Trade Registers where they are supposed to be accessible to shareholders.
116. Financial statements are still prepared mainly for tax authorities. Their quality and reliability varies heavily depending on the size of the company and on the degree to which it is submitted to public scrutiny. Stock Exchanges or Securities Commissions set up stricter and more detailed regulations as for the content, the form, the date and sometimes the place of publication of annual reports. Some Securities Commissions ask for half-year or even quarterly financial statements, as in Bulgaria.

117. Annual reports are usually prepared following national accounting standards¹⁰. These national accounting standards are said to follow IAS but in fact they may differ substantially from IAS on specific issues:

- In **Bulgaria**, National Accounting Standards differ noticeably from IAS on a range of issues (cf PWC Report, 2000). There are still quite a few misalignments. A new accounting act is currently being reviewed in Parliament. It includes many suggestions from the Institute of Chartered Accountants to align more National Standards on ISA. But several amendments are usually added during the parliamentary process, making the final result neither clear nor certain.

- In **Romania**, accounting rules are set by the Ministry of Finance mainly for tax purposes. The “chart of accounts”, revised in 1994, is supposed to be broadly in line with IAS. It still lacks some key elements such as the cash flow statement and notes to the financial statements. Judgmental accounting entries are possible under the revised chart of accounts, but usually the only ones that get recorded are those with tax consequences. Main areas where RAR (Romanian Accounting Regulations) differ from IAS referred to the inflation adjustments, as RAR only require periodic revaluations of fixed assets, based on government decision, the translation of foreign currency transactions, depreciation, and equity reserves.

118. The harmonising process with EU directives regarding accounting practices is still in its infancy. In Romania, the Ministry of Finance already issued in 1999 two documents related to the presentation of financial statements using the format prescribed by the IVth EU Directive and to the preparation of group accounts according to the VIIth EU Directive. The latest accounting regulation was issued in February 2001 and should be applied in around 200 hundred companies in 2001, in another 600 in 2002 and in all public companies by 2005.

119. Companies may well fulfil legal requirements and provide information to the Stock Exchanges or Securities Commission, but the access of shareholders to this information may be problematic and costly:

- Financial statements are very seldom published, or else merely in local and not widely distributed newspapers.
- Companies do not provide their shareholders with direct access to this information through modern communication means such as the Internet.
- Finally, financial statements approved by the AGM are (usually) supposed to be filed in the local trade registries. Nevertheless, this obligation is not always fulfilled by all companies, or else it is done late, and when this is the case trade registries are not always easily accessible to shareholders.
- In **Romania** for example, shareholders may obtain at their own expense copies of financial statements as well as Board and Censor reports. However, they may be prevented from doing so by high prices.
- In **Croatia**, copies of the company statutes are supposed to be available from the companies, the trade registries, or through the CROSEC.

120. However, some Securities Commissions, as in Bulgaria and Croatia, are providing the public with electronic access to company information. The CROSEC makes company information publicly available on its website, as well as physically in its “Public Reference Room” with Quarterly Reports for 700 companies. Moreover, apart from monitoring disclosure for listed companies, the CROSEC is also supervising the mandatory disclosure of information for non-listed companies, which is, by the way, considered to be non-relevant for such an institution. This nevertheless contributes to the overall improvement of transparency.

¹⁰ The problems related to Accounting are dealt within the South East Europe Partnership for Accountancy Development (SEEPAD).

121. Moreover, financial statements are not systematically audited. Even though the laws usually require an external audit of medium and large firms by certified public accountants, this is far from always being the case.

- External auditing is not required for example in Romania, except for banks. Censors traditionally fulfilled the role of auditors, but only one out of three censors had to be a certified accountant. The 1994 Securities Law made compulsory the certification of accounts by an independent censor authorised by the Securities Commission.
- In any case, there are not enough CPAs in most countries, which on its own prevents a great number of companies from being audited.
- Professional organisations are young (in Romania the Chamber of Auditors was created in 1999), usually weak and not always independent from public administration. It rarely has the authority to impose sanctions.
- Moreover, penalties for non-compliance are usually quite low, sometimes lower than the price of an audit. This for example is the case in Croatia, where auditors are only liable for 50000 DM, although this should be changed by a draft revision to the Audit Law. Consequently, being an auditor may be a very profitable business and even many large companies have absolutely unknown and wholly dependant auditors.
- Furthermore, there have not been any cases regarding auditor liability until now, and accordingly no market for liability insurance has developed.
- Indeed, independence is usually rather vaguely defined in Audit Laws. In Croatia, it only refers to financial links.
- Finally, there is no authority to trace compliance, except for tax authorities that sometimes do not themselves require such an audit.

122. Information on ownership structure is usually difficult to obtain:

- In **Bulgaria**, the Central Depository includes information on ownership structure, but a shareholder can not have access to this information. Administrative access procedures are heavy and expensive. Shareholders can still, through intermediaries, access information concerning their own shares and transactions, but they can not get information on the global ownership structure.
- In **Croatia**, shareholders can not easily access information on ownership structure, even if they are entitled by Company Law to ask to the Company for the shareholders list. However, according to the Securities Law, the CDA has to keep nominal accounts secret and consequently does not deliver full shareholders lists. Thus, the shareholders have to ask the company to request the full list from the CDA on their behalf. The new draft Securities Law is expected to improve shareholder access to such information.
- In **Romania**, the Law 99/1999 (measures for the acceleration of the economic reform) extended shareholder access to ownership information.

123. Finally, information provided to shareholders during major corporate events is often not satisfactory:

- In **Bulgaria**, the quality of Initial Public Offerings prospectuses has improved significantly with the recent law, but is still unsatisfactory for investors. Procedures have been quite detailed, but while prospectuses are more than 200 pages long, certain aspects are still not taken into account (concerning off-balance sheet obligations and financial ratio for example).
- In **Croatia**, only companies on the Quotation I segment of the ZSE have to publish prospectuses. Moreover, these prospectuses do not have to disclose the bankers and advisors apart from the managing underwriter.

- In **Romania**, companies have to send “current reports” to the Securities Commission in order to announce any significant event that may influence investors’ decisions, especially changes in the ownership structure (when a shareholder or a group of affiliated shareholders pass the 5 % threshold). But failure to report on these significant events has been widespread. The BSE and the Securities Commission have started to become more stringent on these requirements and to sanction companies failing to comply. Consequently, information on “significant shareholders” is being increasingly published in the media. Nevertheless, major abuses still happen, the most notorious being the controversial ALRO capital increase, which seriously undermined the credibility of the Securities Commission. More generally, the use of nominees, and especially foreign-based nominees, to buy block shares, makes it difficult for the Securities Commission to check compliance.

124. Conflicts of interest are generally considered to be a main concern in corporate governance practices. Some recent legal provisions have tried to offer more protection to minority investors:

- In **Romania**, the Law 99 / 1999 provides shareholders with the right to consult certain documents specified in the company statutes twice a year. They may also notify the board about any transaction, and the board should answer within 15 days. Finally, shareholders representing more 10 % of capital may ask for an independent expert paid by the company to check specific transactions.

- In **Croatia**, disclosure of related party transactions is not required by the Securities Law. Moreover, the Company Law does not prevent directors with conflicts of interest from participating in related decision-making.

125. The role of the media in promoting disclosure and transparency is essential. However, the performance of SEE media to date has been mixed and controversial. While they did play a role in bringing to public notice major scandals and debates, especially in Romania, they are often criticised for being insufficiently educated in business matters as well as for being easily influenced by interested parties.

126. The issue of transparency and disclosure is a necessary pillar for developing good corporate governance practise. It requires altogether legal and regulatory reforms, they concern self-regulatory and professional institutions, and necessitate a strengthening of general fiduciary as well as administrative systems. Furthermore, they may include very technical and complex questions, regarding accounting and auditing standards for example, but rely more fundamentally on a deep, behavioural and necessarily gradual transformation of all relevant players towards the very idea of transparency.

Main Issues Concerning Transparency and Disclosure (to be discussed)

- Accounting and auditing standards
- Easy access for shareholders to Financial Statements and capital structure
- Enforcement power of Securities Commissions
- Information on material events
- Information on Conflicts of interest

IV. Boards

127. The role of the directors (or administrators in Romania), is very often misunderstood. Because of the ownership structure and the close links to major owners, the Board members tend to act in the

interest of some specific shareholders whom they see themselves as representing. From this perspective, they often behave more like managers than like directors.

128. More specifically, the role of independent outside directors that balance inside directors is far from being accepted. At most these outside directors are perceived as being able to give an “external view”. This situation is problematic, since the independence of the board is particularly important in companies where ownership is concentrated.

129. The two existing board structures, one tier or two tiers, are represented in the SEE region, sometimes in the same country. Again, this reflects the blend between the continental and the Anglo-Saxon systems.

- In **Croatia**, there is a two-tier system, based on the German model, with a Management Board and a Supervisory Board. But some highly visible legal experts advocate letting the companies choose between the two systems.

- In **Bulgaria**, companies may adopt a single tier or a two tiers system. Broadly speaking, 2/3 of companies have a single tier system and one third have a two tier system (with a Board of Directors plus a Supervisory Board). The one-tier system is typical of industrial companies, while holding companies usually adopt a two-tier system.

- **Romania** formally adopted a unitary system, but in fact has a more hybrid system with two specific bodies:

* Firstly, the Board can delegate some powers to a Directors’ Committee, composed of a selected number of board members. In practice the non-executive members of the Board end up assuming a role closer to that of a supervisory board. Large companies adopt the hybrid structure, especially foreign controlled companies, as this splits the two main functions into foreign partner and local specialist.

* Secondly, the Romanian law provides for a specific body called the “Censors”. The Censors do not have any role in the decision making process, they are just supposed to monitor the company and the Board, make sure that decisions comply with legislation, and check the financial statements. They are elected by the AGM, but only one of the three censors must be a Certified Public Accountant. Moreover, they have to be elected among shareholders.

- In **FYROM**, companies can choose between the one and the two tiers board structure.

130. The Board’s functions and powers are usually not regulated in much detail, leaving a great deal of room for flexibility in practice. The actual functioning and effective influence of the boards will depend more on the qualities of their individual members as well as on the respective CEOs.

- In **Bulgaria**, even the most usual and basic requirements such as approval of business plans and strategy are not specified in the law.

- In **Romania**, the Company Law sets general rules such as for the appointment of Board members and the organisation of the board, but many details concerning the functioning of the Board are not very explicit and the law even remains quite general regarding the Board functions.

- In **Croatia**, the Company Law specifies the main duties of the Supervisory Board. However, This does not include the approval of management board’s compensation. Neither is there any requirement concerning disclosure of information on the functioning of the supervisory board, for example attendance records.

131. At this stage, there is no detailed empirical analysis of Board structures in the different SEE countries. General observations by experts nevertheless include the following characteristics:
- The composition of the Board usually reflects the ownership structure, except for the State, which is still over represented.
 - The Boards hardly exert any independent control function on management. Indeed, there is no (legal) requirement as for outside or independent directors. Very often, there may formally be outside directors, but *de facto* they represent persons related to the company or controlling shareholders.
 - Some outside directors are mere political appointees, regularly changed following parliamentary elections. This is particularly salient in Romania and in the case of the SIFs.
132. There is a growing separation between the function of Chairman of the Board and that of executive director. In Bulgaria, this is the case in 82 % of companies surveyed by the Initiative for Corporate Governance (2001). Nevertheless this separation seems to still be formal in nature.
133. Most company boards (75% in Bulgaria) do not have specialised committees. Moreover, boards currently have little recourse to outside experts, which hampers their capacity to contribute substantially to elaborating the company's strategy or to effectively monitoring the management.
134. The Board should formally determinate the CEO's remuneration, except in Croatia, as already mentioned. In practice, the remuneration is determined by the majority shareholder.
135. The nomination process does not always allow for the representation of minority shareholders, especially through cumulative voting.
- In **Romania**, the Company Law requires a secret ballot for electing board members. But there is no provision to ensure the representation of specific stakeholders, even minority shareholders, such as through cumulative voting. Nevertheless, in state controlled enterprises, different minority shareholders often have an agreement with the State to include one representative on the Board.
 - In **Croatia**, there are no restrictions against cumulative voting. But designated shareholders may be given the right to appoint up to one third of the Supervisory Board's members without the approval of the shareholders meeting. Finally, shareholders representing more than 10% of capital may propose candidates to the supervisory board.
136. Remuneration of directors is not usually published and tends to give more freedom to Directors in spite of the required formal approval by the AGM. The usual tricks are inflation adjustments or non-specified bonuses.
137. Remuneration packages linking Board remuneration to the performance of the firms are very unusual. Performance-based remuneration has to be approved by an extraordinary general meeting in Romania, unless it has already been provided for in the Constitutive Act of the company.
138. The use of performance-based remuneration may be hampered by legal restriction on remuneration in the form of shares, which seems to be the case in Bulgaria. But they are more fundamentally flawed by the low liquidity of capital markets. Given the widely recognised low efficiency of capital markets in the SEE region, remuneration packages based on stocks would hardly be considered to reflect the results of managers or directors' work and efforts. Nevertheless, the very low level of stock detention by directors indicates that the very idea of a desirable alignment of directors' interest with shareholders' interest via ownership is not widespread.

139. Regarding conflict of interest and material interest, the legislative frameworks differ considerably:

- In **Romania**, conflict of interest disqualifies one from being a board member. A board member can neither be a shareholder, nor a manager, a board member of a competing company or pursue the same business on his own account. Board members must inform other members of the Board when he or any of his relatives have a specific interest in a given transaction. Failing to disclose such information makes him liable for damages incurred by the company.
- In **Bulgaria**, board members are not required to disclose any material interest they may have.
- In **Croatia**, board members do not have to disclose material interest in specific transactions and are not prevented from taking part in the related decisions.

140. The Board should be a crucial body ensuring the strategic guidance of the company, the effective monitoring of the management and the accountability to the shareholders. Indeed, these latter three functions are at the core of the very transition of companies from the old system to the new market system. Nevertheless, the role and functions of the Board are far from being understood and implemented.

Main Issues Concerning The Boards (to be discussed)

- Understanding of the Board's role
- Independence of Board members
- Nomination process allowing representation of minority investors
- Disclosure of material interests
- Transparency on Board practice and compensation