Ervin Kurtbedinov

Corporate Governance in Transition Economies

Comparative Analysis of Russia, Kazakhstan and Uzbekistan

Cuvillier Verlag Göttingen
Internationaler wissenschaftlicher Fachverlag

Corporate Governance in Transition Economies.
Comparative Analysis of Russia, Kazakhstan and Uzbekistan.

Ervin Kurtbedinov

Corporate Governance in Transition Economies

Comparative Analysis of Russia, Kazakhstan and Uzbekistan

Cuvillier Verlag Göttingen
Internationaler wissenschaftlicher Fachverlag

Bibliografische Information der Deutschen Nationalbibliothek
Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über http://dnb.ddb.de abrufbar.
1. Aufl. - Göttingen : Cuvillier, 2009
Zugl.: Bremen, Univ., Diss., 2009

978-3-86727-972-7

Nonnenstieg 8, 37075 Göttingen
Telefon: 0551-54724-0
Telefax: 0551-54724-21
www.cuvillier.de

1. Auflage, 2009
Gedruckt auf säurefreiem Papier

978-3-86727-972-7

To my parents.

Acknowledgement

The writing of a dissertation can be a lasting and hard experience, yet it is obviously not possible without the personal and practical support of numerous people. Thus my sincere gratitude goes to all who helped me to complete the dissertation.

First of all my deepest gratitude is to my advisor, Professor Axel Sell. I have been lucky to have an advisor who gave me the freedom to explore on my own, and at the same time the expert guidance to recover when I was choosing the wrong path. He taught me to see more behind a research than just affirmation of a hypothesis, namely its relevance to the sustainable development and overall well-being of people.

I also wish to thank Prof. Karl Wohlmuth, Prof. Lado Chanturia and Prof. Huffschmid for giving me professional guidance, sharing their rich experience both as academics and practitioners.

Discussions with my colleagues and friends helped me to look at research topics from other perspective and enhance understanding of the problems. For this contribution I warmly thank Dr. Heiko Pleines, Dr. Achim Schramm, Dr. Manuela Troschke, Dr. Kemelbek Choroev, Dr. Tobias Knedlik and Stefan Barenberg.

Without the financial support of the DAAD/OSI joint scholarship program my research residence in Germany would be hardly possible. I thank all employees of this program for professional organization, tolerance and being there whenever the help or advice was needed.

A special gratitude goes to Elzbieta Stabryla who supported me during the whole research process and made the excellent job proofreading my dissertation and sharing her precious opinion.

This dissertation is dedicated to my parents Kurtbedinov Zeni and Kurtbedinova Ayshe who devoted all their love, time and energy to their children, sacrificing every single moment of their life to give the best to the children. All I achieved in my life I owe to my beloved parents.

Content:

List of Tables

List of Figures

List of Abbreviation

AkG – Aktiengesetz

ALI – American Law Institute

BTI – Bertelsmann Transformation Index

CEO – Chief Executive Officer

CGI – Corporate Governance Index

CIS – Commonwealth of Independent States

DGCL – Delaware General Corporate Law

EBRD – European Bank for Reconstruction and Development

ESOP – Employee Stock Option Plan

FDI – Foreign Direct Investment

FIG – Financial Industrial Group

HGB – Handelsgesetzbuch

GCGC – German Corporate Governance Code

IFRS – International Financial Reporting Standards

IPF – Investment Privatization Fund

IPO – Initial Public Offering

JSC – Joint Stock Company

JSIF – Joint Stock Investment Fund

KASE – Kazakh Stock Exchange

KCGC – Kazakh Corporate Governance Code

LSDV – Least Square Dummy Variable

MBCA – Model Business Corporation Act

MEBO – Managers' and Employees' Buy-Out

MICEX - Moscow Interbank Currency Stock Exchange

NSPF – Non-State Pension Fund

NYSE – New York Stock Exchange

OJSC – Open Joint Stock Company

OTC – Over-the-counter

PAMC – Pension Assets Managing Company

RCGC – Russian Corporate Governance Code

RAR – Russian Accounting Rules

RTS – Russian Trade System

SEC – Securities and Exchange Commission

SJSC – State Joint Stock Company

SPI – Shareholder Protection Index

US GAAP – United States Generally Accepted Accounting Principles

VAT – Value Added Tax

VPF – Voucher Privatization Fund

WpHG – Wertpapierhandelsgesetz

WTO – World Trade Organization

‘…any attempt to impose governance system or structures that are overly prescriptive or specific is fraught with danger. By its very nature corporate governance is not something where “one size fits all”.’ (Owen Report, 2003)

Introduction

The first mention of the corporate governance issue can be found in the classical economic literature in the beginning of the XXth century, for instance in the work of Berle and Means (1932) who depicted and described the question in the US corporate sector with strict division of ownership and control over a corporation; nevertheless, more profound researches on the subject were carried out as recent as in the last three decades. The majority of corporate governance theories and the empirical evidence are grounded on the observations and assumptions which, to high extent, consider the developed markets with stable institutional framework. Still, even for the advanced economies the empirical and theoretical works are not complete. Regarding theoretical works some authors express doubts whether the principal-agent theory alone is sufficient to explain the complexity of governance aspects.[1] Moreover, the empirical evidence is available only for a very small sample of countries. In their survey of corporate governance Shleifer and Vishny (1997) concluded that the research of corporate governance has to be extended so as to incorporate the experience of other countries. In the past 10 years multiple studies have contributed to the development of the subject, however, for some countries it remains a relatively new research field. Economies in transition, especially the former Soviet Union countries, are among those which need a deeper survey from a theoretical and empirical point of view. Among these only Russia, due to its size and a geo-political position, can be distinguished among others by the highest number of researches on its diverse issues conducted so far, as opposed to other CIS countries where researches in the field of corporate governance are scarce and inconclusive.

Russia can be considered as a pioneer in many fields of corporate governance. For that reason one of the approaches in the present research is to analyse and evaluate Russia’s experience and compare it with that of Kazakhstan and Uzbekistan. This approach will allow to filter most appropriate practices among the transition economies, and thus learn form the

[1] See for example Daily, Dalton and Cannella (2003)

more successful experience of other countries. On the other hand, it will allow to answer the question whether corporate governance models are exportable among transition economies, or if each country has its own way of creating governance practices. Up till the present moment no comparative researches with similar combination of countries have been found.

The aspects of governance and transition are approached differently by different stands of the finance, economics, management, development and law literature. Most of the researches are conducted from the perspective of one single discipline, and therefore manage to reveal governance aspects separately, depending on the subject perspective. This research will be based on holistic approach pulling together many aspects of the corporate governance subject which were explored separately and study them from an interdisciplinary perspective. The following disciplines will be included: macro-economics, micro-economics, management, corporate finance and law. In order to obtain a possibly complete view over the issue a brief overview of socio-cultural, political and technology aspects will be provided, although it is not a priority in the proposed work. An interdisciplinary approach of this type is quite unique and hardly undertaken in existing literature.

The next aspect which grants relevance to the proposed dissertation is the attempt to distinguish between the transition-economy-friendly practices. The evolution of corporate governance is a complicated process. Both systematic and unsystematic factors influence the evolving of a particular governance model. Therefore, the import of governance practices and codes, without considerations of national peculiarities is unlikely to have a positive effect on development of corporate sector. Most transition economies, though, have adopted corporate laws, securities laws and codes of good governance based on the experience of advanced economies (e.g. Russia adopted initially Anglo-American laws and code), or sometimes even simply importing the normative base.[2] As a result, most of the regulations do not function either due to the lack of corresponding institutional framework or inappropriate regulative requirements. One of the tasks of the dissertation is to depict the regulations and practices which do not correspond to reality in transition environment, as well as to propose a supplementing option. In the concluding part of the work proposals for the improvement of governance models will be made.

The importance of corporate governance aspects has been acknowledged in all transition economies, which may be confirmed by the observation of an increasing attention paid to the issues connected with it. Corporate governance can be viewed from two perspectives: macroeconomic and microeconomic. From the macroeconomic point of view,

[2] See for example Crotty and Jabome (2004), Berglöf and von Thadden (1999)

improvement of corporate governance on a company level is positively correlated with the development of the whole economy. Roe (1994) states that:

> '*Society wins when governance works. Although shareholders profit first from good governance, their profits are not the "bottom line" for public policy here: poor management imposes costs on the firm's employees, its suppliers, its customers and its communities.*' (p.3)

Komulainen et al. (2003) supports this statement when he says: 'w*ithout strong governance at the firm level, economic development at the country level is likely to be held back'* (p.23). According to the microeconomic reasoning, improved corporate governance and investor protection lead to more secure environment and encouragement of capital flows and cheaper external financing (Shleifer and Vishny, 1997).

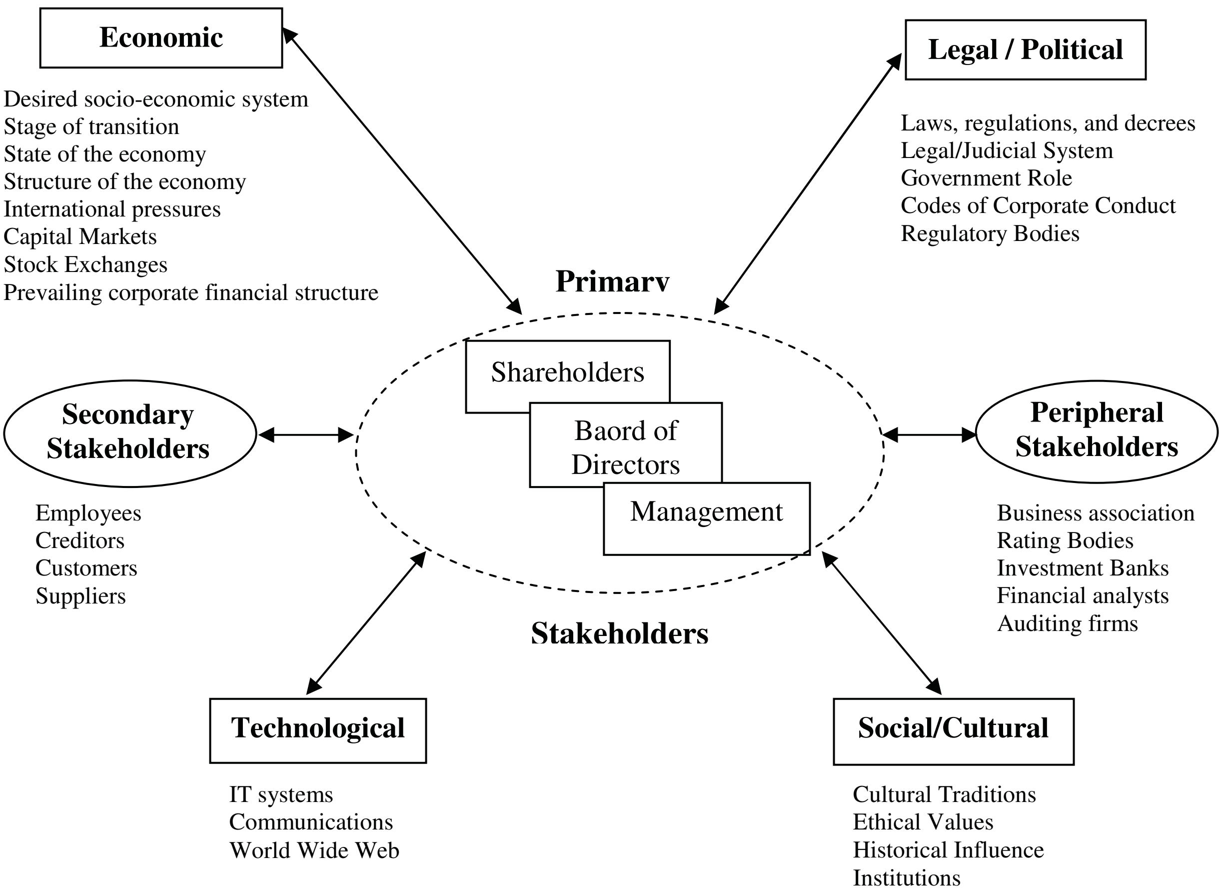
The presented general considerations over the importance of corporate governance were recognized by the policy makers in transition economies. However, selected ways to enhance governance in these countries requires reconsideration and more critical review (Stiglitz, 1999). The evidence of the corporate governance development in transition economies in the last few years has indicated that the approach chosen by some of the transitional countries was erroneous. The fallacy of the policy can be explained by the omitted contextual framework and governance practices in transition economies of each particular country. Most countries in transition implemented legislation and governance codes according to the US and European standards, instead of developing their own practices considering current and past economic development, socio-cultural and political idiosyncrasies. Therefore, due to the contextual difference between transition and advanced economies, it may be assumed that in transitional countries other governance mechanisms would be more appropriate than those copied from the countries with developed market mechanisms. For example, Berglöf and Pajuste (2003) indicate that a more contextualised approach to establish corporate governance codes in transition countries is required and not imported codes from the USA and Europe.

The aim of the proposed dissertation, based on the current state of corporate governance research, is to study the issues of corporate governance which are relevant within the context of transition economies exemplified by Russia, Kazakhstan and Uzbekistan. The main hypothesis of the presented theme is as follows: c*orporate governance models depend on multiple systematic and unsystematic changes which take place in each particular country. Therefore, transition economies have corporate governance context which differs from that in developed economies, and consequently different governance mechanisms should be implemented. Moreover, among transition economies themselves there are certain differences* *in governance models resulting due to the differences in the chosen reform processes*. The dissertation is intended to scrutinize the differences among governance mechanisms and models, which will further undergo a comparative analysis, in order to attempt at evaluation of the optional models for the chosen transition economies.

Methodological Approach

The proposed research will be based on the broader definition of corporate governance, whereas not only shareholder concentrated review will be undertaken, but also some other constituencies – employees, creditors, professional investors, auditors, rating bodies, etc. will be incorporated. Additionally, as mentioned by McCarthy and Puffer (2002), such environmental framework as economic, political, socio-cultural and technological one are of a huge importance while studying corporate governance models. Therefore, the dissertation will be organized as based on the scheme of corporate governance offered by McCarthy and Puffer (See Figure 1).

Figure 1. Corporate Governance Framework



Source: McCarthy and Puffer (2002), p.398.

The dissertation will be divided into four parts. After handling the theoretical framework of the research, the first part will introduce the economic environment in all three countries. Here, the accent will be put on macro-economical aspects such as economic development and finance. In the first stage of transformation, state of economic development, structure of the economies will be briefly surveyed. Then, the ownership patterns of enterprises in all three countries will be examined. However, in this part ownership studies will bear aggregate character. This part aims to depict the main owners of the corporate sector.

According to the theoretical review, the whole corporate governance subject was founded on the concept of external financing and effective utilization of investment resources, when the financing of firm activities and control over its activities are functionally divided. From this point of view, studies of corporate finance are paramount in order to identify the scope of governance problems. Therefore, next step in the research sequence will be to depict the financial sources of the enterprises in each country. The main questions that should be answered are: (1) how do firms finance their investments and (2) to what extent the demand on external finance is satisfied.

As a next step socio-cultural, technological and political frameworks will be reviewed. The range of subject that may be included in this part of research is enormous (e.g. ethnological, religious, cultural, historical studies, etc.). Due to the limited size and time of the research all the aspects cannot be studied in a full range. On the other hand, too wide research perspective may result in significantly disperse conclusion and deviate from economical and legal analyses. That is why in order to encompass these important aspects, but at the same time not to deviate from the core analyses, contextual aspects will be introduced briefly with the reference to the already existing researches.[3]

Followed by analyses of economic environment, the legal aspects will be examined in a separate part (Part II). This part will encompass a descriptive research of three legal pillars of corporate governance – corporate law, securities law, and codes of good governance. The biggest chapter of this part will go through corporate law and be divided in sub-sections handling three main corporate governance conflicts: (1) managers vs. shareholders, (2) majority shareholders vs. minority shareholders, (3) shareholders vs. other constituencies (employees and creditors). According to the design of legal base the frameworks of corporate governance will be depicted. Namely, whom the laws grant the real control over corporate activities and how does it respond to main corporate governance problems. These analyses

[3] For example Buiter (2000), Dallago (2002), McCarthy and Puffer (2002).

will be conducted as based on the comparative approach. Comparison will bear two dimensional characters. First the state of laws will be compared between target countries (Russia, Kazakhstan and Uzbekistan). Second, the laws in transition will be compared with those in developed economies (USA and Germany). This will allow to define how well the existing legislative base reflects the economic environment in transition economies. These descriptive and comparative analyses will be conducted in a line of equal studies of Kraakman et al. (2004) and theoretical research of Easterbook and Fischel (1991).

The essential goal of the second part is to construct a Shareholder Protection Index (*SPI*) using a *leximetrics* method. The review of the available empirical literature in the field of corporate governance reveals that there is no consistent index that reflects the most aspects of shareholders' rights. A number of researches that constructed own indexes often limited the scope of index only to very few parameters that are of course not sufficient to measure the depth of investor protection in a country. Consequently, empirical results provided on the basis of such indexes compilation can be assumed to be incomplete. Therefore, the aim of the Part II is to construct the broad index which will incorporate all important aspect of shareholder protection.

The third part of the research will survey the role of institutional shareholders and various groups of stakeholders. However, here the classification of primary, secondary and peripheral stakeholders as illustrated in the figure will be omitted. Instead, some major stakeholders as state, banks, institutional investors, rating agency and auditors will be selected and their role in the governance models of the three countries will be weighted. The task of the research in this part is to examine the role of some stakeholders as direct investors (shareholders). The analyses of shareholding evidence will be based on the studies of Roe (1994), who states that political factors and lobby of interested groups can influence the governance model in country. Thus, for example, the author has demonstrated how legislative restrictions in the US have kept banks and institutional investors away from significant participation in the governance process, granting corporate managers almost unlimited control power. According to the research of Roe, similar studies will be conducted for Russia, Kazakhstan and Uzbekistan.

The last, fourth part of the research will be based on quantitative analyses of corporate governance. The task here is to study the current governance practices in the corporate sectors of three transition countries and evaluate how the governance practices are related with economic performance of the company. For this purpose the sample of companies listed on the stock exchanges will be selected and examined.

Part I: THE THEORY AND FRAMEWORKS OF CORPORATE GOVERNANCE

1. Theory, Empirical Evidence and Their Implications for Transition Economies

1.1 Introduction

Corporate governance is a salient phenomenon within the current world financial architecture, but its development reaches far back to the past economic theory. Although it has been intensively handled throughout the last 30 years, and especially due to the outbreak of corporate scandals in 90s, its nature had grasped attention of classical economists of the previous epochs.[4] Jensen and Meckling (1976, p.305) noticed that it was Adam Smith who, as early as in the XVIIIth century, detected and described the conflicting interests between managers and shareholders, known today as the principal-agent problem:

> *'The directors of such (joint stock) companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of affairs of such a company.'*[5]

The later prominent writing of Berle and Means (1933) was the first profound work devoted to the new phenomenon of widely dispersed ownership of American corporations of that time. The authors indicated that:

> *'the position of ownership has changed from that of an active to that of a passive. In place of actual physical properties over which the owner could exercise direction and for which he was responsible, the owner now holds a piece of paper representing a set of rights and expectations with respect to an enterprise. But over the enterprise and over the physical property-the instruments of production-in which he has an interest, the owner has little control. At the same time he bears no responsibility with respect to the enterprise or its physical property'*. (p.64)

[4] An exhaustive literature review on corporate governance can be found in the works by Shleifer and Vishny (1997) and Dennis (2001).

[5] Adam Smith, *The Wealth of the Nations*, 1776, Cannan Edition (Modern Library, New York, 1937), p.700.

In both the above cited works authors pay attention to the division between ownership and control over the corporate sector and the potential conflict that may occur between shareholders and managers due to the division of functions. In theory this conflict is described by the principal-agent relations. According to the definition, relations in which the welfare of one party, termed 'principal', depends on actions taken by another party, termed the 'agent', represent the classical 'principal-agent' relations. From the perspective of corporate governance literature shareholders who are corporate owners *de jure* are regarded as corporate 'principals', and mangers who rule the company for the interests of shareholders are their 'agents'.

Why should the relations between shareholders and managers have a potential for conflict? In order to understand this issue we need to refer to the institutional foundations of the agency problem. According to institutional theorists, a firm is viewed as a nexus of contractual relations between different parties.[6] Therefore, the agency conflict between managers and shareholders is also based on contractual agreement. Theoretically shareholders could attain their rights and control over the invested funds by signing a complete contract between managers and shareholders, which would cover all future circumstances and thus predefine a manager's behaviour. However, in reality this cannot be accomplished due to the issue of residual contract rights, e.g. rights to make a decision in circumstances not fully foreseen by the contract. One solution to this problem could be a contract which ensures residual rights of a shareholder, i.e. in case an important decision should be made the manager would be obliged to consult the shareholder. Still, this is not quite realistic, since in most cases shareholders do not poses sufficient qualifications to make an efficient decision, and if the number of shareholders is extremely large, it would be expensive and time consuming to consult them on all residual contract issues. As a result, the residual rights are retained by the managers and they decide how to allocate funds (Shleifer and Vishny, 1997, p.741).

Under the conditions in which managers retain the residual rights so called information asymmetry occurs between the contract parties. Such informational asymmetry opens a possibility of opportunistic behaviour among the managers. Therefore, the existence of asymmetric information is the main feature of the principal-agent problem, also known as 'agency costs'. According to Jensen and Meckling (1976) agency costs can be of three types:

1. *Residual costs* measure the reduction of a company's welfare, which is stipulated when corporate agents make a decision which is not the best possible in particular circumstances.

[6] Coase (1937), Jensen and Meckling (1983) and Fama and Jensen (1983a).

2. *Monitoring costs* incorporate all the costs which principals bear in order to control and supervise agents.
3. *Bonding costs* are expenses which agents bear in order to signalize to principals that they work in their best interests.

In the essence of the above introduced agency conflict between managers and shareholders lies the dispersed ownership structure of a corporation, which implies that companies – with a large number of existing shareholders – do not have a controlling shareholder and no adequate control over management can be conducted. In such case there arises a question: are the dispersed ownership patterns observed all over the world and such a principal-agent conflict relevant to most corporations in the world? The work of La Porta et al. (1998) gives an exhaustive answer. The authors found that the dominant form of ownership is its concentration in the hands of a family, and not dispersed ownership. A widely held ownership structure is a sort of an exception and prevails mainly in Anglo-Saxon countries. Even shareholding in the USA, which is known for its broad ownership dispersion, represents to certain extent modest concentration. In the rest of the world concentrated ownership is found, held by founders (families) who in 69% of cases participate in the management (CEO, the Chairman, the Vice-Chairman).

In the case of concentrated corporate shareholding the principal-agent conflict between shareholders and managers can be overcome because the shareholders are large enough to control the management. However, in such circumstances another potential for a conflicting situation emerges, in which large shareholders (block holders) can expropriate small (minority) shareholders. Fama and Jensen (1983b) describe various possible examples of outside shareholder expropriation by large-block shareholders, who poses enough stocks to dominate the board. Among these examples are excessive salaries for themselves, negotiation of ‘sweetheart’ deals, investment in negative net-present value projects, etc.

Within the presented theoretical framework the task of corporate governance is to create the environment which will be free from opportunistic behaviour of managers and controlling shareholders, and in which investors would feel secure about their funds. In this respect according to the definition by Shleifer and Vishney (1997): ‘Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting return to their investment.’

Apart from the agency problem between managers and shareholders, as well as majority and minority shareholders, numerous other conflicts are discussed in the literature devoted to corporate governance. The so called ‘stakeholder approach’ incorporates other constituencies such as employees, lenders, suppliers, environment, and etc., which are related to a corporation and whose interests may not always ally with the interests of shareholders. Given the existence of other potential corporate governance conflicts it can be suggested that a shareholder-oriented definition is preoccupied with the ways in which corporations' insiders can credibly commit to return funds to outside investors. Therefore, in order to analyse corporate governance in broader frameworks a reference needs to be made to a broader definition. Such definition of corporate governance can be found in Oman et al. (2003) who states that: '*Corporate governance comprises a country's private and public institutions, both formal and informal, which together govern the relationship between the people who manage corporations ("corporate insiders") and all others who invest resources in corporations'* (p.6). Investors may include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow.

It is important to note that although the agency theory dominates the corporate governance research there are some other theoretical approaches that supplement the studies of corporate governance. Among them are a resource dependence theory, a stewardship theory, a power theory, a class hegemony theory, a signalling theory and a social comparison theory, etc.[7] The present research is based mainly on the agency theory and therefore no further elaboration of other theories related to corporate governance will be given here.

1.2 Corporate Governance Mechanisms

Under corporate governance mechanisms all measures and external pressures which help to reduce the monitoring or residual costs will be subsumed. In the corporate governance literature two groups of mechanisms are discussed: internal and external control mechanisms. The former refer to corporate organisation, constitution of governing organs, incentive schemes and forms of financing; all these mechanisms are internal, as their availability depends on the corporate policy. To the latter belong pressures which cannot be effected by a company itself, but they are rather stipulated by market forces; these are: the market for corporate control, product market competition and labour market competition.

[7] For an overview of corporate governance related theories see: for example Daily et al. 2003.

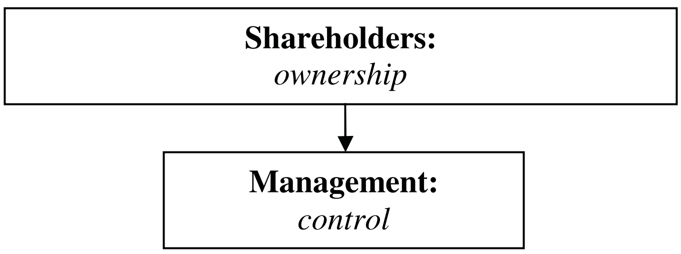
1.2.1 Internal Control Mechanisms

a. Board of Directors

The board of directors is considered by the agency theorists to be an important internal corporate governance mechanism, which contributes to the better monitoring of management and therefore reduces agency costs. Although there is little theoretical underpinning with respect to the role of the board of directors, a great deal of empirical research has been accomplished on the topic. In this section conceptual ideas about the role of the board of directors will be reviewed and a reference will be made to empirical evidence in order to justify the argumentation.

It is essential that any organization has a governance system that provides efficient decision-making. The decision-making structure of an organization can be classified either as 'consensus' or 'authority' (Arrow, 1974). The consensus structure describes those cases where each member of the organization has similar amount of information and interests to other members. In contrast, under the authority structure the members have different interests and amount of information. Under such a structure there is a central body (agency) in which the whole related information is concentrated and which is authorised to make a decision. According to this classification, publicly held corporations have the authority based decision-making structure, where one-party-management has an asymmetrically higher amount of information than shareholders. As it has been discussed in the theoretical part, multiple shareholding restrains effective decision making. The gathering of information which is required for decision-making is a costly process and as long as the costs of collecting information exceed the benefits of its utilization shareholders will be reluctant to participate in the decision-making process themselves. On the other hand, shareholders may not have required qualifications to make effective decisions. Thus, the functions of decision-making (management) are delegated to specially created management organs (*See Figure 2*).

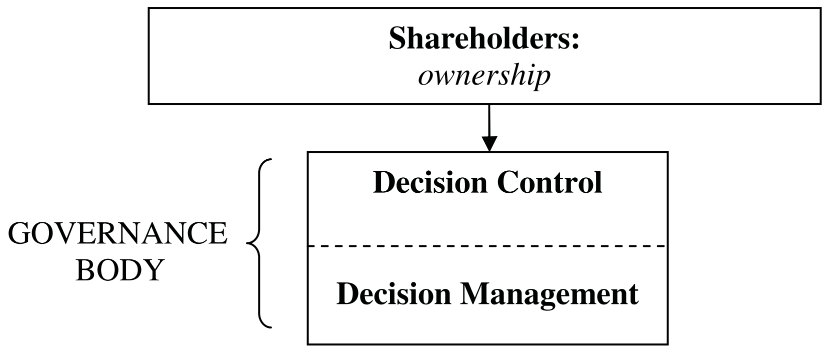
Figure 2: Authority based decision-making structure of a publicly held corporation.



Source: Own Depiction

Such a division of ownership and control functions has as a result the potential agency costs. One solution to this agency problem lies in the gross structure of the management (governance) body. Thus, for example, the separation of the 'decision management' – initiating and implementing decisions – from the 'decision control' can decrease agency costs (Fama and Jensen, 1983a).

Figure 3: Separation of decision management and decision control



Source: Own Depiction

In terms of modern corporate governance practices the management organ is divided into the board of directors and senior executive officers. The functions of the former are to formulate the broad policy of a corporation, elect executive managers, and oversee them, whereas the role of executive officers is to conduct day-to-day business. Several arguments can be identified in favour of the division of the management function into decision management and decision control. The first argument, as already noted, is the reduction of agency costs; directors elected by shareholders are authorised to act in their best interests by controlling executive managers. The other argument of the formal distinction between the board and hired officers is the intractable authority issue. *'Delegation of decision making power to specific individuals notifies a third party as to who in the firm has the authority to make binding agreement'* (Hansmann and Kraakman, 2004, p.11). Additionally, the management body which consists of multiple directors can hardly cope with day-to-day operations due to the large scope of issues they would need to decide on. The multi-member management body would require more time to communicate and decide on each issue, which would be inefficient with respect to dynamic market development (Bainbridge, 2002, p.231). If directors of a large public corporation were involved in the details of the day to day operations, they would be incapable of taking more abstract, important decision at the board level (Du Plessis et al., 2005, p.55).

According to the gross structure governance practices in the world distinguish between two-tier or one-tier boards. The two-tier board is based on semi-hierarchical relationships because a higher chamber of board called a 'supervisory board' appoints the lower board named a 'managing board'. And the one-tier board also called a 'unitary board'. For further analyses of the gross board structure the research will refer to the board schemes introduced by Tricker in his *International Corporate Governance*. The author draws a distinction between a 'managerial pyramid' and a 'governance circle' (See Figures from 4.a to 4.e.).

Figure 4: Schemes of Board Structure

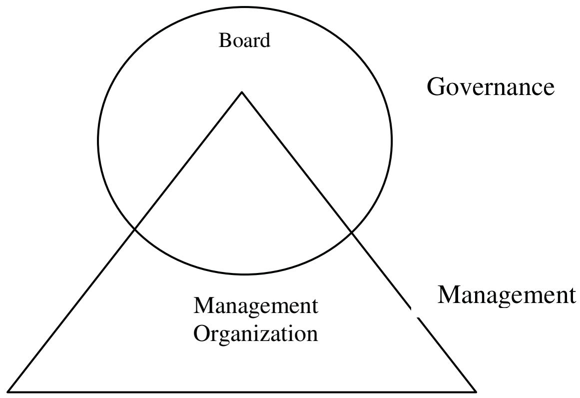


Figure 4.a General Scheme

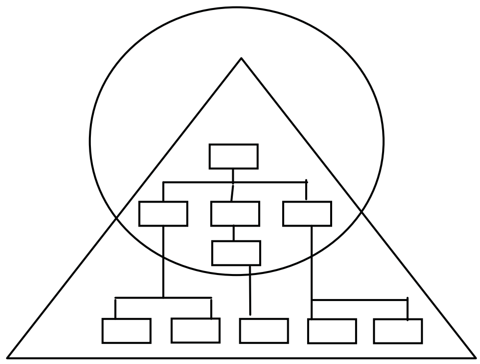


Figure 4.b All-executive board

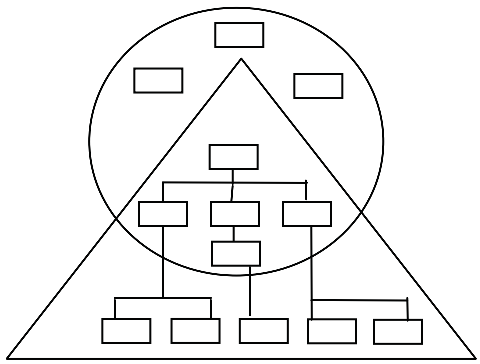


Figure 4.c Majority executive board

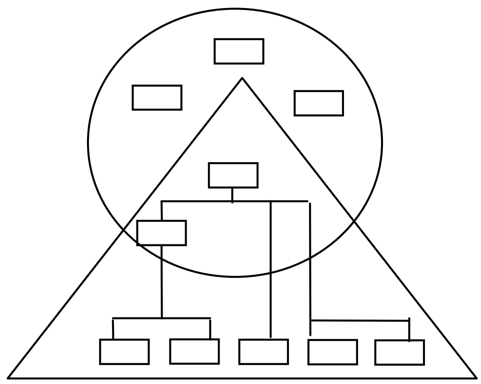


Figure 4.d Majority outside board

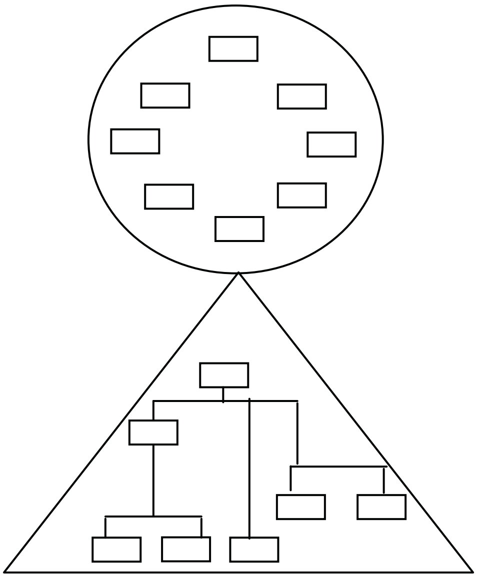


Figure 4.e. Two-tier board

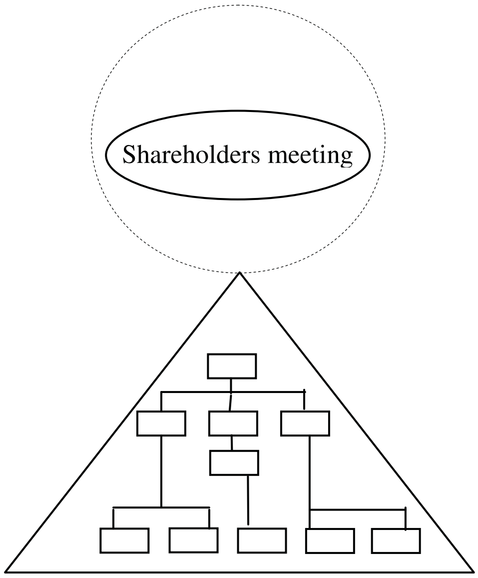


Figure 4.f. The board is substituted by shareholders' meeting

The Figure 4.b. gives a typical example of the board's structure of most public corporations in the past, where the boards were dominated by executive directors. Governance schemes in the Figures 4.c and 4.d are typical of the countries where the growing pressure of capital markets diverts a corporation's choice towards representation of outside directors as an objective judgement source. The Figure 4.d reflects the modern Anglo-Saxon board with dominant number of outside directors. The last type of this classification is the classical two-tier board (Figure 4.e). The governance practices in Germany fall at best into this category. For further analyses of corporate governance in transition economies, however, Tricker's board schemes are not sufficient. For this purpose an additional board scheme is introduced (Figure 4.f). It illustrates cases when in companies with small number of shareholders the board is substituted by a shareholders' meeting.

The landscape regarding the shape of boards is tripartite. On the one hand, there are one-tier systems in the USA, the UK, Ireland, Italy, Spain, Portugal and Greece. On the other hand, there are such jurisdictions as Germany, Switzerland, Austria, the Netherlands and Scandinavian countries that have two-tier boards. The third category of countries is a flexible one, allowing corporations to choose between one- or two-tier structures. Among them are France and Belgium (Hopt, 1998, p.228).

Despite the existing difference among the jurisdictions referring to the choice between the one-tier or two-tier board, it is not simple to draw a clear dividing line between the two board types. Together with the evolving of best practices of corporate governance the distinction between benefits attributed to each system appears to be lessening as practices converge (Du Plessis et al, 2005, p.61). The tendency of one-tier jurisdiction to hire outside independent directors creates a *quasi*-tier within the board of directors. On the other hand, the two-tier jurisdiction allows to represent some executive directors on the supervisory board, thus to some extent uniting both tiers.

The persistence of both one- and two-tier systems is an indication that none of the system prevails over another. The history of incorporation in France, where companies are allowed to choose between one- and two-tier boards, shows that no unambiguous conclusion about the preference towards one of the board structures can be made. In fact, each system has both advantages and disadvantages. The advantage of the two-tire board is that it clearly separates the supervisory body from those who are being supervised. However, this takes place on the cost of worsened information flow between the supervisory and managerial body. In contrast, the advantages of one-tier board are the tight relations among members and better access to information, although this occurs on the cost of blurred discretion between the supervisors and management.

Apart from an overall division into tiers, there are significant differences among the boards regarding their decision making structure. In contemporary corporate governance debate under such structure one understands the ratio of inside directors to independent directors (the more independent directors the better), the frequency of board meetings, availability of committee division (independent audit, nominating and compensation committee) and the size of board (Kraakman et. al, 2004). The empirical research of McKinsey & Co. (2000) has demonstrated that investors consider the board structure as important as financial performance of the company, when they evaluate companies for investment. Next paragraphs will introduce more closely various possible board features.

It has been admitted that a board should consist of multiple members, which is reflected in few arguments. First, in the environment of multiple members consulting and exchange of views is stipulated, which is an integral part of the board function.[8] Second, the presence of multiple directors reduces the agency conflict within the board itself, as each of the directors supervises other members of the board. However, there is no consistent evidence on what the optimal board size should be. Jensen (1993) suggests that large boards can be less effective than small ones, since communication and coordination between the board members gets worse with the increase of board size. The empirical researches of Yermack (1996) provide this claim with support showing that there is a significant negative relationship between the

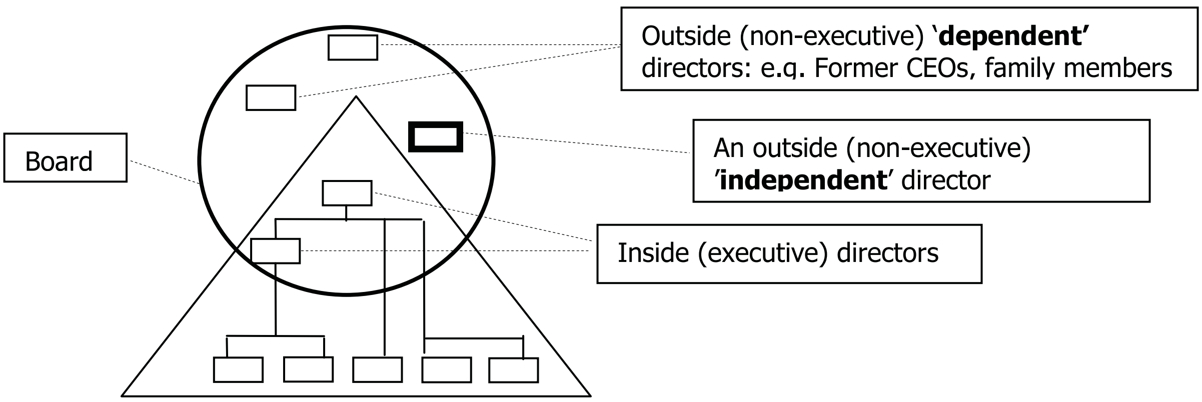
[8] See Bainbridge (2002) with reference to MBCA § 8.20. Model Business Corporation Act is one of the statutes that regulate the aspects of corporate activity within the several US States. Together with Delaware Act it belongs to the statutes under which most companies are incorporated.

board size and corporate valuation. Despite unambiguous empirical results, they should not be interpreted straightforwardly. Keeping the board too small may cause the problem of shareholders being under-represented, as there may be several interested groups with divergent interests (Black and Kraakman, 1996, p.33). Therefore, it can be concluded that boards should be created with attention paid to the trade-off between the under-representation of shareholders and inefficiently large boards.

Another issue regarding the board structure, which has become significant in the discussion on good governance principles, is the classification of directors into insiders and outsiders. The division can be explained by the fact that an inside director can be self-interested (Tricker, 1994). The agency theorists opine that a board should include outside directors, as the outside representation leads to an objective evaluation and better monitoring, thus, assuming that the ratio of outside directors is likely to be positively correlated with corporate performance (Yermack, 1996, p.191).

Regarding the insider-outsider division, the literature on corporate governance uses different terms interchangeably, such as: insider, outsider, executive, non-executive and independent directors, which require thorough determination. Insiders, also called executive directors, work full-time in a corporation and have a contract of service with it. The non-executive directors (outside directors) do not work full time in a company. Their functions are primarily concerned with the board meetings (Du Plessis, 2005, p.75). However, they can also be concerned (connected with the board) in some way, e.g. through family ties or past working experience in the corporation, and thus fail to judge objectively on particular corporate issues. In order to distinguish between the affiliated non-executive directors and those non-executive directors who do not have any connections, a term 'independent director' was introduced. Figure 5 illustrates the distinction among the presented terminology.

Figure 5: The board consisting of outside independent and 'dependent' directors



Source: Own depiction.

Nevertheless, even if the distinctions between these terms are known, the term of 'independence' without specified criteria provokes multitude of individual interpretations. That is why some countries describe in detail what is to be understood under it (Hopt and Leyens, 2004, p.13), e.g. the British Corporate Governance Code (Combined Code) lists seven indicators saying where a director should not be considered independent.[9] These are: employee contract with a company within the last five years, a business relation with a company within the last three years, additional remuneration apart from the director's fee, close family ties, cross directorships, representation of a significant shareholder, or directorship for more than nine years. On the other hand, such technical determination of independence may hinder representation of appropriate directors. Therefore, instead of strict prescription of criteria a review of potential candidate circumstances could be useful.[10]

Despite the inclusion of the independent director recommendation in major good governance codes, there are no unambiguous empirical results regarding the presence of outside (independent) directors in the board. The wide-ranging overview of the empirical literature conducted by Hermalin and Weisbach (2001) showed that regardless of a performance measurement used there is no significant relation between the performance and the proportion of outside directors.[11] Instead, a proportion of outsiders appears to have a positive effect on some firm actions, particularly those that occur infrequently or only in a crisis situation. For example, there is an evidence that boards with a higher proportion of outside directors are more likely to remove poorly performing management (Weisbach, 1988).

It can be therefore stated that generally the board can be expected to play a significant role in monitoring the management and the reduction of agency costs. Moreover, a combination of particular features of the decision making structure of a board as the size, availability of independent directors, division into committees, frequency of meetings and others contribute to the enhancement of governance practices. Nevertheless, with reference to transition economies, scholars argue that board of directors plays a negligent role as a remedy for the agency conflict.[12] This is due to the power of controlling shareholders to hire and fire board members, i.e. the board cannot be expected to play an independent role in such companies.

---

[9] Section 1, A.3.1, The Combined Code on Corporate Governance, Financial Reporting Council, June 2006

[10] The Business Roundtable, Statement on Corporate Governance, p.11

[11] The authors reviewed the studies of Bhagat and Black (2000), Klein (1998), Mehran (1995), Morck et al. (1988).

[12] Berglöf and Pajuste (2003); Berglöf and Claessens (2004).

b. Executive Compensation and Ownership

The principal-agent conflict can be theoretically lessened by means of incentive contracts for managers. Optimal incentive contracts may align the interests of managers with those of investors. Therefore, surveys on executive compensations concentrate to a greater extent on the sensitivity of the executive compensation to financial performance of a company.[13] Incentive contracts may consist of one or several following elements: (1) base salary, (2) annual bonus tied to accounting performance, (3) share ownership and options, (4) long term incentive plans, (5) life insurance and executive retirement plan (Murphy, 1998). The reduction of the value of managerial skills, or simply the threat of dismissal, can also be regarded as an incentive contract (Jensen and Meckling, 1976).

Assuming that managers will be more willing to maximize shareholder value if doing so provides management with a greater reward, it can be argued that the way to accomplish this is to have the management hold the common stock and/or options of a firm (Denis, 2001, p.201). Although Core et al. (2003) state there is no theoretical consensus on how managerial ownership of stocks and options affect firm performance, the empirical evidence suggests that the use of performance based remuneration has grown recently. Murphy (1998) finds that sensitivity of executive compensation, coming mainly through executive ownership of the common stock and of options on stock, to firm performance has increased in the last 20 years. Significantly more companies use stock based compensation. The USA is the leader in applying the stock based remuneration, whereas the elasticity of cash compensation to share price is roughly comparable in the US, Japan and Germany.

While the sensitivity between a stock based remuneration and corporate performance is observable, the degree to which managerial ownership of shares leads to better firm performance is less clear. Both the empirical and theoretical literature in this filed is vast, although no consistent answer to the ownership stake which managers should obtain is available.

In their survey of the US companies in the beginning of the 20th century (1930's) Berle and Means (1932) came to the conclusion that management shareholding is too small to make them interested in profit maximization. In 1976, with the publication of their theoretical work, Jensen and Meckling supported the findings of Berle and Means, claiming that managers tend to allocate corporate resources in their own best interest. However, they also stated that as the

[13] For extensive literature review on managerial compensation See for example Core et al (2003), Murphy (1999).

managers' equity holding increases, their interests coincide closely with outside shareholders. Stulz (1988) develops a model in which market value of a firm first increases, then decreases as the equity ownership of manager's increases.

The first opposing thesis was brought to the dispute by Demsetz and Lehn. In 1983 they introduced a theoretical model and later, in 1985, in an empirical survey of 500 US corporations showed that no significant relationship between ownership concentration and accounting profit rate has been found, especially no significant positive relationship. They estimated a simple linear relationship between profit and ownership and found no correlation.

Morck et al. (1988), discussing the results of Demsetz and Lehn (1985), argued that the use of a simple linear structure on the data is inappropriate. According to Morck et al. (1988) the results of Demsetz and Lehn are wrong, since they studied the linear relationship between profit and ownership by large shareholders, which does not capture an important non-monotonicity. In their own studies they used a non-linear specification (the profit rate in addition to Tobin's Q) and provided significant evidence of a non-monotonic relationship between management ownership and a market valuation of a firm.[14] Tobin's Q first increases as board ownership rises from 0 to 5%, falls as the ownership rises from 5 to 25% and continues to rise as the board ownership rises beyond 25%.

McConell and Servaes (1990) conducted a research similar to that of Morck et al. They also investigated the link between the ownership structure and the value of a firm, measured by Tobin's Q but with a bigger sample (1,173 firms in 1976 and 1,093 in 1986). They found a reverse 'U-shaped' relationship between Tobin's Q and shareholdings of insiders. The company performance of McConell sample first increases as the ownership concentration increases up to 40-50%, then it slightly goes down as the ownership changes beyond 50%. Although having an identical research method the results differ a little from those of Morck et al. As opposed to Demsetz and Lehn, both the studies found a non-linear relation between corporate value and insider ownership.

Since the 90's several researches which investigate the relationship between management ownership and different performance indicators have been conducted in transition economies. Djankov (1999) studied the data from Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Ukraine and finds a non-monotonic relation between manager ownership and enterprise restructuring. The managerial low (below 10%) and high (above 30%) ownership is positively associated with restructuring, whereas the ownership between 10 and 30% level negatively relates to the restructuring. In contrast, observations of

[14] Tobin's Q is a ratio of the firm's market value to the replacement cost of its physical assets.

Filatochev, Buck and Zhukov (2000) on Russian, Ukrainian and Belarusian firms indicate that managerial ownership is positively associated with less restructuring (i.e. downsizing). For Armenian companies Gevorgyan and Melikyan et al. (2004) found that economic efficiency of a company depends on managerial shareholding. Earle (1998) studying the Russian companies soon after the mass privatization of 1994 reports a positive impact of management ownership on firm productivity.

Concluding the researches on managerial ownership and corporate performance it can seen that there is no complete consistency in the findings which have been obtained through the empirical investigation. The low level of pay-performance alignment does not necessarily imply that such a governance practice is inefficient. As firms experience different level of agency conflicts, the internal and external monitoring devices may be more effective for some companies than for others.

The recent corporate scandals in the USA show that incentive schemes cannot alone solve the agency conflict. However, to deny the efficiency of performance based remuneration would be incorrect. To summarize this section with the words of Core et al. (2003) it can be stated that 'simple normative prescriptions, such as "more equity ownership by executives is always better than less ownership" are inappropriate. It is almost always necessary to understand the objectives of shareholders, the characteristics of managers, and other elements of the decision-making setting before drawing any conclusions about the desirability of observed equity-based incentive plans or the level of equity ownership by managers.'

Lucrative incentive schemes, which are used to align the interests of managers with those of shareholders in most developed market economies are not functional in the transition environment. In Russia and Kazakhstan managers who keep large stakes can either directly remunerate themselves by promoting lucrative salaries through a loyal board of directors, or find another fraudulent ways, as e.g. asset stripping. In Uzbekistan, where the state controls the largest stake, managers are paid state salaries which are uncompetitive with private market payments for a similar position. On the one hand, low remuneration reduces incentives for corporate management to lead the business effectively. On the other hand, the potential for self-payment through power abuse by corporate managers, like for example through asset stripping, wasting state resources, conducting related party transactions is increasing.

c. Large Non-Executive Owners

aa. Outside Blockholders

The next corporate governance mechanism which is supposed to reduce the agency conflict is a large non-executive shareholder, also called an outside blockholder. The large shareholder can have an influence on corporate policy either directly by exercising his voting rights or indirectly by having informal talks with management. The reason why the blockholder can take an active part in corporate governance is that his stake is substantial, which on the one hand stimulates him/her to monitor the management better and, on the other hand, such a shareholder in fact can alone or in collaboration with other small blockhoders affect the decision making process (Shleifer and Vishny, 1997, p.758). It is argued, for example, that large investors may find it easier to enforce their rights in court (Davis, 2002). Conventionally, in advanced capital markets shareholders are considered to be blockholders when they hold a 5% stake and more (Denis, 2001, p.204). Such blockholders can be individuals, corporations or institutional investors.

Theoretical works show that the higher the stake of a large shareholder, the better the monitoring of management, and the higher the economic performance of a company (Shleifer and Vishny, 1986). Stiglitz (1985) argues that concentrated ownership is one of most important mechanisms which ensure that the value of a company is maximized. However, empirical evidence regarding the impact of outside blockhlders on firm performance is mixed and inconclusive.[15] Mehran (1995) finds no significant relationship between outside blockholding and company performance measured by Tobin's Q and the return on assets. Seifert et al. in their study of four countries (the USA, the UK, Germany and Japan) found incoherent evidence on the role of blochkolders. They documented a positive impact of blockholders on the performance of the US firms, negative impact on Japanese companies and no significant relationships was found in Germany and the UK.

Although it is at least theoretically clear what benefits a large shareholder provides, one should also count with possible costs of blockholding. First, a possible cost of concentrated ownership is the ability of a large shareholder to serve their own pockets at the cost of small shareholders (Shleifer and Vishny, 1997). Within the framework of a weak institutional environment the possibility of such actions is even bigger. Second, according to the model by Bolton and Thaden (1998a) equity concentration reduces market liquidity, and thus the ability

[15] For exhaustive review of empirical literature on blockholding See Holderness (2003).

of companies to raise quickly required capital. Third, Burkart et al. (1997) points out that 'over-monitoring' by large blockholders can have a side effect, as managers being closely controlled may lose self-initiative to undertake value maximizing strategies. The last cost is the fact that large investors are not diversified because a large amount of capital is bound with one asset, which as a result leads to reduced risk sharing (Demsetz and Lehn, 1985).

With regard to transition economies scholars tend to recognize that large shareholding is perhaps the only corporate governance mechanism which can improve the monitoring of management and reduce agency costs.[16] Although the early post-privatization years in the Czech Republic provide contrary evidence, it is agreed that the reason for blatant asset stripping by investment funds, who at that time were the main outside shareholders of Czech firms, was the weak institutional environment.[17] Thus, in combination with good laws on books, in particular those which protect the interests of minority shareholders and their enforcement practices, large shareholders can be regarded as an efficient mechanism of corporate governance.[18]

The empirical evidence on the relationship between outside blockholding and performance is mixed for transition economies.[19] Kuznetzov and Muravyev (2001) in their survey of the Russian 'blue chips', which encompasses the period of 1995-1997, found a positive relation between ownership concentration and technical efficiency of enterprises, however the benefits of productivity improvement are not reflected in high profitability nor in market value of a firm, hence proposing that large shareholders use their position to extract the private benefit of control. Contrary findings are documented by Pivovarsky (2003) who investigated 376 medium and large firms in Ukraine. The author found that large outside shareholders have a positive effect on performance. Kapelushnikov (2001) also finds a positive relation between outside blockholding and economic performance.

bb. Special case of blockholding: Institutional investors

In the context of outside blockholding separate attention ought to be paid to institutional investors who became active capital market participants in the second half of the 20th century. This particular group includes banks, insurance companies, pension funds and investment companies.

---

[16] See for example Berglöf and Pajuste (2003); Berglöf and Claeesnes (2004), Crotty and Jabome (2004).
[17] See Stiglitz 1999
[18] The Part II of this thesis examines the value of the laws on book with respect to shareholder protection.
[19] For general overview of quantitative researches on the aspects of ownership of Russian companies see Iwasaki (2005)

The growing role of institutional investors is one of the most important factors in changing the financial architecture in the OECD area (Blommestein, 1997). Their development is highly interrelated with the development of securities markets. The bigger securities market and the more liquid it is, the higher is the development of institutional investors and vice versa – the bigger institutional investors and the more active they are, the more liquid the securities market is. As shown in Table 1, the USA with most advanced securities markets in the world has a bigger proportion of institutional investors than of shareholders. They hold 44% of all the equity market capitalization. Although the development of institutional investors in continental Europe lags behind the USA, recent fiscal and regulatory changes in some European countries will promote further rapid devolvement of these actors as shareholders (Davis and Steil, 2004, p.318).

Table 1: The ownership of common stocks (as a percentage of total outstanding common shares in 2002)

<table>
<tr><td></td><td colspan="4">All equity</td></tr>
<tr><td></td><td>US</td><td>Japan</td><td>France</td><td>Germany</td></tr>
<tr><td>Banks and other financial institutions</td><td>2.3</td><td>9.0</td><td>12.1</td><td>10.5</td></tr>
<tr><td>Insurance companies</td><td>7.3</td><td>4.3</td><td rowspan="2">4.5</td><td rowspan="2">9.9</td></tr>
<tr><td>Pension funds</td><td>16.9</td><td>5.4</td></tr>
<tr><td>Mutual funds</td><td>19.5</td><td>1.9</td><td>5.9</td><td>11.3</td></tr>
<tr><td>Households</td><td>42.5</td><td>14.0</td><td>19.5</td><td>14.7</td></tr>
<tr><td>Non-financial business</td><td>n.a</td><td>43.7</td><td>34.3</td><td>34.2</td></tr>
<tr><td>Government</td><td>0.7</td><td>14.0</td><td>4.5</td><td>2.7</td></tr>
<tr><td>Foreign</td><td>10.6</td><td>7.7</td><td>19.2</td><td>16.6</td></tr>
</table>

Source: Tirole 2006, p. 37.

The question of the ability of institutional investors to positively affect corporate performance is the subject of numerous researches. Again, the empirical studies do not give unambiguous answers. McConnell and Servaes (1990) states that there is a positive effect of institutional ownership on corporate performance, suggesting that manager's entrenchment would be more difficult with the existence of institutional investors. Wahal (1996) in a sample of 43 US companies found that the efforts of institutions to promote organizational change via negotiations with management are associated with gains in prices. In contrast, in their literature review Davis and Steil (2004) stated that activities of institutional investors have no improvement influence on the stock price in the long run. Among a few researches made for emerging economies is the one conducted by Xu and Wang (1997). The authors document the importance of large institutional investors for corporate governance in Chinese publicly listed companies. Pivovarsky (2003) investigated 376 medium and large Ukrainian firms and she found no statistically significant relationship between concentrated ownership by Ukrainian investment funds and firm performance.

The varying results may be explained by the differences in interests of institutional investors and the size of the stake held. In fact, the role of institutional investors should not be overestimated and their activism regarded as altruistic behaviour. Institutional investors, in the first place, remain investors with a goal to maximize return on their investment at a minimal cost (transactional and monitoring costs). They, typically, keep small shares in a number of companies in order to diversify their portfolios, reducing the risk of systematic market shocks. The costs of active monitoring of a company, in which institutional investors keep small blocks of shares, as a rule outweigh any benefits that such activism may create (Bainbridge, 2002).

Therefore, the extent of activism of institutional investors depends in the first place on the size of shareholding. Only a large institutional block holding may compensate the high costs of monitoring. However, institutional investors cannot be holders of large share blocks, since then their whole portfolio gets into a higher risk. Most countries legislatively restrict the maximal amount of shares that institutional investors may keep in one joint stock company. In this case the active role of institutional investors is excluded by legislation. Still, they have two options to react on this regulation: (1) they can either passively monitor management 'voting with feet' when the decision of the majority shareholders is not aligned with theirs, or (2) they can unite their vote with some other minority shareholders and in this way promote their goals. The success of the first option is predefined by the existence of liquid equity markets, which are the basic requirement for passive shareholding. The second option can be considered if there is no prohibitive regulation on creating shareholders' agreement and the transactional costs of goal communicating, and their alignment with other minority shareholders, is lower than possible benefits.

The above discussed assumptions are made on the basis of the experience of developed financial markets. Taking all those issues into consideration, it is interesting to analyse the role of institutional investors in transitional economies. As a rule, most transition economies have weak securities markets. Based on the assumption of Davis and Steil (2004, p.26) that institutional investors do not develop until security markets are present, it can be hypothesized that institutional investors have a weak potential to affect the corporate governance in transition economies. But looking from another perspective, one may claim that institutional investors can boost the development of securities markets through better monitoring and professional judgement about the real value of corporate assets. Oman et al. (2003) does consider institutional investors as forces which work for improvements in corporate governance. Malherbe (2003) argues that pension funds are the single most important force in the long run for improved corporate governance in transition countries. The present thesis joins these assumptions and claims that, although intuitively institutional shareholders keep small stakes in transition economies, they may play a unique role in the corporate governance of the transition countries, which differ from that of developed economies.[20] This assumption can be endorsed by four arguments. First, institutional stakeholders have enough capital to acquire relatively large stakes in comparison with individual households. This argument can be considered only if there is no legal restriction on shareholding or active participation in governing organs for institutional shareholders. Second, in transition economies the option of 'voting with feet', which means that shares of poorly governed companies can be sold, is restricted due to the low liquidity of capital markets, which may stimulate institutional investors to monitor their investments more carefully. Third, the options for investments are restricted in transition economies, thus restricting the choice for investors to only few asset types, including stocks. Fourth, in the environment of weak understanding of market processes by the society, professional market participants are the only instances which can monitor and evaluate corporate policies and discuss governance practices in media. Thus, for example, they can react to corporate failures and fraudulent transactions of managers by disclosing and discussing them in mass media. In Korea corporate governance became a household word due to wide media coverage of corporate sector frauds. Berglöf and Classens (2004) argue that mass media is important as a corporate governance mechanism but depends on the competition and independence of the media. According to estimations by international organizations none of the three sample countries has independent (free) mass media (See Table 2). The most severe situation is in Uzbekistan with total control of media by the state bodies and self-censorship. Despite the fact that Kazakhstan and Russia have slightly better indicators than Uzbekistan, they are not much freer. In other rankings of press freedom prepared annually by *Reporters without Borders* Russia, Kazakhstan and Uzbekistan positioned among the last 25% of countries, occupying the 147th, 128th and 158th places respectively, out of 167 places available.

[20] The actual shareholding of institutional investors will be analysed in Part III.

Table 2: The index of independent media

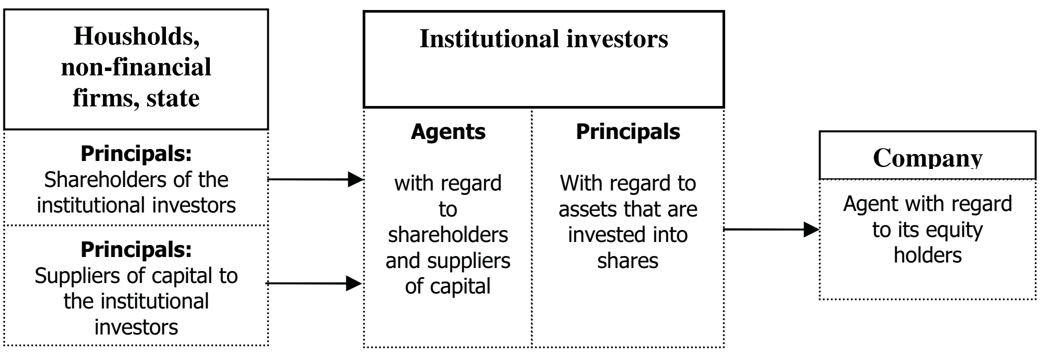
	1997	1998	1999	2001	2002	2003	2004	2005	2006
Russia	3.75	4.25	4.75	5.25	5.50	5.5	5.75	6	6
Kazakhstan	5.25	5.5	5.5	6.0	6.0	6.25	6.5	6.5	6.75
Uzbekistan	6.5	6.5	6.5	6.75	6.75	6.75	6.75	6.75	7

Source: Freedom House 2006 (1- absolutely independent media, 7- totally controlled media)

The present situation in the mass media sector extensively reveals that, though the monitoring by external stakeholders is one of several mechanisms which may stipulate good practices of governance, the lack of independent press hinders their potentially effective role. Therefore, the development of corporate governance and capital market in general is not possible without freeing the media from the influence either from the state or some other interest groups.

It is important to bear in mind the fact that institutional investors themselves, as financial organizations, comprise an agency conflict (See Figure 6). In order to strengthen their role in transition economies it is expected in the first instance to improve their own governance practices, making their work more transparent and subject for disclosure regulation. On the other hand, as the holders of small stakes institutional investors can be regarded as minority shareholders who require better law on books and enforcement practices. It is also crucial to make the activist work of institutional investors available to the public through open and independent media (internet, newspapers and TV). Above listed factors are important to enhance the role of institutional investors in the corporate governance systems of transition economies. In Part III the regulation regarding institutional investors will be reviewed in detail.

Figure 6: The principal-agent relations. From the perspective of institutional investors.



Source: Own Depiction

d. Debt

Except for its tax advantages debt is also considered to serve as a corporate governance mechanism. Financial literature recognizes a role of debt for reducing the agency conflict between managers and shareholders. Unlike financing obtained from equity issuance, the funds received on the debt market must be paid back to creditors, which gives creditors better control over a firm than shareholders have (Shleifer and Vishny, 1997, p.761). Managers are restricted in their decision on free cash flow, as part of it should be redirected for debt service. Thus, debt limits the managerial ability to misuse free cash on their personal needs such as lavish perks (Tirole, 2006, p.51). Furthermore, the requirement to make ongoing cash payments gives management a greater incentive to operate efficiently in order to produce greater cash flow (Denis, 2001, p.205). Nevertheless, debt may also create a negative effect. A highly indebted company could be forced to restrain from profitable projects as the biggest part of cash flow needs to be repaid to creditors. Generally, creditors could be considered as efficient monitors. However, the main condition of their positive effect depends on the health of banking system and the regulatory environment. With respect to transition economies Berglöf and Pajuste (2003) stated that there is a hope that commercial banks could provide some monitoring if the scope of their involvement in corporate financing broadens and the institutional environment enhances further.

1.2.2 External Control Mechanisms

a. The Market for Corporate Control

When the internal mechanisms of controlling managerial opportunism of a publicly traded firm fail, the outside parties may see a profit opportunity (Daily et al., 2003). Buying an under-performing company the acquirer plans to exchange its management which will maximize the value of the firm. Under this scheme, the market for corporate control reduces indirectly the agency costs between managers and shareholders (Easterbrook and Fischel, 1981).

One of the earliest works on the role of takeover in the corporate governance by Manne (1965) concludes that the functioning market for corporate control is a central precondition of effective market capitalism. Jensen and Ruback (1983) in their review of the scientific literature on takeovers available at that time argue that both the target firm's shareholders and the biding firm's shareholders receive gains of a takeover transaction.

In combination with other governance mechanisms, such as e.g. monitoring by institutional investors, the effect of takeover as a disciplining mechanism can be enhanced. Davis and Steil (2004) state that institutional investors can complement the takeover pressure both as a monitoring constraint on managerial behaviour and in evaluating a takeover proposal. Authors support their thesis by citing the work of Clyde (1997) where it is empirically proved that institutional concentration among shareholders was positively correlated with the frequency of takeovers between 1986 and 1990.

Another argument for the effectiveness of takeovers is based on the macroeconomic perspective. The society as a whole benefits from takeovers because it is thought to improve the allocation of scarce resources. Takeovers stipulate that the resources are utilized by the most capable people and yield the maximum return (Coffee, 1984).

In order to acquire the controlling stake a bidder must pay the price which exceeds the market price of shares, the so called premium. The premium paid for control transactions is higher in the countries with weaker investor protection (Grossman and Hart, 1988). This can be explained by the fact that the controlling stake is perhaps the only possible mechanism for the efficient governance. Therefore, the price of control is consequently higher than in developed markets. Through the high premium shareholders of a target company get additional value, which has not been created by the management of the firm.

Despite the above mentioned positive effects that a takeover produces, there are also undermining arguments against it. First, the potential of takeover occurrence forces managers to focus on short-term gains, which manifests itself, for instance, in 'artificial' profit improvements. This can be interpreted as the unwillingness of managers to invest in long-term projects, such as research and development, and instead directing corporate resources towards projects with short-term effects. As a result, shareholders do not receive a long-term value of their investment. Second, a takeover is quite an expensive undertaking and is feasible only when current performance failures of a firm are substantial. Third, takeover transactions require a liquid capital market, where a bidder can quickly raise funds in a very short term (Shleifer and Vishny, 1997). The fourth problem is the existence of anti-takeover instruments which make the acquisition hardly possible, or possible with drastically grown costs. Politicians, empowered by lobby groups, may issue laws which will permit the creation of diverse instruments that impede any takeover attempts.

With respect to transition economies it can be argued that the takeover market, according to the Western understanding, plays a negligible role. Berglöf and Claessens (2004) argue that with strongly concentrated ownership and control the markets for takeovers are likely to be inefficient in any case. Moreover, it should be kept in mind that takeovers also suffer from their own agency problem, which under a weak legal environment can deteriorate the agency problem even more. Although it can be concluded that a takeover is not a feasible corporate governance mechanism in transition economies, the shift of control over the assets including large stakes in companies is taking place in these countries as well. It is therefore required to have legal foundations which will allow for this transaction to take place with the least costs for all stakeholders. With a purpose to analyse the frameworks of a takeover regulation in the transition economies, Part II will undertake a comparison of Russia, Kazakhstan and Uzbekistan.

b. Product Market Competition

The market pressure coming from competitors is considered to be another efficient corporate governance mechanism. According to the evolutionary theory of economic change of Alchian (1950) and Stigler (1958) inefficient (inefficiently managed) companies will be one day displaced by efficient ones. Under the threat of losing the job and their reputation managers will concentrate more on their tasks and restrain from value diminishing activities or perks. Competitors also provide a benchmark according to which management can be evaluated and, if required, exchanged, whereas managers in a monopolist company may refer to bad luck in order to justify poor performance (Tirole, 2006, p.28). Allen and Gale (1999) argue that allowing a management team to compete is a better corporate governance mechanism than monitoring by raiders, directors or financial institutions. Competition fulfils two functions: firstly, it disciplines management and reduces agency costs, and secondly, helps to identify the most capable managers.

Poor political decisions which impede a competitive environment of a country may have an adverse affect on the development of a corporate governance model. For example, subventions, protectionism, political interventions and nationalization may considerably restrict competition. For a brief evaluation of the competition environment in transition economies the present section refers to the Bertelsmann Transformation Index (BTI, 2008).

In Russia institutional foundations assure conditions for the market based competition. The prices on domestic products are generally decontrolled, except for utilities. State subsidies are mainly restricted to agricultural products. Some broad sectors of the economy defined as important to the national security are shield from the competition pressure. The work of the anti-monopoly agency in the liberalized part of the economy is evaluated as efficient. Generally, according to the market organization and competition criteria in 2008 Russia scored 6.3 points out of 10 possible, which is 0.3 higher than in 2006.

A strong institutional framework makes Kazakhstan one of the best developed market-based systems of competition among the post-Soviet countries. However, commentators also note that the share of an informal sector remains rather large and the rules of the game are not equal for all market participants. Some inconsistencies have been observed in the regulation of formation of monopolies and oligopolies. Still, in 2008 Kazakhstan received 7.3 points in comparison to 6.5 in 2006.

The Uzbek market is characterized by a weak competitive environment. Liberalization and deregulation of the economy is in an embryonic state. The government continues to control pricing in most sectors. Many large companies with the state ownership enjoy the monopolistic position and subsidizing. The competition is impeded both for domestic actors through substantial administrative barriers to entry, including elaborate licensing requirements and burdensome taxation, as well as for foreigners through high import barriers (Broadman, 2001). The formation of monopolies and oligopolies is regulated only occasionally. The existing anti-monopoly committee is limited in its powers to conduct investigations and identify anti-competitive practices. Such a weak situation is reflected in the low BTI, which in 2008 and 2006 remained unchanged on the level of 3 points.

Competition alone may however not solve the problems of corporate governance (Shleifer and Vishny, 1997, p.738). The recent corporate scandals in the USA, Germany and Japan which have highly competitive markets prove that statement. It can be therefore concluded that competition is a supplementary condition for effective management but not the panacea against agency conflicts.

c. Labour Market Competition

Another corporate governance mechanism is competition on the managerial market. Managers stay in direct competition to each other. The competition pressure comes both from outside and from colleagues inside a company. The inside monitoring by other managers reduces the chances of opportunistic behaviour by executive directors (Fama, 1980). The managerial competition outside, manifested through multiple head hunting organizations on the market and long traditions of managerial profession in the context of the free market economy, makes managers care about the value maximization of shareholders.

If the managerial market can be an efficient mechanism of corporate governance remains unclear. It can be intuitively assumed that a powerful managerial lobby may design regulations in such way that managers may become more entrenched, regardless of the level of competition on the labour market. Regarding transition economies some authors do not consider the managerial labour market as an efficient mechanism of governance. In a study of Bulgaria, Djankov (1999) concludes that the managerial labour market is not competitive. The threat of being fired in Russia is a negligible mechanism, as managers keep themselves prepared by creating some employment opportunities outside the company, sometimes creating such opportunities at the company costs. In some countries with the feudal features of governance, the control over wealth assets by clans or family groups hampers the competition among talented heads, as the clan members choose candidates not on the basis of their managerial talent but rather simply according to belonging.

2. Economic Frameworks

The purpose of this chapter is to draw the economic frameworks within which the corporate governance model develops. At first, it crucial to understand the macroeconomic tendencies and global governance reforms that are being undertaken, as both these factors have a direct influence on corporate governance. For this purpose Chapter 2.1 presents a brief overview of the macroeconomic environment. Next, the analysis of privatization processes in Chapter 2.2 will help to determine an overall ownership structure of corporations and the class of main owners. After drawing the general frameworks, Chapter 2.3 continues with the study of the business environment in particular. The section will review the aspects of the business climate and the main source of corporate finance.

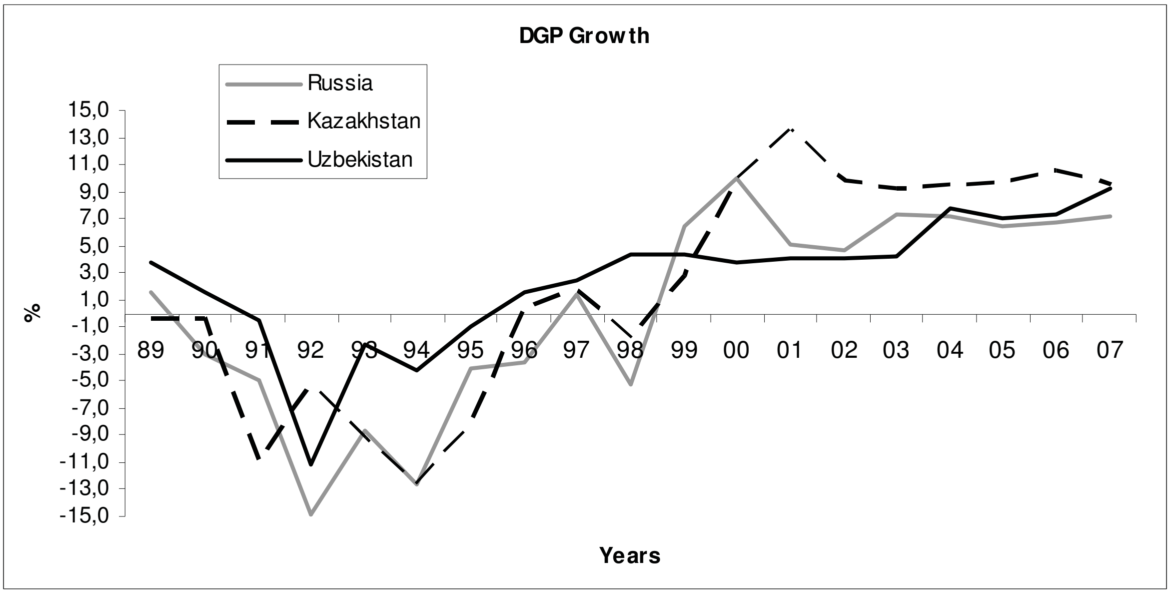
.

2.1 Macroeconomic Environment

2.1.1 Russia

During more than 17 years of transition the Russian economy has been going though many phases of economic development from the deep crises and recessions to stable growth. In the very first years of independence the government chose the course of fast liberalization, known also as shock therapy. Such policy resulted in a sharp output decline, mass unemployment and hyperinflation. This trend was accompanied with unfavourable price conditions on the world commodity markets, which were the main export revenue of the country. Only in 1996 the signs of recovery appeared and the GDP had a positive growth rate (See Figure 7).

Figure 7: GDP growth rate since independence



Source: The EBRD Statistics.

However, already in 1998 the economy was shocked again by financial crises caused by the over-indebtedness of the government and inability to pay back creditors. Consistent economic and legal reforms, combined with a favourable environment helped to recover quite soon. Since 2000 the GDP growth rate fluctuates between 5 and 10 per cent. As in the beginning of the new decade it was mainly the high prices on the Russian export goods that stipulated the growth, it was the domestic demand that pushed the GDP up in 2006 (EBRD, 2007). The developing domestic economy and growing prices on the main export goods stipulated the increase of the budgetary revenue. Since 2001 the federal budget has run surplus, which in 2006 achieved 9% of the GDP.

Table 3: Reform processes since independence

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
RUS	2.96	3.08	2.62	2.54	2.67	2.75	2.92	3.00	3.00	3.00	3.08	3.08
KAZ	2.75	2.88	2.92	2.83	2.87	2.92	2.92	2.96	3.00	3.00	3.04	3.04
UZB	2.38	2.29	2.21	2.13	2.09	2.17	2.17	2.13	2.13	2.17	2.21	2.21

Source: EBRD Transition Index.[21]

[21] *Transition Index is the unweighted average of Price Liberalisation Index, Foreign Exchange and Trade Liberalisation Index, Small-Scale Privatization Index, Large-Scale Privatization Index, Enterprise Reform Index, Competition Policy Index, Banking Sector Reform Index, Reform of Non-Banking Financial Institutions Index.*

Since the early independence years marked by hyperinflation and the forthcoming years of financial crisis also accompanied by high inflation, Russia managed to conduct a consistent monetary policy to fight inflation, which in recent years revolved around a 10-12% rate (See Table 4). However, due to external factors causing inflationary pressure, monetary stability has become a trouble issue for Russia. On the one hand, the global price increase on main agricultural products (crops, milk) pushes up the domestic prices. The other inflationary factor is the large inflow of foreign exchange in form of FDI or the export revenue. As a result, the Central Bank's extensive purchase of foreign exchange increases the money supply.

Table 4: Macroeconomic indicators of Russia

	1999	2000	2001	2002	2003	2004	2005	2006
GDP per capita (in USD)	1,347	1,789	2,123	2,380	2,983	4,058	5,361	6,874
Share of Industry in GDP	30.8	38.6	36.5	34.8	34.9	36.0	na	na
Share of Agriculture in GDP	7.7	6.4	6.8	5.7	5.4	5.0	na	na
FDI net (in mln USD)	1,102	-463	216	-72	-1,769	1,662	119	7,387
Average exchange rate per year (in USD)	24.6	28.1	29.2	31.3	30.7	28.8	28.3	27.2
Trade balance (in mln USD)	36,014	60,171	48,120	46,335	60,493	85,825	118,364	139,234
Government Debt (% of GDP)	90	62.5	48.2	41.4	32.4	25.9	16.5	9.0
Consumer Prices Index	86.1	20.8	21.6	15.7	13.7	10.9	12.7	9.7
Current Account Balance (mln USD)	24,615	46,839	33,934	29,116	35,410	59,514	84,443	96,106
Unemployment	12.9	10.2	8.7	8.8	8.6	8.3	7.6	7.2

Source: EBRD Transition Reports 2005, 2006, 2007.

Within the last few years Russia has made a considerable progress in trade liberalization, which is oriented at the aspired WTO membership. In 2006 a bilateral trade agreement was achieved with the USA, which eased the access to markets for both countries. Due to a favourable export situation on the raw material market the overall trade balance remains highly positive. Nevertheless, because of the growing domestic demand, appreciated ruble and elimination of some trade barriers, import is catching up. In August 2007 the volume of import was equal to USD19.9 bn, which was by 37.2% more than in August 2006. For comparison, on the same date the export was equalled USD30.9 bn, which is only 9.7% higher than in August 2006 (IET, 2007). A considerable success is observable with the reforms of foreign exchange control. Since 2004 the government has enacted a new *Law on*

Currency Regulation that is directed towards a liberal currency control system and a milestone on the way to the fully convertible Ruble.

Russia with its favourable geographic condition, large population, good infrastructure and high level of education is one of the most attractive countries for direct investments. Comprehensive reforms in the legal and real sector have raised business and investors' confidence in its economic perspective which boosted the capital inflow from abroad. Although, initially investments were mainly made in the mining and energy industries, now there is a positive trend of growing investment in other sectors such as machinery, infrastructure and telecommunication.

2.1.2 Kazakhstan

During the first post-soviet years of independence, like many CIS countries, Kazakhstan experienced a sharp decline in the GDP, which fell by approximately 40-60%. In the second half of the 1990s the growth rehabilitated, however the Kazakh economy was negatively impacted by the Russian and Asian crises in 1998-1999 and the price fluctuation for the main export products such as energy and metals. Since 2000 Kazakhstan has made a significant progress in economic performance, owing to both prudent macroeconomic policies and a favourable external environment. The success in the reform policies can be illustrated by the Transition Index of EBRD, which makes Kazakhstan one of the most advanced reformers among the CIS countries. Nevertheless, Kazakhstan still lags behind the transition economies of the Central and Eastern Europe. Solid progress can be observed in all main policy segments such us privatization, liberalization of foreign exchange and trade, and especially reforms in the banking and financial sectors. The USA has recognized Kazakhstan as a market economy.

The positive trend in reforms was accompanied by the favourable conditions on the world commodity markets, driven by increased prices for Kazakhstan's leading exports (oil, metals and grain). As a result, the GDP grew from only 1.7 per cent in 1999 to more than ten per cent in the next years (see Figure 7). Unemployment rate has been steadily going down, constituting in 2006 only 7.8%. At the same time there is a strong wage growth, which on the one hand increases the purchasing power of Kazakh households and, on the other hand, the income part remaining after spending on consumption grows as well, which potentially may have a positive effect on the development of capital markets, if the incentives to direct households' capital to securities market are there.

Table 5: Macroeconomic indicators of Kazakhstan

	1999	2000	2001	2002	2003	2004	2005	2006
GDP per capita (in USD)	1,132	1,231	1,492	1,657	2,062	2,862	3,758	5,222
Share of Industry in GDP	23.9	25.2	25.2	25.3	25.3	25.4	24.2	23.4
Share of Agriculture in GDP	11.1	9.8	10.1	9.5	8.8	8.1	7.9	7.6
FDI (in mln USD)	1,468	1,278	2,861	2,164	2,213	5,436	2,123	6,556
Average exchange rate per year (in USD)	119.5	142.1	146.7	153.3	149.6	136.0	132.9	126.1
Trade balance (in mln USD)	340	2,168	983	1,987	3,679	6,786	9,512	14,642
Export	5,986	9,288	8,928	10,027	13,233	20,603	28,301	38,762
Import	5,648	7,120	7,944	8,040	9,554	13,818	17,978	24,120
Export of petroleum products (in mln USD)	2164	4429	4463	5157	7015	6949	7045	7831
Government debt (% of GDP)	31.5	25.5	20.4	18.0	15.6	13.5	10.1	7.1
Consumer Prices Index	8.3	13.2	8.4	5.9	6.4	6.9	7.6	8.6
Current Account Balance (mln USD)	-236	366	-1390	-1024	-273	335	-1066	-1797
Unemployment	13.5	12.8	10.4	9.3	8.8	8.4	8.1	7.8

Source: EBRD Transition Reports, IMF publication – The Republic of Kazakhstan: Selected Issues and Statistical Appendix.

A considerable success is reported in the FDIs, which are mainly directed to the oil and gas sectors (See Table 5). Despite such a strong orientation on one sector foreign capital has a large spillover effect contributing to the development of the infrastructure and construction sectors. The inflow of foreign direct investments comes from the USA (30%), the UK (14%), Switzerland (13%), Italy (12%), the Netherlands (10%) and Russia (5%).

Large foreign exchange inflows significantly trouble the monetary policy as they cause inflationary pressure. Nevertheless, the monetary policy, which tends to be tighter in Kazakhstan, has been well managed. Inflation remained under control not exceeding one digit figures. The excess of foreign exchange also has an appreciating impact on the national currency (Tenge). The Central Bank was forced in 2006 to intervene and sell a part of its reserves in order to keep Kazakhstan's export competitive with its cheaper Central Asian neighbours. As a rule, the market sets most prices, although the government still retains control over prices through state-owned enterprises and manufacturing subsidies.

The situation of the republican budget has looked positive in the recent years. High revenues from oil and gas industries is the main reason of budget surplus. IMF (2007) evaluates the reforms in the fiscal sector as positive, noting the reduction of corporate, value added and income taxes, which is compensated by the increase of tax on oil exports. The main revenue comes from the oil and gas sectors, which together make up almost 40% of the budget revenue. Since the beginning of the last decade Kazakhstan has maintained a tight fiscal policy. The government tries to maintain the balance between the required spending on social development and infrastructure on the one hand and the growing inflationary pressure caused by the inflow of capital to energy sectors on the other hand.[22]

2.1.3 Uzbekistan

Despite the geographical and cultural closeness, and the shared history of the last 70 years, Kazakhstan and Uzbekistan had different economic conditions in the beginning of reforms (Alam et al., 2000). Uzbekistan was one of the poorest Soviet republics, producing mainly primary goods and raw materials. The collapse of the Soviet Union had a less adverse effect here than in other republics, which had a substantial industrial share in the economy. So, that in comparison to the other ex-soviet republics the decline industrial output in the first year of independence was quite moderate (28% according to the ADB 2005). That is the reason why, for example, the depth and length of the post-independence recession was less severe in Uzbekistan.

Due to quite a gradualist reform approach Uzbekistan avoided a sharp decline in output and increase in poverty observed in more rapid reformers such as Russia, Kazakhstan or Kyrgyz Republic, and without falling into a trap of non-reform like Turkmenistan (Pomfert, 2000, p.12). Since 1996 there has been a positive economic growth, which is higher than in Kazakhstan (See Figure 7). Critics argue that it is controlled prices of the Uzbek policy which statistically showed higher macroeconomic results in comparison to Kazakhstan (Alam et al., 2000). Djankov et al. (2003) claims that because of the very slow reform paste Uzbekistan failed to reap the benefits of economic transition (Djankov et al. 2003, p.13).

After more than 15 years of reforms, in their report experts from the Asian Development Bank (2005) characterized Uzbekistan as a regulated market economy, which combines features of a centrally planed economy with elements of a market economy. The private sector constitutes 45% of the economy, which is considered to be small for an economy that has been in transition for more than a decade (EBRD, 2007). The state still continues the subsidy policy. Although its share has substantially decreased from 20% in 1993 to 3% in 2001, the

[22] The top income tax rate is 20 percent, the top corporate tax rate is 30 percent, and VAT is 14 percent. http://www.heritage.org

implicit subsidies still maintained and, according to the ADB estimates, make up half of the GDP (ADB, 2005). It can be assumed that a soft budget has a moral hazard effect in subsidised companies, and thus hinders the development of corporate governance.

The agricultural sector prevails in the economic structure of the republic. Uzbekistan is one of the biggest cotton exporters in the world. Almost one third of the population is active in the agricultural sector. The government retains control over the cotton industry and its sales. Other main export commodities are gold, gas and metals. The rapidly growing prices of these goods on the world markets have a positive effect on the republican budget, which since few years has been in surplus. Moreover, Uzbekistan has recently increased tax rates, thus belonging to the post-soviet countries with the highest tax burden.

Table 6: Macroeconomic indicators of Uzbekistan

	1999	2000	2001	2002	2003	2004	2005	2006
GDP per capita (in USD)	340.5	366.2	305.6	329.3	380.3	472.3	572.0	655.0
Share of Industry in GDP	14.3	14.2	14.1	14.5	15.8	17.5	20.7	22.1
Share of Agriculture in GDP	29.0	30.1	30.0	30.1	28.6	26.4	25.0	24.1
FDI (in mln USD)	121.0	75.0	83.0	65.0	70.0	187.0	88.0	195.0
Average exchange rate per year (in USD)	257.2	360.7	646.3	885.0	995.5	999.2	1,072.3	1,219.8
Trade balance (in mln USD)	203	494	186	324	835	1202	1447	2001
Export	2,790	2,935	2,740	2,510	3,240	4,623	4,757	5,615
Import	2,587	2,441	2,554	2,186	2,405	3,061	3,310	3,614
Government debt (% of GDP)	na	42.1	59.4	54.6	41.6	35.1	28.2	20.8
Consumer Prices Index	29.1	25.0	27.3	27.3	11.6	6.6	10	14.2
Current Account Balance (mln USD)	-164	218	-113	117	880	1,214	1,950	3,198
Unemployment (in per cent of labour force)[23]	0.4	0.4	0.4	0.4	0.3	0.4	0.3	0.3

Source: EBRD Transition Reports.

The trade policy in Uzbekistan can be characterized as very restrictive. Import barriers remain high in comparison to other transition economies. This is the result of the country's industrial politics oriented towards imports substitution. For the same purpose in 1997 the

[23] Official Figures of the Government

exchange rate policy was tightened and multiple exchange rate regime was introduced. The overvalued currency disadvantaged export oriented industries like gold and cotton, while the importing industries were subsidized (ADB, 2006). In 2003 the government decided to introduce the current account convertibility, lifting several exchange rate restrictions, which finally led to the unification of exchange rates. Nevertheless, obstacles in form of delays in obtaining foreign exchange remained. This is especially observable in times when the government or state owned enterprises have large foreign payments needs (UN Report, 2005).

In terms of the FDI inflows, Uzbekistan performs poorly in comparison to other post-Soviet countries. Although foreign direct investment increased by $195mln in 2006, it still comprised only 1.2% of GDP. In order to foster the inflow of FDI in 1998 an ambitious privatization program was announced, however the results did not match the expectations. Such a weak performance is explained by the absence of reforms to the broader business environment, which remains unattractive (ADB, 2006). According to the UN report held at a Moscow conference in 2005, the main complaints of foreign investors in Uzbekistan were about ambiguous rules, the legislation and presidential decrees which often contradict each other.

It can be concluded that the Uzbek government has managed to avoid large economic distresses in the early transition years. However, such results were achieved at the cost of very gradual reforms, with the main economic power being concentrated in the hands of the government or political elite. Only in recent years some positive reform steps were initiated by the government, which are promised to have a positive effect on economy.

2.2 The Ownership Structure of Enterprises

2.2.1 An Overview of the Ownership Structure in the World

After reviewing the macroeconomic situation it is essential for further analysis to study the general ownership structure in the target countries. Answering the question who the company belongs to and who manages the company is the key to the puzzle of the agency conflict, and thus to defining an appropriate strategy of tackling each particular conflict in order to create a thriving investment environment.

Two basic ownership structures lie in the essence of most analyses, namely concentrated and dispersed ownership. The dispersed ownership implies that a company is widely held and there is no shareholder with controlling rights. In opposite, the concentrated ownership stands for shareholding with one or several controlling owners. As discussed earlier, each particular ownership type is associated with specific categories of interest conflicts. Table 7 illustrates most common ownership types around the world and indicates the potential agency conflicts which occur within particular ownership.

Table 7: Ownership structure, management type and potential agency conflicts

Concentrated ownership			
Ownership types	**Management type:**	**Conflict of interests**	**Prevails in countries**
Family	1) Self-management by a founder or a heir; 2) Delegated to professional managers.	a) Majority vs. minority shareholders; b) Majority shareholders vs. employees; c) Owners vs. creditors.	In most countries of the world.
Managers	Self-management	a) Majority vs. minority shareholders; b) Managers vs. employees; c) Managers vs. creditors.	The countries in which a privatization process was insider oriented (e.g. Russia).
State	1) Delegated to professional managers; 2) Representation in management organs by employees of state agencies (Ministries, agencies); 3) Management trough special state holdings.	a) State vs. minority shareholders; b) State vs. creditors; c) Managers vs. state.	Some developing and transition economies which were slow to privatize (Uzbekistan, Turkmenistan, Tajikistan etc.)
Financial institutions	1) Self-management; 2) Delegation to professional managers.	a) Majority vs. minority Shareholder; b) Banks as shareholders in one company vs. bank's debtors; c) Financial institutions as shareholders vs. their own shareholders.	Germany (banks), Czech Republic in the 90's (banks), the Anglo-Saxon countries (institutional investors).
Non-financial corporations (corporate groups)	1) Self-management; 2) Delegation.	a) Majority vs. minority; b) Majority vs. creditors.	Prevails in many transition economies.
Dispersed ownership			
Dispersed	Delegated	Managers vs. shareholders	The Anglo-Saxon countries: the USA and the UK

Source: Own illustration.

2.2.2 Reasons of Ownership Types

The ownership structure of corporations is subject to permanent transformation. Throughout the history of publicly owned companies it has gone a long way from the dispersed to concentrated shareholding and vice versa, each of them exchanging periodically. There are numerous factors which influence the change in ownership patterns. Kapelushnikov (2005) summarizes four theoretical approaches such as economic, legal, ideological and political, which explain why a particular ownership structure evolves.

The economic theory assumes that many countries do not have such a level of economic development, under which complex organisational structures like corporations and effective capital markets could function. The institutional environment of such countries remains weak. Poor contract enforcement, restricted and non-transparent reporting standards, the lack of legal qualification of judicial organs and high corruption are the factors which stipulate the concentration of ownership. It is argued that it is a consequence of either bad laws or week law enforcement by courts (Shleifer and Vishny, 1997). Another reason of concentration could be a weak bank financing. That is why companies attain funds from familial internal resources.[24] Thus, family and informal ties help to create an autonomic business environment and ensure long-term functioning of business. If contracting parties belong to one family or a clan, the degree of trustworthiness increases and the risk of opportunistic behaviour between them diminishes, as an informal mechanism of enforcement occurs, thus reducing transactional costs (Kapelushnikov, 2005, p.16). The sufficiency of the economic theory is undermined by the existence of concentrated ownership, not only in developing economies but also in most developed countries, which, as opposed to the argumentation above, possess a strong institutional environment. Therefore, some additional factors should be recognized responsible for the divergence in the ownership structure.

Another theory based on legal consideration explains the differences in the ownership structure through the extent of shareholder protection. A number of empirical and theoretical researches suggest that dispersed ownership is common in the countries with better shareholder protection.[25] Moreover, the argumentation is extended to the origin of the law systems, arguing that the common law countries provide better investor protection than those of the civil law origin. Nevertheless, the law theory does not provide an exhausting explanation either. Kapelushnikov (2005) argues that the non-Anglo-Saxon countries

[24] See for example Mayer (1990).
[25] La Porta et al (1998, 2003); Shleifer and Wolfenzon (2002).

throughout their history experienced periods when their systems of corporate governance were based on dispersed ownership with multiple shareholders. Why does the concentration appear again in these countries today?

Based on historical events, it could be noticed that the concentration was also stipulated by an ideological factor. The ideas of socialism and nationalism in continental Europe, which dominated the last century, could be the reasons of ownership concentration, in contrast with the USA and the UK, where the spirit of free market economy was a paramount factor contributing to the development of their models. Taking over the power by socialist or nationalist governments was accompanied by the ownership concentration. This fact has a practical explanation, as it is easier to carry out the planning and regulation in a restricted number of large companies than to deal with unpredictable market forces. Good examples for this argument can be obtained from the history of Germany, Italy, Japan and Sweden.

The next determinant of the ownership structure is a political factor. Roe (1994), the most frequently cited author, argues that political decisions are the main reasons of particular ownership developments. He argues that political decisions in the USA created its corporate environment of widely held shareholding. The reason why large shareholding and majority ownership are relatively uncommon in the US is that high ownership and the exercise of control by banks, mutual funds, insurance companies and other institutions is legally restricted through the lobby of powerful managers. In his later publications, Roe (2003) defines the political orientation of the ruling parties as an explanatory variable of an ownership form. The author broadly notices that ownership concentration in industrial countries is positively correlated with the index of the 'leftist' orientation of a ruling party. He concludes that in the countries which had social-democratic parties, or those with a similar political orientation, for a longer period in their history the concentrated ownership of corporations prevails; while in the countries where social-democrats did not rule, or ruled for a short period, the widespread ownership exists.

It can be summarized that the evolution of corporate ownership and corporate governance models is a sophisticated process, stipulated by different factors, including systematic and random ones, which are interrelating and overlapping. All mentioned theories can be taken into account when explaining the evolution of the ownership structure in the long-term perspective. However, for the case of transition economies perhaps the most crucial explanatory factor – at least in the first periods of transformation – is the privatization process. All post-socialist countries started their reform process with the privatization of state property. Thus, a given privatization method formed a preliminary ownership structure of enterprises and served as a foundation of corporate governance models (Boeri and Giancarlo, 1998, p.73). Therefore, in order to understand and analyze the ownership evolution in the three post-soviet countries an overview of the privatization process is required as well. In the following sections we will give a brief overview of privatization methods, the reforms in transition economies and their results.

2.2.3 Privatization as a Factor of Ownership Building

a. An Overview of Privatization Methods

Three main privatization methods are distinguished as based on the identity of an acquirer. These can be: (1) strategic investors in case of a capital privatization method, (2) managers and employees in case of insider privatization, (3) general community in case of mass privatization. Under the capital privatization method enterprise assets are sold to strategic investors via tenders, public auctions, public offerings and debt-equity swaps. Managers and employees become subscribers to equity issues under insider privatization. Mass privatization implies free (or obtained for symbolic price) distribution of privatization certificates to the community, which gives them the right to acquire corporate shares or invest them in collective investment institution as an investment fund.

The first method – capital privatisation or direct sale – requires availability of capital, as companies are sold in big stakes, which in the conditions of transitional economies becomes a substantial obstacle to privatization, since domestic investors are limited in terms of free capital. A solution could be selling companies to foreign investors or allowing domestic investors the payment in instalments. The problem with this method is that wide masses of population are excluded from the deals, not to mention the weak institutional environment, which is a good background for low transparency and self-dealing. Additional disadvantages of the approach are: high costs, complexity, slow execution and possible resistance coming from company insiders. Most post-soviet countries, except for Estonia and Hungary, refused from this model as a dominant privatization scheme in the initial phase.

The second method – managers' and employees' buy-outs (MEBO) – was popular in many transitional countries such as Poland, Russia, Mongolia, Croatia and Slovenia. The advantage of MEBO is that they are fast and easy to implement. It can mitigate the 'principal-agency' problems between owners and workers. Advantages of MEBO are counterbalanced by its disadvantages. First, there is little or no competition among participants in the process. Second, insiders are not able to bring new skills nor capital to a company, whereas the socialist managers do not have sufficient skills in corporate management. The researches showed that companies privatised through MEBO carried out less restructuring and less investments than those acquired by outsiders.[26] Third, if insiders own only a part of a company together with outsiders, it can only stimulate the principal-agent problem because of the differences in essential goals. According to Gray (1996), insiders are likely to apply for the state support and the government tends to approve of it. There are some proposals which can help its advantages to overweigh the disadvantages. The first proposal is to decrease the state support through subsidised credits creating equal conditions for companies which compete for financial resources. The second one is to stimulate the development of other owners; for the companies which need restructuring and new investment the insider privatization method may not be appropriate. Gray provides an argument for giving insiders a small stake (15-20%) and selling the rest to outside investors. In this case political tension would be lessened as the employees could still receive the share which allows monitoring of the corporate policy. On the other hand, companies would receive barely needed financial investments from the outside shareholders.

The mass-privatization method ensures the involvement of the whole community in the processes. Unlike in the direct sale, instead of cash privatization certificates (*vouchers*)[27] are used. As a rule, vouchers are distributed to the citizens for free, or sold for a very low price. This method helps to avoid capital scarcity in the domestic market. Such countries as Albania, Armenia, Bulgaria, Czech Republic, Estonia, Kazakhstan, Lithuania, Moldova, Mongolia, Poland, Romania, Slovakia, and Ukraine implemented this method. Its main disadvantage is that it does not generate revenue. Obtaining the vouchers for a low price or totally free is questionable. It is often argued that new owners do not realize incentives, which are necessary for effective corporate governance; they simply do not value the acquired assets if they do not pay from their own pocket.

Allowing citizens to invest their vouchers directly in companies creates a highly dispersed ownership environment, which hinders effective governance. In order to solve this problem many mass privatization models introduced intermediaries, usually Investment Privatization Funds (IPF). These were supposed to pool the vouchers from citizens and invest in privatized enterprises. Instead of unqualified population, professional money investors become shareholders. It is however difficult to create truly private funds with market based incentives. First, funds themselves experience liquidity problems because of a non-monetary character of privatization. Second, most enterprises which are privatized perform poorly, at least in the initial phases, which means no or little dividend revenue for funds. Even

---

[26] See for example, Barberis et al 1995.

[27] Some countries introduced privatization certificate which was called „Vaucher"(e.g. Russia). This word is widely used and became a synonym for mass privatization.

considering that both the mentioned problems are unlikely to occur, there is still space for the principal-agent conflict between a fund as a large block holder and other shareholders. The experience of Czech Republic confirms the existence of this agency conflict. For many years that privatization scheme based on IPFs was considered an example of effective privatization and corporate governance. Black et al. (2000) report that in the second half of the 90s, however, the problems of power misuse and assets striping by investment funds questioned their effectiveness as a governance mechanism.

As it has been discussed, all the presented methods have advantages and disadvantages. Some countries were implementing several methods simultaneously, others used different types for each particular privatization period. One argument, undisputable among scholars, is that for efficient privatization the existence of an institutional environment is required, which in the framework of transitional economies is a long-lasting process. That is why reformers face a dilemma: privatize quickly while a required institutional environment is being formed, or first create the environment and privatize afterwards? The former option promises a rapid property transformation, but due to missing legal frameworks and enforcement mechanisms it may end up with an unfair property transformation. In case of the latter one, a delay in the creation of private property institutions will hinder further reform processes.

Aiming to review the ownership structure in the three transitional countries it is crucial to review their privatization processes. The main task is to study political preferences in the distribution of ownership in the initial phase of transformation, and to compare it with the current ownership situation. These analyses will help to define the governance patterns in each country.

b. Privatization Process in Transition Economies

Despite having similar start-up conditions the post-soviet countries chose different privatization pace and methods. A statistical assessment of EBRD (Table 8) illustrates how privatization was carried out in the three transitional countries. Among them Russia managed to privatize the biggest share of its state sector resulting in the private sector share of 70%, which in the last years, due to the nationalization of several big companies, decreased to 65%. Kazakhstan chose a more moderate privatization policy with stakes retained by the state in some important sectors. However, in time the private sector’s share was permanently growing. The method chosen by Uzbekistan stays in absolute contrast to Russia and Kazakhstan. Its government chose very gradual transformation with a substantial state share in the economy. An insignificant share of the private sector is a direct indicator of a highly gradualist approach in Uzbekistan.

Table 8: EBRD assessment of privatization

	2000	2001	2003	2005	2007
Kazakhstan					
Private sector share (in % of GDP)	60	60	65	65	70
Large-scale privatization	3.0	3.0	3.0	3.0	3.0
Small-scale privatization	4.0	4.0	4.0	4.0	4.0
Russia					
Private sector share (in % of GDP)	70	70	70	65	65
Large-scale privatization	3.3	3.3	3.3	3.0	3.0
Small-scale privatization	4.0	4.0	4.0	4.0	4.0
Uzbekistan					
Private sector share (in % of GDP)	45	45	45	45	45
Large-scale privatization	2.7	2.7	2.7	2.7	2.7
Small-scale privatization	3.0	3.0	3.0	3.0	3.3

Source: EBRD Transition Report 2005, 2006, 2007 (from 1 to 4, 1- is no change, 4- standards of market economy).

All the countries managed to privatize small companies with an almost equal success. Russia and Kazakhstan received the highest score (4) for this privatization type. Although in the small scale privatization Uzbekistan achieved bigger progress than in the big-scale, its total score remains lower than in Russia and Kazakhstan. Also in the large-scale privatization Russia retains a leading position with an average score of 3.3. The least successful in privatizing of large companies was Uzbekistan. Despite the policy of active privatization since 1998 the state has retained controlling stakes in most middle and large size companies. The foregoing sub-chapters will give a short overview of the privatization process in the selected countries.

aa. Russia

The Russian privatization process is known as the fastest and largest privatization program ever seen (Nellis, 2001 p.57). At the same time, it is one of the most controversial and dishonest in the world economy. The discussion over its outcomes and possible alternatives continues unceasingly.

In its starting phase, the privatization process faced strong political confrontation between new reformers on the one side and representatives of the socialist wing on the other. While the former were advocating quick denationalization and limitation of the state influence in the private sector, the latter strived to preserve the heritage of the Soviet Union in the hands of the state. New reformers, with their privatization head Anatoly Chubais, managed to put through their plan, although with some trade offs to main opponents. Some international organizations and Western scholars as Shleifer, Vishny, Sachs and others cooperated in the elaboration of the Russian privatization program (Black et al., 2000). The main concept behind it, which the new reformers chose, was to privatize as quickly as possible. Rapid separation of the ineffective state ownership and deficient governance mechanisms from the private sector was the core principle of their plan. The evolvement of private property was regarded as a fundament for further transition to market reforms, whereas the institutional environment was an *ex post* factor, which was supposed to follow up the requirements of the market economy.

Schematically the whole process may be divided into two phases: mass privatization and direct sale. The first phase took place from 1992 to 1994. Insider sale and voucher privatization were chosen as main privatization methods during this period. At first, enterprises were turned into Joint-Stock Companies (JSC), whereas three different schemes were offered to the working collectives: (1) sale of 25% of shares to employees and another 10% for lower prices; (2) acquisition of 51% of shares by employees and (3) free sale of shares for the market price. As opposed to the expectations of reformers, most companies were corporatized according to the second scheme in which managers and employees received a controlling package, whereas the managers were getting higher shares in comparison to ordinary workers (Medvedev, p.18).

As the next step, privatization coupons (certificates) were distributed among the community. Each citizen received one, in Russia known as a *voucher*. The vouchers were tradable and could be freely exchanged for the state property or invested in the Investment Privatization Fund (IPF). Theoretically, each voucher holder was eligible to exchange it for corporate shares. The practice showed, however, that in most cases only the shares of the enterprises where they worked could be acquired. Some 650 investment privatization funds were created in the beginning in order to attract the vouchers. By 1996 only 350 funds remained. 60% of all shares offered in the voucher-auction were bought by the IPFs. Corporate insiders resisted politically against dispersed ownership, which resulted in the legal norms prescribing investment funds to acquire not more than 10% in one company. Totally the investment funds have acquired some 30% of vouchers. However, only 6% of shares of privatized companies were purchased with the acquired vouchers. The small shareholding of IPF stipulated restricted control over privatized companies (Kordasch, 1997, p176). Most of the funds failed to pool enough cash. The illiquidity of the securities market, weak profitability of most companies and lack of dividends were the main factors responsible for the weak performance of IPFs (Pistor and Spicer, 1997, p.34). There are even some cases in which the investment privatization funds were allied with managers buying shares on their order. In that way the actual share of outsiders became even smaller (Szbakin, 1994, p.12).

By the end of the first privatization phase 65% of 200,000 state owned companies were privatized. Around 15,000 medium and large state firms, which employed 17 million workers, were privatized according to the voucher-scheme (Fox and Heller, 1999, p.32). The state obtained the shares in 34 per cent of enterprises. Two million Russians (14%) acquired shares in the privatized businesses.

Privatization in this phase virtually took the form of pure management-employee-buyout because, first, of its preferential treatment of managers and workers. Second, the existing institutional environment could not protect the small share of outsiders. In average, managers obtained 9% and workers about 56%. Outsiders possessed 20-30%, which was split between investment funds and individual investors. The rest of shares was controlled by the government. Moreover, the government retained control over the land where enterprises were located. The critics of voucher privatization call it '*insider privatization, which is hidden behind the populists idea of people's (folk's) privatization*' (Nellis, 2001, p 66). Nellis argues that the outcome of privatization was already planned in the pre-privatization period.

The main outcomes of this phase could be summarized as following: enterprises did not receive the highly needed financial funds and almost no enterprise restructuring took place. Absence of investment inflow is explained by the privatization method, as the ownership transfer was conducted in exchange for vouchers, which were freely distributed and those few monetary transactions that took place were outside the corporate sector (Yakovelev, 2004). The failure to restructure enterprises is explained by the nature of the interest conflict between restructuring and employment. Clearly, employees were opposing restructuring in order to preserve their jobs. Mangers were not insisting on restructuring because available fraudulent mechanisms of doing business, due to the missing institutional environment, were more lucrative than reforming enterprises into profitable business (Black et al., 2000).

The first phase ended up with highly concentrated insider's shareholding, with the permanently growing share of managers. More than 70% of enterprises were in the hands of managers. According to the study by Blasi and Schleifer (1996) the shareholding of Russian managers made up 60 % of the equity capital and was still growing. The mass-privatization led to managers' self dealing, as no controlling mechanisms were present. Thus, the government expectation to create the dispersed ownership of enterprises was not fulfilled. Instead of a wide class of corporate owners, the class of wealthy businessmen was created. The trend has been intensified when the businessmen started to use their economic power, negotiating the new deals with the government. Later this class of wealthy businessman with political connections was labelled as *oligarchs*.

As a means of restructuring, the presidential decree (December 1993) on the creation of the bank-led financial industrial groups (FIG) was issued.[28] By the end of 1995 there were 15 such groups, which included 273 companies and 2 million employees. Companies within a group belonged to the production chain, which also included some big banks. The state was supposed to hold up to 25% of share in them. This concept evolved as an alternative to Chubais's privatization. Banks were encouraged through the FIG to obtain controlling stakes. It was planned that the FIG will acquire, restructure and sell profitable enterprises. It was supposed that banks would drag enterprises forcibly into the market economy. However, the result was quite opposite. Politically connected banks were acting as middlemen between the government and firms, tunnelling subsidies and state loans from the government to enterprises. Against the expectations, the banks were not able to manage companies efficiently and some FIGs just built monopoly positions. They did not make necessary investment in capital and management to accomplish restructuring, instead they received dominant positions both in finance and industry, which stipulated easy access to the political power.

The second phase started in 1995 and still continues. It is based on a direct sale method (case-by-case). In the beginning of the second stage around 65% of industrial companies were still in the state ownership. The reformers' goal was to decrease insiders' ownership and concentrate the shareholding in 'strategic hands' (Kordash, 1997, p.61). The government planned to improve the state budget, selling shares in some lucrative large companies. Nevertheless, the demand on privatised objects was quite low, which was not sufficient to bring preferred capital to cover the budget deficit.

Numerous cases of self-dealing and fraudulent privatisation are described by Black et al. (2000), who shows political and economic elite as actively participating and gives a deep understanding of the whole process during the second phase. Nellis (2001, p.62) characterized

[28] Decree N 2096, Dated 05.12.1993.

this phase as a murky privatization. Many enterprises were acquired in an uncompetitive environment, where potential bidders were excluded. The situation became more dramatic when the 'loans for shares' scheme was launched. In this situation, the newly formed class of extremely rich (oligarchs) came to be the 'saviours' of the government. The oligarchs, at this time owners of private banks, proposed a scheme which was supposed to solve the problem of state illiquidity on the one hand and promote further privatization on the other hand.[29] In this so called 'loans against shares' model, the government received a loan from the banks which was secured by the shares of lucrative industrial giants from the sector of natural-resources, in which it had shares. Black et al. (2000) described this deal in the following way: '*Everyone understood that the government would not repay the loans, and would instead forfeit its shares to the banks that made the loans'*. In fact, the loans were never paid back. The financial consortiums got the right to sell the shares of industrial giants on auctions. Unfair and tricky auctions ensured the ownership of 'interested' groups.[30] Most companies were sold for the price which was slightly above the offer price but was only a fraction of the real market price.

After the August crisis of 1998 the turbulent times of privatizations were slowing down. Two reasons can explain it: first, the big privatization wave almost ended, and second, the much needed institutional environment was evolving. In 2001 the private sector accounted for 70% of GDP with the number of privatized companies approaching 140,000 (Broadman, 2001).

The outcomes of early privatization phase can be traced in the ownership structure. Corporate insiders (managers and employees) who became the main owners of their companies were controlling up to 50% of the shares. In a survey of 135 industrial companies conducted by Aukutsionek and Kapeliushnikov (2001) the proportion of ownership between manager and employees was about 1 to 4 in 1995 (11% managers and 43% employees). In time, the insiders' ownership slightly decreased: in 2001 it was 50% in comparison to 54% in 1995. Although the insiders' ownership has hardly changed, the shareholding within this group has changed considerably. The ratio of shares held by managers constituted 19%, whereas employees were holding only 28%. This shift can be explained by the fact that the managers were encouraging employees to sell their stock to them. The acquisition of shares took different forms, sometimes even violating the law. Not only directors, but also outsiders

[29] The government was running a high budget deficit at that time. The 'loans for shares' program in 1995 and 1996 raised the revenue five times more than in all previous privatization periods.

[30] There were different methods to restrict competition participation. Economic literature names 3 commonly used: (1) auctions were not announced, (2) location of auction places was chosen in distant regions of Russia, (3) even if the competitors were appearing in auction their bidding was forbidden by organizers who later become purchasers or cooperated with purchasers.

were purchasing the shares from workers, thus we can see that outsiders' shareholding also slightly increased (See Table 9).

Table 9: Evolution of the ownership structure of industrial enterprises

	1995	1997	1999	2001
Insiders, total	**54**	**52**	**50**	**50**
Managers	11	15	15	19
Workers	43	37	34	28
Affiliated firms	-	-	1	3
Outsiders, total	**37**	**42**	**42**	**42**
Outside individuals	11	15	20	22
Other enterprises	16	16	13	12
Commercial banks	1	1	1	1
Investment funds	4	4	3	3
Holding companies	4	4	3	4
Foreign investors	1	2	2	0
State	9	7	7	7
Total	**100**	**100**	**100**	**100**
Number of enterprises	136	135	156	154

Source: Aukutsionek and Kapeliushnikov (2001, p.11).

Dolgopyatova and Uvarova (2005) conducted a similar research, however with a larger number of companies, incorporating not only industrial companies in their model. In their sample, the concentration of ownership in the hands of employees and managers is smaller than in industrial companies (38% against 47%). The rest of shareholder groups, however, have approximately similar weight in both the surveys.

Table 10: The ownership structure in Russian companies

Shareholders	**1998**	**1999**	**2002**
State	11,3	9,5	6,9
Commercial organizations (no credit-financial organizations)	21	22,2	28,4
Credit financial organizations	1,2	0,7	0,8
Physical persons	17,1	18,5	22,7
Employees and managers	45,6	44,9	38

Source: Dolgopyatova T. and Uvarova O., (2005).

To sum up, by the end of the active privatization process the ownership structure of Russian enterprises can be described as insider-oriented. From the very beginning of the privatization old corporate directors overtook the management chairs. Initially, their share was insignificant in comparison to employees, however in time it was permanently increasing. As noted by Judge and Naoumova (2004), nowadays a light shift of ownership structure towards outsiders can be observed (p.308). Individual investors and the recently emerged new class of institutional actors on the Russian market are those outside shareholders. However, the trend should be regarded with caution as the outside shareholding is often represented through nominal owners, who in reality are foreign or off-shore companies controlled by current managers or large shareholders. It can be assumed that the highly concentrated ownership in the hands of insiders will continue to be the main pattern of the Russian corporate sector. According to Yakovlev (2004) the leading business in the form of JSC is accompanied with high costs, whereas the compensation by access to cheaper investment resources through the stock market is restricted. That is why, it can be expected that the insider concentrated ownership will dominate the Russian corporate sector and its corporate governance model.

bb. Kazakhstan

Privatization schemes in Kazakhstan can be divided into three groups according to the size of companies: small-scale privatization of micro- and small enterprises, mass privatization of middle-size enterprises and case-by-case privatization of industrial giants. The government started with the small scale privatization (1991-1992), under which approximately 2,500 medium and 4,000 small companies were privatized. During this phase 30% of enterprises from the trade, 40% from the construction, and 25% of catering sectors were privatized. Only in 20% of the companies the whole ownership was transferred into private hands. Together with the small-scale privatization, citizens received coupons for the privatization of own houses, which were at that time in the state ownership. Coupons not utilized for the house privatization could be used for the privatization on the auction basis in the first phase.

Through the small privatization approximately 50% of all companies were acquired on money basis, the rest through the coupons. In its first phase the process was dominated by employee-buyouts. The working collective of companies of the size up to 100 people received favourable privatization conditions, under which they could acquire shares at a discount or even for free. The earnings received from privatization were 42% less than the real value of objects (Welp, 1999, p.179).

In the second and the third phases, the accent on privatization through working collectives was diminished and employees did not receive all favourable conditions as in the first phase. Nevertheless, employees' buy-outs remained one of the most frequently used methods. The problems of the employees' ownership were: first, privatization itself did not accumulate the capital necessary for restructuring (the small earnings that the state received were not used for enterprise restructuring), second, even if privatized companies were making profits, the decision was made in favour of the dividend payments instead of reinvesting the so badly needed capital. The ownership transfer to other investors was restricted as no secondary market was yet established. The positive side of the Kazakh model of employees' buy-out was that, at least in the first phase, the state did not obtain any shares, completely transferring the ownership to working collectives (Welp, 1999, p.182). During the whole small scale privatization approximately 14,000 companies were privatised.

Similarly to Russian approach, there was an attempt to improve the mistakes of the first stage by introducing the state holding structures. Companies were united in holdings which kept the shares of these companies. The state would retain the major share in a holding. In some sectors even several holdings were created, so as to stipulate a competitive environment. The idea behind it was to restructure the companies and gradually sell their shares on the market.

Based on the Russian experience Kazakhstan launched in 1993 its mass-privatization program, which lasted till 1994. In the framework of mass privatization program, more than 2,300 companies were privatized till 2002. As in Russia, privatization coupons were distributed among the population, but they were not tradable and did not have a nominal value. Coupons could be invested only in the Investment Privatization Funds (IPF). Through the participation in auctions the IPFs, the number of which at that time reached 167, invested the collected coupons in privatized middle-size enterprises with the number of employees between 500 and 2000. Following the law, employees of privatized enterprises received 10% of preferred stock, 51% was supposed to be offered on auction to IPFs, the remaining 39% was kept by the state.

The IPFs had a form of a closed fund and they were allowed to invest not more than 10% in equities of one enterprise. Some 67% of all the distributed coupons were collected by IPFs and almost all of them were reinvested in shares. From 1994 to 1996, 22 big auctions took place in Kazakhstan in which 1,700 enterprises were privatized. Totally 1,712 companies participated in the mass privatization. The privatized companies were from the following industries: gas industry – 1%, geology – 4%, research institutes – 3%, reparation companies – 12%, light industry – 13%, metal industry – 1%, oil industry – 1%, machinery – 3%, wholesale – 17%, agro-industrial sector – 14%, construction – 15%, transport and telecommunications – 14%, chemical industry – 2%, energy industry – 1%.

This privatization method had many disadvantages. As stated by some privatization funds most of enterprises were economically unattractive because of their poor performance and required restructuring. Privatization did not stipulate capital investment either, having a character of a pure share transfer. This method ended with highly dispersed ownership among various IPFs. As a result such diffused ownership allowed the ‘old’, less innovative managers to retain control effectively without accountability to diverse shareholders. Most of the funds were quite small to participate in the corporate policy and were not capable to inject capital resources in the next periods. The IPFs themselves were often confronting with their own principal-agent conflict. As described by Welp, the sale of coupons was conducted through the saving banks, which in some cases were failing to create a register of coupon holders (Welp, 1999, p. 209). Thus, a shareholders’ meeting as the main governance mechanism in the IPFs was initially impossible, as the list of shareholders (register) with contact addresses was missing.

The next phase started in 1996 and was based on an individual privatization method. Mainly big companies from strategically important industries were targeted during this phase. Although in some cases the IPFs were also allowed to participate, the main goal was to transfer the ownership to strategic investors. Both residents and non-residents were allowed to take part in the money privatization. As in the case of Russia, the privatization of lucrative big enterprises, mainly from the natural resources sector, was associated with widespread corruption (Pomfret, 2000, p.5).

The list of the enterprises to be privatized in the course of the individual privatization included 150 large companies and some strategic companies which produced socially important products and provided services. Some banks were also involved in the case-by-case privatization, as part of shares was transferred to banks in order to ensure financial support for restructuring (Stelzer-O’Neil, 2000, p.58). In the beginning of the third phase, the ownership structure of Kazakh firms looked as presented in Table 11. For a comparison, the ownership structure of Russian firms is also provided.

Table 11: Change in the ownership structure

	Managers	Employees	State	Outside local investors	Outside foreign investors	Individuals
Kazakhstan						
1995	23.1	10.7	34.8	23.6	4.4	3.4
1997	29.4	8.2	16.1	30.2	6.8	9.3
Russia						
1995	25.4	26	23.5	23.4	1.6	0.1
1997	36.3	23.3	14.7	21.5	3.8	0.4

Source: Djankov (1999).

The table shows that as in the case of Russia the share of managers was increasing with further progress of privatization, from 23.1 in 1995 to 29.4 in 1997. However, unlike Russia, the total share of insiders was lower in Kazakhstan, constituting in 1997 only 37.6%, compared with 59% in Russia for the same period. The state equity holding was also decreasing and its total share can be compared with Russia. The opposite picture to the Russian shareholding can be found in the outside investor's structure. Common shareholding of both domestic and foreign outside owners constituted 37%, compared with 25.3% in Russia. Noteworthy is a big share of individual investors who accounted almost for 9.3% in total shareholding, compared with only 0.4% in Russia.

In 1998 facing the low world-prices of oil and gas industries the privatization of corporations in these sectors was delayed. Additionally, the high privatization tempo and low participation of domestic investors caused the delay. In 2003 a new law was adopted on granting equal rights to Kazakh and foreign investors. The main method of privatization at that time was offering the state shares on the stock exchange.

Totally, during the privatization period from 1991-2005 approximately 39,853 objects of the state property were privatized. The Kazakh privatization in the initial phase took the form of insider privatization as in Russia, with a relatively week role of the IPFs. However, in comparison to Russia, stakes of outside and individual investors represented a bigger part in the whole shareholding.

cc. Uzbekistan

Among the former soviet countries Uzbekistan belongs to the group of countries which achieved the least progress in the privatization of state enterprises.[31] In the official language of Uzbek authorities this policy is called 'gradual privatization'. As an argument for slow a privatization the authorities indicate the disadvantages of 'speeded' privatization and Russia's experience in the 90s. In fact, Uzbekistan avoided potentially serious risks of a rapid privatization and, analysing macroeconomic conditions of the first independent years, the Uzbek policy can be justified. Keeping strong administrative control in most middle and big enterprises, the banking system with subsidised financing, the government managed to avoid mass closures of enterprises and growing unemployment, which could have resulted in social pressure. This evidence serves as a reason for positive evaluation of the initial reform phase in Uzbekistan by some scholars.[32]

However, the Uzbek transition has had a very slow pace and the policy of gradual transformation became 'extremely gradual'. After 15 years of independence only small enterprises and private housing were privatized. In most middle- and large-size companies, the state retains a controlling share and those which have been partially privatized remain under the governmental supervision and control.

Schematically, the privatization process in Uzbekistan can be divided into 3 phases. The first phase, called the small privatization, lasted from 1992 to 1993. During this period small and micro enterprises of retail trade, service and food sectors were privatized.[33] In the above mentioned sectors 53,902 enterprises were privatized, including 26,118 companies which were privatized through corporatization. All the corporitized companies took the form of Closed Joint-Stock companies, in which the government owned 51% of shares and employees 49%. Together with the small-scale privatization, the private housing sector was created, through which almost every owner of the state housing became a private owner.[34]

The statistical success of the privatization of companies during this phase should not be overestimated, since most enterprises did not change their business approach. After 3 years of independence they still resembled the enterprises from the administrative-command era. The reason is that the ownership remained in the hands of labour collectives and the government. Only small scale firms and private housing were successfully privatized in this period.

[31] Other countries from that group are Tadjikistan and Turkmenistan.
[32] See for example Pomfret (2000), p.13
[33] These were mainly small shops, restaurants, an some few light industry companies
[34] The Law on privatization of state housings, Uzbekistan, Dated 07.02.1993.

The second stage of privatization started in 1994 and lasted till 1998. In this phase reformers aimed to secure the participation of population in the process. With this aim the so called mass privatization in the Uzbek manner was launched. The Uzbek model differs from the Russian and the Kazakh one in that it is based on monetary mechanisms. In Uzbekistan privatization certificates were not distributed among population, but rather people could buy the shares of Investment Privatization Funds (IPF) for cash. Pooling the money from the population IPFs acquired the shares of privatized enterprises. To pursue this scheme, closed joint stock companies were transformed into an open form. The share capital of these companies was supposed to be divided into four equal shareholdings as following: state – up to 25%, employees – up to 26%, not less than 25% to foreign investors and the rest for outside sale.[35] This regulation should have been maintained for one year. Afterwards, all unsold shares were to be allocated by the State Privatization Committee which in turn was supposed to sell them to outside investors. Between 1994 and 1995 approximately 2 million people, mostly employees, became owners of corporate shares.

The initial introduction of investment funds took place without a legislative basis. The strong centralised government managed to avoid the pyramidal systems or uncontrolled black market trade as in the neighbour countries (GTZ, 2000, p.66). The upcoming legislation of 1996 allowed the creation of 2 types of investment funds: (1) open or closed investment funds and (2) investment privatization funds (IPF). The IPFs differed from the first category by additional regulations and preferential treatment. Assets of all investment funds must be managed by independent asset-management companies. Only the interests or dividends received from companies may be paid to fund investors but not the payments from capital assets or speculative profits. In 1998 there were 85 registered IPFs with ca. 80.000 investors and total net investment assets of more than 50 billion Sums, which were managed by 31 active asset management companies.

Since the Uzbek model did not rely on a non-monetary distribution of privatization coupons the IPFs needed to attract the savings of the population. The state supported the process through financing a marketing program (advertising in mass media) and granting credits for acquiring equities in privatized enterprises. For each sold share the IPFs received a credit form the state in proportion 1:6, thus they could increase their capital six fold. In the first wave of privatization auctions 310 companies were offered for sale to IPFs of food, cotton processing, constructions material and medicament-producing industries, from which totally 226 companies for the amount of 1.3 billion Sums were sold. During the second wave

[35] Presidential Decree, N UP-1740, On measures for development of securities market and increasing of foreign investors participation on stock market of the republic, Dated 31.03.1997.

of auctions 200 companies were offered for sale, whereas 121 of them were offered for the first time. However, this time the state credits were granted only to those IPFs which did not participate in the first wave of auctions and the cash-credit structure changed as well. The ratio of cash to credit was 3:7, meaning that for each 3 shares acquired by an IPF they received another 7 in the form of credit. In two auctions the Uzbek PIFs acquired the shares of 431 companies (Stelzer-O'Neil, 2000).

As in most other transition economies the Uzbek IPFs did not play an active role in the corporate restructuring. One of the most important reasons is the low participation of investors, caused by poor performance of the IPFs' shares. Such factors as low profitability of companies in the portfolios of IPFs and violations of conduct on shareholders' meetings resulted in low dividend payments, making investments in shares of the IPFs uninteresting. For example, out of 281 companies in the portfolio of 11 IPFs, only 18% on average were paying dividends (Stelzer-O'Neil, 2000). Some of the companies were paying dividends in a natural form, distributing their products to shareholders. Although, IPFs were allowed to acquire up to 30% of a privatized company, rarely were they achieving this amount. In 1,756 companies IPFs were holding less than 10%, only in 7 companies the share acquired by IPFs reached 30%. After paying back the credit to the state, IPFs were transferred to open investment funds. As a consequence of slow privatization, in December 2005 there were still 8 IPFs on the market.

The results of the second stage of privatization indicate the weakness of the legislative base, as the ownership was still concentrated mainly in the hands of the state and employees (more than 50% of shares). This of course discriminated the rights of other shareholders, including IPFs. The problem grew when some privatized companies were integrated into hierarchical structures of holdings and associations, in which the government kept the controlling stake. Each of such organizations was responsible for a particular economic sector.[36] These organizational structures took their origin in the soviet line Ministries, which were responsible for particular economic branches. Although they acquired the market economy terminology, their nature was similar to the soviet time counterparts. For example, many companies relied heavily on the state financial support instead of switching to market based mechanisms. Privatization in this phase can be labelled as formal, without involving actual ownership. Those few outside shareholders who evolved were minor and did not participate actively in the decision making process. Frequent amendments of the laws during this period contributed to the decreasing investor's activity.

[36] For example: the Association of Uzbek Agro-Machinery Service, the Uzbek chemical industry and the wine holding.

The third stage of privatization was launched in 1999 and still continues. The aim was to privatize the middle and big enterprises through the direct sale to strategic investors. For further promotion of privatization the share of employees in the equity capital was decreased.[37] Nevertheless, the success of this method remained very scarce, as the state still holds large stakes in most medium and large size enterprises. In 2001, out of 1,803 large and medium industrial enterprises, only 10% of them was fully privatized.

Moreover, many large and middle-sized companies were controlled by businessmen who held governmental positions. As noted by the International Crisis Group (2004), this business elite which controlled companies through their government positions is now consolidating their holdings through the investment via front companies in Lichtenstein, Switzerland and Russia. This trend can be welcomed as a positive sign if it results in capital return to the country. '*But in most cases the amounts paid for potentially lucrative privatisations have been well below the market rate, and promised investments may well not materialise*' (ICG, 2004, p.19).

The outcomes of the privatization process in Uzbekistan can be illustrated in Table 12, which summarizes the data of 1995-2001. It is evident that state has the highest shareholding in the corporate sector (50% on average). However, the virtual role of the state is even higher, due to other mechanisms of control and crossholding ownership. Thus, for example, shares which are not placed remain under the control of state agencies. Additionally, other legal entities that constitute the main part of outside shareholding often contain the state's shares, hence creating a pyramidal structure with state dominance. Individual shareholders, represented mainly by company employees, who due to their loyalty to management and their weak understanding of corporate governance mechanisms contribute with their shares to the state's shareholding.

Table 12: The ownership structure of JSC in Uzbekistan

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Value of issued shares (million Sums)	1,592	11,825	52,700	168,600	212,864	395,038	815,615
Not allocated	81.1	48.9	52.8	17.8	15.3	4.5	7.5
Allocated among:							

[37] The Decree of the Cabinet of Ministers N119, dated on 09.03.2001.

- Legal entities	1.9	6.2	5.6	23.5	17.3	18.8	29.5
- State	16.3	42.2	32	54.5	60.9	72.1	59.4
- Individuals	0.69	2.6	7.8	4.1	5.5	3.7	3.1
- Foreign investors	0.01	0.1	1.8	0.1	1	0.8	0.5

Source: Economic Review 2006

To sum up, the privatization processes in Uzbekistan, within the sample of the selected countries, had the lowest pace. Reformers chose a gradual process in order to avoid the risks of a quick privatization. The state remained the main shareholder in multiple medium and large scale enterprises. Some experts positively evaluated the reform process in Uzbekistan in the initial phases, referring to the relatively scarce structural problems in comparison to Russia and Kazakhstan. Nevertheless, after 15 years of independence the extent of economic activity of the state did not diminish. It still plays a major role both directly as a shareholder and indirectly as a regulator.

2.3 Business Environment

The best way to evaluate a business climate of a country is to do it with the eyes of foreign independent evaluators. This method should be approached carefully, since the opinion of organizations can be biased. However, it can still help to figure out the main trend. To give an overall trend here, a reference will be made to two researches: of the World Bank and of the Heritage Foundation.

In 2004 the World Bank started issuing annual reports under the title ‘Doing Business’, which investigated the regulations that enhance business activity and those that constrain it. It represents quantitative indicators that measure the easiness of doing business on ten parameters, such as starting a business, dealing with licenses, employing workers, registering property, getting a credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. Table 13 shows a considerable reform progress in Kazakhstan since 2006, whereas there is a significant regress in Russia falling from the rank 79 in 2006 to the rank 106, still, placed higher than Uzbekistan, which is the most difficult place to do business among the three countries.

Table 13: Ranking of the World Bank survey: Doing Business

	2006	2007	2008
Russia	79	96	106
Kazakhstan	86	83	71
Uzbekistan	138	147	138
Total number of countries	155	175	178

Source: World Bank reports.

Another known indicator which evaluates general economic freedom including the business environment is the Index of Economic Freedom developed by the Washington's think-tank *The Wall Street Journal* and *The Heritage Foundation.* It covers 162 countries and evaluates them upon 10 specific freedom categories such as trade freedom, business freedom, investment freedom, fiscal freedom and property rights. Based on these criteria the overall freedom index is calculated according to which companies are grouped into one of the following categories: 'free', 'mostly free', 'moderately free', 'mostly unfree' or 'repressed'. According to this index Kazakhstan performs best as a moderately free country, followed by Uzbekistan as mostly unfree. Interestingly, Russia is presented on the scale as a repressed country together with the least developed countries, most of which are in Africa. The only two countries of the former Soviet Union which have a lower ranking than Russia are Turkmenistan and Belarus.

Considering both the indexes it can be concluded that Kazakhstan stays on the track of development, and that despite the authoritarian regime a healthy business environment has been evolving during the last few years. The indexes for Uzbekistan show clearly that the environment of doing business is unfavourable there and is even worsening in time. The restrictive political regime has a direct impact on the business environment, which suffers from over-regulation and corruption. The EBRD (2007) lists the most dramatic obstacles for the private sector such as control and cash restrictions, confusing a normative base and limited access to foreign exchange, which hinder the development of market economy. Regarding Russia it can be stated that in the recent years the extent of state intervention into the business sphere has dramatically increased, which limits the freedom score. Thus, it can be agreed with the general trend of the environment worsening, however it is an exaggeration to put Russia in one category with the least developed countries of the world.

2.4 Corporate Financial Structure and Securities Markets

2.4.1 Russia

The financial structure of Russian companies does not differ much from most world practices. The biggest part of it occupies internal financing. In 2006 40% of all investments in fixed capital were financed by corporate internal resources (See Table 14). It is noteworthy, however, that throughout the years the overall share of internal funds was slowly diminishing in the structure of financing. Instead the other alternative financial sources were increasing. A big role in financing is still played by budget funds, which in 2006 constituted more than 20% of all funding. An important trend can be noticed on the securities market, which in the last few years had a significant growth in the overall financing structure, although it is still small in relation to other funding sources.

Table 14: The structure of gross investment in fixed capital by the source of financing in Russia (percentage of total)

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Total investment in fixed capital (in bln Rubles)	1,165	1,505	1,762	2,186	2,865	3,611	4,580
Retained earnings	23.4	24.0	19.1	17.8	19.2	20.3	19.9
Depreciation	18.1	18.5	21.9	24.2	22.8	20.9	19.1
Bank credits	2.9	4.4	5.9	6.4	7.9	8.1	9.6
Including credits of foreign banks	0.6	0.9	0.9	1.2	1.1	1.0	1.6
Other credit organizations	7.2	4.9	6.5	6.8	7.3	5.9	6.0
Budget funds	22.0	20.4	19.9	19.6	17.8	20.4	20.2
Equity financing	0.5	0.1	0.3	0.3	0.2	3.1	2.3
Corporate bonds	Na	na	0.1	0.2	0.2	0.3	0.04
Others	25.9	27.7	26.3	24.7	24.6	21	22.9

Source: Federal State Statistics Service, Extracted from the official web page http://www.gks.ru/eng.

Observing the very large number of joint-stock companies it can be assumed that the Russian securities market has a big potential for development. According to the estimations of Iwasaki (2004) there are 370,000 closed and 60,000 open joint-stock companies in Russia. In fact, a positive trend can already be observed; due to the market capitalization Russia belongs not only to the leaders among transition economies, but it even overtook some developed countries (See Table 15). In 2006 the stock market capitalization achieved USD 966 bln, which makes 77% of GDP, whereas already in 2007 the ration 'capitalization to GDP' almost achieved the 100% mark.

Table 15: Aggregate information on the Russian stock market

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Number of companies whose shares are traded on stock exchanges (RTS and MICEX)	na	na	na	na	na	407	473
Trade volumes with shares on the Russian Stock Exchange (bln USD)	22	29	45	93	124	180	426
Stock market capitalization (bln USD)	38.9	79.6	127	220	256	472	966
Stock market capitalization – % of GDP	15	26	37	51	44	79	77

Source: The Bank of Russia, Annual Report; ITE 2007.

The demand on stock of Russian issuers grew due to multiple factors. On the one hand, domestic demand caused by the increasing role of institutional investment schemes and activation of private households served as a demand impulse. On the other hand, foreign portfolio investors recognized the potential of Russian market and started approaching it. Since 2003 Russia was granted an investment rating by the international agency Moody's, which opened the Russian stock market to large international investors who can form their portfolio only with rated securities (Abramov, 2005, p.46).

In the recent years, the number of Initial Public Offerings (IPO) has increased considerably. In the beginning of the decade it were only a few IPO's which have been recorded, but in 2005 and 2006 their numbers achieved 16 and 20 respectively. Most companies prefer to make the IPO's on foreign stock exchanges, with the London Stock Exchange being the most attractive place (BDO, 2006). In 2006 there were 75 Russian stocks listed abroad in form of depository receipts (DR).

Despite such a favourable situation market capitalization alone does not provide for an adequate indicator to evaluate the securities market. A glance at the volumes of trade with stocks reveals that the liquidity of the Russian stock market remains quite low, even in comparison to many developing countries. The largest companies listed in Russia and abroad let only a small ration of shares freely float, and only 5-6% of the listed stocks are traded on the largest Russian stock exchange. The trades are conducted mainly with 'blue chips'. Thus, for example in 2006 on the RTS stock exchange 83% of all transactions were concluded with six most liquid stocks, which is a clear signal of low market liquidity (BDO, 2006).

Regulated domestic market represented by the three main stock exchanges: the Moscow Interbank Currency Stock Exchange (MICEX), the Russian Trade System (RTS) and the St. Petersburg Stock Exchange, with more than 300 companies being quoted on them and the Federal Financial Market Service as a regulator. Unlike the experience of developed capital markets, Russian exchanges cannot be yet considered as effective monitors of corporate governance practice and compliance. This is because Russian exchanges stay in competition with foreign exchanges, which restrains them from rigorous compliance checking in order not to reduce the demand of domestic companies to list on Russian stock exchanges (Crotty and Jabome, 2004, p.31). Nevertheless, the positive macroeconomic environment and consistent political reforms created favourable conditions for the development of the securities market in Russia.

2.4.2 Kazakhstan

Like in Russia, Kazakh companies rely heavily on internal resources to finance fixed capital investment, although in 2006 the ration of internal capital made up 60% of all financing sources, which is much higher than in Russia (40%). It is also noteworthy that the share of the budget resources which constitute only 12.4% of financing structure is considerably small. The share of foreign investments and borrowed resources is has been calculated as 19.7% and 7.8% respectively.[38] Despite the growing securities market few companies use it as a source of external financing.

The supervision over the securities markets is conducted by the Agency for Regulation and Control over the Financial Market and Financial Entities, which is also responsible for the regulation of banks, quasi-bank entities, insurance companies and accumulation pension funds. There is only one Kazakh Stock exchange, which was established in 1993 by the commercial banks and the National Bank (Central Bank of Kazakhstan) as a currency exchange for the development of the domestic currency market. In 1996 the exchange started trading securities. Nowadays, the following financial instruments are traded there: the foreign

[38] Annual Report of the National Bank of Kazakhstan, 2006

currency, the government securities, non-governmental securities (shares, bonds, GDRs), securities issued by international finance organisations and foreign state securities, REPO instruments, term contracts and promissory notes. The Exchange also offers the possibility of direct trade on the over-the-counter market (OTC).

Consistent reform politics and favourable market conditions have fostered the development of the securities market in Kazakhstan. It received a special impulse though the development of a private pension system. Both the number of listed companies and the overall market capitalization have been permanently growing in the last decade. Totally, in the beginning of 2008 approximately 2,200 joint-stock companies were represented on the market and 68 quoted on the KASE (Kazakh Stock Exchange). The overall market capitalization in 2007 was 6,476 bln Tenges or 50% of GDP. This is, however, less than in 2006 when the capitalization achieved the record high of 7,190 bln Tenges or 70% of GDP. Such a sharp decrease can be explained by the global effect of financial crises which had a considerable impact on stock values of Kazakh corporations, especially those from the financial sector. Despite the decrease in the market stock capitalization the trade volumes have doubled during the same period, which speaks for enhanced market liquidity (See Table 16).

Table 16: Aggregate information on the Kazakh stock market (2004-2007)

	2004	2005	2006	2007
Number of companies traded on the stock exchange	68	57	95	136
Trade volumes with stocks on the primary and secondary markets (in mln USD)	1,181.078	1,040.46	4,026.60	8,924.42
Trade volume with bonds (in mln USD)	47,402.05	62,747.48	96,148.79	17,8607.33
Market capitalization through stock exchanges (in mln USD)	3,940.67	10,521.19	56,611.40	53,830.66

Source: Federation of Euro-Asian Stock Exchanges, data extracted from www.feas.org,

The development of the bond market is also worth paying attention to. The bond market capitalization of listed companies constituted 1,638 bln Tenges in 2006 and 1,789 bln Tenges in 2007. Almost 25% of all bonds are located in the portfolios of pension funds (FSA, 2008).

Among the former post-soviet countries Kazakhstan became the first to receive an investment grade, which was issued by Moody's in September 2002. According to the report of the National Bank (2006) more than USD4.7bln flew to the Republic as portfolio investment of non-residents, including the issuance of the depository receipts by Kazakh companies abroad. Generally, it can be concluded that Kazakhstan's securities market is one of the leaders among the post-soviet countries and has a big potential for further development.

2.4.3 Uzbekistan

Among the three target countries Uzbekistan has the weakest financial system. This statement is based on the quantitative results of evaluation programmes and by the polls among entrepreneurs. The sources of external financing to large extent are restricted and financial intermediation appears to be ineffective. According to the polls of the IFC (2005) 10% of large firms claim that the access to financing is the major obstacle for them. The main constraints are a high loan collateral requirement (122% of the loan size) and costs of financing. Only 3.4% of total investments in fixed capital were financed in 2006 by bank credits (See Table 17). As a rule, most investments are financed by internal resources – reserves and depreciation. The sources obtained on the securities market are negligibly small, which is a result of the small and underdeveloped securities market.

Table 17: The structure of investment in fixed assets by the source of financing in Uzbekistan (percentage of total)

	2002	2003	2004	2005	2006
Internal funds	40.0	41.8	43.2	46.0	48.3
Population funds	12.0	11.1	12.4	11.4	11.7
Commercial banks	1.6	1.9	2.3	3.5	3.4
Other external funds	0.7	0.8	0.3	0.3	-

Source: CER, 2007.

One factor which effects the development of the securities market is the small number of issuers. In Uzbekistan this parameter has drastically decreased in the last few years. Thus, in the beginning of 2008 there were 1,900 Joint Stock Companies, whereas in 2003 their number reached almost 5,000. Such a dramatic change can be explained by the presidential decree of 2003 upon which the equity capital of every JSC must be increased to USD

50,000.[39] This measure forced many companies either to change their juridical form or to dissolve.

The next obstacle on the way to a robust securities market is its concentration. Five per cent of all JSCs issues 88 per cent of all outstanding shares in the republic (CER, 2007). The most liquid stocks included in the listing of the National Stock Exchange 'Tashkent' represented by only eight companies. Even worse is that all the listed companies are commercial banks, which negatively effects investors' ability to diversify. Most of the country's 'blue chips' are in the state possession and they are not represented on the stock exchange. If 'blue chips' were offered on the stock exchange, it could boost the development of the securities market.

Although the statistical data (Table 18) show an increase in the stock market capitalization, it should be noted that this is due to the new privatization programme, according to which shares of companies with the state's stake are offered for sale on the stock exchange. The same argument can be referred to the large number of companies with traded stock. On average companies offer only 12-15% of shares in a free float. Even the shares from the highest listing grade are traded at a nominal price or slightly above it. The individual investors are virtually inactive on the market. Although their overall number makes up 96% of all shareholders in the republic, they hold only 23% of shares. Many individuals became stock owners during the privatization programme passively holding the shares of their employers' enterprises. All the mentioned indicators stay for very low market liquidity in Uzbekistan.

Table 18: Aggregate information on the Uzbek stock market (2004-2007)

	2004	**2005**	**2006**	**2007**
Number of companies with shares traded on the stock exchange	145	166	621	430
Number of quoted companies	6	8	8	8
Trade volumes with stocks (in mln USD)	40.3	38.03	111.4	89.96
Trade volume with bonds (in mln USD)	0.15	0.26	0.77	0.65
Stock Market capitalization (in mln USD)	4.3	37	1,588	1,921

Source: The Federation of Euro-Asian Stock Exchanges, data extracted from www.feas.org.

[39] The Presidential Decree №-3202, 'on measures of coordinal increase of private sector's share in the economy of Uzbekistan', dated on 24.01.2003.

Considerable progress can be observed on the corporate bond market. It developed from almost nonexistent market in the beginning of the new decade to the market with turnover of USD0.77mln. This is mainly due to the cancellation of restrictions for JSC on bond issuance.[40] Nevertheless, there is no reason to be euphoric about such a trend, as in most developing economies the indicators on the bond market development are better than in Uzbekistan. To sum up, the Uzbek securities market is far behind the level of many developing and transition countries. The main reason is the restrictive economic policy and constant state interventions into the entrepreneurial life.

3. Other Frameworks

3.1 Social and Cultural Frameworks

The next aspect which will be briefly reviewed in the context of the frameworks is the cultural or socio-economic environment. The importance of the cultural issue for a corporate governance study is widely recognized among scholars, however, with a few exceptions, they treat it as a black box (Licht, 2005).

In order to include culture in the comparative studies of corporate governance it is necessary to determine dimensions according to which the distinction line between cultures or countries can be drawn. Most studies in this field incorporate the dimensions elaborated by Hofstede – the first researcher to provide such a classification. The author proposed five categories according to which any culture can be distinguished. These are: (1) small vs. large power distance, which shows the extent of social inequality, including the relationship with authority; (2) individualism vs. collectivism – the relationship between an individual and a group, (3) masculinity vs. femininity – social implications of gender; (4) strong vs. weak uncertainty avoidance – shows the extent to which members of a society attempt to cope with anxiety by minimizing uncertainty and (5) long- vs. short-term orientation, which shows the time horizon of a society. It can be assumed that the mentioned categories to certain extent may define the design of a corporate governance system within a country. For example, countries with a high degree of collectivism can experience more frequent cases of related party transactions. An individualistic society may show greater pressure on disclosure regulations in order to make it more transparent and allow private investors make an individual decision about investments (Farina, 2005). Also the policy towards managerial remuneration can be reviewed through the prism of culture. To explain the interrelation

[40] Presidential Decree №-3047, dated on 30.03.2002.

between executive compensation and culture some additional dimensions are required, which cannot be directly extracted from Hofstede's categories. For this case Licht (2005) refers to such cultural categories, proposed by Schwartz, as mastery, hierarchy and egalitarianism. For instance, in the countries with strong egalitarian tendencies the large discrepancy between the managerial salaries and salaries of average employees will be harshly criticised and not tolerated. These and many other cultural aspects have a direct impact on the corporate governance practices of a country. Following the path of the dependency theory many cultural values will be reflected in the laws, including corporate and securities laws.

The recent examples from Russian history demonstrate that when cultural differences are ignored the reforms of corporate law are condemned to failure. Therefore, the attraction of cultural aspects in the study of corporate governance in transition economies is indispensable. Based on the empirical research of 22 countries Roth and Kostova (2003) came to the conclusion that culture must be considered when studying corporate governance in transition economies. In order to incorporate culture into the research it is necessary to know under which categories a researched country falls. Unfortunately, no empirical studies in this respect were found for the sample of the selected three transition economies. Therefore, the present thesis may shortly refer to general information about these countries and extrapolate the knowledge of other studies for the three transition economies.

All the three countries have a record of almost 70 years of living under the most radical socialistic ideology manifested in the communist doctrine. The core of the system was the inexistence of private property, collectivism and suppressed freedom of choice. It can be therefore assumed that up to the moment of the collapse of the Soviet Union, among the population no representatives of the pre-communist times and the non-socialistic environment were present. This argument is often brought as a proof of the reasons why East-European countries which experienced communism for significantly shorter period of 50 years do economically better than the former soviet republics.

The political system substantially affected the corporate governance of the soviet times. Crotty and Jabome (2004) give some examples of the corporate governance in a soviet firm. Firm managers were not the main decision-making instance, as the residual decision making power rested with the administrative and political elite. Consequently, such scenario led to coordination and management problems. The inefficiency in resource allocation, which is typical for a command economy, was compensated by reporting false figures and circumventing the laws.

Thanks to their closeness to the political elite managers were enjoying a privileged position with the access to the products which were deficit for most of the population at the time. Brown and Shkurupiy (2000) show examples of managerial self-dealing, though noting at the same time that such transactions seldom had an extremely blatant character, since managers were closely monitored by KGB, ministries and the Communist Party. The misuse of the state property could be observed on all levels. Objects which did not have a personified owner were easily appropriated. On the background of self-dealing transactions and circumvention of the law the new transition economies evolved.

Further, mistakes in the reforms led to disappointment in the transition process and mistrust between individuals and elites. People were forced to rely on personal networks to achieve their objectives, rather than to follow incomplete laws or the corrupted and inefficient government (McCarthy and Puffer, 2002). Under such conditions related party transactions or self-dealing becomes a usual way of conducting business. This, in turn, was reflected in the low willingness to disclose. Authors like McGee and Preobragenskaya (2004) referring to Russia argue that the preference not to disclose anything they do not have to disclose is an attribute of the Russian culture and mentality.

It can be intuitively assumed that the most sever problems of corporate governance as self-dealing and insider trading are associated with ethical standards of a country. The lower the ethical standards, the more frequently self-dealing transactions will take place. Enriques (1998) proposes the level of official corruption as a proxy for a country's ethical standard. Referring to the corruption scores for countries developed by the Transparency International (see Table 19) it is obvious that the level of ethical standards in these countries is low and therefore self-dealing both on the side of managers and large shareholders can be viewed as a crucial corporate governance problem in and should be targeted more closely.

Table 19: Corruption perception index: score and ranking (in brackets)

	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Russia	2.3 (81)	2.7 (74)	2.7 (87)	2.8 (95)	2.4 (128)	2.5 (121)	2.3 (146)
Kazakhstan	2.7 (73)	2.3 (89)	2.4 (101)	2.2 (124)	2.6 (110)	2.6 (111)	2.1 (151)
Uzbekistan	2.7 (74)	2.9 (69)	2.4 (103)	2.3 (119)	2.2 (143)	2.1 (151)	1.7 (175)
Total number of countries	91	102	133	146	159	163	180

Source: Transparency International, Data extracted from http://www.transparency.org/.

Apart from the shared history under the soviet power and transition the three countries differ in terms of their basic cultural features such as religion, ethnic groups and societal form of life, which also contribute to the formation of particular corporate governance practices (see Appendix I). Both Kazakhstan and Uzbekistan are representatives of an Islamic and oriental context. Uzbekistan is more populous and dominated mainly by the Muslim population, whereas Kazakhstan has a relatively small number of population, divided almost equally between Muslims and Christians. Due to the long border line between Russia and Kazakhstan a very large ethnical group of Russians lives in Kazakhstan, which constitutes 30 per cent of the total population. According to the ethnic or religious criteria Russia is much more segmented, although generally it is oriented towards with Western traditions.

This short review of cultural dimensions and the ethnic-religious classification shows that despite long common history each of the countries is unique. The effectiveness of any further reforms in corporate governance should consider the cultural aspects and not be simply copied from each other. The present work does not go into the details of the cultural aspects, the purpose of this section was to give an overview and show the differences among the three so equal and at the same time different countries.

3.2 Technological Frameworks

Good corporate governance is associated with availability of complete and accurate information provided within very short time frames. In this respect, the technology infrastructure is the fundamental aspect in responding to information requirements of the market. Without an effective technological infrastructure companies would be unable to meet the requirements of numerous external institutions for disclosure (McCarthy and Puffer, 2003). Nowadays, modern technologies allow investors to obtain information within much shorter period than a decade ago and the key role of this progress belongs to the development of the Internet. In technologically advanced economies the Internet became an integral part of information sources about the corporate sector. Good structured home pages constitute an additional communication device between companies and investors. Not only the disclosure itself but also direct communication between governing bodies and other stakeholders have significantly improved. To conduct shareholders and board meetings long journeys or costly meeting halls are not necessary any more. All this can be avoided by the implementation of the tele-conference technologies. Big companies in the developed economies have intensively involved the modern technologies to improve their governance practices and the results are apparent. In these countries the number of both professional and household investors has significantly increased, the securities markets become more liquid, and the number of the Initial Public Offerings (IPO) is permanently growing.

The positive effect of new technologies on the development of corporate governance was also realized in transition economies. Both private users and firms refer frequently to the Internet in order to obtain or disseminate business related information. With respect to home pages of corporations, there is an evidence of shift from solely consumer-oriented to investor related web pages. Although the quality of corporate home pages is still far behind those in the developed markets, it is evident that big companies have realised the advantages of the Internet which help them to care for investor relations. Part II of this study will provide a general review of the legal provisions regarding information disclosure and the implementation of the Internet. Part IV will proceed with the case study of the applicability of the Internet for disclosure purposes by the listed companies in the selected transition economies.

3.3 Political Environment

Perhaps one of the most important aspects in a study of corporate governance is the political environment. Politics can affect the corporate governance via different channels: (1) participation in the governance of the firm through the shareholding of state, (2) indirectly by drafting the regulatory frameworks (laws, decrees, orders) and (3) through different forms of interventions (e.g. interference in takeover 'poker' which concerns national interests, granting and withholding of licenses, extraordinary environmental and tax checks, introduction of exceptional provisions for selected companies).

In the Western and especially in the Anglo-Saxon literature, due to the negligently small state shareholding and the dominating neo-liberal doctrine of non-intervention in corporate life by the state, the discussion on the role of politics is restricted mainly to its pressure on the legal base which affects the corporate governance system. In the most frequently cited book on the role of politics, Roe (1994) demonstrates how legal actions supported by the political environment created dispersed ownership in the US firms. For example, the author shows that through specially designed laws banks, insurance companies, mutual funds and pension funds were all prevented from becoming influential in corporate life. Similarly, the interested lobby groups in the 80's pushed up the laws which allowed the creation of anti-takeover mechanisms. Bebchuk (2005) shows that control concentrated in the hands of managers is also stipulated by the laws which deny shareholders' power to intervene in corporate business. The same argument of political pressure can be applied to explain the powerful role of banks in the corporate sectors of Germany and Japan (Shelifer and Vishny, 1997, p.771). In this context, for the purpose of investigating the political pressure on the corporate governance systems of the transition economies, in Part II a detailed review of the regulation will be undertaken, which will examine whose interest the existing legal provisions mostly reflect. Additionally, Part III will investigate whether the role of institutional investors in the national corporate governance models is restricted by the laws.

While studying the influence of political aspects on corporate governance, it is also important to consider the extent of direct shareholding of state. Although, the state ownership is insignificantly small in the Western firms, in transition economies, where for 70 years no alternative for the state ownership existed, this aspect deserves a separate study. The Part III of this work provides detailed analyses of the state shareholding in the corporate sector and the way the state shares are managed.

The last channel of political influence on the corporate governance is the direct intervention of the state in the corporate sphere. The conventional thought which reigns in the Anglo-Saxon and continental European countries propagates the restriction of state influence on the decision making process in corporations. Although the idea is solidly rooted in theory, life shows reverse facts. Sell (2007) demonstrates broad evidence of the state direct interference. Among them the cases of takeover fights between Luxembourgian 'Arcelor' and 'Mittal Steel', and between Spanish 'Endesa' and 'Eon'. In both examples, national governments were interfering in the takeover poker in order to hinder the deal and secure the national economic interests. Another example is the case of Airbus, when during the crisis both French and German governments saw no other way of solving the problem but political interference. On this background the role of politics in the corporate governance of the transition economies does not look as an exception. In fact there is a number of cases which illustrate how in Russia, Kazakhstan and Uzbekistan the politics is used to promote the national economic interests, which in turn has an impact on the shape of the governance system both on the global and corporate levels. However, it is important to differentiate between the political intervention in order to promote national economic interests and the one which safeguards the interests of a tiny fraction of political elite. Still, as much as the former type of intervention can be applicable to a corporate governance model of a country, the latter type of intervention is an absolute threat to its development.

4. Conclusion of Part I

This part provided an overview of the main corporate governance theory and a brief description of the contextual frameworks which determine further development of a corporate governance model in the three post-soviet countries. According to the principal-agent theory, due to the very nature of the authority delegation from owners to management the agency conflict occurs, as it can be expected that managers will not be always acting in the best interests of shareholders. This is especially the case in the countries with dispersed ownership. In order to resolve the conflict the corporate governance literature proposes a number of mechanisms which can mitigate the main agency conflict. These are: incentive schemes, takeovers, competition, monitoring by the board and by large shareholders. In the environment of transition, apart from the monitoring by large shareholders most of other mechanisms are applicable only to a little extent or do not function at all, as virtually all corporations have concentrated ownership. In fact, the review of the privatization process in transition economies showed that regardless of privatization methods chosen, the concentrated ownership structures of enterprises became a predominant pattern in all the countries. However, a privatization method is crucial in answering the question in whose hands the ownership ought to be concentrated and to what extent? On the sample of three transitional economies – Russia, Kazakhstan and Uzbekistan it has been shown that all the three countries have the concentrated ownership, whereas Russia and Kazakhstan have insider concentration and the ownership of the Uzbek corporations concentrated in hands of the state. In this respect, the interest of small investors should be protected from abusive actions of large shareholders. This would ensure small investors' confidence in the market and foster the development of stock markets, which would reduce the costs of borrowing capital for firms.

The socio-cultural, technical and political frameworks play an important role in the design of the national corporate governance models, since they directly affect the way of doing business in a country. The brief overview showed that despite the common history during the soviet times and similar economic structures there is a big scope of divergence between the countries with respect to the contextual frameworks. Therefore, for better efficiency of the corporate governance regulation contextual aspects must be reflected in laws, rules and codes. Despite divergence, transition countries have a common problem which is a poor institutional environment and law enforcement in particular. The court system is not working efficiently and is characterised by corruption, which undermines the trust of market participants in the judicial system. Corruption and related party transactions are perhaps the biggest threat to the emergence of efficient corporate governance and must be incorporated as a 'priority number one' problems in the reform agenda.

Part II: LEGAL FREAMEWORKS. THE REGULATION OF CORPORATE GOVERNANCE IN TRANSITION ECONOMIES

1. Introduction

After the breakdown of the socialistic system each of the new countries which evolved from the 'ashes' of the Soviet Union faced the problem of institutional vacuum. A new course towards market development required new institutions inevitable for sustainable development. No one doubted the necessity of creation of a new court system, legislative base and supervisory organs. The only paramount question was how to create the legal frameworks in a period short enough to avoid legal vacuum and long enough to manage to prepare the solid legislative base that would correspond to the reality of those days. The easiest way was to import required laws from the countries with established legal traditions. However, this approach contradicts the theory of path dependence, which explains the risks of welfare losses for adoption of an outside institutional arrangement (Bratton et al., 1999). In this respect De Soto (2001) cites one old German saying that the law must be spoken out from the thought of the people.[41] On the other hand, the elaboration of rules of the games that correspond to the environmental conditions of a particular country is a time consuming process. Today's situation of almost two decades of reforms indicates that there has been no one best solution for legal transformation. It is rather a combination of the appropriation of successful experience and adjustment to the conditions of transition economies. In terms of corporate governance, the task of law is to target the agency conflicts and find mechanisms which will at best secure the interests of different corporate stakeholder.

The review of ownership structure and environmental conditions in transition economies (Part I) concluded that nowadays the major problem of transition economies is the interest conflict between the controlling (major) shareholders and minority shareholders. Without proper protection of the minority shareholders no further flow of capital in corporate sector is feasible. Empirical researches prove that legal protection of the minority shareholders and creditors is a significant determinant of financial development (La Porta et al. 1997). Therefore, the main task of law is to provide protection for small investors – the most vulnerable party in the environment of transition economies.

This part reviews the legal bases of Russia, Kazakhstan and Uzbekistan concerned with corporate governance aspects. It is aimed to analyse the state of law in these countries, compare it with each other and find the weak points in the regulations. It is noteworthy that

[41] "Das Gesetz muss aus dem Gedanken des Volkes gesprochen sein".

only the state of law will be reviewed, and not the quality of enforcement. We realize that enforcement itself plays more significant role than the law on books.[42] Nevertheless, enforcement is not a direct goal of the research in this part.

The comparative analyses of a legal base will be conducted on two levels. On the first level, the legal base of each transition countries will be compared. On the second level, in order to define the direction to which transition countries move, their experience will be compared to the German and US regulation. Such a comparison will help to identify which of the two selected countries influenced the corporate legislation in transition economies and to what extent. The idea to choose the USA and Germany is based on multiple considerations. Firstly, both countries represent two different law systems, namely the common law and the civil law. In this respect, it is interesting how the three transition economies, which belong to the civil law family, cope with rules borrowed from the USA. Secondly, both countries undertook the attempts to consult authorities in these three transition economies. Therefore, it is important to investigate which of the lobby groups were more successful to promote its own rules. Thirdly, due to the accent that a legislator puts with respect to those whose interests will be mainly protected, corporate governance differentiates between the shareholder-oriented and stakeholder-oriented systems. The US corporations are known for having securities markets as their main source of financing, which implies that the interests of shareholders are more closely considered. In contrast, the German corporations get external funds to a large extent from a banking sector. Additionally, the role of employees has a long-standing tradition in the German economy. All these factors have stipulated the evolvement of the stakeholder-oriented corporate governance system in Germany. The proposed comparison will show whether the corporate governance legislation in transition economies tends to the shareholder- or the stakeholder-oriented systems.

The specifics of multi-statute corporate law in the USA makes it hardly possible to consider the corporate laws in each particular state. For the purpose of simplification, mainly the statute of the Delaware State will be taken for comparison. The reason for referring to Delaware is that about half of all publicly traded corporations are incorporated there (Booth, 2006, p.719), so that some scholars even call Delaware's law de facto federal law (Black, 2006a, p.22). The motivation for companies to choose Delaware State as a place of incorporation is the rules, which are more investor-friendly than in other states. The evidence of that can be found in the share prices of Delaware corporations, which are higher in comparison to other states.

[42] See for example the research conducted by Pistor, Raiser and Gelfer (2000); Oman et al. (2003).

The overall structure and logical sequence of comparative analysis will be based on a similar research conducted by Kraakman et al. (2004), which reviews corporate law legislation in major world jurisdictions such as the USA, Japan, Germany and France. In a similar manner, the research of the legal base will be divided into four subchapters: (1) the basic governance structure, (2) the related-party transactions or self-dealing, (3) significant corporate actions, and (4) takeover regulation. The focus of the research will be on three potential agency conflicts, and it will aim to observe how the law in three transition economies addresses the conflicts. These agency conflicts are (a) conflict that may take place between managers and shareholders, (b) potential power misuse of controlling shareholders, and (c) interests of other constituencies such as creditors and employees. By the end of the discussion on each considered aspect of corporate governance a comparative table will be drawn. According to the descriptive qualitative analyses, the comparison will be supported by quantitative data in order to determine whether the rules of the German or the US law dominate in the transition jurisdictions.

The essential goal of the present part is to construct the Index of Shareholder Protection (ISP) with the use of a *leximetrics* method. A review of available empirical literature in the field of corporate governance reveals that there is no consistent index which would reflect most of the aspects of shareholder rights. A number of researches, which constructed new indexes, often limited the scope of an index to very few parameters that are certainly insufficient to measure the depth of investor protection in a given country. Consequently, empirical results provided on the basis of such indexes compilation can be assumed to be incomplete. Therefore, the aim of this part (Section E) is to construct a broad index which will incorporate all important aspect of shareholder protection.

Finally, it should be noted that the analyses in the present part are conducted as departing from the economic background and purpose of the research. The study does not intend to deepen the legal area and scrutinise in details the juridical aspects of corporate governance; the aim here is rather to pick out the main legal provisions which are necessary to draw general frameworks of corporate governance in each particular country.

2. The Sources of Regulation of Corporate Governance

Referring to the theory of perfect capital markets which states that in the environment where parties have perfect information and no contract costs, all corporate constituencies such as creditors, shareholders, suppliers, employees do not need legal protection because their interest rate returns provided by contracts correlate perfectly with the risks they bear. However, the perfect capital market is a utopia. That is why intervention of the state in the form of legal regulation is inevitable (Armour, 1999, p.5).

The regulative base is also applicable to corporate governance, which is reflected in several laws. Regulation of corporate governance can be schematically divided into three categories of laws: hard, hybrid and soft laws. Du Plessis (2005, p.113) gives the following definitions: hard laws are traditional black letter laws, soft laws are voluntary sources of corporate governance, the adoption of which depends on companies' choice, and hybrid laws represent a mixture between two previous as they are neither mandatory nor purely voluntary.

In the review of the hard laws the main focus of the analyses will be on the law on Joint Stock Companies (JSC Law), also called corporate law. We will not consider laws applicable to specific industries such as banking or insurance. Starting with corporate law the main question which may come to one's mind is about the purpose of corporate law. Kraakman et al (2004) argue that objective of corporate law is to '*advance the aggregate welfare of a firm's shareholders, employees, suppliers, and customers without undue sacrifice- and, if possible, with benefit- to third parties such as local communities and beneficiaries of the natural environment*" (p.18). With respect to agency theory, scholars see corporate law as a mechanism of constraining agency conflicts (Bainbridge, 2002, p.207). Such conflicts may occur potentially on three corporate levels: (a) between managers and shareholders, (b) between controlling shareholders and minority shareholders, (c) between a corporation and other constituencies (e.g. creditors and employees). Critics may argue that remedies for all potential conflicts can be privately settled in contracts between concerned parties. The answer to this statement is found in the secondary objective of the corporate law, which is the reduction of the costs of contracting for participants of corporate venture by drafting overall frameworks in the law. According to Easterbrook and Fischel (1996), '*corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency is sufficiently low'* (p.15). The importance of the corporate law has been recognized in three transition economies. As early as in the beginning of 90s preliminary entrepreneurship laws were adopted, later on replaced by corporate laws. Russia was a pioneer in the introduction of the new law, which mainly addressed the interests of Joint Stock Companies. In 1995 Russian parliament approved and adopted the law which borrowed considerably many Anglo-Saxon aspects. The main advisors of the law making were Black and Kraakman (Coffee, 1999). One year later, corporate law appeared in the Uzbek legislation. The Uzbek law in its turn was to huge extent copied from the Russian one. Later on, in 1998 Kazakhstan introduced its law on Joint Stock Companies. Till today the laws have been regularly amended and adjusted to the environmental conditions. Commentators opine that currently the law in the three countries are of high quality and resemble the regulation of advanced jurisdictions.[43]

The comparative analyses of corporate law will be supplemented by the review of the law on securities markets. In fact, the boundaries between securities and corporate laws are indistinct: '*Some countries will choose to regulate certain issues related to publicly-quoted companies and their shareholders through securities regulation, while others include such provisions in the general company legislation* (Avilov et al., 1999, p.7). An empirical research by La Porta et al. (2003) found that investor protection provided by security law matters not to less extent than the protection provided by corporate law. It is therefore meaningful to review some aspects of securities market regulation in the three transition economies.

A substantial role is given to hybrid laws while regulating the corporate governance. In this part such hybrid laws as listing rules, regulations issued by supervisory authorities and accounting standards will be shortly considered and explicitly indicated in case they represent a paramount role for corporate governance development.

Last, but not least, the review will refer to soft rules, so called codes of good governance. As the name of the law says, their character is non-mandatory and the corporations themselves decide whether to adopt them or not. In the last decade we could observe the wave of multiple corporate governance codes initiated by different institutions. One of the most renown codes is the one issued by the OECD in 1999. This code is considered to be a reference for the codes developed by countries on nation levels. Although it is explicitly underlined that OECD principles of corporate governance are solely approximate frameworks and that they should be adjusted to the legal and business praxis of particular countries, it can be stated that national codes across the world show large similarities. Berglöf and Pajuste (2003) noticed that corporate governance codes in various countries are very identical, in spite of highly divergent institutional environments in developing, transition and advanced economies. In the same way Croty and Jabome (2004) opine that the OECD framework may not reflect the conditions within transition states, since the principles of the code are grounded firmly in the agency tradition of Jensen and Meckling (1976). Corporate governance codes should not repeat the existing laws, but rather elaborate further on better quality governance. Sell (2004,b) underlines the importance of corporate governance codes and remarks that codes can be useless if the rules mentioned there lie far below the legal rules that are already fixed in laws. Such situation, which can be illustrated on

[43] See for example EBRD assessment of commercial law in transition economies (2005), Schramm (2007), Crotty and Jabome (2004).

the example of Germany, may occur when authors of the codes are at the same time practitioners, for whom these codes are written. It is therefore important, while developing national corporate governance codes, to consider the peculiarity of domestic environment.

The Russian Code of Corporate Governance was developed by the Federal Financial Markets Service (FCSM) with the cooperation of a private sector and introduced in 2001. There are 3 institutions promoting the corporate governance reform in Russia: (1) global rating agencies, (2) institutional investors, (3) the administration of the president V. Putin (Judge and Naoumova, 2004, pp. 310-311). The Code is not legally binding for joint stock companies. However, according to the Resolution of FCSM 17/PS dated 31 May 2002 it is required that the annual report of joint stock companies contains information on their compliance with the Code's principles, and explains deviations from these principles should any of those occur. The Kazakhstan Code was introduced a year later. According to the listing requirements of the Kazakh Stock Exchange, company listed under the category 'A' and 'B' should have its own Corporate Governance Code.[44] Contrary to Russia and Kazakhstan, no Corporate Governance Code has been implemented so far in Uzbekistan. Nevertheless, the foundation of the Corporate Governance Center in 2003, initiated by the presidential decree, can be regarded as a positive improvement of the situation.

After pointing out the main sources of regulation in corporate governance, in the next chapter we will shift to the concrete measures of regulating the potential agency conflicts by means of hard, hybrid and soft laws.

[44] Listing requirements of the Kazakh Stock Exchange, Part 3, Chapter 1, Article 9, (9-1).

A. Basic Governance Structure

While tackling the agency conflicts primary attention is to be addressed to governance structure, namely corporate organs and the way these organs are structured and regulated. As it was discussed in the beginning, shareholders delegate management of the corporation to the third party – managers. In these circumstances their main concern should be a creation of efficient and responsive governance structure. Hence, shareholders need to create strategies to design the governance structure, which will protect their interests. It is apparent that these strategies should be based on granting a right to shareholders to select firm's managers. Kraakman et al. (2004) calls this strategy an '*appointment strategy*', which represents the most basic protection of the collective interests of the shareholder as a class. The following subchapters will present the basic governance strategies that are designed to mitigate agency costs. In order to examine the extent in which particular strategy contributes to the agency cost reduction, the following analysis will be divided into three subchapters and each strategy will be analysed regarding one of the three main agency conflicts, namely (a) managers vs. shareholder, (b) majority vs. minority, (c) shareholders vs. other constituencies.

1. First Agency Problem: Managers vs. Shareholders

1.1 Appointment Strategy

As discussed above the board of directors is the main managing organ of corporation, which represents interests of concerned parties. The right to choose the board members is one of the strategies which could protect the interests of particular concerned party. This strategy is named in the literature as *appointment strategy*. Shareholders in general have a possibility to exercise control over a company by shaping the basic structure, composition and power of the board.

1.1.1 The Gross Structure and Composition of the Board

Similarly to major jurisdictions, in transition economies the board of directors together with shareholders' meetings belong to the main corporate organs.[45] In the three observed

[45] JSC Laws: Russia - §64; Uzbekistan - §63; Kazakhstan -§33.

countries the board has a two-tier shape, divided into supervisory and management boards. In the statutes of these countries the term supervisory board is used interchangeably with the term board of directors, whereas management board is defined as an executive organ (either individual or collective). In order to avoid confusion in further parts of this work the term *board of directors* will be used as a general definition for both board tiers. Upper and lower board will be called *supervisory* and *management board* consequently.

The creation of a two-tier board is mandatory in all three countries. However, Russian and Uzbek statutes allow not to introduce the supervisory board in companies where the number of shareholders (owners of voting shares) equals or is less than 50 and 30 consequently. In that case, shareholders' meeting fulfil the functions of a supervisory board.[46] The governance structures of corporations in transition economies can be schematically presented as based on the model developed by Tricker. Russia's statute allows board models depicted in Figures 4.f, 4.d, 4.e. Boards in Figure 4.f or 4.e correspond to the Uzbek statute. Kazakh governance model is reflected in Figure 4.d and 4.e. Although the general structure of statutes in three transition economies is similar, there are some different features regarding the gross structure of board.

1.1.2 The Power to Replace the Board Members

The appointment of directors is a half of the rights which are required to protect the interests of shareholders. Another part of rights is replacement rights. Combination of these rights ensures adequate representation of shareholder's interests: 'As long as shareholders have the power to replace the directors, corporate decisions can be expected to serve shareholder interests'. The right to replace a disloyal board is one of the crucial rights of any corporate governance system. Kraakman, et al. (2004) distinguishes two aspects that are important for replacement right. The first aspect considers the length of ruling term and the second one refers to the rights to replace directors in the mid-term. The experience of most developed countries indicates that jurisdictions which provide long or no-limit ruling term of the board, allow shareholders to replace directors easily in the mid-term. Reversely, the jurisdiction which guarantees short-term board occupation makes directors almost immune to the mid-term replacements by shareholders. The UK and France belong to the first group with long-term appointment (even lifetime), but offset this by providing strong removal power. Japan belongs to the second group, providing weaker removal power, but the term in office is

[46] JSC Laws: Russia - §64(1); Uzbekistan-§78.

sharply restricted. Among the major jurisdictions only Germany provides both long time of office for supervisory directors and the rules of hindered replacement (Kraakman et al., p.38).

In the USA members of board (directors) are elected by shareholders typically for one year. In most states board members can be easily removed without any cause, if simple majority of outstanding voting shares approve such resolution[47] (Merkt/Göthel, 2006, p.313). At first glance, it may make an impression that shareholders are vested with the power to change the board easily. In practice however, most American statutes impede the removal rights, allowing corporation to create *staggered boards* (also called a *classified board*)[48]. The staggered board typically consists of two or three fractions. Only one fraction of the board is elected annually (Kraakman, et. al, 2004 p.37). Thus, for example, under the staggered board with three fractions, a shareholder must wait three years until it can replace the whole board. In the Delaware state members of the staggered board can be removed in mid-term only in some particular cases (Merkt/Göthel, 2006, p.655). In order to restrict the misappropriation of the rights to form the staggered boards the maximal number of fractions in staggered board has been specified.[49]

In comparison to the major world jurisdictions Germany provides a lengthy term of office for supervisory directors. Typical term of the directors is five years. The articles may fix shorter term but not a longer one (Adolff et al., 2002, p.38). Each member can be removed from board without a cause before his term in office expires; in this case law requires the majority of three quarter of votes cast.[50] However the articles of association may relax the majority requirement to the level of simple majority. Thus, both the USA with its staggered boards and Germany with long term on board belong to the jurisdiction with attenuated removal power of the shareholders.

The statutes in transition economies both provide for a short-term on the board and easy removal rights. In Kazakhstan the office term of the supervisory board members is not specified by the law, but rather left to the discretion of the shareholders' meeting.[51] In contrast, Russian corporate law restricts the office term of supervisory board till the next annual shareholders' meeting.[52] As for the regulation of directors' terms Uzbek law reminds the former version of the Russian law, which has often been criticized in this respect

[47] Delaware - §141(k).
[48] Delaware - §141(d).
[49] Companies listed on the NYSE (New York Stock Exchange) are allowed to have maximal 3 fractions of the board according to §304.00 of NYSE listed company manual.
[50] AkG, Germany - §103(1).
[51] JSC Law, Kazakhstan - §55(2).
[52] JSC Law, Russia-§66(1).

(Teljukina, 2005, p.416). Members of board are elected for one year.[53] Understanding literarily, it means that a company must hold its shareholders' meeting on the same day every year. If the period between annual meetings is longer than one year, there is a risk that decisions taken by the board over one year after its members were elected will be found invalid, as the official term of directors has expired (Black et al., 1998, p.384).

The re-election of the supervisory board members is allowed for unlimited term in all three jurisdictions. JSC Laws in Russia and Kazakhstan mandate the approval of simple majority of votes cast to remove the supervisory board in the mid-term.[54] In Uzbekistan the removal of directors in the mid-term is harder. The law facilitates removal in the mid-term only if the qualified majority (75%) of participating votes during shareholder meeting approves the decision.[55] There is a significant detail in the removal rights that may nullify the effect of other legal strategies which target protection of minority shareholders. For example, unlike Russia, Kazakhstan's shareholders can remove not only the whole board, but also individual directors.[56] Due to this right the majority of shareholders can vote to remove those directors who were elected cumulatively by a minority shareholder. Therefore, the effect of cumulative voting can be abolished in Kazakhstan. Neither does the Uzbek law specify whether only the removal of the whole board is possible or single directors can be displaced as well.

The right to remove executive managers in most jurisdictions lies in the domain of the supervisory board. Thus, for example in the USA and Germany the board of directors has the right to remove executive managers. Similarly, Kazakh JSC law reserve this right to supervisory board only. Russia and Uzbekistan in opposite grant the removal rights to shareholders as default rule, whereas articles may vest supervisory board with such power.

To sum up, on the one side, there is Kazakh board which theoretically can be elected for a long-term, but the rule of easy removal is preserved for shareholders. The term in office for Russian directors is short, and the law provides for strong powers to remove them. In Uzbekistan directors are elected for a short term but removal power in the mid-term is restricted by high voting requirement.

[53] JSC Law, Uzbekistan - §83.
[54] JSC Laws: Russia- §49(2); Kazakhstan-§36(2).
[55] JSC Law, Uzbekistan - § 66.
[56] JSC Laws: Russia - §66(1), Kazakhstan - §55(3).

1.1.3 The Decision-making Structure of the Board

With regard to the decision making structure, the boards can be differentiated according to multiple features, such as the size, availability of independent directors, division into committees, frequency of meetings and many more. The mentioned features are regulated in some countries mainly by codes of good governance or listing the requirements, whereas in other countries they are coded in the hard law.

Concerning the board size the law could draw the overall frameworks of the size, leaving the actual decision about the board size to the discretion of each particular company. It is welcomed that the minimal size of the board estimated by the law, because it assures representation of different shareholder groups, which may have different interests.

Most the US statutes abolished the mandatory number of the board members (Merkt/Göthel, 2006, p.317). In contrast, German law gives a detail prescription of minimal board number according to the size of company. In companies with the number of employees up to 2,000 the default minimal number of the supervisory board should be three. Larger companies, with more than 2,000 employees, must have at least twelve members, those with more than 10,000 employees must have at least sixteen members, and if there are more than 20,000 employees, it must have twenty members. Such large board size can be explained by codetermination rule which mandates companies with more than 500 employees to provide for employee representation. Further details on employee representation will be reviewed closer in Chapter 3 of Section A.

Similarly to Germany, transition statutes define minimal number of the supervisory board members according to the size of company, however with some minor differences. Both Russian and Kazakh JSC Laws mandate default minimal number of directors. Kazakhstan provides for at least three seats in the supervisory board and Russia mandates at least five.[57] Additionally, Russian statute mandates default minimal board size for companies with larger number of shareholders. Seven and nine board seats are to be created in companies with 1,000 and 10,000 shareholders.[58] Kazakhstan in contrast does not prescribe default minimal number for larger companies, or companies with higher number of shareholder. This theoretically allows even larger companies to keep their boards small and thus stipulate under-representation of minority shareholders. In opposite to Kazakhstan, Uzbek statute determines the default minimal number for corporation with larger number of shareholders. Corporation which has more than 500 and 1,000 shareholders must at least have seven and

[57] JSC Laws: Kazakhstan - § 54 (5); Russia - §66(3).
[58] JSC Law: Russia - §66(3).

nine board seats available.[59] Nevertheless, Uzbek law fails to mandate default minimal number for the smaller corporations. Thus, theoretically companies with the number of shareholders between 30 and 500 may have only one director board.[60]

Another issue is the maximal size of board. An extremely large board can hinder effective fulfilment of board functions due to coordination problems. For example, in Germany the supervisory boards which have 15 and more members are considered as overloaded, although according to the Section 95 of the corporate law corporation may have up to 21 members (Peltzer, 2004, p.92). With reference to this point none of the statutes of observed transition countries define the upper border in the number of directors, although this could be a significant detail. Instead, some non-binding recommendations are made in soft laws, such as Corporate Governance Codes. Russian Code advises the boards to be of the size which will ‘enable the board of directors to hold productive and constructive discussion, make prompt and rational decisions, and efficiently organize the work of its committees’.[61]

In the USA the law does not require mandatory representation of independent directors. Instead the listing requirements of the NYSE (New York Stock Exchange) and NASDAQ mandate the majority of the board to be accomplished by independent directors. The rules of NYSE define an independent director as one who has no material relations with a listed company (Merkt/Göthel, 2006, p.317). In fact, most US corporations accomplish a half or the entirety of their boards with independent directors. Thus, outside directors represent to some extent a separate organ and informal division of a unitary board takes place: ‘It is nowadays beyond dispute that modern ‘unitary board’ has much more in common with the traditional ‘two-tier board’ than many would be prepared to admit’ (Du Plessis, 2005, p.61).

The German corporation law is silent as for the director independence. The law prohibits simultaneous representation of management directors on the supervisory board.[62] Accordingly, the members of the German supervisory board are all non-executive directors. However the newly adopted German Corporate Governance Code (GCGC) recommends directors to be independent. A decisive criterion for independence is the lack of business or personal relations with company.[63] Additionally, German Code advices to restrict a maximal number of seats on the supervisory board occupied by former executive managers up to two places.

---

[59] JSC Law: Uzbekistan - §83.
[60] As mentioned above according to Uzbek law companies with less than 30 shareholder may offset supervisory board with shareholders meeting.
[61] Russian Corporate Governance Code (RCGC) - Chapter 3, Paragraph 2.1.4.
[62] AkG: Germany - §105.
[63] German Corporate Governance Code (GCGC) - §5.4.2.

The three transition jurisdictions have different approaches to the handling of outside director's representation on the supervisory board. Only Kazakh corporate law strictly prescribes the board composition with non-executive and independent directors. It mandates at least one-third of the supervisory board seats to be occupied by independent directors.[64] From executive directors only a chairman can be elected to the supervisory board. However, he/she cannot be elected as a chairman of the supervisory board.[65] It is noteworthy that there is a confusion in wordings between Kazakh JSC Law and Kazakh Corporate Governance Code considering the representation of independent directors. The Code recommends that the number of independent directors should not exceed the limit fixed by the law[66], although, as mentioned above, the law does not post any upper limitation on the representation of independent directors, rather providing the bottom line border (minimum of one-third of independent directors). Similar to the American approach, neither Kazakh JSC Law nor Code specify the list of criteria in order to define an independent director. The definition of director's independence is left rather to company's discretion, although the Code gives a minimal orientation to independence, recommending director to be independent of a controlling shareholder, management and state.[67]

Executive directors in Russia, defined as those who occupy the lower management board, have the possibility of broader representation on the supervisory board than those in Kazakhstan. They may occupy up to one-fourth of the board. But same as in Kazakhstan a chairman of the management board (executive officer) may not be elected as a chairman of the supervisory board.[68] Another difference between Kazakh and Russian law is that mandatory representation of independent directors is not mentioned in Russian JSC Law. Independent directorship belongs rather to the Good Governance prescriptions of Russian Code. It advices that independent directors should be represented on the supervisory board, and for the purpose of enabling them to participate actively in decision-making process their number should comprise at least one-fourth of all directors, whereas any board should have at least 3 members.[69] Unlike Kazakhstan, Russian Code prescribes detailed criteria that should assist the defining of a director's independence. Such detailed definition resembles the criteria of British Combined Code on Corporate Governance. The following requirements must be fulfilled in order to deem a director as independent. Independent Director:

[64] JSC Law, Kazakhstan - §54(5).
[65] JSC Law, Kazakhstan - §53(4).
[66] Kazakh Corporate Governance Code: Chapter 3, Compiling the Board of Directors.
[67] Kazakh Corporate Governance Code: Chapter 1, Principles of director's activity.
[68] JSC Law, Russia – §66(2).
[69] Russian Corporate Governance Code (RCGC): Chapter 3, Paragraph 2.2.3.

(1) over the last three years has not been, and at the time of election to the board of directors is not, an officer (manager) or employee of the company, or an officer or employee of the managing organization of the company;
(2) is not an officer of another company in which any of the officers of the company is a member of the appointments and remuneration committee of the board of directors;
(3) is not an affiliated person of an officer (manager) of the company (officer of the company's managing organization);
(4) is not an affiliated person of the company or an affiliated person of such affiliated persons;
(5) is not bound by contractual relations with the company, whereby the person may acquire property (receive money) with a value in excess of 10 percent of such person's aggregate annual income, other than through receipt of remuneration for participation in the operations of the board of directors;
(6) is not a major business partner of the company (a business partner with an annual value of transactions with the company in excess of 10 percent of the asset value of the company); and
(7) is not a representative of the government.

No director may be deemed to be independent if he has acted in the capacity of a member of the board of directors of the company for 7 years' [70].

In addition, according to the listing requirements of Russian Stock Exchange (RTS) companies listed in 'Category *A*' must report the compliance with corporate governance standards (full, partial, no-compliance) – report that they have at least 3 independent directors, explaining their independence according to the 7 criteria.

In Uzbekistan current structure of a board resembles that of Germany. The supervisory board is compiled only from non-executive directors, as the law prohibits executive managers to sit in it.[71] However, Uzbek statute does not distinguish between non-executive and independent directorship and the absence of Codes of Good Governance, which could at least facilitate the unbinding prescription of independent directors, deteriorates the governance practice, leaving space for representation of various concerned corporate groups that may fail to judge objectively on corporate issues.

Another good governance practice that is supposed to enhance the decision making structure of the board is committee. In almost all major jurisdictions Good Governance Codes recommend boards of directors to be composed of committees that specialise in particular board functions.[72] The committees are supposed to assist the board in fulfilling its primary functions and allow specialisation in particular fields. In modern corporate practices appointment, remuneration, nomination and audit committees are frequently used features of good governance.

[70] RCGC, Chapter 3, paragraph 2.2.2
[71] JSC Law, Uzbekistan - §83.
[72] See for example, Corporate Governance Code (Germany); Principles of Corporate Governance, The Business Roundtable (US); The Combined Code on Corporate Governance (UK).

The USA was one of the first countries which introduced committees on the board. The committee structure can be created if others is not stated by articles or bylaws.[73] Except the recommendation to create committee structure provided by corporate governance codes[74], the listing requirements of NYSE and NASDAQ also mandate committees. Typical committees of the board are: nominating, compensation, and audit. Committees are occupied by members of the board (Merkt/Göthel, 2006, p.322). For further comparative analyses, in order to enable the analysis of experience in transition economies, the audit committee will be distinguished from other committees. The task of audit committee is to monitor financial reporting process and oversee hiring and performance of external auditors. In contrast to other committees, they are mainly occupied by outside directors, who are neither executive officers nor employees (Merkt/Göthel, 2006, p.324).

German corporate law mentions committees as optional choice for corporations[75]. In practice committees are less common, however, a strongly growing tendency towards nomination, remuneration and audit committees can be recognized, and many large companies have already introduced them (Hopt and Leyens, 2004, p.5). The German Code recommends committees, whereas the formation of audit committee is emphasised.[76]

In transition countries as well the committee division is proposed by the codes of good governance, and not mandated by the JSC Law. Codes of Russia and Kazakhstan advise the creation of committees which will allow preliminary discussion on most important issues and provide recommendations, based on which the board can make informed decisions; although the exact type of committees is left to board discretion. The Codes recommend the following particular committees such as: strategic planning, audit, human resources, remuneration, ethics and committee on resolution of corporate conflicts.[77]

It is also necessary to handle law provisions that are specific for transition economies. Thus, unlike Germany and the USA, corporate law in transition economies prescribes the creation of internal audit organ (commission), which is optional in Kazakhstan and mandatory in Russia and Uzbekistan.[78] This organ, however, must be distinguished from audit committee of the western type as its members cannot hold seats in the supervisory board. Schramm (2007) opines that functions of an internal audit organ intersect with those of the supervisory board, which can prove to be problematic when defining the liabilities of parties. Other

[73] Delaware - §141(C).
[74] American Law Institute (ALI), Principles of Corporate Governance: Analyses and Recommendations, § 3A.02-3A.05.
[75] AkG: Germany - §107(3).
[76] GCGC - § 5.3.2.
[77] RCGC - Chapter 3, Paragraph 4.7.1; KCGC: Chapter 3, Organization of Supervisory Board (7).
[78] JSC Laws: Russia - §85; Uzbekistan - §100; Kazakhstan - §61.

studies also reveal low effectiveness of this organ in transition economies.[79] Kazakhstan's authorities have recognized the weaknesses of this organ, stating in the government's decree N 620 of 30 June 2006 that one of the reasons of poor performance of the internal audit is that it is not clear according to which criteria the members of this organ are elected and there is lack of standards for the guidance.[80] The quality and effectiveness of such an organ is therefore questionable and requires deeper analyses.

The last good governance feature in this context is frequent meetings of a board of directors. It is assumed that the more often the board meets the better the monitoring of corporate policy is. Thus, the codes of major jurisdictions include frequent meetings of the board as one of good governance principles. An exception could be Germany where the minimal frequency of board meeting is mandated by the law. Here, the listed companies should ensure that the supervisory board meets at least two times, and boards of a not listed company must meet at least once a year.[81] Nevertheless, the empirical studies show that the supervisory board in Germany meets seldom (Black and Kraakman, 1996, p.30). As in most major jurisdictions transition economies do not regulate board meeting mandatory in their statutes, but rather leave this issue for company's discretion. In contrast to Kazakh Code, Russian Code of Good Governance recommends that the board meetings take place regularly and at least once in 6 weeks.[82]

1.2 The Decision Rights Strategy

Although shareholders are represented through a board of directors, which is authorised to decide on corporate activities, there are some corporate activities on which the decision is supposed to be made by the shareholders themselves. That is '…because boards can too easily become lazy or be captured by management' (Black and Kraakman, 1996, p.29). According to its functional purpose, such a strategy is called in the literature as 'decision rights strategy' (Kraakman et al., 2004). Under this strategy one understands the ability of shareholders themselves to make decisions on particular corporate actions. This is the case when significant corporate actions are on the agenda, the decision over which may drastically alter corporate constitution.

[79] For Russia see Ichiro Iwasacki (2004), *For Uzbekistan See Butikov (2006).*
[80] The decree of the Government N 620 „On the approval of program on management of state assets for 2006-2008“ management of state assets", Dated 30.06.2006.
[81] AkG, Germany - §110 (3).
[82] RCGC: Chapter 3, Paragraph 4.2.1.

In countries where the dispersed ownership dominates the corporate landscape, decision rights are not very important as a strategy for protecting shareholder interests from managerial opportunism, because the logic of collective action leaves shareholders with little alternative to delegate management powers (Hansmann and Kraakman, 2004, p.48). This is however not the case with the company's which have few controlling shareholders. The foregoing review of ownership structure showed that most companies in transition economies have concentrated ownership. Therefore, it can be concluded that decision rights strategy could be of huge importance in these countries to protect the interests of shareholders as a whole. Nevertheless, another potential agency conflict may occur in this context, if controlling shareholders misuse their power against small owners. The concrete cases of the decision rights strategy and its effect on all involved parties will be discussed in the next chapter.

1.3 Reward Strategy

As it has already been mentioned in the theoretical part of the thesis, reward strategy belongs to one of the main mechanisms which contribute to the reduction of agency costs. The adequate remuneration of management may help to align his/her interests with those of shareholders and other constituencies, hence, reducing the agency costs. The remuneration of management for pursuing shareholder interests is stipulated by contracts rather than by law. Nevertheless the law can regulate reward strategy to some extent, for example, French law mandates nominal share ownership by a director, although in most jurisdictions their stock ownership is voluntary (Hansmann and Kraakman, 2004, p.51).

Under the common law, board members (not executive officers) usually do not receive remuneration for their activities, because as a rule they are at the same time shareholders of the company and receive remuneration from the development of stock price (Merkt and Göthel, 2006, p.332). Nevertheless, due to the growth of directors that do not keep shares most corporations nowadays pay salaries to directors. According to Delaware statute the board itself may decide on the remuneration of its members and executive directors.[83] That is why corporate governance codes recommend that not the whole board, but a special remuneration committee decides on that issue.[84] Companies listed on the NYSE are banned to pay excessively high salaries for independent directors (limited to 100.000 per year), as it may effect their position of objectiveness (Merkt and Göthel, 2006, p.317). Shareholders are entitled with decision rights on remuneration only in case of the stock option plans, and only

[83] Delaware - §141(h).
[84] American Law Institute (ALI) §3A.05, cited by Merkt/Göthel, p.332.

in companies listed on the NYSE and NASDAQ. Generally, the US corporations are free in fixing the size of remuneration schemes. Payments to managing entities are not in any way restricted by the law and can be significantly high.

In Germany shareholders decide on remuneration of the supervisory board members, whereas the payment schemes of the management board members is determined by the supervisory board. In opposite to the US statutes, Germany requires the salaries of both supervisory and management board members to be reasonable in relation to the duties of members and the situation of a company.[85] Regarding the performance based remuneration German regulator also recognizes its importance and allows stock option plans which must be approved by shareholders.[86] Additionally the German corporate governance code recommends success oriented compensation of managers.[87]

Laws in transition economies do not provide extensive provision on compensation schemes. In all the three countries shareholders are vested with decision rights on the payment to the supervisory board members, whereas payments schemes to the executive directors are determined by the supervisory board.[88] With respect to the stock option plans shareholders' meeting is authorised with decision making power in Russia.[89] Although it is not evident in the laws in Kazakhstan and Uzbekistan, it can be assumed that the decision making power on stock option schemes belong to the supervisory board. In the same manner like in Germany, the Uzbek law requires that remuneration of both the supervisory and management board members should be reasonable in relation to the duties of members and economic conditions of the company.[90] Finally, it is necessary to consider the proposal of the soft laws. Only the Russian Corporate Governance Code recommends the remuneration of executive directors to be based on the long-term success oriented incentive schemes.[91]

2. The Second Agency Problem: Majority vs. Minority

2.1 The Appointment Rights Strategy

The appointment rights strategy includes some mechanisms which can help to protect minority shareholders. There are two main techniques of protecting small investors through

[85] AkG, Germany: §§87(1), 113(1).
[86] AkG - §192.
[87] German Corporate Governance Code, Chapter 5.4.7.
[88] JSC Laws: Russia - §64(2); Kazakhstan - §36(1); Uzbekistan - §81.
[89] JSC Law, Russia - §33(2).
[90] JSC Law: Uzbekistan - §§81, 86.
[91] Russian Corporate Governance Code - Chapter 4, Section 5 (Remuneration of executive bodies).

the appointment rights strategy; the first technique implies the reservation of seats on the boards of directors for minority shareholders. The second one is limitation of voting rights for large shareholders (Hansmann and Kraakman, 2004, p.54).

To start with the first technique, it is apparent that small shareholders can barely influence corporate policy, but the representation on the board can at least secure access to valuable information which is handled during the board meeting. That is why the board seat can be very valuable for minority shareholders. Protection of minority shareholders through reservation of seats may be stipulated by mandating bicameral board structure, with one board elected on one-share-one-vote basis and the other elected on one shareholder-one-vote basis. None of the major jurisdictions (Germany and the USA) and none of the three transition economies use this technique because such bicameral structure would create a serious “risk of deadlock” (Hansmann and Kraakman, 2004, p.34).

Another less radical method to secure the representation of minority shareholders on the board is proportional or cumulative voting rule.[92] According to this rule, if board consist of *n* members, a shareholder who holds 1/n of the votes can elect one director (Black and Kraakman, 1996, p.33). Despite the advantageous role of the cumulative voting most jurisdictions do not mandate it in their corporate statutes. In the USA cumulative voting is mandatory only in few states. In the rest of the state, including Delaware[93], the cumulative voting is available only if it was explicitly included in articles (Merkt and Göthel, 2006, p.316). Although cumulative voting rights are available for corporate sector, its effect can be neutralized in the states which allow to create a staggered board, as only one fraction of board can be elected at a time (Merkt and Göthel, 2006, p.316).

There is no rule of proportionate representation in Germany. A major shareholder with 55 % can appoint all shareholder representatives on the supervisory board (Adolff et al., 2002, p.38). However, the German law provides for another mechanism that can allow minority protection. The articles of association can provide the right for a particular shareholder to

[92] “*Cumulative voting is a type of voting process that helps strengthen the ability of minority shareholders to elect a director. This method allows shareholders to cast all of their votes for a single nominee for the board of directors when the company has multiple openings on its board. In contrast, in "regular" or "statutory" voting, shareholders may not give more than one vote per share to any single nominee. For example, if the election is for four directors and you hold 500 shares (with one vote per share), under the regular method you could vote a maximum of 500 shares for any one candidate (giving you 2,000 votes total - 500 votes per each of the four candidates). With cumulative voting, you could choose to vote all 2,000 votes for one candidate, 1,000 each to two candidates, or otherwise divide your votes whichever way you wanted.* “ (Securities and Exchange Commission – www.sec.org)

[93] DGCL - § 214 (opt in).

appoint members of the supervisory board.[94] In this case, the shareholder has the right to appoint and remove relevant representatives outside the shareholders meeting.

In contrast, all three transition economies mandate the cumulative voting for the election of the board of directors.[95] However, the description of procedures in Uzbekistan is not as thorough as in Russia and Kazakhstan, which may lead to weak understanding of mechanism both by directors and by shareholders.[96] Nevertheless, the cumulative voting alone does not provide sufficient basis for protection of shareholders. The existence of supporting rules, or non-existing of 'destructive' ones, is essential to effective functioning of the rule. Thus, for example, the failure to mandate a minimal board size, or in case when a minimal board size is very small, cumulative voting as a technique has no use. Among the three jurisdictions, Uzbekistan fails to mandate minimal board size for companies in which shareholder number varies between 30 and 500. Kazakh JSC law, though, defines minimal board size of three, this however may be too small to allow minority representation. Only Russia manages to define the minimal board size (five), which is not too small to secure efficiency of cumulative voting. The other aspect that may harm the effect of cumulative voting may be the right of majority shareholders to remove a single board member in the mid-term. Russian JSC Law allows only the removal of the whole board, thus safeguarding the directors who represent minority interests. In contrast, in Kazakhstan not only the whole board, but individual directors can be removed, which neutralizes the effect of cumulative voting (*See section about removal rights*).

The second technique of protecting minority rights through appointment rights strategy is based on the principle of limitation of voting rights for large shareholders, also called vote cap (Hansmann and Kraakman, 2004, p.55). There are 'strong' and 'weak' vote caps. 'Strong vote cap' reduces the voting power of large shareholders below their proportionate economic ownership. Regardless of the number of stocks owned by the large shareholders they are allowed to vote within definite voting threshold. Therefore, the rights of small shareholders are implicitly inflated. For examples, no shareholder receives voting right more than 10 % on the shareholders meeting, even if her ownership rights lie higher than 10 %.

According to Delaware the 'vote cap' statute could be possible, because they are not expressly prohibited, although for the listed companies this mechanism is not available. In Germany, as well, the limitation of voting rights is eligible only for the unlisted publicly held

[94] AkG, Germany - §101(2).
[95] JSC Laws: Russia - §66(4); Kazakhstan- §54 (2); Uzbekistan - §76 and §83.
[96] Survey of the Center for Economic Research on "Problems of Corporate Governance introduction in Uzbekistan" revealed that in fact the understanding of cumulative voting mechanism remains weak among Uzbek directors.

corporations.[97] However, such limitations of voting rights are only valid for decisions which require simple majority of votes. It is not applicable for resolutions that require the qualified majority of 75 % of votes (Adolff et al., 2002, p.9). Therefore, this type of minority protection cannot be utilised for decisions on significant corporate actions (Section B). In Russia and Uzbekistan vote caps are possible if it was specified in the articles of association.[98] The Kazakh law is stricter in this respect. Limitation of voting rights is possible, however, if only it is provided by other national laws.[99]

In opposite 'weak vote caps' restrict the extent to which shareholders can exercise their power, which exceeds their economic stake in the firm. For example, those who have 10 % stake cannot receive voting power of more than 10 %, which is possible in the case when there are different share classes with different voting weight (e.g. one share – three votes). Hence, small shareholders receive protection due to mandated equal voting power, which leads to the one-share one-vote rule.

Until 1998 German corporations were allowed to issue shares with multiple voting rights, after the approval of the Federal Ministry (Adolff et al., 2002, p.9). Currently Germany belongs to the few jurisdictions which, as stated in AkG §12, mandate the one share-one vote rule (Hansmann and Kraakman, 2004, p.56). The introduction of this rule in Germany is especially remarkable in comparison to the development of the European Law. In October 2007 due to the lobby of big shareholders the European Commission abandoned its attempt to introduce this principle into the European Law (*The Economist*, 13.10.2007). Today, the US state law provides corporations with considerable flexibility with respect to allocation of voting rights. The one share-one vote provision is adopted in almost all statutes as a default rule, but a corporation can depart from this provision by fixing multiple voting rights in their bylaws (Bainbridge, 2002, p.453).

The one-share one-vote rule is included in the statutes of all three transition economies.[100] Nevertheless the statutes of Russia and Kazakhstan allow special voting rights – called 'golden shares'.[101] The owner of the golden shares has the right to block the decision approved by the shareholder meeting, supervisory or management board. Usually 'golden shares' are preserved for the state ownerships, as in case of Russia. In contrast, the Kazakh regulation is even more far reaching, providing that any shareholder can be the owner of a 'golden share' and each corporation can issue one 'golden share'. Such a provision can

[97] AkG: Germany - §134(1).
[98] JSC Laws: Russia - §11 (3); Uzbekistan - §15.
[99] JSC Law: Kazakhstan - §12.
[100] JSC Laws: Russia - §59; Kazakhstan - §50(1); Uzbekistan - §76.
[101] JSC Laws: Kazakhstan - §13(5); Russia - §1(5).

considerably harm the balance of power among different shareholders (Schramm, 2003). The regulator in Kazakhstan has recognized the destructive effect of 'golden shares' on the concept of minority protection and has banned such rights in newly introduced form – Public Company (*publichnaya kompaniya*).[102] Law explains the notion of Public company as one whose shares are traded on the regulated or open market; at least 30% of shares must be owned by shareholders, each of which may not have more than 5% of stake.[103]

The Uzbek law is silent regarding the 'golden share' rights. However, the law allows a rule that can be regarded as substitution of the 'golden share' rights (Schramm, 2007). In a corporation in which the state keeps the share of not less than 25%, the state can appoint its representative to the board and upon the decree of the Cabinet of Ministers vest this representative with other rights than simple supervision.

2.2 The Decision Rights Strategy

In this section such crucial rights of shareholders will be reviewed as participation in the decision making process, monitoring and controlling of management processes by the shareholders' meeting. Facing the problem of distinguishing between the rights of a shareholder in general and those of minority shareholders no strict differentiation line between them will be drawn in this chapter. Thus, all the listed aspects can be related both to minority shareholder rights and to shareholders in general. The main concern here will be to determine to what extent (minority) shareholders may exercise their participation in the decision process. The main issue of this section is to consider three main groups of rights regarding the decision making at the shareholder meeting: (1) the rights before the shareholder meeting, (2) the rights at the meeting itself and (3) rights to set aside the decision made at the meeting. The group of rights prior to meeting range from calling a special (extraordinary) meeting and making proposal to the agenda to the right of shareholders to inspect the share register (voting list) with the purpose to contact other shareholders and concluding voting agreement with them. In the course of the second group of rights, the existing types of shareholder meeting and the possibilities of participation which our target jurisdiction provide will be compared. Finally, an important right that will be reviewed is the ability of a shareholder to claim against the decisions taken in the general meeting and setting them aside. Thus, in the next section only those provisions will be closely observed which can foster the position of shareholders.

[102] JSC Law: Kazakhstan - §4-1(2).
[103] JSC Law: Kazakhstan - §4-1(1).

2.2.1 The Rights Prior to the Shareholders' Meeting

a. Calling Rights

Commonly company management is vested with the right to call a general meeting and determine the agenda. In cases when the management does not call the meeting the law must provide for provisions that in a way provide for 'calling rights'. The world praxis knows three kinds of calling rights: (a) a shareholder may force a manager to convene the shareholder meeting, (b) they can call the meeting themselves, (c) they may apply for a court order to call the meeting (Zetzsche, 2005, p.10*)*.

In the USA, the right of shareholders to call a meeting directly is considerably restricted. The US shareholder can call the meeting directly only in an extraordinary case, such as the absence of directors in the office. As a rule any shareholder can apply to the court if an annual meeting was not called by directors.[104] It may seem that the US shareholders are vested with great calling rights. This is, however, not the case, as the US courts retain the discretion right whether to proceed with requested meeting. German statute provides for a threshold minimum requirement to request the meeting. A minority shareholder with aggregate stake of 5% can file a written request to the management board to call an extraordinary shareholder meeting.[105] If the request is not met, the court may authorise those shareholders who filed it to convene the general meeting or publish the item.[106] According to the German law transition economies established the minimal threshold in order to call the shareholder meeting, which is higher than in Germany and equals 10% of share capital in all the three countries.[107]

The willingness of an active shareholder to call a meeting depends mainly on financial consequences of such action. A small shareholder will not initiate the meeting if he/she runs a risk of taking over all costs of doing it. Thus, important aspects in governance and control are cost issues. The Delaware General Corporate Law does not specify who pays the costs of a meeting convened by shareholders. Instead, a shareholder meeting decides whether to compensate the initiative or not. It is more likely that shareholders will apply to the court, since the court involvement reduces the financial risk of the shareholders (Zetzsche, 2005). In

[104] DelGCL - § 211 (c) 3.
[105] AkG, Germay - §122 (1).
[106] AkG, Germany - §122(3).
[107] JSC Laws: Russia - §55(1); Kazakhstan - §37(2); Uzbekistan - §72.

Germany a company bears the costs of the general meeting conducted either on the request of a shareholder or if it was fostered by the court.[108]

The Russian and Uzbek laws follow the line of the US rule stating that the cost of calling an extraordinary meeting can be compensated by the decision of the general meeting.[109] The Kazakh regulation is rather opaque and it is not explicit who bears the costs of an extraordinary meeting; it states that a corporation bears the costs of the general meeting, except for the cases defined by the JSC Law.[110] However, no further mention of exceptional cases was found. It can be assumed that the costs of an extraordinary meeting will be covered by the corporation as well.

b. Proposal Rights

In the cases when management duly calls the general meeting according to the statute it is necessary to vest shareholders with proposal rights. In fact, this provision could be found in all our observed jurisdictions. However, the difference lies in the details such as: (a) eligibility to make a proposal, (b) timeliness, (c) space limit and (d) managers' ability not to accept proposals into the agenda.

The lowest threshold right to make a proposal is fixed by the Delaware Statute, which is fixed for 1% of voting shares. However, in order to propose an own candidate any shareholder is entitled with the right to do so. At first glance it appears that a shareholder is vested with broad nomination rights in the USA. This is, however, illusory as the actual proposal is combined with highly expensive proxy solicitation requirements, which will be closely reviewed later in this section. According to the German statute an owner of at least 5% of stake or of the proportionate amount of EUR 500,000 can make a proposal to the agenda.[111] Although for the proposal of a director candidate the law empowers any shareholder with such a right.[112] All three transition economies have different quantitative requirements that empower the proposal rights. The lowest threshold of 1% of voting shares is fixed in the Uzbek JSC Law, followed by the minimum 2% stake required by the Russian law and the highest one of the minimum 10% mandated by the Kazakh law.[113] In respect to proposing a director candidate the Uzbek and Russian JSC laws maintain the same

[108] AkG, Germany - §122(4).
[109] JSC Laws: Russia - §56(8); Uzbekistan - §72.
[110] JSC Law, Kazakhstan - §37.
[111] AkG, Germany- § 122(2).
[112] AkG, Germany - §§ 126, 127.
[113] JSC Laws: Russia - § 53; Kazakhstan - §43; Uzbekistan - §70.

thresholds.[114] Kazakhstan, in contrast, relaxes the threshold requirement for a proposal to any single shareholder.[115]

In addition to the threshold, a provision is supplemented by a minimum holding requirement of shares. The minimal holding rule is meant to prevent the proposal right from being abused (Zetzsche, 2005, p.15). Thus, the US law provides for a long holding requirement. Only shareholders who hold a required number of shares for at least one year can file their proposal.[116] The German law does not require the minimal holding period. Neither the laws in the three transition economies provide for the minimal holding period before the proposal can be made, which grants relatively lax rights to shareholders and can result in abuse of power by minority shareholders.

Another important aspect is timeliness, e.g. the minimal period within which shareholders may file a proposal. The closer the deadline of the proposal, fixed by the law, to the actual general meeting, the better proposal rights the shareholders have, as they may decide on the agenda at a moment's notice. Moreover, it is also important if the proposal can be made before (initiative proposal) or after (responsive proposal) the managers send an agenda note to a shareholder. The US law mandates a long period within which initiative proposal could be submitted, thus depriving shareholders of a spontaneous proposal opportunity. It requires that a shareholder sends a proposal 120 calendar days before a company's proxy statement is released.[117] In addition, the rule restricts the maximal length of the proposal, which may not exceed 500 words.[118] In contrast, the German statute allows both initiative and responsive proposals at relatively short notice. The management board must convene the meeting at least one month before the meeting[119] and shareholders may file their proposal within 10 days after convening the meeting.[120] The three transition economies differ in their approach to the proposal timing. The Kazakh law allows making short responsive proposals, as shareholders must receive proposal not later than 15 days before the general meeting[121], whereas the notice deadline about a forthcoming meeting is to be submitted by management not later than 30 or 45 days before the meeting.[122] Thus, a shareholder can make a proposal at very short notice. The JSC Laws in Russia and Uzbekistan give a greater decision right to corporate articles of association. As a default rule shareholders may file a

[114] JSC Laws: Russia - § 53; Uzbekistan - §70.
[115] JSC Law, Kazakhstan - §14 (5).
[116] SEC Rule 14a-8(b) sub 1. of U.S. Regulation 14A.
[117] SEC Rule 14a-8(e).
[118] SEC Rule 14a-8(d).
[119] AkG, Germany - §123(1).
[120] AkG, Germany - §124(1).
[121] JSC Law, Kazakhstan - §43.
[122] JSC Law, Kazakhstan - §41(1).

proposal not later than 30 days after the end of the financial year[123] and the regular shareholder meeting is to be conducted not later than 6 months after the end of the financial year.[124] Thus, based on the default rules, if we take the extreme deadlines stipulated by the law, then maximal possible period between the proposal and the meeting can be 5 months (ca. 150 days), which is even longer than the default rule in the USA. Additionally, the Russian law provides provision about a proposal for an extraordinary meeting. In case of the extraordinary meeting a shareholder can file a proposal on a director candidate not later than 30 days before the meeting, whereas management should send a notice about a forthcoming meeting not later than 70 days before the meeting.[125] Therefore, in this case Russia grants shareholders the right to file the proposal of a director at a very short notice.

The last crucial issue which determines the extent to which shareholders may use their proposal rights is the cost of making a proposal. According to the US law shareholders must not pay for the proposal made (Bainbridge, 2002, p.496). It is different, however, if a shareholder proposes their own candidate to the board. In this case he/she must start a proxy contest,[126] which implies that an insurgent shareholder must bear the costs of proposal himself/herself. In Germany, as the proposal is related to the general meeting, it can be referred to AkG §122(4), which provides that a company bears the costs of the general meeting. Among the transition economies only the Kazakh law provides the bearer of costs in connection with an ordinary meeting. The article §37 of the Kazakh JSC Law defines a corporation as the cost bearer in case of an ordinary meeting. Thus, the costs of shareholder proposals belong also to the burden of the corporation. In contrast, both Russia and Uzbekistan fail to explicitly define the costs aspect, which may substantially hamper the will of activist shareholders to make a proposal.

c. Shareholder Communication and Information Rights

It is quite obvious that a shareholder with a small number of votes may be interested to unite with other small shareholders in order to be able to foster a particular issue of their common concern. The right to request a list of shareholders is essential to solicit support from other shareholders (Black et al., 1998, p.326). Even if a shareholder has the right to look into a corporate register, it is important that he/she can at minimal cost apply to other shareholders

[123] JSC Laws: Russia- §53(1); Uzbekistan - §70.
[124] JSC Laws: Russia - §47(1); Uzbekistan - §64.
[125] JSC Law, Russia - §53(2).
[126] Proxy contest – is the battle for control of a firm in which a dissident shareholder seeks from the firm's other shareholder the right to vote those shareholders' shares in favour of the dissident group. Contest is stipulated as shareholder in this case competed against the proxy rights of incumbent directors.

prior the general meeting. In fact, some jurisdictions mandate the procedures that substantially inflate the financial burden of a shareholder, which hampers the shareholder's will to look for communication.

The German corporate law does not provide for a wide spectrum of information rights (Wirth et al., 2004, p.125). For example, the right to inspect a shareholder list in Germany is restricted; a shareholder may only demand information with respect to his person as entered into the share register.[127] It may seem that communication among shareholders is considerably hampered due to such restriction. However, recent changes in the regulation give substantial communication and coordination toolkits to the German shareholders. Thus, the interests of shareholders can be united under the guidance of one of the two main shareholder associations created to fulfil the functions of guardians of shareholders' interests.[128] Furthermore, in order to facilitate shareholder coordination the recent law amendments provide the shareholder platform for communication and coordination of shareholder interests.[129] According to this law a shareholder and shareholder associations can post their issue and information about them in a special section of the German Federal Electronic Bulletin (*elektronischer Bundesanzeiger*). All other shareholders can access this electronic forum free of cost (Zetzsche, 2005, p.26).

In contrast to the German regulation, the US shareholder has the essential right to look into a shareholder register (Merkt and Göthel, 2006, p.356). However, he/she must provide that inspection has a proper purpose, such as, e.g. communication with a fellow shareholder (Bainbridge, 2002, p.462). The differentiation between proper and improper purpose is not easy, whereas it is shareholders' burden to provide the proof of good purpose. Despite the essential rights to inspect the register, communication and coordination rights of shareholders are significantly impeded due to the proxy regulation. Any shareholder who wants to obtain the support of other shareholders must launch a complicated and costly proxy contest[130], whereas the rules of proxy already apply if the shareholder wants to address more than 10 other shareholders (Merk and Göthel, 2006, p.399).

All the three transition economies stipulate the right of shareholders to access the register. In Russia a shareholder who is included in a share register and holds not less than 1% of shares may request to review the list of persons that are supposed to participate in the

[127] AkG: Germany - §67(6).
[128] German Association for the Protection of Securities Holders (*Deutsche Schutzvereinigung für Wertpapierbesitz*) and Association for Protection of Investors (*Schutzvereinigung der Kapitalanleger*)
[129] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), §127a; 22 Septemebr 2005.
[130] Proxy procedures require a written application for the votes of other shareholders. In US corporations where shareholders' number often increases several hundred thousand, the proxy costs may run to a million dollar threshold. *See examples provided* by Merkt and Göthel (2006), p.414.

shareholders' meeting. However, the required data of particular shareholders (address) can be provided only if such a shareholder authorised the company to give data on him to third parties.[131] The Uzbek law allows only large shareholders with a stake of 10% to inspect the list of persons who are eligible to take part in the general meeting.[132] The Kazakh law can be compared with the US where any shareholder can request a copy of a shareholder list eligible to participate in the meeting.[133] It can be therefore summarized that regulations in the transition economies do not provide hindering procedures for communication among shareholders, however communication among them is also not fostered as in the case of Germany.

Information rights of shareholders are not exhausted with the right to look into a shareholder register. Inspection of other corporate documents is a paramount aspect in safeguarding their right to know a company's situation. According to the US Common law any shareholder can request an inspection of all corporate documents and contracts that are relevant to corporate activity (Merkt and Göthel, 2006, p.368). Proving the proper purpose of investigation a shareholder can look virtually into all corporate documents such as: a protocol of the board of directors meeting, protocols of the general meeting, accounting documents, contracts, tax related documents and corporate correspondence (Wohlwend, 2001, p.23). The proper purpose can be provided if a plaintiff has the evidence of impropriety. Unlike the US, the law in Germany provides very few inspection rights. Shareholders can solely view the financial statements and the management reports (Wirth et al., 2004, p.125). While in the USA shareholders can choose any time to exercise inspection rights, German shareholders are only eligible to inspect allowed documents in respect to the forthcoming shareholders' meeting in order to be able to make a decision on the agenda issue (Lommer, 2005, p.223).

Stating generally, shareholders in the tree transition economies have the right to inspect corporate documents. Nevertheless, detailed review indicates that these rights vary considerably between the countries. The Kazakh law can be compared with the US regulation, where shareholders have very broad range of inspection rights, including such important elements as accounting data and protocols of the board meeting.[134] In contrast, Russia and Uzbekistan impose some restrictions. The Uzbek law, although it allows an inspection of multiple documents, negates the right of shareholders to view the protocols of the executive board meeting and accounting reports.[135] Opposite to that, the Russian law limits some

[131] JSC Law, Russia - §51(4).
[132] JSC Law, Uzbekistan - §68.
[133] JSC Law, Kazakhstan - § 80.
[134] JSC Law, Kazakhstan-§§14 (3); 80(3).
[135] JSC Law, Uzbekistan - §§106,107.

inspection rights in accordance with the ownership threshold.[136] For example, a shareholder should obtain at least 25% of stake in order to access accounting reports and protocols of the executive board meeting.

Interesting in this context is also the aspect of the inspection of corporate documents by a member of the board. The right of a director, appointed by a minority shareholder and serving his best interest, to inspect internal documents could also be regarded as the mechanism of minority protection. According to the German regulation, the management board must provide regular reports to the supervisory board.[137] Such functional division, however, bears considerable problems. Firstly, the management board can provide only information which it possesses itself. Secondly, the management board, which is subordinated to the supervisory, may have a direct interest not to disclose the whole information because such data may be implemented as disciplinary measures against managers (Lieder 2006, p.784). In order to reduce this agency conflict the German law allows the supervisory board as a whole entity and its particular members to apply to the management board with the request to submit the needed information. Although, in this case the information is also coming from the management board. If the supervisory board doubts the correctness or the completeness of the provided information, it is entitled by the law to conduct its own inspection and examination of the required documents.[138] The list of the documents and material objects that can be inspected is not restricted by the law (Kropff and Semler, 2004, p.1021). It is noteworthy that the whole supervisory board, and not its particular member, is vested with inspection rights. The law however specifies that the inspection function can be transferred to a singe board member.[139] In opposite to Germany, the US regulation provides a single director with the absolute right to inspect corporate documents (Lindquist, 1956, p.420). This right is grounded in the common law. The scope of documents that can be inspected is not limited, which means all corporate books and records can be inspected. The regulation of the reviewed transition countries does not provide for explicit provisions in this respect (Schramm, 2007). It is therefore not clear if a single board member has the right to conduct independent inspection in the three transition economies.

[136] JSC Law, Russia - §§ 89, 91
[137] AkG, Germany - §90.
[138] AkG, Germany - §111(2).
[139] AkG, Germany - §111(2).

d. Blocking Shares Prior to the Meeting

Jurisdictions which allow the issue of bearer shares practice the requirement of blocking these shares prior to the meeting, so that the owner may not sell them a few days before the general meeting (Braendle, 2006). The reason is to avoid the exercising of the voting right of one share for several times (Wohlwend, 2001, p.96). In contrast, those countries which allow only for registered shares do not need the blocking provisions. La Porta et al. (1998) included the blocking issue in their *Anti-Director Index,* which implies that countries which prohibit the blocking rule are better off than those which mandate the shares to be blocked. The negative side of the provision is reflected in reduced liquidity of shares prior to the meeting, which impedes the exit right of an investor. Investors attach importance to the possibility of selling and transferring shares at any time, should the operating price be unsatisfactory or should the share price decline (Baums and Schmitz, 1999).

The US law does not provide for blocking provisions because since 1991 American corporations offer only registered shares. In contrast, in Germany both bearer and registered shares are allowed and the German corporate law provides that articles of association may make attendance of the general meeting or exercise the right to vote conditional upon the shares being locked (deposited) by certain date prior to the meeting.[140] With the new directive of the EU this rule is going to expire in all EU countries at the latest by 2009.[141]

Most transition economies follow the practise established in the USA, allowing the circulation of registered shares only (Schramm, 2007, p.272). Among the three target countries only Uzbekistan provides the possibility to issue registered and bearer shares.[142] However, no requirement to block the shares prior to the meeting was found in Uzbek law.

e. Corporate Reporting and Disclosure

aa. Primary Market Disclosure

Apart from the inspection rights shareholders in different jurisdictions are vested with wide range of information rights that stipulate their decision making process both on the general meetings and outside of them. The agency costs arise due to the information

[140] AkG, Germany - §123.
[141] Directive of the European Parliament and of the Council on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market**,** June 2007.
[142] JSC Laws: Russia - §25(2); Kazakhstan - §12(1); Uzbekistan - §24.

asymmetry, when a (minority) shareholder poses less information than large shareholders or mangers. This problem can be solved if a good disclosure regulation is available. Transparent information policy plays a crucial role in corporate governance because, firstly, investors are provided with better information, based on which they make their decisions. Secondly, according to the available information contracts can be better examined and proved. The following sub-chapter will review the regulations with respect to disclosure standards and look through all possible sources of information available for investors.

The traditional method of obtaining information for shareholders is participation in the general meeting. However, the meeting alone is insufficient as a source of information because it usually takes place only once a year, the presented information reaches investors quite late and the participation is normally restricted to shareholders only (Baums, 2002, p.10). All these factors stipulated the evolvement of other disclosure practices. The requirement to disclose company related information can be generally classified as divided into primary market (*ex ante*) and secondary market (*ex post*) information.

The primary market information relates to the issuance of new shares through a public offer and aims to provide investors with sufficient material information, which will help investment decisions. The main source of information in this respect is a securities prospectus which must be disclosed in the course of the public offer.

According to the US regulation provisions with respect to the issuance of new shares are found in the Securities Act 1933. It makes it illegal to sell securities to the public unless they have been registered with the Securities and Exchange Commission (SEC).[143] In Germany the related issues are regulated since 01.07.2005 in the special law on Securities Prospectus (*WpG-Wertpapierprospektgesetz*). Also, the three transition economies provide rules on the issuance of new shares to the public in their capital market laws.[144] Here as well, prior to offering the securities to the public, the issuance must be registered by the financial supervisory authority.

As a rule shareholders make a decision to participate in public offering based on the information in the prospectus. Thus, any misguiding information in the prospectus or incompleteness of it, omitting the disclosure of substantial facts about corporate activity may considerably damage the position of shareholders. In this respect it is necessary to provide shareholders with sufficient protection by means of imposing the liability on parties that would be interested in dissemination of wrong information or omitting substantial facts. Due

[143] The Securities Act 1933, Section 5.
[144] The Laws on Securities Market: Russia - §19; Kazakhstan - §9; The law on securities and Stock Exchange, Uzbekistan-§11.

to the specifics of the US juridical system shareholders are vested with the widest range of rights to bring the suit against management. Incomplete and misguiding prospectus is not an exception and managers can be personally made liable for such misdeeds.[145] It is not required to show director's intent to defraud (Ripin and Winker, 2006, p.95). In contrast, German law defines a corporation as subject to liability for defect information in the prospectus, whereas the liability of members of the governing organ is permissible only when they had personal interests of disclosing defect information (Schmitz, 2004, p.327). Similarly to the German regulation with respect to this issue the Russian Law defines parties that have signed the prospectus (an executive director, auditor, independent evaluator) as liable if the fact of their guilt is stated.[146] In Uzbekistan the law qualifies only a corporation as liable for the defect prospectus.[147] Kazakhstan gives only general statement providing that parties who have violated the law on the securities market are liable according to the laws of the republic.[148]

After an initial subscription of shares the information of an investor still needs to be satisfied assuming that they will make a decision whether to hold shares, sell them or buy more. Also a potential shareholder will require such information in order to make a decision about share purchase. Baums (2002) refers to such type of disclosure as 'secondary market information'. This disclosure category can be schematically classified into: (a) annual, (b) interim and (c) current (*ad-hoc*) reports.

bb. Secondary Market Disclosure: *Annual Report*

The requirement to prepare an annual report belongs to fundamental disclosure elements on the secondary securities market. It provides investors with aggregated annual information. According to the US Securities and Exchange Act 1934 corporations whose shares are registered by the SEC should prepare annual reports and file them within 90 days after the end of the fiscal year.[149] The report is based on the *Form 10-K*, which lists all required information to be included in the report.[150]

In Germany annual reporting rules are coded in the Commercial Code (*Handelsegesetzbuch*).[151] Noteworthy is that Germany has long history of consolidated

---

[145] Securities Act - §§11, 12; Rule 10b-5.
[146] The Law on Securities Market: Russia - §22.1(3).
[147] The Law on Securities and Stock Exchange, Uzbekistan - §11; The Law on mechanism of functioning of securities marker - §31.
[148] The Law on Securities Market, Kazakhstan - §113.
[149] Securities and Exchange Act 1934 - §13(a)(2).
[150] All Forms discussed in this chapter (Form 10-K; Form 8-K; Form 10-Q) are available on the official web page of the SEC.
[151] HGB, Germany - §§242, §264.

financial statements *(Konzernabschlüss)* that corporate groups must prepare.[152] Such consolidated statements present an aggregated look at the financial situation of a parent company and its subsidiaries, thus enabling investors to evaluate the overall health of the whole group of companies as opposed to a single company's separate position. Since 2005 all listed companies of the European Union should prepare consolidated financial statements using international accounting standards (IFRS); accordingly control is presumed when a parent acquires more than a half of the voting rights of an enterprise or there is an agreement to govern another enterprise.[153] In contrast, the US GAAP do not define control, focusing instead on the ownership of a majority voting interest.[154] It is likely that more entities will be subject to the preparation of consolidated statements upon IFRS than those subject to the US standards.

The corporate laws in all the three transition economies mandate the disclosure of annual reports and financial statements. Regulation of this aspect can be extracted from various legal sources. Firstly, the corporate law of the three countries comprise provisions in respect to disclosure of annual statements.[155] Kazakhstan and the Uzbek corporate groups are required to prepare consolidated financial statements, whereas no similar provisions were found in Russia.[156] Consolidated statements are mandatory in Russia only for financial industrial groups.[157] This regulatory gap in Russia can be substituted by listing requirements. It is likely that Russian companies listed in the category 'A' will prepare consolidated statements, as according to the listing rules they must report either using the IAS or the US GAAP.[158] Furthermore, the practice of disclosure in the Russian corporations has been undergoing considerable improvements in the last few years. Thus, the Decree of the Financial Market Supervisor on the 'Information Disclosure by Issuer' mandates corporations that make public offer of shares to prepare annual statements either according to the IFRS or US GAAP.

[152] HGB, Germany - §§ 290-315.
[153] IAS 27.13.
[154] SEC Concept Release: International Accounting Standards, Securities and Exchange Commission, Release NOS. 33-7801, 34-42430, International Series No.125, http://www.sec.gov/rules/concept/34-42430.htm.
[155] JSC Laws: Russia - §92; Kazakhstan -§76; Uzbekistan - §108, The law on functioning of securities market, Uzbekistan -§26.
[156] The laws on accounting: Kazakhstan - §17; Uzbekistan - §17.
[157] Decree on consolidated financial statements of the Industrial-Financial Groups (IFG).
[158] RTS Listing Rules 5.1.10 and 5.2.10.

cc. Secondary Market Disclosure: *Interim Report*

Annual reports are not sufficient to provide investors with continuous informative support either. In order to stipulate higher market liquidity and strengthen investors' trust in the market legislators mandate more frequent reporting. Thus, pursuant to the Securities and Exchange Act 1934 registered companies should prepare quarterly reports according to the *Form 10*-Q and file them with the SEC. If the company is listed on one of the national stock exchanges it should also file reports with the exchange.[159] The German law on Stock Exchange requires that listed companies must prepare at least one interim report, quarterly reports are made voluntarily.[160] Companies listed on the Frankfurt Stock Exchange under the category '*Prime Standard*'[161] must also prepare quarterly reports not later than 60 days after the end of the period.[162] Russian regulation resembles that of the US. In case the issue prospectus is registered by the Financial Supervisory Authority a company should publish quarterly reports.[163] Listing rules of RTS require that companies listed under the category 'A' and 'B' file quarterly reports with the Stock Exchange.[164] In Kazakhstan only listed companies are required to provide stock exchange with quarterly reports.[165] In contrast, no interim report requirements are found in Uzbekistan.

dd. Secondary Market Disclosure: *Current Report* (*ad-hoc*)

Apart from periodic publication of annual, semi-annual or quarterly reports on the secondary market, some special irregular events in the corporate life can be of significant relevance for investors' investment or divestment decisions. A list of substantial events is long and to name only few of them would include: changes in control structure, purchase or sale of large assets, insolvency application, resignation of the director, etc. The task of an *ad-hoc* publication is to complement regular publications (annual, interim reports) and prevent insider trading (Assman and Schneider, 2006, p.500).

[159] The Law on Securities and Exchange 1934 - §13(a)(2).
[160] BörsG, Germany - §40.
[161] "*Prime Standard*" is the highest listing standard on the Frankfurt Stock Exchange. Other available standards: "*General Standard*", "*Entry Standard*", "*Open Market*".
[162] See the listing rules of the Frankfurt Stock Exchange on the official web page http://deutsche-boerse.com.
[163] The Law on Securities Market, Russia - §30, See also Decree of the Financial Supervisory Authority on Information Disclosure by the issuers of securities, Chapter V.
[164] Listing rules of the RTS – Section 5.1.9 and 5.3.8.
[165] Listing rules of Kazakh Stock Exchange: Chapter 2, Section 25(1).

The US corporations the shares of which are registered by the SEC must publish a current report.[166] Publication should be made in compliance with the *Form 8-K*, which provides the catalogue of all significant corporate events that must be immediately disclosed after their occurrence. Apart from disclosure requirements in the book US courts have also developed additional disclosure duties pursuant to the Rule 10b-5. These are: (1) duty to speak completely, (2) duty to update, (3) duty to correct and (4) fiduciary duties (Sauer, 2004, p.111). Moreover, listing rules of stock exchanges mandate the *ad-hoc* publication.[167]

The German law also mandates the disclosure of substantial facts that can affect the equity price.[168] An a*d-hoc* publication in Germany not only complements periodic publication requirements, but also acts as a preventive mechanism against insider trading (Schmitz, p.171). In opposite to the US regulation, the German law does not provide for a catalogue of all significant events that must be disclosed (Sauer, 2004, p.110).

Among the three transition economies Russian regulation has the most advanced provisions in respect to the *ad-hoc* publication. The capital market law and a special decree on information disclosure by securities issuers provide a list of substantial facts that are to be published.[169] In addition, companies listed on the RTS under the category 'A' should also disclose information on substantial facts.[170] Apart from disclosure of substantial facts, the decree of the Financial Supervisory Authority also provides a list of facts that may affect stock prices and must be disclosed.[171]

The Kazakh law on securities markets requires disclosure of any changes in the activity of the issuers that concerns the interest of shareholders.[172] Such changes comprise alteration in governing organs, change among shareholders who owe 10% stake and higher, reorganization and liquidation of the issuers and its subsidiaries, receipt of the license, the decision of the general shareholder meeting, changes in the list of organizations in which an issuer obtains the stake. The issuer should disclose the above mentioned information within 15 days after occurrence of such change.

Such long timelines of disclosure contradict the world practice according to which *ad-hoc* information must be disclosed within the first few days. Timelines standards that are closer to the world regulation are available according to the listing rules of the Kazakh Stock

[166] The Securities and Exchange Act - §13(a)(1).
[167] See for example NYSE §§201.00ff.
[168] WpHG, Germany - §15.
[169] The law on securities market, Russia - §30; Decree of the Financial Supervisory Authority on "Information disclosure by the securities issuers – Chapter VI.
[170] Listing rules of RTS - Section 5.1.9.
[171] Decree of the Financial Supervisory Authority on "Information disclosure by the securities issuers – Chapter 8.6.
[172] The Law on Securities Markets, Kazakhstan - §102.

Exchange.[173] The issuer should notify the Stock Exchange about any information that may have an impact on the stock prices or may concern the interests of the shareholders within the first three days. It can be also assumed that in Kazakhstan an *ad-hoc* publication is prescribed by the JSC Law as well. In fact, Schramm (2007) assumes that through §79 of the JSC Law the legislator tries to regulate the *ad-hoc* publication. Although this article states that a company should notify shareholders about the facts that concern their interests, no detailed information on timelines of publication is given. Therefore, it can be also read from this article that information may be disclosed not in a form of current report but rather by means of inclusion in the quarterly or annual reports. We consider that importance of *ad-hoc* information lies in short publication timelines (max. 3 days after the occurrence of the fact) and the noted article may not be observed as an *ad-hoc* provision without the specification of timelines. In contrast to Russia and Kazakhstan, the Uzbek regulator does not provide provisions applicable to the ad-hoc publication.

Like in the case of executive directors' liability for failures during the primary market disclosure, the liability of German directors for false information in the secondary market disclosure is rather restricted in comparison to the liability of the US directors. The liability of executive officers in Germany for false information in annual financial statements is restricted to the cases of deliberate actions, which in comparison to the US regulation seems to be doubtful as an instrument of shareholder protection (Schmitz, 2004, p.164). Although the Russian and Uzbek laws define the liability of executive directors for the correctness and completeness of disclosed data, empirical evidence[174] does not provide for sufficient indication of the effectiveness of such a mechanism for shareholder protection.[175]

Although mandatory disclosure contributes to the creation of transparency frameworks in a country, its effect may be decreased if the users of information face hindrances to the access of reports. Such typical barriers are high costs of purchasing the information or its limited circulation. Nowadays, technological development and application of the Internet may help to considerably improve the access to corporate reports. In fact, many countries already use the Internet as the main platform of disclosure. For example, since 1996 in the USA reports are filed solely in the electronic form through the EDGAR-System (*Electronic Data Gathering, Analysis and Retrieval*). Every person can access it through the Internet

[173] Listing Rules of Kazakh Stock Exchange: Chapter 2, Section 27.
[174] See for example Knieper 2003, Schramm 2007.
[175] JSC Laws: Russia - §88(2); Uzbekistan - §105; The laws on accounting: Russia -§18, Uzbekistan -§24; The law on Securities Market: Russia - §30; Decree of the Financial Supervisory Authority on Information Disclosure by the issuers of securities: Russia- Chapter V, Paragraph 5.4.

anytime at no costs.[176] A similar concept was launched in Germany under the name DGAP (*Deutsche Gesellschaft für Ad-Hoc Publizität*), according to which listed companies disclose through the Internet their regular and current reports, important corporate news, director's dealings, etc.[177] Like in the USA, the access here is possible at any time and no costs for the users. The practice in transition economies deviated from the Western countries in terms of the source of information; the main disclosure platform there is created on the official web pages of the stock exchanges. For example, in Kazakhstan all necessary information on listed companies can be found on the web page of the Kazakh Stock Exchange (KASE) and in Russia on the Web page of the Russian Trading System (RTS).[178] Some other web pages on the disclosure of corporate information are available in Russia, however they charge user fees, which is a considerable obstacle for small investors. Uzbekistan represents an exception in this case as well, as no open sources of corporate reporting were found on the Internet.

ee. Financial Reporting and Accounting Principles

Along with the extent of disclosure an important aspect of good governance is the quality of financial reporting or the standards of accounting. To assure investors about the potential economic perspectives companies need to report using credible accounting standards that allow for no or little data concealment.

Some transition economies realized this means to enhance their financial systems, and the way to overcome the lack of credibility on the side of investors is to adopt internationally recognized accounting principles. More transparent financial statements obtained by the introduction of international standards ensure numerous advantages. First, companies in transition economies can be listed on the world biggest stock exchanges provided that they implemented one of the leading accounting standards. Second, common standards allow comparing financial statements throughout the countries. Global institutional investors are interested in diversification of their portfolio and may invest in shares of companies from transition economies and for this they need comparable reporting standards. Another advantage of the international standards is that reporting is prepared for different target groups (stockholders). In their early stages of evolving the main purpose of national accounting standards in transition economies was to provide information for tax authorities. Nowadays, the trend is changing, so that the tax authorities are no more the only readers of

[176] USA - http://www.sec.gov/edgar.shtml.
[177] Germany - www.dgap.de.
[178] Kazakhstan - www.kase.kz; Russia - www.rts.ru.

financial statements. Especially big companies prepare qualified reports in order to get access to international capital markets.[179]

Consideration of the adoption of international accounting standards is interrelated with better credibility of investors; it can be hypothetically assumed that switching to better accounting standards leads to increased capital flow into the country. In fact, an empirical research by Preobragenskaya and McGee found relationship between the IAS and foreign direct investment (FDI) in Russia (2003). The main result was that the lack of credibility of Russian financial statements was impeding the inflow of foreign capital. The following sections will give an overview of the situation in the transition economies with respect to the actual accounting standards used.

a.a.a Russia

Since 1998 the government of Russia has been implementing a program to harmonize national accounting standards with the IFRS. It is being conducted in two directions: on the one hand, the efforts are made to align the Russian accounting practices with the IFRS. For this purpose the Ministry of Finance has issued twenty accounting rules which in many parameters resemble the IFRS principles. Nevertheless, the Russian Accounting Rules (RAR) are not yet in line with the International Financial Reporting Standards.[180] On the other hand, for some concrete organizations direct implementation of international standards is considered. Since 2004 all commercial banks are mandated to file their statements in accordance with both the national accounting standards and the IFRS.[181] Additionally, there is a law in the project on mandatory filing of consolidated financial reports in accordance with the International Accounting Standards. Currently, there is no normative act that mandates reporting of consolidated financial statements for holdings and company groups.[182]

For some companies oriented at capital market it is also mandatory to report in accordance with the international standards. Joint Stock Companies listed on the Russian Stock Exchange (RTS) under the category ‘A’ shall keep their audited annual financial records in compliance with the International Accounting Standards (IFRS) and (or) the US Generally Accepted Accounting Principles (US-GAAP).[183]

---

[179] For more reasons why IAS should be introduced in transition economies see argumentation of Preobragenskaya and McGee (2003) based on the example of Russia.
[180] For more about the problem in Russian standards see PWC” PriceWaterhouseCoopers, 2006, p20
[181] Information from the official web page of Deloitte www.deloitte.ru
[182] From the Interview of Alexandr Bakaev, the head of the department of methodology of accounting and reporting, Ministry of Finance, http://www1.minfin.ru/buh/int160107bakaev.pdf (Stand, January 2007)
[183] Listing Rules on RTS. See Section 5.1.10 and 5.2.10

To conclude, it is evident that Russia has taken a direct course on the implementation of the international accounting standards and adjustment of the national principles to the IFRS. However, forecasts say that a complete transformation to the international standards may not take place earlier than 2010.[184]

b.b.b Kazakhstan

Kazakhstan was among the first CIS countries to promulgate accounting standards with the initiation of a policy of developing the National Accounting Standards (1995) oriented at the International Accounting Standards (World Bank, 2007). The accounting law introduced in 1995 has since been amended for several times. Prior to a recent amendment, the law obliged all financial organizations to launch reporting in accordance with the IFRS since January 2003, Joint-Stock Companies since January 2005 and other organizations since 2006. However, only after the enactment of the recent amendment of February 28, 2007 the terms and conditions for implementation of the IFRS became more realistic, as compared with the previous plans. Thus, amendments introduced three pillars of the reporting system; micro-enterprises would report as based on simplified tax-based rules, small and medium-sized companies would be required to apply the national accounting standards, and the third pillar mandates reporting according to the IFRS for large companies, financial institutions and companies with state participation. Joint Stock Companies listed on the Kazakh Stock Exchange (KASE) under the highest listing category (A) are required to prepare their financial statements in accordance with the IFRS. Companies listed under the lower category (B) may choose to prepare reports either in accordance with the IFRS or the Kazakh Accounting Standards (KAS).[185] The work is also being carried out with the national accounting standards; like in Russia, the national accounting standards are being adjusted to the IFRS. Today, the Ministry of Finance has issued 31 standards of accounting.[186] Though such concrete targets have been established, it is doubtful whether selected terms are realistic and can be fulfilled according to a fixed plan.

---

184 From the Interview of Alexandr Bakaev, the head of the department of methodology of accounting and reporting, Ministry of Finance, http://www1.minfin.ru/buh/int160107bakaev.pdf (Stand, January 2007)
185 Appendix III of the Listing Rules of Kazakhstan Stock Exchange ()
186 The data obtained from the official web page of the Ministry of Finance of the Republic of Kazakhstan. http://www.minfin.kz/index.php?uin=1133955383&lang=rus (Stand August 2007)

c.c.c Uzbekistan

Uzbekistan's accounting and auditing reform progress has been relatively slower than that of Russia and Kazakhstan. Accounting in Uzbekistan is regulated by the Law 'On Accounting' N 379-I of 30.08.96. The National Standards of Accounting are adopted by the Order of the Ministry of Finance N 103 of 09.09.02. The accounting laws mandate companies to follow the national standards rather than the IFRS or the ISA. The international accounting standards can be applied in practice, but in addition to the National Standards. Only banks started reporting according to the IFRS, but still not all of them (CER, 2006). According to the answers provided to the OECD questionnaire by national specialists local accounting standards are too complicated and hard to read for non-professionals, which gives additional reasons for reforming the national standards and gradual integration of the international accounting standards.[187]

2.2.2 Rights on the General Meeting

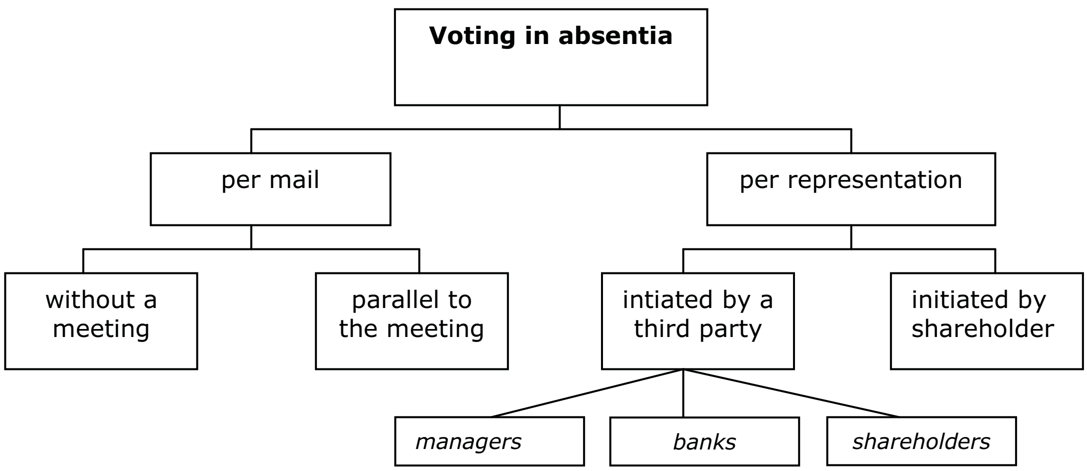
An important aspect of safeguarding shareholders' interests is connected with procedural rights on the general meeting; to be more specific, provisions that facilitate easy voting options and high quorum requirements. The former aspect considers the rights of shareholders to submit the vote without high costs involved. Thus, for example, the options to vote by mail or through a representative (proxy) are essential when participation in person is either time consuming, costly or simply inconvenient. The latter procedure provides rules that make it difficult for management or a large shareholder to conduct the meeting and accept a resolution with a tiny ratio of participants. The higher the quorum requirement for the general meeting, the lower is the probability that a decision opposed by multiple shareholders will be accepted. The actual voting rules have already been discussed in the chapter on the appointment rights strategy and that is why solely the voting mechanisms will be introduced here.

[187] OECD, Transparency and Disclosure Questionnaire, answered by Ilkham Azizov, 2003

a. Voting in Absentia

Participation in the decision making process is one of the pillars of shareholder rights, and therefore must be facilitated in every corporate governance system. The OECD principles of corporate governance emphasize the importance of taking part in the voting either in person or in absentia.[188] Especially important is the right of voting in absentia, either through mail or by proxy. A minority shareholder is often negligent towards the general meeting because the costs of participation are often higher than expected benefits. Therefore, the possibility to vote in absentia can provide incentives for small stockholder. It can take the form of mail voting or through a representative. However, the possibility to vote in absentia may by itself not be sufficient, as some small shareholders may still be reluctant to participate. In such circumstances a regulator may look for supplementary mechanisms that encourage the participation of shareholders in the voting process. In fact, some countries introduced mechanisms which foster third parties to pool the votes of shareholders, so that they do not need to initiate participation themselves. In practice the role of a third party can be taken by management, banks, shareholder associations, brokers, etc. Schematically forms of voting in absentia can be shown as depicted in Figure 8.

Figure 8: Forms of Voting in Absentia



Source: Own Depiction

In American widely dispersed corporations only a very tiny fraction of shareholders directly participate in a shareholders' meeting. As a rule, voting is stipulated through the

[188] OECD Principles of Corporate Governance, II.C.4 .

representation of managers, known as proxy voting (Merkt and Göthel, 2006). Managers send proxy cards to shareholders with a request to vote on proposed issues or simply to authorise them to vote on the issues. The US system favours representation by managers as the costs of proxy solicitation are covered by corporations. A third party, for example a shareholder, can also apply to other shareholders with a request to represent their votes. However, in such case all costs of solicitation are to be borne by the shareholder himself, which considerably reduces his willingness to file the proxy.

The German law provides shareholders with several opportunities of voting in absentia (Wirth et al, 2004, p. 131). Any party without restriction can be authorised to represent the votes, including a member of management and supervisory boards, and shareholder associations. In order to ease shareholder participation and reduce costs, the law allows shareholders to give representation rights to banks which hold their shares. A bank can exercise voting rights for deposited shares only if proxy has been granted to it.[189] Thus, German shareholders have also simplified way of taking part in the general meeting.

The regulation in transition economies with respect to voting in absentia is to great extent uniform. Shareholders can participate in the voting either directly or through their representatives.[190] Generally, any party can take the function of the representative. Only Kazakhstan restricts the possibility of representation, banning executive managers from undertaking these functions. Although shareholders in the transition economies are not vested with proxy rights of the American type, if a corporation initiates the representation of votes and encourages a shareholder to submit them to management or vote on their proposal, they still have the right to vote by mail. Voting by mail can be undertaken either as a sole voting option or parallel to the general meeting. The Russian and Kazakh corporate laws provide the opportunity for both types of voting through mail.[191] In contrast, the Uzbek law restricts the rights of shareholders' voting in absentia, allowing only closed joint stock corporations to conduct mail voting without physical meeting being held.[192]

b. Quorum Requirements

Shareholders could be considerably disadvantaged if the general meeting was conducted with only a tiny fraction of shareholders being represented. Thus, managers or large shareholders could have an opportunity to hamper the access to the meeting and conduct it

[189] AkG, Germany - §135 (1).
[190] JSC Laws: Russia - §57; Kazakhstan - §47; Uzbekistan - § 74.
[191] JSC Laws: Russia - § 60; Kazakhstan - §49.
[192] JSC Law, Uzbekistan - §67.

according to their own interests. In order to escape such crude violation of shareholder rights most jurisdictions prescribe a minimal quorum threshold which ensures the participation of at least shareholder majority.

According to the Russian and Kazakh JSC Laws the general meeting can be eligible only if at least owners of simple majority of shares take part in the meeting.[193] Uzbekistan imposes a higher quorum requirement of 60%.[194] If the quorum is not achieved, in order to ease the organisation aspects the regulation may require a lower quorum threshold for the repeated general meeting. In fact, Russia allows the quorum of 30% and in companies with more than 500 shareholders the articles of association can prescribe even lower quorum requirements.[195] In Kazakhstan the quorum of the repeated meeting can be reduced to 40% and for companies with over 10.000 shareholders it can even be reduced to less than 15%.[196] In this respect it remains unclear why the legislator in Uzbekistan keeps the quorum of the second meeting as high as that of the first one.[197] As a rule, most American statutes define the quorum as the simple majority of outstanding shares, whereas no particular differentiation in this respect is done between an ordinary and extraordinary meeting. In Delaware the quorum can be reduced to 1/3 of the outstanding shares.[198] In contrast with the reviewed countries, the German law does not provide for a particular quantitative threshold for the quorum. Instead, it is defined by the corporate articles of association (Wirth et al., 2004).

2.2.3 Actions to Set a Resolution Aside

Decisions taken on the general meeting may have far reaching effects on a corporation. It is therefore important that corporate law vests (minority) shareholders with rights to put a claim against decisions taken on the general meeting which violate laws, provisions in corporate articles or private interests of particular shareholders. In this section the way five jurisdictions regulate the aspect of setting a resolution aside will be reviewed.

In Germany shareholders have the right to launch action to set aside the resolution which violates the law or articles of association.[199] In order to be able to set the resolution aside a shareholder should either raise objection to the resolution on the general meeting or be absent on meeting if the meeting was not properly convened, or the subject matter of the

[193] JSC Laws: Russia -§58; Kazakhstan - §45.
[194] JSC Law: Uzbekistan - §75.
[195] JSC Law: Russia- §59.
[196] JSC Law: Kazakhstan - §45.
[197] JSC Law Uzbekistan - §75.
[198] Delaware - §216.
[199] AkG: Germany - §243.

resolution was not properly announced.[200] The action must be taken by the shareholder within one month after such a resolution has been adopted.[201] No similar provisions which allow shareholders to appeal resolutions made at the annual meeting can be found in the US law.[202]

Among the transition economies Russia and Uzbekistan provide shareholders with the right to claim against a resolution, however the quality of provisions differs substantially between the two countries. In Russia a shareholder can appeal to the court a decision of the meeting which was adopted in violation of the JSC Law, other legal acts of the Russian Federation or the company's charter. The right to appeal is available if the shareholder did not vote or voted against the resolution, and when it violates his rights.[203] In Uzbekistan the law tries to give similar claiming rights to shareholders, however because of missing clarification the law is misguiding. A shareholder in Uzbekistan can claim against a resolution if he did not participate in the general meeting or if he voted against it.[204] This is quite a general rule and some specification is required. For example, it is not clear whether the shareholder can claim against the resolution in any case of his absence in the meeting or only when the general meeting was conducted with violation of the law, e.g. the meeting was not properly convened, which led to non-participation of the shareholder. Neither does the Uzbek law specify whether simple voting against a resolution empowers a shareholder to claim or the shareholder is eligible to claim only if his rights are violated. It is logical and advisable that such right is granted to the shareholder only when the accepted resolution violates his rights. The Kazakh law is even more laconic with respect to claims against a decision.[205] The law only states that shareholders have such a right, but no further clarification of details is available, which may represent a problem for concerned parties.

3. The Third Agency Problem: Shareholders vs. Stakeholders

Theoretically any non-shareholder constituency can be protected by the board representation, but in practice only employees are protected directly by the law. Employee representation can be observed mainly in European countries. The only EU countries that have not introduced any form of worker representation on the board are Portugal, Belgium, Italy and the UK (Hansmann and Kraakman, 2004, p.61).

[200] AkG: Germany - §245.
[201] AkG: Germany - §246.
[202] See, Braendle (2006), Schramm (2007).
[203] JSC Law: Russia - § 49(7).
[204] JSC Law: Uzbekistan - §66.
[205] JSC Law: Kazakhstan - §14(6).

The German system is a typical corporate governance system, where employees have legally prescribed representation in governance structure of publicly held companies. It is regulated by three statutes for different sectors of the economy and company sizes. The pioneer law was Montan-Mitbestimmungsgesetz of 1951 which provides for co-determination rules in the coal, iron and steel industries. For companies in other industries with the number of employees from 500 to 2000 the Works Constitution Act of 1952 (Betriebsverfassungsgesetz) prescribes one-third of employee representation on the supervisory board. Finally, the Co-Determination Act (Mitbestimmungsgesetz) of 1976 covers companies with over 2000 employees, for which it is mandatory to have 'quasi-parity' on the board – half of the board must consist of employee representation. This structure is called 'quasi' because a chairman of the board, who usually represents shareholders, has a double vote right, thus in case when decisions of the board are blocked by board parity between employees and shareholders, the chairman casts a second deciding vote. The chairman of the board is elected by two-third majority of the board. If the majority cannot be obtained, shareholders elect the chairman. Nevertheless, the rights and functions of employee representatives should not be underestimated because of their veto power over the appointment of the management board. The election of the management board requires two-third majority of the supervisory board, which gives a veto to employee representatives.

The US statute do not explicitly protect employees, however none of the state prohibits employee participation on a board of directors. Similarly, the JSC Laws in transition economies do not directly mention an employee's right to be represented on a supervisory board, but they also do not ban their representation (except Uzbekistan). A member of the supervisory board can be an elected person who is not the shareholder, and who was not proposed to the board as the one who represents the interests of shareholders. Nevertheless their maximal number in Kazakhstan is restricted to one half of the whole board.[206] Russian statute is more discrete while expressing the employee representation; it only mentions that members of the board can be non-shareholders.[207]

4. Results

The legal approach in the transition economies is in most cases similar to the major jurisdictions observed in this chapter – the USA and Germany. With respect to the gross structure of a board the three countries chose the two-tier system, although only in Uzbekistan

[206] JSC Law: Kazakhstan - § 54(3).
[207] JSC Law: Russia - § 66(2); Labour Code, Russian - § 53.

the two-tier board can be compared with German boards. In Russia and Kazakhstan the board represents the mixture between the American and German board structure, where despite of the two-tier structure executive directors can also reside on the supervisory board. None of the transition economies utilizes German legal approach with respect to protection of employee rights by mandating their representation on the board, although the JSC laws do not prohibit their representation. Also with respect to the elements that define the board structure such as size, representation of independent directors, availability of committees there are many differences between the three post-soviet countries whose approaches represent amalgamation of the American and German laws.

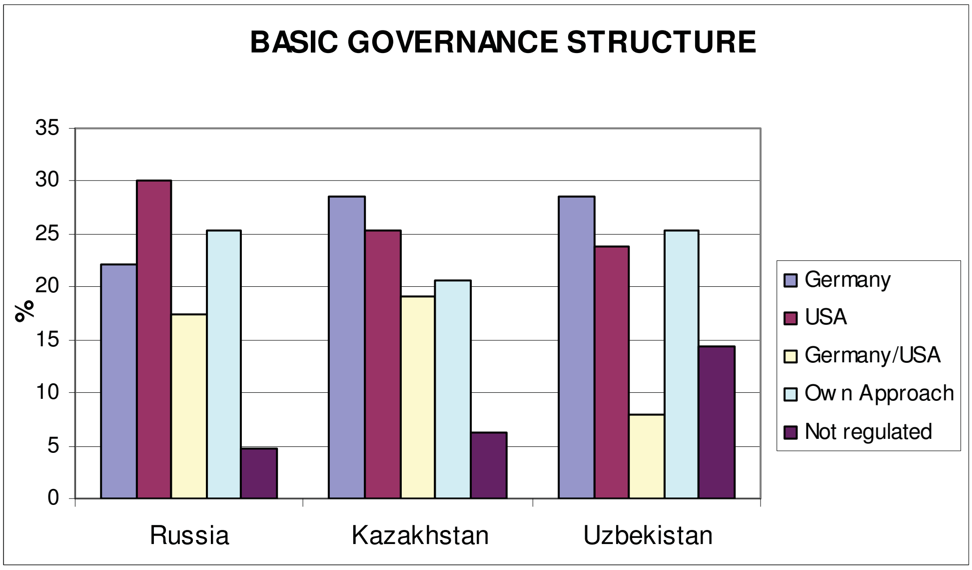
The transition laws consider the appointment rights of minority shareholders allowing for cumulative voting. Nevertheless, some problems still hinder the effectiveness of this provision, e.g. the Uzbek law fails to give an adequate definition of the cumulative voting, whereas the absence of supplementary provisions in Kazakhstan nullifies the effect of the cumulative voting. The rule 'one share-one vote' is also available and it is mandatory in all cases. Additionally, shareholders in all the three economies are vested with more easy to remove rights than their counterparts in the USA and Germany, as both the term on the board is short and the required majority threshold to remove directors is small.

In terms of participation rights of shareholders both prior and during the general meeting the German regulation provides for better protection and controlling powers than the American one. On the scale of shareholder power the three transition jurisdictions can be located between the USA and Germany. Law gives better participation rights in the transition economies than in the USA, however not as extensive as in Germany. In contrast, the US law being capital-market-oriented fosters better transparency, investigation of corporate books and enforcement in the court. In the German law these issues, though having been considerably improved recently, are still behind the US regulation in terms of their extensiveness. Perhaps the most troublesome aspect is the ability of shareholders to enforce their rights in the court. The problem lies in the codification of rights, poor definition of liabilities and weak position of enforcement institutions. The situation is better with the information rights; the disclosure requirements in Russia and Kazakhstan according to their extent and depths have reached the standards of the developed countries.

Finally, the comparative analyses of corporate law elements regarding the basic governance structure can be depicted on a scale (S*ee Figure 9*). The legal approach in transition economies will be compared with the approaches in Germany and the USA. In order to present the comparative analyses in a graphic form the 63 elements of law have been distinguished, which at best target the agency cost reduction with regard to the basic governance structure (See: Appendix II). These elements are compared with those in Germany and the USA. If a particular element is found either in the German or the US law (Delaware), it is included in one of these groups. Those elements of transition laws which can be found both in the USA and the German statutes are summarized in the group 'Germany/USA'. In case the particular issue is not available in the regulation of the transition economies it is placed in the category 'not regulated', or if provisions are different than those in Germany and USA, they are marked in the category 'own approach'.

The figure shows that the Russian law has more elements of the American law (30%) than of the German law (22%). In contrast, in Kazakhstan and Uzbekistan the German law prevails, however with only a tiny majority over the US provisions. It is noteworthy that 25% of all provision in Russia and Uzbekistan and 21% in Kazakhstan belong to the category 'own approach', which means that on some particular issues the three countries apply other elements in the law that differ from those in Germany and the USA. With respect to the issues that are not regulated by the law the leading position is held by Uzbekistan – with 14% of unregulated aspects. In contrast, in Russia and Kazakhstan this category is relatively small reaching 5% and 6% respectively.

Figure 9: Basic Governance Structure



Source: Own Depiction.

Note: The figure illustrates quantitative results of law comparison (See Appendix II, Table 1 and Table 2).

B. Significant Corporate Actions

As it has been mentioned above, making a decision about daily corporate policy by multiple corporate owners (shareholders) is hardly possible due to high transaction costs caused by the necessity to instruct shareholders, communicate with them and decide on the matter. On the other hand, shareholders with small stakes are not willing to participate in active management, as the costs of the participation are as a rule higher than an economic result of such involvement. These are the reasons why day to day business is delegated to professional management body and not fulfilled by shareholders themselves. Commonly, in order to provide for effective management, the authority of directors is rarely limited across jurisdictions. Nevertheless, there are some corporate actions in course of which the decision making power of directors is restricted by means of transferring the decision rights exclusively to shareholders or entitling the latter with the approval power.

What are the criteria of such transactions? Kraakman et al. (2004) determined three criteria on which such transactions can be distinguished from daily corporate agenda. Transactions must: (1) be large relative to the value of the company; (2) require broad investment-like judgements that shareholders are arguably equipped to make; and (3) bear potential conflict of interests for directors. Therefore, shareholders must approve all significant corporate actions that are large, investment like and bear potential conflict for self-interested behaviour of managers. The list of such transactions includes: organic changes and mergers, sales of major corporate assets and alteration of capital. In the following sections the way laws in the countries under consideration regulate the above mentioned transactions will be analysed, and the protection of group interests will be scrutinized.

1. The First Agency Problem: Managers vs. Shareholders

1.1 Mergers and Consolidations

Mergers and consolidations are significant corporate actions and they are being handled in all major jurisdictions. Before coming to the actual regulation it is necessary to give clear definitions. The problem of understanding of translated terminology may lead to misinterpretations. The English language literature gives definitions as follows: "*A merger is a combination of two or more corporations in which one of the constituent parties survives. In a consolidation, two or more corporations combine to form a new corporation"* (Bainbridge, 2002, p.623). From the corporate law perspective the distinction between the two definitions is semantic. Company laws of the transition economies apply the same terminology, however with reverse definitions. What in the USA is defined as *merger*, in transition laws is called *consolidation*, and the US form of consolidation is equal with transition economies' merger (Black, et al., 1998, p.174). To omit misinterpretations, in the following sections the definition according to the US law will be used.

In order to safeguard shareholders' rights most jurisdictions provide that merger and consolidation are approved by supermajority[208] of voting shares (Rock et al., 2004, p.134). The German corporate law requires 75% of votes participating on shareholders' meeting to approve a merger, although even higher threshold can be estimated.[209] In the USA under the Delaware State a simple majority of outstanding shares is required to decide on such transactions.[210]

However, shareholders' approval is not compulsory for all mergers and consolidations. In cases when the acquiring company is considerably bigger than the targeted one shareholders' approval is not required, as long as the merger does not alter the surviving corporation's charter (Rock et al., 2004, p.135). In Germany if 90% of capital belongs to the surviving company shareholders' approval can be omitted.[211] In the USA (Delaware State) voting is not prescribed in cases when the amount of additional shares issued by the surviving corporation constitutes less than 20% of total new equity capital, or when the merger agreement does not amend the surviving corporation's articles of incorporation.[212]

Under some jurisdictions in order to strengthen the decision on the issue of a merger or consolidation an independent expertise of a third party is required. In Germany independent experts are to prepare a report about terms of a merger prior to shareholders' meeting. These experts are selected by the merging companies themselves.[213] In the USA companies assign an investment banker to prepare a report about fairness of the merger and submit to shareholders prior voting. The primary purpose of such independent evaluation is to prevent the decision from shareholder suits (Rock et al., 2004, p.135). The essential difference between the German and the US legal approaches lies in the way these transactions are regulated and screened. Germany relies heavily on legally prescribed *ex-ante* procedures for mergers to safeguard shareholders' decision rights, whereas the USA refers to the judiciary to screen them.

---

[208] Supermajority – 2/3 or 3/4 of votes; Simple majority - (50 % + 1 Vote).
[209] Restructuring Act, (Umwandlungsgesetz) Germany - § 50 (GmbH) and § 65 (AG).
[210] Delaware (DGCL) - §251 (c).
[211] Restructuring Act, (Umwandlungsgesetz), Germany - §62.
[212] DGCL - § 251(f).
[213] Restructuring Act (Umwandlungsgesetz), Germany - § 9.

In all the three transition economies under research the merger and consolidation transactions require approval of shareholders.[214] However, in opposite to Germany and the USA where some small transaction belong to the domain of the board, in the transition economies, regardless of size, all such kinds of transactions must be approved by shareholders. The selected countries differ in terms of required number of votes for approving the transaction on merger and consolidation. Similarly to the Delaware statute, the Kazakh statute prescribes the voting majority defined on bases of all outstanding shares, whereas the qualified majority of 75% is required, and not simple majority like in the USA.[215] In contrast, the Russian and Uzbek laws require only 75% of votes that take part in shareholders' meeting.[216]

None of the transition jurisdictions mandates the appointment of a third party to submit an expertise on a major organic change. However, the Russian Corporate Governance Code (RCGC) recommends an independent evaluator to be involved in the determination of the conversion value of stocks after reorganization is undertaken.[217]

Considering the merger and consolidation it is evident that the provisions differ slightly among transition economies but general frameworks of the legal approach resemble the US regulation, where no detailed legal prescriptions on most issues regarding mergers and consolidation exist but the judicial system is rather entitled to play a significant screening role. The present work does not evaluate however how well the judicial institutions in transition economies are prepared to offer efficient screening of transactions.

1.2 Corporate Divisions

Splitting one corporation's assets and liabilities into two or more surviving corporations is defined as *corporate division*. Thus, it represents an opposite transaction to a merger. Unlike mergers, corporate divisions are not heavily regulated. The US does not regulate divisions at all and the decision on them commonly belongs to the domain of the board of directors (Rock et al., 2004, p.136).

Major jurisdictions usually classify several forms of divisions. In the USA three main forms of division are known as: *spin-offs*, *split-offs*, and *split-ups*. '*In a spin-off a firm distributes shares in a subsidiary to its shareholders in a stock dividend. The spin-off splits a corporation into two distinct entities, each held by original shareholders of the parent. If the*

[214] JSC Laws: Russia - §48 (1); Kazakhstan - § 36 (1); Uzbekistan - § 65.
[215] JSC Law, Kazakhstan - §82.
[216] JSC Laws: Russia - §49 (4); Uzbekistan - § 66.
[217] Russian Corporate Governance Code - §3.2.

entire firm is broken up in a series of spin-offs, some call it a split-up. In a split-off a parent exchanges shares in a subsidiary for its own shares or other assets.' (Oesterle, 2002, p.6).

The German law differentiates between three types of division procedures: *Aufspaltung*, *Abspaltung* und *Ausgliederung*.[218] *Aufspaltung* is an inversion of a merger. In the English language literature it is translated as '*Corporate Division'*.[219] In order to escape confusions further in text the word *division* will be used as an umbrella definition for the three sub-types of a division, whereas *corporate division* will refer to a particular division type – *Aufspaltung*. According to the definition 'Corporate Division' stands for '*the separation of the assets and liabilities of one corporate entity and their transfer to two or more others* […] *It results in the termination of the transferring entity without liquidation*.' (Adolff et al., 2002, p.291). *Abspaltung* in the literature is also called *spin-off* and differs from the previous division type (Aufspaltung) in that the transferring entity survives. *Ausgliedetung* stands for vertical expansion, as a new subsidiary of the transferring entity, to which a part of the assets and liabilities of the entity are transferred, is created. In order to effect the corporate division shareholders must approve the contract or plan with 75% of votes participating on the meeting.

Although divisions are being closely regulated in Germany the reach of the regulation can be avoided. For instance, companies can sidestep a detailed division regulation by adopting alternative transactional forms (sale of assets for stock or cash), which does not underlie the division regulation (Rock et al., 2004, p.137). Nevertheless, it does not mean that German companies can avoid all restrictions on a corporate division. German boards can go so far only if they evade shareholders' voting requirements.

In terms of the typology and definition of divisions, the transition laws resemble the German legislation. There are two types of divisions distinguished: according to the first type, a single corporation is divided into two or more new companies, whereas the former stops existing,[220] which is similar to the German corporate division (*Auspaltung*). The second type encompasses divisions under which a single corporation is reorganized with creation of one or more new companies, whereas the former continues to exist.[221] This type can be compared with the German spin-off type (*Abspaltung*). In the three transition economies corporate divisions are categorised under reorganization transactions. That is why all regulations with respect to divisions are similar to a merger and consolidation. Division transactions can be approved only by shareholder's voting by supermajority rule. The Russian and Uzbek laws

[218] Restructuring Act (Umwandlungsgesetz), Germany - §1 and §123 – Aufspaltung, Abspaltung, Ausgliederung
[219] See Adolff et al.(2002), p.291.
[220] JSC Laws: Russia - §18; Uzbekistan - §98; Kazakhstan - §84.
[221] JSC Laws: Russia - §19; Uzbekistan - §99; Kazakhstan - §85.

mandate 75% of participating shares.[222] In Kazakhstan the qualified majority (75%) of all outstanding shares is a rule.[223]

In addition Russian and Kazakh laws foresee that all shares of a new company should be proportionately distributed among old shareholders, whereas the Russian law explicitly defines that shareholders who voted against such transaction or did not participate in voting are entitled with the right to exchange their current shareholding to shares of the new company.[224] Thus, the rights of shareholders in Russia are protected more strongly in comparison to Uzbekistan and Kazakhstan, which do not have such a provision.

To sum up, the statutes positions in the transition economies regarding different forms of divisions take a form of a mix between the US and German jurisdictions. On the one hand, they are not completely subject to judicial screening, on the other hand the regulation of divisions is not as detailed as in Germany.

1.3 Amendment of Articles of Association

Opportunistic as it may be, a change of the articles of association by directors may increase agency costs between mangers and shareholders. That is why in order to protect shareholders from an unilateral board decision to change corporate features most jurisdictions require shareholders to approve of a material amendment to the charter. Regulating these aspects, statutes require obligatory inclusion of certain important issues in the charter. The list of mandatory elements prescribed by the law usually consists of such elements as the statement of the number of authorized shares, their par value, the number of share classes, powers, rights, qualifications, and restrictions on these shares (Rock et al., 2004, p138).

The mandatory structure of articles differs among the main world jurisdictions in terms of two aspects: the board size and the statement on corporate subscribed capital. Some jurisdictions require the inclusion of the board's size in the articles, which implies that any changes with respect to board structure will require the approval of shareholders. In other jurisdictions the provision about the board size is included in by-laws rather than in articles, thus giving the board of directors themselves the power to decide on the structure of the board, rather than requiring shareholders to approve. The German law adheres to the former case. The articles of incorporation should specify the number of supervisory board seats if it is

[222] JSC Laws: Russia - §49 (4); Uzbekistan - §66.
[223] JSC Law, Kazakhstan - §36 (2).
[224] JSC Law, Russia - §18(3.3).

to comprise more than the mandatory minimum of three seats.[225] In contrast, the US law authorizes the board itself to decide on its structure, and the articles do not include such information. Among the transition economies Russia and Uzbekistan follow the German example and require the inclusion of information on board structure to the articles of association.[226] As opposed to that, the Kazakh law does not mandate the information on board to be stated in articles.

The second substantial aspect in terms of which jurisdictions differ is the treatment of corporation's legal capital. The US statute does not require such provisions to be included in the articles, whereas the German Corporate law does.[227] Similarly to the USA, the three transition economies do not mandate the statement on subscribed share capital in the articles of association.

As a rule, the rights of shareholders are protected by them being authorized to approve any amendment in the corporate charter with the qualified majority of votes. In Germany a resolution on an amendment requires the majority of three quarters of the votes cast.[228] Any amendment of articles according the Delaware statute requires a board resolution; then the board must propose the amendment for shareholders' approval, which should decide with the simple majority of all outstanding voting shares. The articles of incorporation can however state the qualified majority of all voting shares.[229] Voting rules in the transition countries resemble those of the German law, where shareholders must approve amendments. The only difference among the three economies lies in a quantitative threshold of approval. Russia and Uzbekistan mandate the qualified majority of voting shares that participate in the meeting, whereas Kazakhstan imposes a harsher rule which requires 75% of outstanding shares to approve amendments in the articles.[230]

Therefore, with respect to the charter content Russian and Uzbek regulations constitute a mixture between the US and German laws, whereas the Kazakh law is identical with the US law. The voting rights in all the three economies, however, are similar to the German voting rules.

[225] AkG, Germany - § 23 and §95.
[226] JSC Laws: Russia - §11(3); Uzbekistan - §15.
[227] AkG, Germany - §23(3).
[228] AkG, Germany - §179 (2).
[229] Delaware - §242(b)(1) and (4).
[230] JSC Laws: Russia - § 49; Kazakhstan- §36(2); Uzbekistan - §16.

1.4 Sales of Assets

Sale of all or substantially all assets is distinguished as a separate transaction of significant corporate actions because it may have a considerable influence on a corporate structure and can be compared with an acquisition of a target company (Rock et al., 2004, p.145). Thus, most jurisdictions treat a sale of most corporate assets as a large transaction and require shareholders' approval, although the transaction may not cause any change in a corporate charter.

In the USA the board's authority to sell, lease, mortgage, or otherwise dispose of corporate assets is unrestricted. An exception takes place when the board decides to sell all or substantially all assets. In the latter case, the shareholders' approval of selling the assets voted by the majority of outstanding shares is required.[231] The phrase 'substantially all assets' may lead to a confusion, since no concrete measurement threshold is determined. As a rule of thumb, the sale of more than 75% of assets can be considered as substantially all assets. For the cases when the sale exceeds 25% of the balance value of assets a reference to the previous decisions of the Delaware court could be helpful (Bainbridge, 2002, p.627). The German law requires shareholders' approval for a very large or total sale of company assets.[232]

In the transition economies sales of assets, as well as their purchase is handled in separate chapters of the corporate law under the title '*large transactions*', thus granting this transaction a significant weight.[233] It is, however, noteworthy that according to the Russian legislation, except for sales and purchase of assets, other actions such as credit, mortgage and guarantee belong to the group of large transactions. In order to be treated as a large transaction its volume must exceed 25% of corporate balance sheet assets.[234]

The procedures of approving a large transaction differ among countries. For transactions with the value between 25-50% of the balance sheet sum, only the approval of supervisory board is required according to the Russian and Uzbek legislation. The decision should be taken unanimously by all directors. If the unanimity is not achieved, the decision rights are delegated to the shareholders' meeting.[235] The difference between these two countries is that the Russian law prescribes a quantitative threshold for a transaction approval (simple majority of voting shares that participate in shareholders' meeting), whereas the Uzbek law does not clarify that issue. A larger transaction, the value of which exceeds 50% of the balance sheet

---

[231] DGCL - §271.
[232] AkG, Germany - 179a.
[233] JSC Laws: Russia – Chapter X, Uzbekistan – Chapter VIII, Kazakhstan – Chapter VII.
[234] JSC Laws: Russia - §78(1); Kazakhstan - §68(1); Uzbekistan - §89.
[235] JSC Laws: Russia - 79(2); Uzbekistan - §90.

sum must be approved by shareholders with the supermajority of 75% of participating voting shares.[236] In Kazakhstan the supervisory board is authorised to decide on large transactions irrespective of its size. However, the statute allows for transactions that can be approved by the shareholders' meeting but these must be explicitly indicated in the articles of association.[237] It can be, therefore, concluded that shareholders are vested with greater decision making power in Russia and Uzbekistan, whereas the Kazakh law tends to follow the US regulation, where the primary decision power is given to the board.

1.5 Capital Alteration and Distribution

1.5.1 Actions to Reduce or Increase the Legal Capital

Another set of transactions which belong to the significant corporate actions and may increase agency costs between different corporate constituencies are those that bear the flow of equity into and out of the corporation. These transactions combine the following interrelated forms: (1) the increase and reduction of registered share capital and (2) the distribution of capital through share repurchase and dividends. All the three main corporate constituencies – shareholders as a class, minority shareholders and corporate creditors – are concerned with these transactions, and without legal interference the agency costs may be substantially big if one of the parties behaves opportunistically (Rock et al., 2004, p.146).

To start with shareholders as a corporate constituency, the main strategy to protect them from opportunistic behaviour of management is to let them decide on the actions that may alter the legal capital of a corporation. Therefore, a decision rights strategy is again one of the remedies against the agency problem. The German and the US jurisdictions differ with respect to granting the decision making rights. In order to proceed with decision rights on capital increase it is necessary to note that the legal approaches differ in terms of the possible ways of a capital increase.

In the USA a capital increase is possible within authorised shares. If the authorised capital is defined in the articles of associations, the board of directors decides about the increase of share capital, as well as about the type of shares and their amount,[238] otherwise, if the authorised capital first needs to be fixed in the articles of association the approval of shareholders' meeting is required to introduce the change (Engert, 2006, p.756). Nevertheless,

[236] JSC Laws: Russia – 79(3); Uzbekistan - §90.
[237] JSC Law Kazakhstan - §70(1,2).
[238] Delaware - §152, §153(a,b).

the board's decision power on capital increase is not absolute. Companies listed on the New York Stock Exchange are subordinated to some additional rules which require shareholders' approval of the capital increase in some particular cases. For example, shareholders' approval is required if interests of a director upon concrete actions contradict the interests of a corporation or shareholders; or in cases when decisions about large changes in capital are to be made (e.g. capital increase that exceeds 20% of existing shares) (Engert, 2006, p.756).

In Germany an increase of share capital requires an amendment of the articles of association and consequently the procedures connected with the amendment are applied. The majority of 75% of casting votes is required to approve the resolution on a capital increase. However, the articles of association may prescribe higher or lower capital majority but not less than simple majority.[239] These rules apply in case of an ordinary capital increase, a conditional capital increase and an increase of share capital from corporate reserves. One more form of the capital increase available in Germany that deserves a more detailed review is the increase within authorised capital, which is a more common practice in Germany (Wirth et al, 2004, p.149). In contrast with the previous forms, the capital increase within authorised share capital can be granted to management board for the maximal period of five years, whereas no shareholder resolution is required.[240]

Moreover, a decision about a capital increase may conflict with a decision on an organic change. The US jurisdiction has recognized this issue and requires shareholders to approve the action if a large capital increase is implemented for the sake of a merger. In contrast, the European Law has omitted this aspect (Engert, 2006, p.757). Thus, for example the German law grants the managing board the right to decide on the capital increase within authorised share, which can achieve 50% of existing share capital, giving the management board an indirect right to conduct a merger.

The approaches of the transition legislations concerning a capital increase share common features both with the US and German statutes. Russia and Uzbekistan have equal approaches in this respect; the capital can be increased either through issuing new shares or through increasing par value of shares.[241] New shares can be issued only within the authorised capital.[242] As a default rule, shareholders decide on issuing additional shares, however the articles of association may authorise the supervisory board to decide on this issue.[243] In case of the capital increase through raising par value of shares the Russian law grants exclusive

[239] AkG, Germany - §182(1).
[240] AkG, Germany - §202 (1).
[241] JSC Laws: Russia - §28(1); Uzbekistan - §21.
[242] JSC Laws: Uzbekistan - §22; Russia - §28(3).
[243] JSC Laws: Uzbekistan - §21; Russia - § 28(2).

rights to decide to shareholders,[244] whereas the Uzbek law also allows the supervisory board to decide on the capital increase through raising par value, if so stated in the articles.[245] Another drastic difference is that in Russia the capital increase can be conducted through corporation reserves, whereas the increase of capital by means of raising par value can be done only through corporate reserves.[246] Contrary to that, the Uzbek corporations, do not have such an option.

In comparison to Russia and Uzbekistan, the capital increase in the Kazakh law undergoes more simple approach. Only one form of a capital increase is available under the Kazakh corporate law, namely the issue of shares within authorised capital.[247] Regarding the decision rights, preference is given to the supervisory board, which is defined by the law as a default decision making body on the capital increase, however articles may authorise shareholders' meeting to decide.[248] This approach is close to that of Delaware's corporate statute.

The same as a capital increase, capital reduction belongs to significant corporate actions and requires special regulation. Most laws respond to this concern by mandating that any reduction in subscribed capital must be approved by the qualified majority of shareholders (Rock et al., 2004, p.146). Usually, capital reduction is undertaken either during company's crisis in order to adjust the registered share capital so as to compensate for losses or in order to pay back surplus capital to shareholders (Wirth et al., 2004, p.165).

The German Corporation Act differentiated between an ordinary and a simplified share capital decrease. Commonly simplified capital decrease is utilised in order to compensate reductions in value or to cover losses shown in a balance sheet, whereas the ordinary capital decrease can be implemented for any purpose, as e.g. to repay the share capital to shareholders or to distribute reserves (Dornseifer, 2006, p.243). Shareholders decide on the ordinary capital reduction, whereas the qualified majority of casting votes (75%) is required.[249] By contrast, most of the US jurisdictions allow companies to reduce their capital without shareholders' approval (Rock et al., 2004, p.146). For instance, in the Delaware state the capital reduction can be undertaken by the board of directors.[250]

---

[244] JSC Law, Russia - § 28(2).
[245] JSC Law, Uzbekistan - §21.
[246] JSC Law, Russia - §28(5).
[247] JSC Law, Kazakhstan - §3(3).
[248] JSC Law, Kazakhstan - § 18(1).
[249] AkG, Germany - §222(1).
[250] Delaware - §244.

Both in Russia and Uzbekistan reduction of capital can take the form of: (1) reduction of par value of shares or (2) reduction of the number of shares, including share repurchase.[251] Share repurchase is allowed only if such possibility is provided by the articles of association. In Russia the decisions on capital reduction through a decrease of par value and of the number of shares are approved by shareholders' meeting.[252] To approve the decision on capital reduction the Russian JSC Law requires the qualified majority of 75% of cast votes.[253] The Uzbek law also authorises shareholders' meeting to decide on capital reduction[254], however it fails to give exact details on voting rules for this issue, as the numbering of the paragraphs is misleading, so that the voting rule may either be the simple or qualified majority.[255] The Kazakh law does not explicitly articulate the possibility on capital reduction. It can be extracted from other laws that capital reduction is possible through repurchase of shares and as a default rule this authority is granted to the supervisory board.[256]

1.5.2 Corporate Distributions: Dividend Payments and Repurchase of Shares

An outflow of capital from a company represents one of the significant corporate actions which may result in the increase of agency costs. The main forms which the capital outflow may take are distribution of dividends or repurchase of shares.

Dividend payment, like other forms of corporate distributions, leads to the reduction of capital. Actions that effect capital outflow have a potential to impair the rights of some corporate groups. Shareholders as a class bear the costs of the ownership reduction if corporate capital is extracted from the firm without their concern by the decision of the board. In the corporate governance literature such action is called 'tunnelling' or 'hidden dividends'. This aspect will be closely observed in the chapter about related party transactions (Section D).

Another problem occurs when particular groups of shareholders receive unusually higher dividend payments at the cost of small shareholders. A considerably bigger resonance in the discussion on capital reduction, including the case of dividend payments, has been received by the aspect of creditor protection. Extremely high dividends to shareholders may threaten corporate ability to pay back creditors. It is therefore apparent why decisions on dividend payments receive special attention in the law literature regarding creditors'

[251] JSC Laws: Russia-§29(1); Uzbekistan - §22.
[252] JSC Law, Russia - §29(2).
[253] JSC Law, Russia-§29(3).
[254] JSC Law, Uzbekistan - §22.
[255] JSC Law, Uzbekistan - § 65 and §66.
[256] JSC Law Kazakhstan - § 26(2).

protection. Through different provisions most countries try to find a remedy against potential agency conflicts, however the chosen approaches differ from country to country.

As in most significant corporate actions the first strategy to protect shareholders as a class from the opportunism of managers is to let them decide or approve the decision on dividend payment. In the USA, particularly in the Delaware state, the board decides if dividends are to be distributed and it is protected by the business judgement rule[257], i.e. their decision cannot be revised by the court, as long as directors act in line with their fiduciary duties.[258] In fact, shareholders have no rights to require dividend distribution in the USA (Merkt and Göthel, 2006, p.297).

As opposed to the USA, in Germany shareholders' meeting is competent to resolve on the appropriation of the balance sheet profit. To adopt the resolution only the simple majority of participating shares is required.[259] Shareholders have the right to decide freely on dividend payment, including the amount to be distributed.[260] However, before the dividend payment can be started, the legal reserves are to be built up. One-twentieth of the annual net income shall be allocated for such reserves, till the legal reserves reach one-tenth or higher proportion of the registered share capital fixed in the articles of association.[261] Moreover, the management and the supervisory board may allocate part of the annual net income to other revenue reserves.

Similarly to the German practice, the selected transition economies authorise the shareholders' meeting to resolve on the issue of dividend payment, whereas the simple majority of votes is required.[262] However, it is noteworthy that dividends may be distributed only if legally prescribed contribution into reserve fund has been made. Like in the German law, Russia and Uzbekistan mandate the creation of a reserve fund. In Russia it should be not less than 5% of share capital.[263] To pool the money in the reserve fund, annually 5% of profit must be transferred to it. The Uzbek law mandates a higher reserve threshold, namely 15% of share capital. In order to accumulate the required reserves, a company must contribute not less

[257] DGCL - §170.
[258] The concept of fiduciary duties was first developed by common law judges, operating without applying the formal written law. According to this concept directors owe to the shareholders two main fiduciary duties: the duty of loyalty and the duty of care. *Duty of loyalty* implies that directors acts in the best interest of the corporation and not in his own interest. If restated it means that director should not engage in the transaction that involve conflict of interest. According to the *Duty of care* director should pay attention and try to make a good decision.
[259] AkG, Germany - §119 (1).
[260] AkG, Germany - §174 (2).
[261] AkG, Germany - §150.
[262] JSC Laws: Russia - § 42(3), Kazakhstan - §22(1); Uzbekistan - §53.
[263] JSC Law, Russia - §35(1).

than 5% from the net profit.[264] The Kazakh legislator has taken away the provision about the creation of reserves, which were still mandatory in the JSC Law from 1998. The actual purpose of the fund is to provide better protection, and it is therefore advisable to include it in the corporate law (Schramm, 2003 p.15). Although the decision to pay dividends is finally made by shareholders, they can still be restricted by directors' proposal to pay some particular amount as dividends. For example, the Russian and Uzbek laws do not allow for dividend payments which exceed the amount proposed by the supervisory board.[265] In contrast, the German Corporate law explicitly indicates that shareholders are not bound by the proposal of the management board on the appropriation of the balance sheet profit. They can decide on the distribution of the whole balance sheet profit (Wirth et al., p.148). The Kazakh law does not contain provisions in this respect.

A repurchase of shares can be conducted with the purpose of corporate distribution, and thus can be compared with the dividend payment. There are numerous reasons why shares must be repurchased, e.g. in developed securities markets shares can be repurchased with the purpose of price maintenance, especially when they are traded below the expected value or they could be repurchased for further sale to employees. In the advanced securities markets like the USA, a repurchase of own shares is one of frequently used instruments of financing. It can be conducted as an alternative of dividends distribution, in cases when revenue surplus cannot be meaningfully reinvested (Merkt and Göthel, 2006, p.304). Additionally, it can be implemented as a protection mechanism against unfriendly takeovers.[266]

The conflict potential for shareholders lies in the fact that shares maybe repurchased for excessively high price from only a few or even one shareholder, so that the ownership rights of other shareholders can be damaged. As a strategy against possible agency costs, shareholders may be requested to decide on the issue, or if the decision on share repurchase lies in the domain of the board, then at least all shareholders must be notified about the forthcoming repurchase.

In the Delaware state shareholders are not required to approve the share repurchase.[267] The board can purchase the shares back, which thus obtain the status of authorised shares (capital).[268] Nevertheless, shareholders are protected through the information disclosure on the repurchase action. Additionally, shareholders are protected through fiduciary duties of directors who are obliged to act in best interests of a corporation and take the financial

[264] JSC Law, Uzbekistan - §34.
[265] JSC Laws: Russia - §42(3); Uzbekistan - §55.
[266] The later aspect will be closely reviewed in Section C, Chapter 1.2.2.
[267] Delaware - §160.
[268] Delaware - §243

situation and other circumstances into consideration when it decides to repurchase shares (Merkt and Göthel, 2006, p.305).

In Germany the repurchase of own shares was until recently permitted only for exceptional cases. Since 1998 the law has handled repurchase transactions more liberally.[269] Currently, up to 10% of own shares can be purchased on the stock exchange. Shareholders must approve it, while the board of directors can be also authorised to repurchase shares for the period of 18 months, whereas the maximal allowed amount of shares which can be purchased may not exceed 10% (Adolff et al., 2002, p.219).

Regarding the repurchase of shares the Kazakh law is closer to American rule. The law defines supervisory board as a default body which must decide on the issue, however the shareholders' meeting can also be authorised.[270] The Russian regulation distinguishes between various purposes of the share repurchase: if shares are repurchased in order to reduce registered share capital, only shareholders decide on this issue.[271] For purposes other than capital reduction both the supervisory board and shareholders can be entitled to decide on the repurchase.[272] The Uzbek law defines only shareholders as a decision making body for share repurchase both for the capital reduction and for any other purposes.[273] Thus, among the transition economies only Uzbekistan protects shareholders with strict decision rights. It can be, however, impractical in the case of companies with multiple number of shareholders and if the decisions are supposed to be made quickly.

2 The Second Agency Problem: Major vs. Minority Shareholders

2.1 A Merger and Other Organic Changes

Jurisdictions differ substantially in terms of the extent to which they provide targeted protection of the interests of minority shareholders in significant corporate actions. Several main strategies can be distinguished as implemented in order to protect small shareholders (Rock et al., 2004, p.139). The first strategy is the supermajority shareholder approval of an organic change. Forming larger blocks (usually 25 and 30%) minority shareholders can block decisions on the organic change. As mentioned in the previous chapter, the Russian and

[269] AkG, Germany - §71(1).
[270] JSC Law, Kazakhstan - §26(2).
[271] JSC Law, Russia - §29(2).
[272] JSC Law, Russia - §71(2).
[273] JSC Law, Uzbekistan - §22.

Uzbek minority shareholders may block the decision if they collect 25% plus one vote which participate in the shareholders' meeting, which is similar to the German voting rule. In Kazakhstan the law estimates a voting threshold not in accordance to votes that participate in the meeting but, like in the USA, in accordance with the total outstanding shares. So as to block the decision 25% of all outstanding shares must vote against a proposal, whereas in the US the required blocking power may be created if 50% of the outstanding shares vote against.

In the second strategy called a 'trusteeship strategy' only the board is authorised to initiate a merger and consolidation transactions, and shareholders are given the approval rights.[274] The reason why only the board should propose the transaction is that shareholders might initiate a poorly informed or opportunistic transaction. Such a scheme can be observed in the statute of the Delaware state.[275] Similarly, the Kazakh law requires only the supervisory board to initiate merger transactions and shareholders are given the approval rights.[276] However, if shareholders can be assumed to be better decision-makers, the law can allow the shareholders' meeting to initiate the transaction as well. The German regulation can serve as an example of the second scheme, where shareholders can initiate an organic change without the board of directors, calling for an extraordinary shareholders' meeting and also approving the proposal (Rock et al., 2004, p.140). Similarly, Russia and Uzbekistan require the supervisory board to initiate a major organic change as a default rule,[277] which means that articles of association may entitle shareholders also as initiators. To submit a proposal shareholders would need to call for an extraordinary meeting. Unlike the 5% threshold necessary for shareholders in Germany to be able to call for an extraordinary meeting, the Russian and Uzbek law define a slightly higher threshold of 10%.[278]

The third strategy which can be implemented in order to protect minority shareholders is called 'exit strategy'. Within the corporate law it is called 'appraisal right'. It allows dissatisfied small shareholders to sell their shares back to the company at a reasonable price, if an approved organic change does not correspond to their interests. Thus, unpopular decisions may make it expensive for the managers to pursue them. The appraisal rights are of a greater importance in the countries where shareholders are restricted in their ability to sell their shares, due to the low liquidity of securities markets (Schramm, 2007, p.334). Nevertheless, appraisal provisions can be found also in the countries with highly liquid markets. The use of these rights is limited mainly to the significant corporate actions.

---

[274] For more about trusteeship strategy see Kraakman et al., 2004
[275] DGCL - §251.
[276] JSC Law, Kazakhstan - §82(4).
[277] JSC Laws: Russia - §49 (3); Uzbekistan - §66.
[278] AkG Germany-§122; Russia - §55(1), Uzbekistan- §72.

Virtually all the US statutes provide appraisal right provisions in the course of mergers and sales of assets (Merkt and Göthel, 2006, p.586). The Delaware law is more restrictive in this respect, as the appraisal rights are allowed solely in the context of a merger.[279] Other significant corporate actions such as sales of assets and corporate divisions do not give shareholders the right to sell their shares back to the corporation (Bainbridge, 2002, p.633). The German jurisdiction is more sceptical towards the appraisal rights due to a special role of creditors which implies the rule of capital maintenance (Schramm, 2007, p.334). Only in the course of few corporate actions such as reorganization and a takeover the appraisal rights are eligible.[280] However, the appraisal requirement is put not against the corporation but against the third party, which helps to avoid the problem of capital maintenance.

All the three JSC Laws in transition economies provide for appraisal rights with respect to any from of corporate reorganization,[281] large transactions (asset sales) and charter amendments with merely slight differences in conditions. Russia and Uzbekistan give the owners of ordinary shares the appraisal remedy if they voted against one of the above listed transaction or did not participate in the voting on these issues.[282] The Kazakh law allows for selling back only if the shareholder (owner of preferred and ordinary shares) participated in the meeting and voted against the reorganization.[283] Additionally, all the three jurisdictions set limits on the number of shares that a company can buy back when the appraisal rights are exercised. Russia and Uzbekistan define that the total sum of corporate resources for the purpose of share repurchase cannot exceed 10% of company net assets,[284] whereas Kazakhstan imposes a restriction based on the outstanding shares (max. 25% of them can be repurchased) and the equity capital (10%).[285] The Kazakh threshold for the share repurchase is high not only in comparison with transition economies but also in reference to the EU standards of 10%, which my have a negative impact on securing the creditor rights (Schramm, 2003, p.27).

[279] DGCL - §262(a).
[280] Germany: AkG - §305, UmwG - §§29,125,207.
[281] All three transition countries classify five forms of corporate reorganization: (a) merger, (b) consolidation, (c) corporate division, (d) spin-off and (e) change in corporate form.
[282] JSC Laws: Russia JSC - §75 (1); Uzbekistan - §44.
[283] JSC Law, Kazakhstan - §27(1).
[284] JSC Laws: Russia §76 (5); Uzbekistan - §45.
[285] JSC Law, Kazakhstan - § 28.

2.2 Legal Capital, Share Issues, and Corporate Distribution

2.2.1 Actions to Increase or Reduce the Legal Capital

A capital increase through an additional issue of shares stipulates potentially significant corporate conflicts, namely the ownership dilution. The higher the ratio of the newly issued shares, the smaller the ownership rights of each particular shareholder becomes (Merkt and Göthel, 2006, p.279). Corporate legislations across the world stipulate two protection mechanisms for minority shareholders. The first one has already been discussed in the context of the protection of shareholders as a class, namely the decision rights strategy. As long the decision rights on capital increase are given to shareholders and the qualified majority is required to adopt the resolution, minority shareholders have a chance to block the decision. The second strategy to decrease the vulnerability of minorities against the ownership dilution is the pre-emptive or subscription right which mandates the management body to offer the newly issued shares to all existing shareholders, prior to offering them on public sale. The aspect of pre-emptive rights belongs to the paramount shareholder rights and serves as important protection of the minority interests.[286]

Among different countries the statutes make the use of either one of these strategies, or even both simultaneously. In this respect the USA statutes represent an exception because both the mechanisms of minority protection are hardly used. First, as the US corporate statutes give the decision power to the board, minority shareholders do not have the decision-blocking rights. As opposed to the blocking rights, the pre-emptive right is an available remedy to preserve the proportional interest of existing shareholders in the US corporate sector. There are two types of legal approaches towards the pre-emptive rights: the first type embraces so called 'opt-out' statutes which define pre-emptive rights as a default rule, whereas articles may expel it. The rest of the statutes, including the Delaware, use an 'opt-in' option where no pre-emptive rights are mandated by the statutes, however articles my include them.[287]

In the praxis, implementation of the pre-emptive rights is not common for several reasons. If shareholders have no sufficient funds to exercise their pre-emptive option, it may have little significance for protecting their rights (Bainbridge, 2002, p.78). On the other hand, shareholders have an alternative to purchase shares on the open market. In fact, instead of pre-emptive rights, the US common law protects minority shareholders through the fiduciary duty

[286] Annotations to OECD Principles, Part Two, III A. 2.
[287] Delaware - §102 (b) (3).

of the majority shareholders, i.e. large shareholders may not issue new shares with the only purpose to dilute the shareholding of small stockholders. The new issue should rather have a valid business purpose (*bona fide business purpose*) (Merkt and Göthel, 2006, p.280-281).

Germany, like most European statutes, relies on both the above described strategies of minority protection, however to different extent. First, if large minority groups collect together 25% of vote casts, they may block the decision to increase capital. This rule applies for all types of capital increase. Even if the resolution is approved on the meeting, shareholders have the pre-emptive rights to sustain their ownership ratio.[288] The pre-emptive rights can be overridden only under special circumstances, when pivotal interests of a company outweigh the protection of shareholders against the dilution of their voting rights (Nörr et al., 2003 p.66). In terms of the types of capital increase German law determines different provisions on exclusion of the pre-emptive rights. While in the case of the ordinary capital increase only shareholders can remove the pre-emptive rights, in course of the authorised capital increase mangers can be authorised as well to resolve on the exclusion (Wirth et al., 2004).

Like Germany, the three transition economies make the use of two minority protection strategies. However, the degree of protection differs among them. Both Kazakhstan and Russia restrict in their corporation acts the decision rights of minority shareholders. Russian law does not require the supermajority to approve the resolution on the shareholders' meeting, since only the simple majority suffices.[289] Kazakhstan, in contrast, grants the decision making power to the supervisory board if statutes do not state otherwise.[290] In this respect the Uzbek law protects minorities better, requiring the supermajority of 75% to approve the resolution on capital increase.[291]

Although the decision rights strategy is being approached differently, the three transition laws include the pre-emptive rights provision.[292] In Russia and Kazakhstan the pre-emptive rights have a mandatory character, i.e. the articles may not opt-out from that provision and neither shareholders' meeting can decide about opting it out. The Uzbek law, as opposed to that, vests the shareholders' meeting with the decision rights on opting-out from this right. Moreover, it is noteworthy that the Uzbek shareholders can make the use of the pre-emptive rights only in the case of issuing the securities convertible into shares. The purpose of such a provision is unclear and it may be assumed that it is a simple oversight of regulator

---

[288] AkG, Germany - § 186(1).
[289] JSC Law, Russia - § 48(6) and §49(2).
[290] JSC Law, Kazakhstan - §18(1).
[291] JSC Law, Uzbekistan -§ 66.
[292] JSC Laws: Uzbekistan - § 39; Kazakhstan - §16 ; Russia – §40(1).

(Schramm, 2007). Therefore, both Russia and Kazakhstan give the strategy higher significance, whereas the Uzbek minority shareholders are restricted in their pre-emptive rights.

Finally, the rights of minority shareholders can be suppressed within the transaction of capital reduction. The reduction of capital through the decrease of par value is conducted by means of converting old shares into newly issued with a lower par value. In order to protect shareholders from the dilution of their property through disproportional reduction of the share capital in comparison to major shareholders, it is recommended to specify in the law that the reduction must proceed proportionally for all shares (Teljukina, 2005, p.180). For example, the Uzbek law fails to specify whether the reduction relates proportionately to all shares. This omission may lead to an agency conflict if the reduction does not involve all shares but only some part of them.

2.2.2 Corporate Distributions: Dividend Payments and Repurchase of Shares

Laws regard corporate minorities as potential victims of opportunism initiated by large shareholders, and thus provide for special rules regarding dividends which may contribute to the reduction of agency costs. At first, minority shareholders can be protected by the mandatory disclosure of the decision to pay dividends. Among the three transition economies Uzbekistan and Kazakhstan explicitly prescribe the disclosure of dividend payment within the period defined by the law.[293] Another important mechanism is the principle of equal treatment of all shares, including the rights of shareholders within the same class of shares for equal dividends. This rule belongs to universal ones and can be found in almost all statutes of the world, including observed sample group.[294]

In reference to the repurchase transaction, the rights of minority shareholders can be violated in the same way as in course of dividend payment, which means that the 'capital tunnelling' within the share repurchase transaction may take place as well. This can occur if large shareholders sell their shares back to the company at an excessively high price, at the cost of small shareholders. Therefore, a possible way to escape the misappropriation of small shareholders is to make this information available to all shareholders through a mandatory disclosure and mandate shares at an equal price from all shareholders. The US regulations oblige a publicly held corporation to disclose the information on share repurchase (Merkt and

[293] JSC Laws: Kazakhstan - §23(2) and §24(3); Uzbekistan - §61.
[294] JSC Laws: Germany - AkG §11; Russia - §31 for ordinary shares and § 32 for preferred shares; Kazakhstan - §12(4); Uzbekistan - for ordinary shares §28 and §29 for preferred shares.

Göthel, 2006, p.304). In Germany the repurchase may be carried out only by means of a self-tender offer to all shareholders or on the stock market.[295] The three transition economies also protect their minority shareholders by a mandatory disclosure.[296] In Kazakhstan the repurchase of own shares must be disclosed if the amount of shares exceeds 1% of all outstanding shares.[297] Regarding the way of notification problems may occur if the law does not stipulate exact procedures of the disclosure. None of the three countries define how shareholders must be informed about the share repurchase, which in may appear problematic (Teljukina, 2005, p. 478).

Another proposal to protect some groups of shareholders from expropriation through shares purchase at an extremely high price is to impose approval rights and allow shareholders who do not participate to decide on the transaction if the purchase price exceeds the market price by more than 5% (Black et al., (c), 1998, p.408). The regulation in the observed countries remains silent in terms of this aspect.

3 The Third Agency Problem: Shareholders vs. Stakeholders

3.1 Major Organic Changes

The major jurisdictions protect at least one of the non-shareholder constituencies, for instance the EU and Japanese jurisdictions are considered to be more creditor-friendly than the US (Kraakman et al., 2004, p.144). The trend of creditor friendliness in the EU remains the same in regard to organic changes. Commonly, creditors lack the power to stop organic changes but they are authorised to demand adequate protection when a merger puts their claims at risk.

The corporate statutes in the three transition economies pay considerable attention to creditor protection, while major organic changes, however, differ with respect to some significant details. JSC laws in all the three countries mandate companies which undergo reorganization (a merger, consolidation, corporate division, spin-off, a change of corporate form) to inform their creditors.[298] The Russian JSC Law requires a written notice to a creditor and disclosure in printed media not later than 30 days after the decision about reorganization has made.[299] The Uzbek law also requires written notification of creditors within 30 days,

[295] AkG Germany - §71(1).
[296] JSC Laws: Russia - §72(5); Kazakhstan -§24(6); Uzbekistan - §41.
[297] JSC Law, Kazakhstan - §26(4).
[298] JSC Laws: Russia - § 15 (6); Kazakhstan - §81(2); Uzbekistan - §95.
[299] JSC Law, Russia - §15(6).

however the disclosure in printed media is not mandated.[300] Although similar requirements can be found in Kazakhstan, no strict time frames for notification are defined by the law as in the case of Russia and Uzbekistan. Like in Russia, the Kazakh law obliges companies to disclose the information in printed media.[301] All the three jurisdictions allow creditors to require pre-mature credit reimbursement while the reorganization is being conducted, whereas both Uzbekistan and Russia pose time restrictions for creditor's decision and Kazakhstan omits such time frames. This may be disadvantageous, as no fixed time frames may severely harm both creditors and the corporation. For better protection of creditors, the JSC law may require a written confirmation to the financial supervisory authority about the notification of creditors on reorganization. Among the three countries only the Russian law mandates it.

Another element in the law which considers the rights of creditors says that in the case when specification of an entity responsible for debts is impossible during reorganization, all the participating parties are mutually responsible for their liabilities. Like the German statute, both the Russian and Uzbek corporate law define the mutual liability of new companies if it is not possible to figure out from dividing balance who in particular is responsible for corporate debts.[302] This rule was not found in the Kazakh company law.

Employees are another non-shareholder constituency which is protected by the law of some countries. Germany belongs to few European countries where the employees' rights are separately considered during particular significant corporate actions, thus, e.g. employees are provided with the information rights (Beinert et al., 2000, p.116). In Germany the resolution on a merger should include the point about the merger consequences for employees and their representatives.[303] A long-lasting campaign in the EU lobbied by Germany resulted in the EU directive (OJ L 294/22) which provides workers with the negotiation rights when a merger or other organic change is intended, putting them in a privileged position in comparison with other corporate constituencies (Kraakman et al., 2004, p.144). Among the transition economies under observation none of the statutes explicitly protects the rights of employees when major organic change transactions take place.

[300] JSC Law, Uzbekistan - §95.
[301] JSC Law Kazakhstan: Mergers - §82(7); Consolidation - §83(5); Corporate division - §84(5) and §85(6).
[302] For Germany See Adolff, J., et al. 2002, p.292; JSC Law: Russia - §15(6); Uzbekistan - §95.
[303] Umwandlungsgesetz Germany - §5 (9)

3.2. The Legal Capital and Corporate Distributions

3.2.1 The Legal Capital Rules

The essential idea behind the legal capital is to ensure the protection of corporate creditors. The capital serves the function of a puffer which provides creditors with the rights to appropriate assets of a company when it stands to be insolvent. This creditor security can be to some extent provided by a legally fixed minimal capital, which cannot be altered within the life cycle of a corporation. However, the role of such a fixed minimal capital requirement is ambiguous: '*It remains unclear how much real protection these rules provide to creditors, particularly since any firm's initial capital is likely to be long gone before it files for bankruptcy*' (Kraakman, 2004, p.84). The opinions of scholars with respect to the minimal capital requirements were divided in two lagers. One of them, coming from the continental European jurisdictions, supports the idea that the legal capital is necessary and makes sense also in contemporary market environment. In opposite, proponents of the Anglo-Saxon corporate tradition opine the minimal capital rule to be anachronistic and superfluous (Lutter 2006). In this section it is not aimed to elaborate on the debate about the necessity of such requirements. The main goal here is only to review the legal approach regarding the creditor protection in the three transition economies and compare it with the German and the US approaches.

In the USA most statutes do not require a minimal charter capital, so that theoretically corporations can be founded with one cent charter capital (Merkt and Göthel, 2006, p.213). The state with most of incorporations in the USA, Delaware, does not require a minimal capital either (Engert, 2006, p.755). Instead, the articles of association must specify the amount of capital in the process of incorporation and specify the par value of each share. An important detail in regard to the protection is that shares cannot be issued at a price below the par value, if the latter is indicated in the articles (Adolff, 2002, p.48). It is, however, not difficult to keep the par value as small as possible. The corporation law provides almost no provisions in the USA to secure the creditor protection; instead, creditors must rely mainly on the negotiated contractual protections, fraudulent transfer law and ultimately the bankruptcy court (Booth, 2006, p.735).

In contrast, the German corporate law, like most continental European jurisdictions, provides for a stronger creditor protection rule. The minimal capital requirement is estimated on the level of EUR50,000 for publicly held corporations.[304] Both shares with and without par value are eligible.[305] The statutes also fix the minimal value for par value shares at one Euro rate and no issuing below the par value is allowed.[306]

Like in Germany, the corporate laws in transition economies have been designed as inclusive of the elements of creditor protection. All the three transition jurisdictions require a minimal registered capital. The Kazakh statute provides for the highest level of creditor protection in terms of the required minimal capital. In order to found a publicly held company the monetary equivalent of 50,000 fold minimal wage[307] must be contributed within 30 days after registration.[308] In Russia the minimal share capital should amount to not less than 1,000 minimal wages[309] and for closed joint stock companies a lower minimal capital is defined – 40 folds of the minimal wage.[310] Shares must be paid in within one year, whereas 50% must be contributed within the first three months.[311] Admitting the significance of the minimal capital requirement, Uzbekistan also lifted its capital threshold up to $50,000 for publicly held corporations, calculated on the basis of the official exchange rate[312] and to 200 fold of the minimal wage for closed joint stock companies.[313] Like in Russia, the Uzbek law stipulated more lax timelines for the capital contribution than in Kazakhstan. Both in Russia and Uzbekistan shares must have par value[314], whereas only Uzbekistan, like Germany, defines the minimal par value of one share[315] and only the Russian law explicitly notes that shares cannot be issued below the par value.[316] In contrast, Kazakhstan prescribes that shares must be paid in during the initial capital contribution by the founder and no later nominal value is to be fixed.[317]

Another possible mechanism of the creditor protection is the fact that any reductions of capital should be disclosed in certain time to creditors. In Germany the law enhances the creditor protection by requiring corporations to inform creditors about capital reduction caused by a share repurchase (Dornseifer, 2006, p.243). Russia and Uzbekistan provide for

[304] AkG, Germany - §7.
[305] AkG, Germany - §8(1).
[306] AkG, Germany - §9(1).
[307] Minimal wage in Kazakhstan – 9752 Tenge = € 55.2 (Stand: December 2007).
[308] JSC Law, Kazakhstan §10.
[309] Minimal Wage in Russia – 2500 rubles = € 70 (Stand: December 2007).
[310] JSC Law, Russia - §26.
[311] JSC Law, Russia - §34(1).
[312] It is necessary to note that the was quite a big gap between official and "black market" exchange rates due the policy of exchange rate rationalization. However, recently the policy of liberalization was gradually implemented what lead to the significant reduction of the gap. According the market date the official exchange rate equals to 1 Dollar = 1251 UZ. Sum; "Black market" rate 1 dollar = (stand April 2007).
[313] JSC Law Uzbekistan - §20.
[314] JSC Laws: Russia – §25(1); Uzbekistan - §19;).
[315] JSC Law, Uzbekistan - §25.
[316] JSC Law, Russia - § 36(1).
[317] JSC Law, Kazakhstan - §11(1).

such a rule in their laws as well.[318] However, the law does not explicitly define the form of the notification. It may be done by simply printing the decision in public media or sending a direct message to creditors. In the latter case the extent of protection is higher (Teljuina, 2005, p.30). The Kazakh corporate law, in contrast, does not impose any obligations to inform creditors.

Despite the existence of the minimal capital requirements it is not sufficient in itself to provide protection to creditors. The minimal capital becomes useless if a company can freely alter its amount during the life cycle. That is why in addition to the minimal capital requirement, the capital maintenance rule ought to be provided. Such a maintenance rule prohibits the company to distribute corporate assets below the estimated amount both in the form of dividend payment and the share repurchase.

3.2.2 Corporate Distributions: a Repurchase of Shares and a Dividend Payment

Corporate distribution in the form of dividend payment and share repurchase constitutes the main source of the agency conflict of creditors, since it may considerably hamper the ability of a company to pay back its liabilities. As a rule, creditors are protected by the law that bans any form of distribution that may influence the ability of a company to pay back to creditors or that may reduce the minimal legal capital, which serves as a security for creditors.

The first protection mechanism under consideration here is determination of the source of dividends. It is clear that creditors' interest lies in the fact that a corporation retains its share capital. For this purpose most laws define only corporate profit as a legitimate source of dividend distribution. Germany bars any distribution which would reduce the legal capital. Only the balance sheet profit may be distributed among shareholders.[319] Russia and Uzbekistan explicitly indicate the same prescription.[320] In contrast, some US statutes allow dividend payments not only from the earned surplus, but also from other sources, as e.g. the capital surplus (paid in surplus) can be used to award shareholders (Merkt and Göthel, 2006, p.299). In the same manner, Kazakhstan omits direct indication of the dividend source.

[318] JSC Laws: Uzbekistan - § 23; Russia - §30.
[319] AkG, Germany - §57.
[320] JSC Laws: Russia - §42(2); Uzbekistan - §53.

Instead, the law prohibits any payments while the equity capital is negative or becomes negative after the dividend payment.[321]

The next crucial aspect is dividend payment in relation to insolvency. Dividend payments are not eligible when a company has the features of insolvency or they occur after the payment. Although in the USA creditors are poorly protected by the capital rules, there is an equity insolvency test which protects them from an 'illegal' dividend distribution (Booth, 2006, p.735). The test implies that distributions may not be done if it impairs a corporation's ability to pay back the creditors. In some states this test is included in the corporate law, whereas in Delaware this issue is regulated by the case law (Booth, 2006, p.736). The transition laws determine that dividends may not be distributed if a corporation has insolvency features or if they will occur after the dividend payment. [322]

Another rule found in all jurisdictions is the prohibition to pay dividends before shares are fully paid. Russia and Uzbekistan included this rule in their statutes[323], whereas Kazakhstan omits such restriction because the payment for shares must be concluded within a very short period of 30 days. [324]

In the cases when the dividend payment was conducted with the violation of the above mentioned rules, the laws of some developed countries foresee the liability of directors (Black et. al.,(c), 1998, p.274). In the USA members of the board are liable if they have deliberately violated the rules of dividend payment.[325] Each member is obliged to compensate for the amount which the creditors lost due to an illegal dividend distribution. Directors are not liable if they acted neither negligently nor deliberately towards the dividend issues. Also shareholders can be liable if they knew about the inadmissibility of dividend distribution and still received them (Merkt and Göthel, 2006, p.302). The transition laws do not establish the liability of board members. Instead, members of the board are liable only if they fail to act reasonably and in a good faith.[326]

From the perspective of a creditor, a repurchase of own shares has the same effect as the dividend payment, as both lead to reduction of capital (Merkt and Göthel, 2006, p.307). Therefore, some similar regulations apply for the case of share repurchase. The repurchase of shares is not allowed if it will lead to impairment of the registered capital, insolvency or if

[321] JSC Law Kazakhstan - §22(5).
[322] JSC Laws: Kazakhstan - §22(4-5); Russia- § 43; Uzbekistan - §60.
[323] JSC Laws: Uzbekistan - §60; Russia - §43(1).
[324] JSC Law Kazakhstan - §11(2).
[325] Delaware (DGCL) - §281.
[326] Comments for Russia see Black et al 1998, (c), p 274; JSC Laws: Russia - § 71(2); Uzbekistan - §88; Kazakhstan - §62

shares are not fully contributed.[327] Additionally, creditors are protected by a quantified threshold above which shares may not be repurchased. In the USA no such limitations are available, which means that a company can buy a large number of its shares. Russia in line with the German quantitative rule allows for maximal 10% of outstanding shares.[328] In Kazakhstan the maximal number of shares that can be repurchased may not exceed 25% of all outstanding shares and total costs should not exceed the amount equal of 10% of share capital.[329] According to Schramm (2007) this is quite a large threshold that can endanger the capital maintenance rule. The situation in Uzbek law is even worse from the perspective of creditor protection, since like in the USA no limitation for repurchase of own shares is provided by the law.

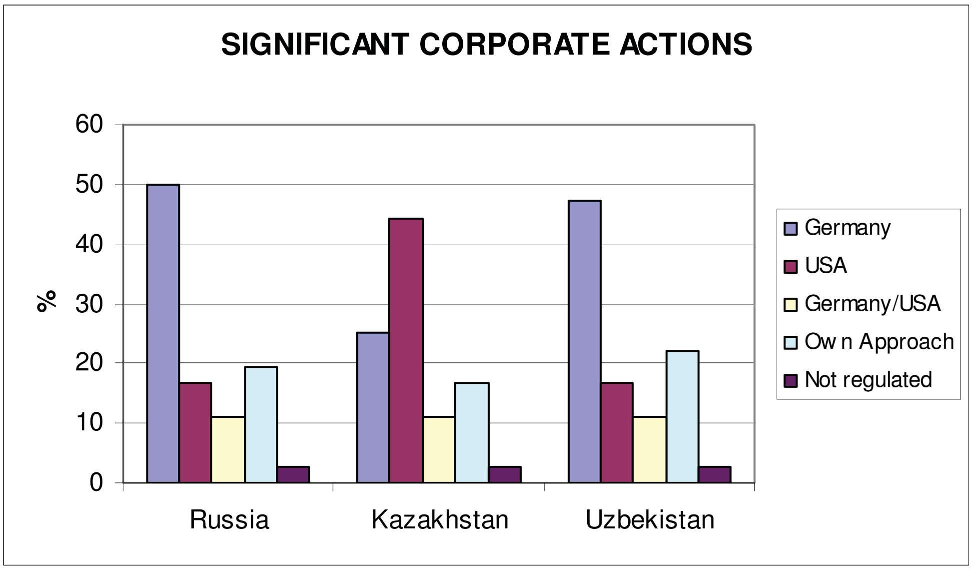
4. Results

All the three post-soviet economies regulate significant corporate actions in their corporate laws, devoting separate sections to the issues of corporate reorganizations and amendments to articles. As a rule, provisions on significant corporate actions go in line with the US and the German rules. Shareholders are vested with the decision making rights on all substantial transactions, whereas the voting supermajority rule is compulsory in all cases of large transactions.

In terms of details in the legal provisions on significant corporate actions there are big differences among the transition economies (See Figure 10). On the one hand, there is Russia and Uzbekistan the laws of which are mainly oriented towards the German regulation and Kazakhstan which tends to align its rules with the US law. The number of provisions that can be found both in the USA and in Germany are approximately similar in all the three countries. It is noteworthy that all the three laws record insignificantly small ration of unregulated aspects regarding large transactions, which corresponds to the Western regulative standards.

[327] JSC Laws: Kazakhstan - §26(3); Uzbekistan - §42; Russia- §73.
[328] JSC Law, Russia - §72(2).
[329] JSC Law, Kazakhstan - §28.

Figure 10: Significant Corporate Actions



Source: Own Depiction.

Note: The Figure illustrates quantitative results of law comparison (See Appendix II, Table 3 and Table 4).

C. Control Transactions (Takeover)

1. Introduction

Takeover regulation is an essential element of corporate governance. Provisions on takeover not only have an impact on the level of investor protection, on development of capital market and market of corporate control, but they also may cause changes in ownership structure (Goergen et al, 2005, p.2). As indicated in previous chapters, all aspects of corporate governance subject revolve around the issue of who possesses control over a company. Under the control one understands the ability to appoint nominees to the board of the company and thus influence corporate policy (Davies and Hopt, 2004, p.157). Control transaction, also known as takeover, belongs to the acquisition transaction, when an acquirer (a private person or company) attempts, through offers (bid) to company's shareholders, to obtain large stake in the corporation. Having the features of substantial actions which can influence corporate constitution, control transaction could be classified into the section together with other significant corporate actions. However, as in takeover transaction a new party occurs, namely the bidder, it sheds a new light on takeover transaction which differs from other significant corporate transactions and therefore requires a separate review in this chapter.

Control over a corporation can be obtained in a variety of ways: via private negotiation with small shareholders, open market purchases or public offer to all shareholders of the target company, whereas the offer can be supported by director of the targeted company (friendly takeover), or made over the heads of target management (hostile takeover). Another special way of acquiring control can be added to this list, namely the purchase of whole or large stake in the corporation in course of privatization program. The last category can be still observed in some transition economies, including Russia, Kazakhstan and to bigger extent in Uzbekistan. Nevertheless, the purpose of this chapter is the control transaction initiated by an acquirer (bidder) and not by the state in course of denationalization. As in previous chapters, the review of legal systems will pass through three main agency conflicts, encompassing the remedy mechanisms designed to diminish agency costs.

Empirical researches indicate that control transaction have the highest frequency on established capital markets with relative high ownership dispersion. At first glance it may appear that regulation of takeover transaction is not necessary in the frameworks of transition economies. Nevertheless, the gradual development of capital markets and evolvement of institutional investors on the markets of transition economies require that national legislation encompasses provisions available in developed market economies. It is therefore reasonable to include regulations of control transactions, which in their turn have reverse impact both on ownership structure and evolution of capital markets in transition economies.

The laws that regulate control transactions vary among jurisdictions. Some countries do not issue special takeover regulations; they rely instead on corporate law to deal with control shift. Among them is the USA, where securities law handle only limited aspects of control transactions and the significant area is regulated by corporation law (Davies and Hopt, 2004, p.159). Other countries (among them Germany) issue special laws on regulation of control transactions.

All three transition economies do not have special legislation regarding takeover transactions. Related provisions can be derived from the Laws on Joint Stock Companies and the Law on Securities Markets, whereas Russian law is the most advanced one. Kazakhstan and Uzbekistan do not provide for targeted regulation of takeovers. Instead takeover aspects are regulated indirectly, as some particular rules in respect to takeover can be found in relation to other governance issues.

2. Protection of Shareholders as a Class in the Course of Takeover

Due to its features, takeover belongs to the transactions called significant corporate actions. However, there is a significant detail that draws differentiation line between takeover transactions and other big corporate actions; it is the availability of a new actor, namely a bidder. Appearance of another interested party stipulates potential for additional conflict of interests. Therefore, shareholders face the conflict not only with managerial interests, but also with those of the bidder. This happens because the mechanisms that the bidder implements may discriminate the corporate shareholders. These both agency conflicts will be closely reviewed in the following chapters.

2.1 The Agency Conflict between a Bidder and a Shareholder

2.1.1 Regulation of Abusive Strategies of Bidders

The agency conflict between current shareholders and potential investors (a bidder) is stipulated when a bidder forces the target shareholders to accept the offer that does not correspond to the optimal possible outcome for the shareholders. There are multiple mechanisms that a bidder may utilize to pressurize shareholders. As with many other elements of corporate governance, the USA used to be a pioneer in designing and implementing such mechanisms. Today, many of these tools have been outlawed by special tender offer rules (Nörr et al., 2003, p. 40). In the following sections some frequently mentioned abusive offer strategies will be drafted and the regulation of such strategies in countries under consideration will be evaluated.

a. Time Restriction

A bidder can exercise pressure on the target shareholders by restricting the period within which shareholders may respond to an offer. It is in the interest of a bidder that management does not have enough time to prepare defence strategy. In the USA such timely restricted offers were a common practice. It was even allowed to make an offer restricted up to 5 working days, a so called '*Saturday night offer*'. Under this scheme target shareholders were receiving offer on Friday and were supposed to give answer latest by next Friday (Merkt and Göthel, 2006, p. 627). Another way of accelerating the target shareholders' response is the limitation of an offer to special amount of shares. Thus, the shares are acquired on principle first come first serve.

In both cases shareholders must react quickly if they desire to sell shares for the highest possible price. Such timely limitation of shareholders' decision bears the problem of poorly informed decision that shareholders make. On the other hand, target management does not have sufficient time to react on an offer that could negatively affect future corporate perspectives. In order to reduce such agency costs the law can stipulate the minimal period during which the offer is open. However, the period should not be extensively long, in order not to damage the corporation, keeping interested party in uncertainty for long. With introduction of the Williams Act in 1968 the US has solved the problem of time pressure. The law prescribes the minimal period of 20 working days (Merkt and Göthel, 2006, p.630). Similarly, the German law mandates the opening offer period to be between four and ten weeks.[330]

As already mentioned, in comparison to other transition economies Russia regulates takeover transactions to larger extent. According to the Russian corporate law, shareholders are granted a minimal decision making period of 70 days. On the other hand, two long openings of a tender offer may hold up normal business. The aspect of extremely long offer

[330] Takeover Act, Germany - §16(1t).

period is also considered by Russian law, thus restricting the opening period to 90 days.[331] These rules are applied both when an acquirer plans to make first offer to buy controlling stake of 30 % or more, and when an acquirer holding stake of 30% and more must make an offer to remaining shareholders to acquire their stocks. In contrast, Kazakh law prescribes no minimal tender offer time when an acquirer aims to buy more than 30% of shares. Instead, upper time frames are defined for offers when an acquirer already possesses 30% of shares and must make an offer to the remaining shareholders.[332] Uzbek legislation, in contrast, does not regulate these issues at all.

b. Two-tier Offers

In 1980 the two-tier offer was a popular offensive strategy in the USA. Within such strategy a bidder was announcing that he/she will purchase controlling stake in the target company for the price higher than the market value of shares. After gaining control he/she acquires the rest of shares at significantly lower price. Even if target shareholders are not willing to sell the shares at first offer, they are forced to do so, as they are afraid that they will be squeezed-out in second stage of the offer and must sell shares for considerably lower price (Nörr et al., 2003, p. 40).

From the perspective of federal legislation the two-tier offers are not prohibited in the USA. However, because of the increasing use of the defence strategy - *poison pill*s[333], recently they have become unattractive, and accordingly are rarely used. On the other hand, the jurisdictions of particular states allow shareholders who sold their shares in the second offer for lower price to claim in the court to be compensated for the price difference between the first and the second offer (Merkt and Göthel, 2006, p.636). In contrast, two-tier offers were never permissible in Germany. It is banned by the law to squeeze shareholders at unfair price. If a shareholder (minority shareholder) considers the price offered to be inadequate, he/she may appeal in court. Additionally, shareholders are protected by the principle of equal treatment. Therefore, the same price has to be offered to all target shareholders (Nörr et al., 2003, p.41).

In general, it can be stated that shareholders in transition economies are protected against discriminating two-tier offers through the principle of equal rights of shareholders. So that theoretically, a bidder cannot buy one stake for significantly high price and another stake

[331] JSC Law Russia – § 84.1 (2)
[332] JSC Law Kazakhstan - §25(3)
[333] ‘Poison Pills’ will be discussed in chapter 1.2.1 g.

for prices that are below the real value. Nevertheless it could be useful it law includes special provision on that issue. For example among observed transition economies only Russia explicitly handles the two-tier offers. The law says that the owner of large stake (30% and more) must make an offer to acquire the rest of the shares for the price which cannot be lower than the price he/she paid to acquire the previous shares.[334] Additionally, a shareholder can contest unfair prices in the court. In contrast both Kazakhstan and Uzbekistan do not restrict this possibility of opportunistic behaviour of a bidder after gaining the controlling stake.

c. Greenmailing

Greenmail is a transaction within which an acquirer buys minority interest in a target company and then threatens to make an acquisitions offer unless the target company repurchases shares for a premium price (Nörr et al, 2003, p.42). If payments are made, the remaining shareholders bear the costs of such transaction. Thus, a bidder gains premium earning on costs of existing shareholders. In the USA 'greenmailing' is theoretically allowed (Merkt and Göthel, 2006, p. 671). However, for several reasons it does not exist any more. There is a tax that is imposed on greenmail profits, raising the capital gain tax on greenmail profit to 90%. Moreover, some courts defined greenmail payments as a breach of fiduciary duties of directors (Nörr et al., 2003, p. 42).

Also in Germany greenmailing is not directly prohibited by the law. However, there are several factors that restrict the use of it. According to German legislation only limited number of shares (10% of issued shares) can be repurchased by a company. The repurchase of shares maybe carried out only by means of public self-tender offer, which means that the offer must be made to all available shareholders. Therefore, purchase for excessively high price is not possible in Germany (Nörr et al., 2003, p. 43).

Greenmail in western meaning is not possible in transition economies for the same reasons as in Germany. As earlier discussed, companies (except Uzbekistan) are allowed to re-purchase only limited number of own shares and the decision to buy own shares must be announced to all existing shareholders. Nevertheless, the Russian experience indicates another form of greenmailing which conceptually can be compared with 'black mailing'. Weak institutional environment – incomplete laws and corrupted judicial system – make the greenmailing of Russian type a very profitable instrument of getting premium price for minority stake. Techniques of such greenmailing are diverse and very creative. For example,

[334] JSC Law, Russia - §84.1.

some Russian companies report that acquirers of small stakes sometimes require a company to repurchase this stake for excessively high price, not threatening with takeover, as in western greenmail, but rather by promising to hinder normal business process, for example: appealing in the court any small incompliance with prescribed rules, which in turn may hold back normal business activity of a company, and in some cases even by means of arresting the corporate assets. The use of mechanisms depends on the budget of greenmail. Higher budgets greenmail even allows to involve corrupted authorities such as judges and the police (Ionzev, 2002, p.11).

Under such circumstances a paradoxical situation occurs when a minority shareholder becomes an aggressor, whose actions may abuse the rights of the other shareholders. The problem here is that small owners hide their real purposes behind the principles of minority protection. No further elaboration of the topic is foreseen for this section.[335] The purpose here is solely to figure out the problem which some transition economies confront. This issue may not be resolved with ordinary mechanisms of corporate governance. The problem belongs rather to the aspect of improved global governance and enhancement of institutional environment.

2.1.2 Some Other Strategies

Together with above mentioned legal regulation against abusive actions of a bidder, there are some other supportive mechanisms that may enhance the position of shareholders. One of them is the disclosure requirements. In Germany, as soon as a decision on acquisition of controlling stake (more than 30% of voting rights) has been made, a potential bidder must publish this information to inform the target and market[336]. The bidder is not obliged to give any detailed information about the forthcoming offer. Apart from the publication in special magazines, the Federal Supervisory Office and authorities of the concerned stock exchange must be informed. Right after the publication a special notice must be made to target's management (Nörr et al., 2003, p.29). In the US, according to §14(d) of the Securities Exchange Act any offers directed to more than 5% of outstanding shares oblige a bidder to notify the SEC (Securities and Exchange Commission), the target company and the stock exchange on which the target company is listed (Merkt and Göthel, 2006, p. 635).

As the documents of an offer represent the main source of information, based on which the target shareholders will be making their decision, it is necessary to define penalty for a

[335] For more about corporate blackmailing See Schramm 2007
[336] Takeover Act, Germany - §10.

bidder if the given information is inaccurate. Both in Germany and the USA a bidder is liable for breaching the requirement to publish the offer and for publication of inaccurate offer.[337] In Germany the bidder's board is liable to the target's shareholders for accuracy of the offer document. Any losses of target shareholders caused through accepting inaccurate information in the offer documents lead to the liability of the party which issued them (Adolff et al., 2002, p.160). The liability can be excluded only if the person responsible for information can prove that they were not aware of the incompleteness of information (Nörr et al., 2003, p.37). In the same way, the US shareholders have the right to sue the bidder if disclosed information is inaccurate.[338]

The laws in Russia make the decision to disclose plans to make an offer optional. It is left to a bidder's discretion whether to notify a target corporation.[339] In contrast, Kazakhstan and Uzbekistan mandate the disclosure of a bidder's intention to make a public offer.[340] Another difference in the regulation of the three countries refers to the quantitative threshold when the offer must or may be (in case of Russia) disclosed. This threshold is usually defined on the level when the tender offer targets a substantial stake in the corporation. Thus, in Russia the bidder may, and in Kazakhstan he/she must disclose the takeover intention if 30% and bigger stake is to be acquired. In Uzbekistan the disclosure must be submitted if acquisition of 15% stake is planned.[341] In this respect, it is not clear why in Uzbekistan, where the degree of ownership concentration is considerably higher than in Russia and Kazakhstan, the disclosure must be made on the 15% level.

A bidder may also purchase shares before the decision about takeover is made. It can be done on the open market. In this case, major world jurisdictions mandate the disclosure of small stake building: "Information about major share blocks allows the regulator, minority shareholders and the market to monitor large blockholders in order to avoid that the latter extract private benefits of control at the expense of other stakeholders. In other words, transparency minimizes potential agency problems ex ante. Moreover, transparency allows the regulator to investigate, for instance, insider trading or self-dealing by large blockholders." (Goergen et al., 2005, p. 13). Assman et al. (2006) speak in this respect about the protection of investors and strengthening their trust in securities markets.

As a rule, in large and liquid capital markets such notification threshold is small. In Germany, investors that achieved the threshold of 5%, 10%, 25%, 50% or 75% in a listed

[337] Germany, Takeover Act - §61
[338] For more about litigations of shareholders See Merkt and Göthel (2006)
[339] JSC Law, Russia §84(1).
[340] JSC Law - §25(1); Kazakhstan- Decree on information disclosure of security market participants, Uzbekistan - §5-1.
[341] Uzbekistan §5-1 Decree on information disclosure of security market participants.

company must inform about this fact the company itself and *Bundesanstalt (BaFin)*.[342] Similarly, the US law requires that any person who directly or indirectly became a beneficial owner of more than 5% of shares must within ten days of such acquisition send a detailed notification to the issuer, stock exchanges and SEC.[343]

In the observed transition countries, the disclosure provisions are regulated on two levels: the corporate law and the capital market law. On the corporate law level, it is required in all three countries that an affiliated person informs the company about obtained shareholding.[344] Only the Kazakh JSC Law determines the features of the affiliated person in its corporate law. Thus, a shareholder with 10% is the affiliated person and must notify the company about obtaining such a stake. In contrast, Russia gives a definition of affiliated parties in the Antitrust law (Schramm, 2007, p.645). According to it among other features affiliated party is a natural or physical entity that poses more than 20% of voting shares.[345]

On the second level the disclosure aspect is handled by the law on securities markets. The Kazakh law requires that an issuer, and not a shareholder, must disclose the information if a 10% stake was obtained.[346] The largest disclosure level is determined in the Uzbek law; here investors must notify the state Supervisory Authority about building of a 35% stake.[347] It is not clear why particularly this threshold was selected. In the world practice the disclosure of small stake building notifies both shareholders and the market in order to prepare all participants to a possible tender offer. In Uzbekistan, in contrast to all other reviewed countries, the notification threshold (35%) is higher than the tender offer threshold (15%). In contrast, the Russian regulation is oriented towards the Western capital market standards. Since 2006 a shareholder who achieves the stake of 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75% must notify the state Supervisory Authority about the fact within 5 days after the acquisition.[348]

2.2 The Conflict between Target Managers and Shareholders

The conflict between managers and shareholders, generally and particularly in the course of takeover, constitutes the main agency conflict in companies with widely dispersed ownership (Davies and Hopt, 2004, p.159). '*The conflict of interest between management and*

[342] Securities Trading Act (WpHG) Germany - §21.
[343] Securities Exchange Act 1934, USA - §13(d) (1).
[344] JSC Laws: Russia - §93; Kazakhstan - §67(3); Uzbekistan - §109.
[345] The Law on Competition and Restriction of Monopolistic Activities on commodities market, Russia -§4.
[346] The Law on Securities Market, Kazakhstan - §102(2).
[347] Decree on Information Disclosure, Uzbekistan - §5(25).
[348] Law on Securities Market, Russia - § 30.

outside shareholders arises solely from the fact that a successful tender offer affects the welfare of outside shareholders and managers differently' (Stulz, 1988, p.26). In a corporation with multiple shareholders *de facto* control belongs to managers, who are in the position to undertake actions that may harm existing shareholders. This conflict has two-fold character. First, from the perspective of target shareholders the transaction can be value increasing, senior managers may persuade shareholders to reject the offer or managers may themselves block the transaction in order to preserve their job and perquisites. Second, managers may persuade target shareholders to accept takeover bid, which does not have wealth maximizing effect but secures their job (Davies and Hopt, 2004, p.160).

As already discussed in previous chapters a crucial mechanism for mitigating corporate conflict is the decision rights strategy. A tender offer can be either accepted or it is decided to fight the offer by implementing some anti-takeover strategies. The latter aspect is discussed in the upcoming chapters. With respect to the party to whom the decision making power is granted, two models can be distinguished. In the first model only shareholders have the sole right to decide on a tender offer. Such scheme can be observed in the UK. Under the second model, target directors may have decision rights together with shareholders. In this case the offer cannot be put to shareholders without directors' consent and, on the other hand, shareholders may also block the decision of the directors. The latter model can be found in the USA, where directors have authority to implement available defence strategies in order to protect the company from an abusive offer (Davies and Hopt, 2004, p.164). This is stipulated by high ownership dispersion in the US corporations, where through proxy machinery and support of large shareholders mangers remain with residual decision rights. Additionally, the strong federalism leads to the highly competitive environment among the US states, which compete with each other to be the primary choice for incorporation among the US companies. As a consequence, statutes of most states provide for manager friendly anti-takeover mechanisms. The crucial idea behind such position has an economic underpinning. After successful takeover from another state, activities of a corporation decrease in the 'home' state. (Merkt and Göthel, 2006, p.644). From this perspective it is apparent why so many states introduce multiple anti-takeover mechanisms.

Most European countries (the UK, Austria, Portugal, Switzerland, and France) apply the first model in their jurisdiction, allowing mainly shareholders to take the decision on takeover (Davies and Hopt, 2004, p.170). Germany, in this respect, represents a sort of amalgamation of two models. Here, managers can be permitted to utilize specified defence measures through resolution adopted in advance of a hostile offer. Such permission can be granted for maximal period of 18 months and must be approved by three-quarter majority of vote casts.[349] If no such resolution was issued, management would not be able to undertake any actions that may prevent the bid being successful.[350]

Giving the mangers discretion to react on takeover bid, the main agency conflict is triggered. Here it is important to ensure that managers do not follow their private goals but rather act in best interests of shareholders and other corporate constituencies. This can be stipulated by allowing shareholders to contest the decision of management in the court. In the USA the decisions of boards are commonly protected by the Business Judgement Rule. The idea behind such concept is that courts may not interfere as board purpose can be attributed to any rational business purpose. However, in the takeover transactions the conflict of interest is so apparent, that alone the reliance on the Business Judgement Rule cannot mitigate the agency conflict. Based on this consideration, in 80s the Delaware court ruled in additional conditions that are known currently as the *Unocal* and *Revlon* doctrines (Bainbridge, 2002, p.701-703). The *Unocal* doctrine stipulates that the board has rights to apply defensive measures against hostile takeover, as long as she/he can prove that implemented measures were serving the best interests of a target corporation. The *Revlon* doctrine prohibits the board to take any defensive measures if the success of takeover is unavoidable and the proposed offer is not grossly inadequate.

Under the German law, when reacting on takeover decision, the board must act in best interests of not only shareholders, as in the USA, but also consider some other interests, such as those of employees, a given company and public (Nörr et al., 2003, p.47). Such wide range of interests leaves management with quite large discretion. For example, it can be always argued that board acted in best interest of employees when using some defensive mechanism, whereas the shareholder may be disadvantaged through a lost opportunity to sell shares for premium price. To avoid such particular situation, the board in Germany is obliged to stay neutral; this means that after the moment an official offer has been made, the board is prohibited to undertake action that may hinder the success of takeover completion (Thaeter and Brandi, 2003, p.179). The German Takeover Act does not specify the liability of the target's board for the breach of its fiduciary duties when responding to a takeover offer. Therefore, the general principles that specify the liability of target's board must apply (Nörr et al., 2003, p.69).

It is apparent that in countries with mainly concentrated ownership pattern a better solution on the takeover issue is the application of the first model, in which shareholders

[349] Germany, Takeover Act - §33(2).
[350] Germany, Takeover Act - §33(1).

decide whether to take the offer or not. For transition economies, the choice of the first model is strengthened by weak institutional environment in which managers can hardly be made liable for the breach of fiduciary duties.[351] In Russian law the decision making authority with respect to takeover lies in the domain of shareholders. The board has fairly passive role in a tender offer process. Its functions are limited to giving qualified recommendations.[352] Pursuant to the Joint Stock Companies Law members of a target's board could be liable for damages caused by their failure to perform their respective obligations.[353]

The regulation of control transaction in Kazakhstan requires separate consideration, since it is complicated through division procedures into transaction before the control is acquired (pre-bid) and actions after control acquisition (post-bid). Before acquiring controlling stake, a bidder must disclose the intention to do so. The law mandates the submission of intention to the company, although shareholders as an addressee are not clearly specified.[354] It is also not clear if managers must inform the shareholders about the decision made and make their recommendations about the offer. Thus, it is theoretically possible that the management may decide whether to notify shareholders about the bid or not. In contrast to pre-bid procedures, after acquiring controlling stake a bidder must submit remaining shareholders an offer to acquire the stake left. In this case, the law explicitly determines that shareholders are to make the final decision to sell shares. Unlike the both mentioned countries, Uzbek jurisdiction has not introduced any rules regarding control transactions.

Even if shareholders have the decision making power on an offer, some law provisions can provide with anti-takeover mechanisms that can help to frustrate the offer. In the following chapter, some frequently used mechanisms will be closely considered. It is critical for further analyses to examine their availability in transition economies and to figure out who has the decision power to implement these mechanisms. The anti-takeover strategies can be classified into: pre-takeover and post-takeover. The first implies that the strategy is activated before a tender offer was made, the latter, in contrast, is implemented after a tender offer.

Anti-takeover strategies can help to challenge abusive offers that may harm some interested parties or, in case of some large corporations, even undermine the economic equilibrium of a particular country. Nevertheless, the usability and efficiency of anti-takeover provision is questioned by many scholars. For example, Black et al. opine that '*managers typically argue that they must be able to reject hostile takeover bids to protect shareholders'*

[351] In the context of transition economies fiduciary duties mean to act in best in interest of corporation and with considerable care.
[352] JSC Law, Russia - §84.3.
[353] JSC Law, Russia - §71.2.
[354] JSC Law, Kazakhstan - §25.1.

interests. We are sceptical of this argument in developed economies and even more sceptical in emerging markets, where managers are already often heavily entrenched.' (Black et al, 1998, p.72). The study by Bebchuk et al. (2004) shows that firm value is negatively correlated with takeover provision. The purpose of this section is not to deepen the discussion about the necessity of anti-takeover provisions, but rather to give a general overview about tools that are available in five countries and what party is vested with rights to implement defence strategy.

2.2.1 Pre-bid Strategies

Long before a takeover bid, a corporate structure can be shaped in such a way that makes the target unattractive for an acquirer. Most pre-offer strategies require approval of shareholders meeting as they effect changes in the articles of association. Among such strategies are: staggered (classified) board, dual class shares and vote caps, golden parachutes, cross-shareholding, supermajority requirement, restriction on transferability of shares, poison pills and employee ownership plans.

a. Staggered Boards (Classified Board)

As already discussed, a staggered (classified) board consists of several fractions, only one of which is elected annually.[355] The bidder must wait for several years (usually two) to accomplish the board with majority of own directors. Therefore, this defence tool is efficient only in cases when a bidder does not have sufficient time to wait until he gets control powers. Normally, this applies to situations when a bidder borrows money with hope to repay debt with assets of an acquired company (Bainbridge, 2002, p.677). Otherwise, if a bidder can wait for longer period, this defence is of little benefit. Additionally, in order to make a staggered board an effective defensive strategy, supplementary provisions are required. First, if controlling shareholders can remove directors without a cause in the mid-term, there is a little use of staggered boards. A staggered board can be protected by giving the decision rights about the board's size and filling the vacancy to the board itself. Moreover, the laws may restrict a shareholder's right to call for special shareholders' meeting or remove a director without a cause.

[355] See Section A, Chapter 1.1.2 (Power to replace board members)

The very constitution of a board in Germany and provisions which define its structure hinder an acquirer from easy appointment of own representatives. The review of basic governance structure showed that, at first, the qualified majority of vote casts is necessary to remove the board without a cause. Even if an acquirer collects required number of votes, only a half of a big company's board can be removed because the other half consists of employee representatives, who are traditionally opposed to takeovers, since they usually result in job cuts. In addition, staggered boards are permissible under both the general German Corporate Law and Takeover Act (Nörr et al., 2003, p.57). Thus, the board structure of a German corporation is a crucial hurdle against takeover. In the USA, a staggered board is a common practice among corporations. Nevertheless, it is not a significant obstacle against takeover because in practice any bidder may remove the board, paying lavish compensation if directors step back voluntarily (Merkt and Göthel, 2006, p.655).

Corporate laws in transition economies do not provide for staggered boards as a defensive strategy.[356] Shareholders must elect a new board by the end of its term.[357] In Russia and Kazakhstan a bidder can remove directors in mid-term if he holds majority of votes cast on a meeting. In Uzbekistan this threshold is higher as a bidder needs to poses 75% of votes on a shareholders' meeting. Theoretically, a bidder in Russia and Kazakhstan can change the board acquiring more than 25% of outstanding shares and in Uzbekistan with 45% of shares. These figures take into account the fact that required quorum of shareholders meeting in Russia and Kazakhstan is achieved when more than 50% of voting shares participate in the meeting and in Uzbekistan 60%.[358] However, the rights to remove the board in the mid-term may depend on shareholders' right to call for an extraordinary meeting. If shareholders are not authorised to call for such meeting, this may also to some extent hinder the takeover attempt, or at least postpone the board removal till the next shareholders meeting. All three transition economies allow a large shareholder (owning 10%) to call for a special meeting.[359] It can be concluded that a staggered board is not available as a defence mean in transition economies. Moreover, the laws in the three transition countries make a consequent change of the board an easy procedure for shareholders who obtained large stakes.

[356] See for example Iwasaki Ichirio (2007), p.4 for staggered boards in Russia.
[357] JSC Law: Russia-§66(1); Uzbekistan-§83; Kazakhstan - §55(2).
[358] JSC Laws: Russia-§58(1), Kazakhstan-§45(1); Uzbekistan - §75.
[359] JSC Laws: Russia -§55(1); Kazakhstan - §37(1); Uzbekistan - §72.

b. Dual Class Shares and Vote Caps

Defensive strategy that has been frequently used in the USA is the dual class of shares (Bainbridge, 2002, p.454). According to this scheme there are several classes of shares; while one class of shares gives its owners usually only one vote per each stock, other classes may grant multiple votes per stock (between 10 and 200) (Merkt and Göthel, 2006, p.656). Usually shares of the second class are under control of management or their allies. Thus, any attempt of an acquirer to terminate the board can be outvoted by existing management. As mentioned above Delaware provides default 'one share-one vote rule' thus allowing the corporation to opt out from the provision.[360] Since Germany introduced one share one vote rule, this defence tactics in not available for German corporations.[361] Similarly, transition economies are banned from using dual class plans because one share one-vote rule is explicitly indicated in their jurisdictions.[362]

The voting cap can also serve as an anti-takeover mechanism, as it limits the number of votes which one shareholder can exercise (Goergen et al., 2005, p.15). The availability of such a limitation may diminish the chances of takeover, which may have a positive effect on the shareholder's wealth rewarding them with a premium price. This rule is not available for the listed companies both in Germany and the USA, which emphasizes the revert effect of this rule on depth of the capital market. In contrast, the statutes of Russia and Uzbekistan allow voting caps.[363] For their introduction the amendment of articles of association is required, which in these two countries can be implemented only if three-quarter of votes cast on the shareholders meeting accept the decision. Therefore, in Russia and Uzbekistan voting caps are theoretically eligible as an anti-takeover mechanism. The Kazakh corporate law states that voting caps can be introduced if provided in other laws.

c. Golden Parachutes

The golden parachute is a mechanism which protects the executive managers in case of takeover though the lavish post-employment payments. In theory, the golden parachute increases the costs of takeover for an acquirer, which sometimes may achieve two-digit-million sums, and is therefore included on list of defensive tactics. However, in practice the role of such protection from takeover is equivocal, because managers maybe self-interested in

[360] Delaware - § 212(a).
[361] AkG Germany - §12(2).
[362] JSC Law, Russia - § 59.
[363] JSC Laws: Russia- §11(3); Uzbekistan - §15.

takeover to obtain their golden parachute rights. On the other hand, in time when the takeover deals attract enormous capital, a several million payment to managers is not a real obstacle for a bidder. The German Takeover Act outlaws any such payments to the target's managers which exceed usual compensation sums (Nörr et al., 2003, p.45).

In the USA 'Golden parachute' belongs to the usual practice. This could be explained by highly competitive managerial market, where companies strive to appoint the best managerial heads offering them attractive incentive schemes. However, since 1986 according to SEC proxy rules golden parachute agreements must be disclosed (Merkt and Göthel, 2006, p.665).

The laws in transition economies do not explicitly articulate the issue of manager's compensation as a consequence of takeover act. Only Uzbek law requires that compensations of both the supervisory and management boards' members are reasonable in relation to the situation of a company. In all three economies the supervisory board decides on compensation of an executive board, and shareholders determine payment to supervisory board members. One important aspect in this context is whether the decision on remuneration can be made after the offer has been submitted and which body is qualified to decide on this issue. The JSC Law in Russia extensively articulates this aspect. It is allowed to introduce golden parachutes after a bid, however in contrast to regular law, after the takeover bid, rights to decide on this issue are transferred to shareholders.[364] Therefore, it can be concluded that 'golden parachute' as a defence tool is available in Russia and Kazakhstan, whereas, in contrast to Kazakhstan, Russian shareholders are protected by the decision making power after the bid has been made.

d. Cross Shareholding

The cross-shareholding between affiliated companies can serve as an efficient defence tool, as it reduces the number of shares in free float and allows the target company to hold its shares indirectly (Nörr et al., 2003, p.58). Commonly jurisdictions restrict the right of a corporation to hold own shares; cross shareholding enables it to avoid such restriction. Nevertheless, some countries implement an additional regulation that may to some extent restrict the effect of cross-shareholding. For example, the German company law restricts the cross voting rights. If the number of shares held in cross shareholding exceeds 25%, the voting rights attached to them are limited to 25% (Adolff et al., p 208). Similarly, the Kazakh law restricts the voting rights up to 25% of shares, if they are held in cross-shareholding.[365] In the USA a subsidiary cannot vote with shares of a parent company, if the parent holds the

[364] JSC Law Russia - §84(6).
[365] Civil Code Kazakhstan - §95(3).

majority of shares in the subsidiary.[366] As for Russia and Uzbekistan, Schramm (2007) notes that these two countries have chosen more moderate provisions, as their laws state that the maximal limit of cross-shareholding and voting rights, which one of such companies has, is defined by the law.[367]

e. Supermajority Requirements

The supermajority requirement to approve significant corporate actions lift up the threshold of votes required for a bidder, and thus hampers the successful changes after the completion of takeover. The required voting majority regarding particular corporate actions has been discussed in the previous chapters. In this section only some concrete aspects interrelated with takeover actions will be scrutinized.

When initiating hostile takeover the primary goal of a bidder is to exchange the management as soon as the required majority has been achieved. Among transition economies both Russia and Kazakhstan keep the required majority relatively small. In both countries simple majority of votes cast are sufficient in order to replace the supervisory board in a mid-term. In contrast, Uzbekistan mandates the qualified majority of votes participating in a meeting.

The acquisition of a corporation may become unattractive for a potential bidder if amendments in the articles of associations require the approval of strict majority (e.g. 75%). This will make any simple changes in the articles of association, like for example changing the name, a complicated action for a bidder (Adolff et al., 2002, p.210). Kazakh jurisdiction makes it almost impossible to implement changes in the articles unless the bidder collects 75% of all outstanding shares. Lower voting requirements provide Uzbek and Russian laws, where only qualified majority of votes cast are enough. Keeping in mind the quorum requirements in both countries, it can be stated that theoretically 45% of outstanding shares in Uzbekistan and 40% in Russia will suffice to change required articles. It is noteworthy that all stipulated majority requirements make sense when a bidder is not planning to acquire absolute control over a corporation. In conclusion, it can be stated that unless a bidder intends to acquire the whole corporation, voting rules in transition economies can be considered as one of the defence mechanisms.

---

[366] Delaware - §160(C).
[367] Civil Codes: Russia - §106(3), Uzbekistan - §68.

f. Restriction on the Transferability of Shares

Another way to defend a corporation from takeovers is to restrict the transferability of shares. This rule hinders that corporate shares appear in hands of a hostile bidder. Usually it is based on the principle that managers must approve of a transfer of such shares. The German Law allows for such a defence mechanism (Adolff et al., 2002, p.12). However, only transferability of registered shares can be limited (Schramm, 2007). Usually these rights are created during the formation of a corporation. Subsequent to the formation, they can only be introduced if each affected shareholder approves such rights. Moreover, shares with restricted transferability can only be listed on the stock exchange if their free negotiability is assured. Thus, a theoretically attractive defence mechanism is hardly available in practice for a listed corporation (Adolff, et al., 2002, p.214). According to the US regulation share transferability can be also restricted by law (Merkt and Göthel, 2006, p.362-363). The Russian and Uzbek laws also contain provisions which restrict free transferability of shares. Thus, the law differentiates between two types of joint stock companies – open and closed.[368] While the shareholders of an open joint stock company may freely sell their stocks, in closed joint stock companies the shares must be offered to other shareholders before offering to the public. In contrast, the Kazakh law has refused from the two types of companies in 2003 (Schramm, 2007) and it introduced the provision that bans any restrictions on share transfer.[369]

g. Poison Pills

'Poison pills' belong to one of the most frequently used defence mechanisms in the USA. The official name of this strategy is 'shareholder rights plan' (Bainbridge, 2002, p. 680). The concept implies that, in the course of a concrete situation, shareholders of a target company get the right to buy its further shares at a bargain price, thereby diluting the position of the offeror (Nörr et al., 2003, p.52).

Poison pills have never been permitted in Germany.[370] The introduction of rights plans does not generally lie within the responsibility of the board: it requires shareholders' resolution (Nörr, et al., 2003, p.55). Moreover, as mentioned above, managers can be granted the right of restricting the subscription rights of shareholders, however this can be done only in very limited circumstances. On the other hand, the contribution paid for new shares may

[368] JSC Laws: Russia - §7, Uzbekistan - §6 and §7.
[369] JSC Law Kazakhstan - §25(2).
[370] Schanz, NZG 2000 p.337, 343 cited by Nörr and Stiefenhofer, p.55.

not be less than the value attributable to each existing share, which means that a subscriber may not receive newly issued shares too cheaply. This is the reason why poison pill strategies that involve the restriction of subscription rights, as well as the issue of shares at a discount, are not available in Germany (Adolff et al., 2002, p.218).

In transition economies shareholders cannot be excluded from the subscription rights. Newly issued shares must be distributed among shareholders in relation to their current stake. If a bidder already possesses the shareholding, he/she cannot be excluded from the issuance. On the other hand, even if the bidder is granted pre-emptive rights, his shareholding can be diluted by issuing the shares to other shareholders for considerably lower price. Kazakhstan extensively mandates equal price for all shareholders.[371] In addition, investors are protected by the principle of equal treatment of shareholders. Therefore, the 'poison pills' within the Western worldview are not applicable in transition countries.

In this respect, it is noteworthy that 'poison pills' exist in transition economies, however their definition differs from the poison pills reviewed earlier. In fact, poison pills are regarded not as privileged rights of existing shareholders to acquire shares, but rather as an action initiated by former managers which have negative effects on a corporation and its new owners (Ionzev, 2005, p.211). As an example, Ionzev indicates contracts which the managers of a target-company have concluded shortly before the takeover. Commonly such contracts include the long-term purchase of resources for excessively high prices or sale of own products for low prices, thus, extremely hampering the profitability of a new owner. Refusing to fulfil the contract agreement is punished with high fines. Although mainly Russian literature discusses this aspect, theoretically it can be assumed that this protection mechanism is available in Kazakhstan and Uzbekistan as well.

h. The Employee Stock Ownership Plans (ESOP)

Corporate takeover and its consequent restructuring, or in some cases even dissolution, have negative repercussions on employees. That is why in most cases employees are against takeovers. Such attitude of one of the main corporate constituencies may stimulate the wish of managers to distribute some shares among employees. Employees' shareholding in combination with shares held by founders, or other interested groups reluctant towards the takeover bid, may help to block any decision (e.g. removal of supervisory board members, capital increase, purchase of own shares, etc.) that is initiated by a bidder who already

[371] JSC Law Kazakhstan - §18(2).

possesses some shares. Thus employee stock ownership plan can be used as anti-takeover instrument.

The German law allows the authorization of management to issue shares under the ESOP (Employee Stock Option Plans) up to maximum of 10% of the issued share capital.[372] Contrary to the US law, share options must be issued conditional on certain defined targets being achieved. Such targets can be the specified threshold profit or share price (Nörr, et al., 2003, p.57).

Issuing shares to employees was a part of privatization programs in transition economies. As the chapter on the ownership structure and privatization has shown, employees received significant stakes in privatized corporations. In some companies, ownership of these stakes shifted in later periods to corporate managers. Nowadays the orientation of the laws to safeguard interests of employees has diminished. Only some minor law elements explicitly mention interests of employees. For example, due to very low pace of privatization in Uzbekistan, the company law includes an article which states that in the companies which undergo privatisation through incorporation employees have the right to acquire its shares.[373] Solely, the Russian law stipulates creation of reserve funds that can be utilized to acquire shares from shareholders and sell them to employees.[374] The maximal number of shares sold to employees may not exceed 10% of all issued shares, as the law allows to repurchase shares to this threshold (Teljukina, 2005, p.35). No such kind of limitation was found in Kazakhstan and Uzbekistan, which automatically erases the ESOP as possible defence mechanism in these countries.

2.2.2 Post-offer Strategies

a. Share Repurchase

The overall legal frameworks of share repurchase were discussed in the chapter on significant corporate actions. In the context of control transaction the repurchase of shares is also interesting as it may serve as additional defence mechanism. It acts against a hostile bid in two ways. Firstly, managers may transfer acquired shares to their allies, which may dramatically deter a bidder's ability to acquire controlling majority (Adolff et al., 2002, p.220). Secondly, on the liquid capital markets stock repurchases as a rule lead to the increase

[372] AkG Germany - § 192
[373] JSC Law Uzbekistan - §37-1
[374] JSC Law Russia - §35(2)

of share price. This happens because on the one hand, the number of outstanding shares decreases and, on the other hand, it signals that management is supportive of shareholder interest. As a result, the increase of stock price makes the premium offered by a bidder appear unattractive (Bainbridge, 2002, p. 692).

The extent of the use of this mechanism may be limited by law. In fact, similar to German legislation, Russian and Kazakh laws impose quantitative threshold of maximum shares that can be purchased. It is allowed to buy out only 25% of own issued shares in Kazakhstan, whereas in Russia only 10% of issued capital could be bought back.[375] The Uzbek law does not regulate the quantitative restriction, what goes in line with the US approach. It means that theoretically a company can buy out unlimited number of shares, as long as it does not breach the minimal capital maintenance rule. According to the Russian and Uzbek law shares repurchased not for the purpose of capital reduction must be cancelled after one year if not sold within that time.[376] In contrast, corporations in Kazakhstan are not mandated to cancel repurchased shares.

Also an important aspect here is to whom the decision making rights belong after the offer has been announced. Under the German rule shareholders make a decision themselves about a proposal, although managers may also be authorised to decide for the maximal period of 18 months (Adolff et al., 2002, p. 219). Russia strictly mandates that the exclusive right to decide about an offer belongs to shareholders. Uzbek law does not regulate this aspect in respect to takeover.[377] It can be referred to general rule of shares repurchase, under which only shareholders are authorised to decide on the matter. Similarly, in Kazakhstan no special rules for share repurchase in the course of takeover offer are available. Thus, applying the standard practice, the supervisory board is in the position to decide on this issue.

Due to the current state of the law, it can be concluded that the repurchase of shares has a significant importance as a defence mechanism in Uzbekistan, followed by Kazakhstan and Russia with quantitative limits on the acquisition of own stocks. The positions of shareholders are safeguarded by allowing them to decide on the issue in Russia and Uzbekistan. In Kazakhstan, if the decision rights are fixed to the supervisory board, shareholders may potentially be confronted with agency conflict.

Despite its functions of a defence mechanism, the purchase of own shares bears the threat of other problems, namely those which arise in the contest of self-dealing (Bainbridge,

[375] JSC Laws: Russia- § 72;2 Kazakhstan - §28(1)
[376] JSC Laws: Uzbekistan - §45, Russia- §72(3)
[377] JSC Law Russia - §84(6)

2002, p.692). These aspects related with self-dealing will be closely observed in the Section D.

b. The Increase of Share Capital

The increase of share capital by a target company after a takeover offer is made, may create additional impediments for a bidder. On the one hand, the increase of capital implies that a bidder will need to mobilize larger capital in order to complete the transaction. Although this may not be a large impediment for takeover, it may cause a delay. On the other hand, the new shares can be issued to a "friendly" bidder, considered that current shareholders refuse to make use of their pre-emptive (subscription) rights, and management can even limit these rights.

All jurisdictions allow for capital increase within authorised capital. Under the German law, the increase of authorised share capital is the most powerful defensive measure (Adolff et al., 2002, p 218). In Germany management may be authorised for up to five years to issue new shares within the authorised share capital. The amount of new issued shares may not exceed 50% of available share capital. In addition, with approval of the supervisory board management may restrict the subscription rights (pre-emptive rights) of existing shareholders, which enables managers to issue capital to a 'friendly' bidder, thus deterring a hostile bid. Nevertheless, the managers have freedom to undertake all the above mentioned transactions only before the bid was officially made. Once the takeover has been launched, the target board's duty is to remain neutral (Nörr et al., 2003, p.59).

In Kazakhstan and Uzbekistan there is no special regulation of capital increase after takeover announcement. Therefore, the ordinary rule of capital increase must be considered, which implies that either shareholders or the board can be authorised to approve capital increase. Russian law, as in the case of share repurchase, considers special rule for a takeover transaction, which says that after takeover was announced only shareholders are qualified to make a decision.[378] In contrast to Germany shares may not be issued to a concrete 'friendly' person, since pre-emptive rights may not be opted out. Therefore, with respect to capital increase the law in transition countries deteriorates takeover chances but not to such extent as in Germany.

[378] JSC Law, Russia - §84(6).

2. Protecting Minority Shareholders in the Course of Takeover

In companies where a controlling shareholder is available the decision making rights of shareholders may have no use, since a controlling shareholder may determine whether to accept a bid or not (Davies and Hopt, 2004, p.184). Like in case of all other governance actions minority shareholder may turn into victims of large shareholders. The latter may enter an agreement with a bidder, who will later "loot" it, or will be simply less respectful of the interests of non-controlling shareholders, or may induce minorities to sell shares too cheaply (Black et al, 1998, p.71). Against the abusive offers of bidders minority shareholders are protected through the same strategies as all other shareholders. That is why in this section, we consider only the aspects of small shareholder protection against the misappropriation of large stakeholders.

2.1 Mandatory Bid

The first strategy that is supposed to act as a mechanism of protection of minority interests is mandatory bid. It provides minority shareholders with an opportunity to leave a company on fair terms after the controlling stake in company has been acquired. *"The rule requires the acquirer to make a tender offer to all the shareholders once she has accumulated a certain percentage of the shares*." (Goergen et al., 2005, p.10). According to this rule, if an acquirer obtained control of significant stake, which varies from country to country (usually 30% is taken as standard threshold), he/she is obliged to make an offer to all remaining shareholders, whereas the condition of the offer mustn't be economically disadvantageous in comparison to the first offer.

In Germany mandatory bid provisions retained statutory authority since January 2002 with the coming into force of the Takeover Act. As soon as a shareholder acquires 30% or more voting rights in a target, she/he must make mandatory bid to remaining shareholders.[379] If the controlling shareholder fails to comply with the requirement to make mandatory bid, he/she faces multiple sanctions imposed by §60 and §61 of the German Takeover Act, which vary from suspending voting rights of the controlling owner in the target company to up to one million euro (Nörr et al., 2003, p.89). In contrast, the US statutes do not prescribe mandatory bid rule. Instead, it is mandated in the statutes of a few US states that after the controlling stake has been acquired the remaining shareholders have the right to require their shares to be repurchased by the

[379] Takeover Act, Germany - §29(1).

controlling owner. In different states the threshold for the activation of the rights to require share repurchase can be 20, 30 and 50% of issued shares (Merkt and Göthel, 2006, p.648).

The role of mandatory bid rule in transition economies is not as undoubted as in countries with advanced economic and legal frameworks. It is debatable if mandatory bid is a proper mechanism for transition economies. Some authors argue that this remedy of minority protection leads to the ownership concentration in countries were the ownership is concentrated anyways. Berglöf and Pajuste (2003) argue that "*mandatory bid rule (MBR) requiring owners with large controlling stakes to buy out remaining shareholders also forces firms to delist, thus undermining the sustainability of these fledgling stock markets*" (p.3)…"*Sales of large blocks are desirable and critical to successful corporate restructuring in these countries, but the Mandatory Bid Rule essentially closes down the market for block trades. Moreover, since an MBR reduces the likelihood that a bid will be made in the first place, it entrenches the incumbent controlling owner, and diminishes any disciplining role that the market for corporate control may have. Given that transition countries will have concentrated ownership for the foreseeable future, the MBR, at least not in its strict form (which leaves no control premium), does not seem to be part of an optimal regulatory environment.*" (p.23).

Nevertheless, both Russia and Kazakhstan have introduced in their legislations the mandatory bid rule, whereas Russian law more deeply considers the details and procedural issues.[380] The Russian law imposes the mandatory bid rule if any person acquired more than 30, 50 and 75% of issued shares. Additionally, the price of the mandatory bid may not be lower than average price of the last six months.[381] In contrast, Kazakhstan's law prescribes mandatory bid only if controlling stake of 30% is acquired on the secondary market. In both countries, it is not clear what happens if no mandatory bid has been made after the controlling owner has evolved. In opposite to the two mentioned countries, the Uzbek law does not articulate the mandatory bid rule.

2.2 Squeeze-out

The squeeze-out transaction is another corporate action in which minority interests are extensively concerned. Squeeze-out provisions give large shareholders or a bidder who acquired a dominant stake in a target company the compulsory purchase powers over dissentient minority's shares. The compulsory buy-out threshold is usually fixed at the 90% or 95% level (Davies and Hopt, 2004, p.183).

[380] JSC Laws: Russia- §84.2(1),(7); Kazakhstan - §25(3).
[381] JSC Law Russia- § 84.2 (4).

Here arises the question: why a controlling shareholder may desire to squeeze-out a minority shareholder? In the literature a few substantial reasons, such as cost reason and free riding of minorities, are extensively discussed. The small shareholder due to some private reasons may act destructively by means of making use of some basic rights provided by corporate law that have a blocking effect on further corporate transactions and restructuring in particular (Baums, 2001, p.25). The problem is that minority shareholders use lawful means which cannot be easily refrained. One of the classical deeds of 'frustrating' minorities is challenging the decisions of shareholders' meeting, which may postpone significant actions and in long term even injure the image of a company.

Another reason is that the existence of small shareholders stipulates disproportionately high costs. The basic shareholder rights which most jurisdiction grants to shareholders are connected with some costs for corporation. To such rights belong the information rights and the right to participate at least once a year in the shareholder meeting (Nörr et al., 2003, p.129). Additionally, the potential synergy effect and rationalization of management may also be included in the list of pro squeeze-out arguments (Merkt and Göthel, 2006, p.613).

All the above mentioned reasons explain why the exclusion of minority shareholders by means of squeeze-out could be advantageous for corporation and controlling shareholders. However, the squeeze-out does not solely protect the interests of controlling shareholders. It may also mitigate potential agency conflict between controlling and minority shareholders (Goergen, 2005, p.14).

Although the introduced issues represent the advantages of squeeze-out for involved parties, the absence of accompanying provisions may considerably hamper the position of minority shareholders and thus injure the image of capital market. Among such accompanying provisions are the right of a minority shareholder to be paid a fair buyout price, the permission for minority shareholders to sue to stop the squeeze-out, the availability of clearly defined liabilities of appraisers, officers and directors for the breach of their duties. In the following paragraphs the experience of five countries under research will be closely reviewed.

In Germany, squeeze-out provisions became the integral part of corporate regulation only recently, when, together with the enactment of the Takeover Act, the legislature has amended the Stock Corporation Act (Adolff et al., 2002, p.294). According to the law any shareholder that obtains 95% stake in a corporation has the right to buyout shares from the remaining shareholders.[382] German provisions, although going in line with most other European jurisdictions, have details that differ from some other European practices. Thus, for example, the squeeze-out rule is not only restricted for listed corporations, but minority

[382] AkG, Germany - §327a.

shareholders of privately held public Stock Corporation may also be squeezed out. Another difference is that squeeze-out is possible without a prior takeover bid or a mandatory offer made by the majority shareholder being required (Nörr et al., 2003, p.128).

Allowing for squeeze-out transactions German legislator implemented some crucial provisions that are pivotal for protecting the minority shareholders from being expropriated. The minority shareholders have two possibilities to challenge the squeeze-out transaction: either by an action to set aside the resolution or by the compensation assessment proceeding (Nörr et al., 2003, p.126). The causes to set the transaction aside are limited. Among those few are improper calling of shareholders' meeting, errors in voting procedures or the allegation that the controlling shareholder did not own the required 95% stake (Nörr et al., 2003, p.127). In contrast, the compensation assessment proceeding does not have the blocking power. The claim that compensation is inadequate does not give a shareholder the right to block the resolution, and thus set it aside. As a rule, it is task of court to determine an adequate compensation.

Before proceeding to the US experience, it is necessary to figure out some key definitions that may lead to confusion. In the US practice two similar definitions – *squeeze-out* and *freeze-out* are utilized. The difference between them is that in the *freeze-out* action the minority shareholder is excluded from ownership by means of legally supported technical methods. In the *squeeze-out* the minority shareholder is forced to leave a corporation, because further keeping of shares becomes economically uninteresting for him/her. This can be achieved, for example, through repeated decision not to pay dividends (Merkt and Göthel, p. 608). Unlike the regulation in the EU, there is no way of direct exclusion of minority shareholders by the controlling shareholder in the USA (Posegga, 2006, p.47). Instead, minorities can be freezed-out indirectly, implementing diverse merger transactions.[383]

As in most other corporate transactions, minority shareholders have a significant protection in the USA against discriminating freeze-out. Both federal law and the statutes of particular states consider the rights of minority shareholders. According to SEC Rule 10b-5 the managers are mandated to disclose correct and complete information on the freeze-out transaction. The laws of all states require that 'leaving' shareholders are fairly treated (intrinsic or entire fairness test) and that freeze-out transaction has recognizable business purpose (Merkt and Göthel, 2006, p.617). The fairness test implies in the first instance that the shareholders are fairly remunerated. The price received by minority shareholders for their stocks cannot be lower than pre-offer share price (Amihud et al. 2004, p.18).

[383] For more about freeze-out mergers See Merkt/Göthel, p.609-612.

In the same manner as Germany, the Russian JSC law also includes the aspects of squeezing the minority shareholders after the controlling shareholder has achieved the threshold of 95%.[384] The controlling stakeholder can direct an offer to the remaining shareholders within 6 months after having built the 95% stake. An independent appraiser must determine the buy-out price, whereas the price may not be below the market value of shares and below the price paid during the voluntary and mandatory bid.[385] Those shareholders who do not agree with the price, may claim in court the reimbursement of the losses connected with improper stock valuation. Additionally, in case the newly evolved controlling shareholder does not make use of squeeze-out rights, minority shareholders are protected by the right to offer their stock for sale to the controlling owner, whereas the latter is obliged to purchase those shares.[386] The statutes of the remaining countries – Kazakhstan and Uzbekistan do not include squeeze-out provisions.

Despite such detailed determination of the purchase price, introduction of squeeze-out provisions faced wide criticism in Russia from the side of foreign institutional investors. Thus, for example, William Browder[387] opines that legal environmental conditions in Russia are not comparable with the Western jurisdiction where the existence of squeeze-out provisions are supported by fair buy-out price, the right to set the resolution aside, the liability of officers, directors and appraisers for the breach of fiduciary duties.[388]

3. Protecting Other Corporate Constituencies

It is presumed that due to restructuring, followed by successful takeover, the interests of employees are considerably hampered due to potential threat to their working places. Although there are still no unequivocal empirical results available, it can be admitted that there might be diverse reasons to restrict or even totally eliminate working places after successful takeover. The main purpose of this section is not the discussion on economic effects of takeover on employees, but rather to point out how legal systems in the countries under discussion consider the interests of employees in the pre- and post-offer phase.

Basically, the legal provision can foresee three strategies regarding the rights of employees. At first, law may require a bidder to state his/her intention regarding the

[384] JSC Law, Russia - § 84.8.
[385] JSC Law, Russia - § 84.8(2).
[386] JSC Law, Russia - §84.7.
[387] William Browder is the CEO of Hermitage Capital Management, an investment advisory firm which manages the Hermitage Fund, the largest Russia-dedicated investment fund
[388] Newsletter of the World Bank published on-line. Browder William, The Threat of Minority "Squeeze Outs" in Russia, available on http://www.worldbank.org/html/prddr/trans/december_2004/pg18.htm. Stand: April 2008.

employees of the target company. Secondly, in case when directors are authorised to decide on the takeover offer, the law can mandate that interests of employees to be considered as well. Thirdly, employees can retain the decision making role (Davies and Hopt, 2004, p.188).

As discussed in the previous chapter, it was evident that Germany belongs to jurisdiction with substantial concern of stakeholder interests. The aspect of takeover regulation is not an exception. Thus, for example one of the main objectives of the new German Takeover Law is the improvement of information and transparency for employees (Nörr, et al., 2003, p.13). In line with the first strategy mentioned above, the bidder must notify the target company about the plan of takeover, including the plans in respect to employment policy. No other country under consideration prescribes such strong informative rights. Only Russian law mentions that a bidder may decide to inform the target company both in course of voluntary and mandatory bid about the forthcoming plans regarding the employees.[389] However, the disclosure of plans is not mandatory. After receiving the bid, the supervisory board must prepare qualified recommendations about the offer, including the price, future plans of an acquirer with respect to the company and employees in particular.[390] Further obligations are not imposed on the bidder to engage employees in the takeover process. In Germany, the board's obligation to inform concerned parties is even broader, as managers of the target company must inform directly the employees and trade unions (Nörr et al., 2003, p.33).

The second strategy of protecting interests of employees prescribes consideration of their interests when the decision on takeover is made. This strategy is eligible only in those jurisdictions where the supervisory board is or may be authorised to make a decision on the takeover offer. Although the USA is considered to be based on the principles of shareholder value maximization, there are already around 30 states that issued the provision which allows directors to consider the interest of other stakeholders, including those of employees (Merkt and Göthel, 2006, p.649). Moreover, in the Principles of Corporate Governance issued by the American Law Institute it is prescribed that when making the takeover decision the board may consider the interests of employees, if doing so would not disadvantage shareholders in the long-term.[391] However, this principle is considered to be puzzling, as it is not clear how much injury to the shareholders the target board can cause before the shareholders are 'significantly disfavoured' (Bainbridge, 2002, p 741).

---

389 JSC Law, Russian: §84.1.4 and §84.2 2.
390 JSC Law, Russia - §84.3.
391 ALI Corporate Governance Principles - Section 6.02.

In contrast, the German law requires that interests of various groups should be taken into account: shareholders, employees, a company and public (Nörr et al., 2003, p.47). In many cases it is doubtful whether protecting the interests of non-shareholders, for example of employees, directors is not concerned with own interests, as the following states: '*The greater the range of interests which are entitled to take into account when exercising their discretion, the more difficult it will be to demonstrate that the standard has been breached*' (Davies and Hopt, 2004, p.188). That is why in order to avoid the fact that managers may misuse the principle of protecting the position of other stakeholders, the German law forbids the management board of the target company to take measures that could prevent the success of the bid.[392] The second strategy is not applicable in Russia and Kazakhstan, as only shareholders are authorised to make a decision on the takeover offer. Uzbek law does not take a position on that issue, since the takeover regulation is totally absent.

Finally, the third strategy in which the decision making power on the takeover issue is given to employees is not available in any of the observed jurisdictions.

4. Results

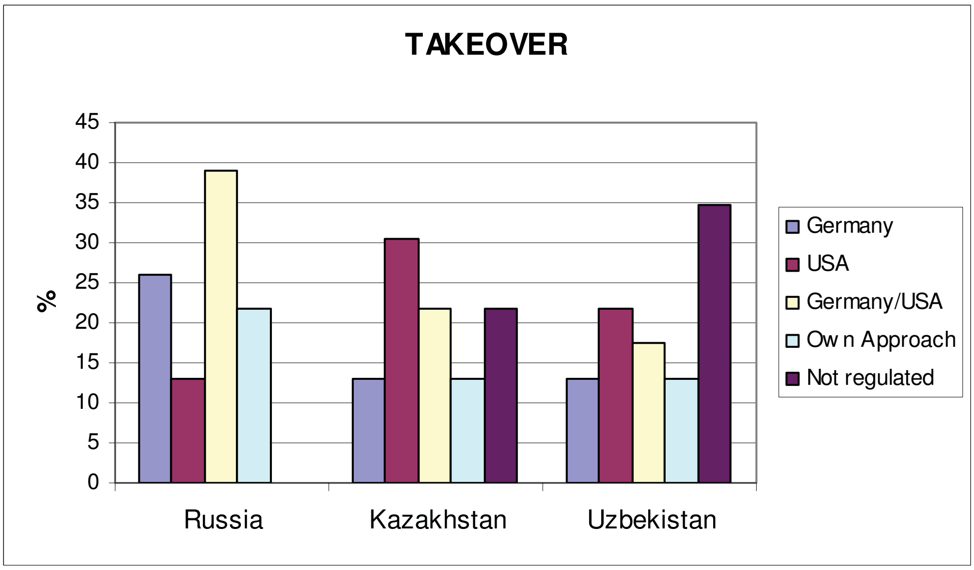
In terms of takeover transactions there is a tendency of regulation convergence among developed economies. There is a clearly observable trend towards the direction of a pro-capital market oriented system. Within the last few years Germany has integrated multiple provisions which resemble those of the USA. Nevertheless, the German law remains unique regarding the issues of the employee rights, which are more deeply considered in the German Takeover Law.

In their methods of regulating takeovers the transition economies resemble the US approach which regulates the takeover aspects not in separate laws but rather in the corporate law and the law on securities markets. Among the three transition economies only Russia has elaborated a thorough list of provisions, which mostly go in line with the US and German approaches (See Figure 11). Particular attention must be also paid to the minority rights protection which is poorly regulated in Kazakhstan and Uzbekistan. Although with regard to the minority protection the Russian law is more complete, the foreign portfolio investors still express scepticism about new provisions on the squeeze-out and the appropriateness of this mechanism in the hands of controlling shareholders.

[392] Takeover Act Germany -§33(1).

It is noteworthy that the Russian law, like the German one, has a number of provisions with respect to the employee rights. Kazakhstan chose an approach closer to the US regulation, whereas some necessary provisions are missing. The least developed law on takeovers is found in Uzbekistan with most of the provisions missing. It can be concluded that takeovers, and especially hostile takeovers, are very rare transactions in the context of the transition economies, which explains the law compliance of Uzbekistan and Kazakhstan with the recognized Western standards.

Figure 11: Takeover Regulation



Source: Own Depiction.

Note: The figure illustrates quantitative results of law comparison (See Appendix II, Table 5 and Table 6)

D. Related Party Transactions

1. Introduction

Insiders, being in control of a corporation, have de facto power to divert value to themselves. The World Bank uses the notion of "self-dealing" to designate the practice of transferring money or assets from a company to corporate insiders – a dominant corporate owner, a manager or a director (World Bank Group, 2006). In the literature such transactions are given several names. They can be called "related party transactions," "self-interested transactions," "self-dealing transactions," or "conflict-of-interest transactions" (Black et al., 2006). For the analyses of this chapter only the notions of self-dealing and related party transactions will be used.

Multiple researches have shown that the ability of an insider to expropriate outsiders undermines an investor's confidence in markets.[393] Empirical researches provide for the evidence that better regulation of self-dealing is associated with enhanced economic environment. Measuring the economic effect of self-dealing regulation, Djankov et al. (2006) found that the anti-self-dealing index, constructed on such variables as extensive disclosure, approval procedures and private litigation, is associated with valuable stock market, greater number of IPOs (Initial Public Offering) and higher number of domestic firms.

Self-dealing operations are especially prevalent in developing countries, which commonly have such features as small markets, weaker regulation and concentrated ownership (Nenova and Hickey, 2006, p.2). Nevertheless, even the jurisdiction in developed countries provides conditions for tunnelling assets, which is in some cases even legal (Johnson et al., 2000, p.10). Therefore, the existence of an efficient regulative mechanism of mediating the potential conflict of self-dealing is pivotal for all countries.

It can be intuitively assumed that self-dealing transactions are flourishing in countries with low ethical standards. Enriques (1998) proposes the official corruption index as a proxy for ethical standards. Referring to the corruption index of the three transition economies[394], it can be expected that due to high rate of corruption there is large space in business environment for self-dealing operations. According to Enriques (1998) the problem in the countries with high corruption rate is that legislators and judges share the same ethical

[393] See for example: La Porta et al., 1997, 1998; Shleifer and Wolfenzon 2002.
[394] Part I Chapter 3.1, Social and Cultural Frameworks of Corporate Governance.

standards as the society as a whole. Therefore, the regulation of self-dealing in these countries may require more thorough approach.

In general, there are two extreme approaches to the regulation of self-dealing (Djankov et al., 2006). The first extreme approach denies any legal regulation of self-dealing, and instead market forces should take care of the problem. No country has implemented such liberal approach, because the possibility to "take the money and run" in unregulated environment is too tempting. Another extreme approach is directed to the prohibition of any transaction which may potentially have self-dealing character. In fact, in the past some jurisdictions used to prohibit related party transactions. For example, Anglo-Saxon jurisdictions used to ban the self-dealing transactions of directors. Nowadays, the law in most developed countries allows some self-dealing for practical reasons (Hertig and Kanada, 2004, p.101). The decision to allow such transactions is connected with a positive effect that some of them may have: Poluyahtov (2005) gives an example from banking sector, arguing that related party transactions in bank sector decrease banks' costs required to evaluate a client's credibility.

Who are actually the related parties? Jurisdictions across the world differ to some extent with respect to the listing of related parties. According to IAS 24 those parties are related if one party has the ability to exercise influence or control the other party in making financial and operating decisions. The actual list of related parties given by IAS 24 is long and, for simplicity of our further analyses, only top management, directors, large stakeholders, their relatives and affiliated companies will be emphasized. It is also noteworthy that since the amendment of IAS 24 in 2003, profit oriented state-controlled entities are also considered as related parties when dealing with other state-controlled entities, and thus must provide a disclosure of any operations among them. After defining related parties, it is important to define transactions marked as related. Again, referring to the definition by IAS 24, the answer is that any transaction which incurs the transfer of resources, services or obligations between related parties, regardless whether a price is charged, is called related party transaction.[395]

The JSC Law of the three transition economies also contain provisions that regulate related party transactions. All the three laws include in the list of related parties the members of managing bodies, large shareholders and close relatives of the mentioned parties.[396] The only difference is in the definition of a large shareholder. Russia and Uzbekistan determine a large shareholder as an owner of 20 per cent stake and larger, whereas in Kazakh law already a holder of 10 per cent stake falls under the category of a large shareholder.

[395] IAS 24.9.

[396] JSC Laws: Russia- §81; Kazakhstan-§64, Uzbekistan -§91.

As it has been accomplished in the previous chapters, the regulations regarding this corporate governance aspect will be observed in the target countries, with the focus on two problems, namely the related party transactions of managers and large shareholders. No special review of the agency conflict between shareholders and other corporate constituencies will be made in this section. Instead, it will be shortly referred to in the chapter on the shareholders' rights.

2. The First Agency Problem: Managers vs. Shareholders

In countries with dispersed ownership potential danger of self-dealing comes from the side of managers. This is because de facto control power belongs to them. In many developed countries transactions between managers and a company are permitted, however they are subject to legal control (Hertig and Kanada, 2004, p.102). Four types of managerial transactions are regulated by the corporate law: (1) traditional self-dealing, (2) compensation policy, (3) appropriation of corporate opportunities, and (4) insider trading.

An example of the first transaction could be the managerial purchase, directly or through his/her family members, of corporate assets which could be sold on the market on more favourable conditions for a corporation. The second type of self-dealing is based on appropriating corporate money by approving extremely high compensation schemes to the members of governing entities. Interest conflict of the third type is based on appropriating corporate opportunities, which means that managers simply compete with a corporation by taking investment opportunities that should be offered to their company. The last regulated transaction is insider trading. Based on the information that is not disclosed to the public, an insider may trade with corporate stocks, thus undermining investors' trust in corporate shares and securities market.

Law adopts a range of legal strategies to combat the opportunistic transactions of managers. Among them are: (1) mandatory disclosure, (2) prohibition, (3) approval and ratification by the board and (4) by shareholders, as well as rules and standards constraining managerial conduct.[397] The following sections will review how the mentioned legal strategies are implemented in the countries under consideration.

[397] Kraakam et al 2004; Enriques (1998).

2.1 Mandatory Disclosure

Mandatory disclosure is one of the most significant control mechanisms, which alerts shareholders and the market about a related party transaction (Hertig and Kanada, 2004, p.103). Transparent and accurate information ensures investors about credibility of a target company, which is interrelated with the readiness of potential investors to trust their money, and for the target company it diminishes the costs of attracting the capital. On the other hand, the disclosure of related party transactions helps to strengthen control over decision-makers in a corporation. Mass media can use disclosed information in order to combat self-dealing though 'naming and shaming'. For example, in Korea huge concern about corporations' activities has been shared by the public through the internet, which helped to reveal the wrongdoings of corporate directors to masses (Nenova and Hickey, 2006, p.3). However, the existence of independent mass media is required per se; in countries with no free mass media this positive effect of disclosure is neglected.

Nevertheless, despite the advantages of disclosure, in the systems where centralized reporting fails the disclosure of a related party transaction can be a costly undertaking. Another disadvantage of disclosure is that during this process competitors obtain information that may hamper the competitive position of a disclosing company (Berglöf and Pajuste, 2005, p.9). Therefore, it can be assumed that companies will be willing to reveal their activities voluntarily for investors if the expected advantages of disclosure will exceed potential costs. As the benefits of omitting the disclosure are in some cases higher than the benefits of transparent activity, companies may be tempted not to provide required information to the market. In this case, law interferes by mandating the disclosure. However, the extent of information that must be disclosed vary among the countries.

Together with corporate and capital market laws, widely recognized international accounting rules also enhance the level of transparency, and the disclosure of related party transactions in particular. For instance, according the IAS 24.16 a company must disclose the key management personnel compensation in total and each of the concrete forms of compensation.[398] The IAS also require to disclose the nature of a related party transaction, as well as the information on transactions and outstanding balances necessary for the understanding of the potential effect of the relationship on the financial statements (IAS

[398] Short-term employee benefits; post-employment benefits; other long-term benefits; termination benefits; and equity compensation benefits.

24.17-18). Last, but not least, there are soft rules in form of Codes of Corporate Governance, which underline the necessity of the disclosure of a related party transaction.[399]

It is true that the advanced highly liquid capital markets, in their nature close to 'efficient markets', have more stringent disclosure requirements. In contrast, poorly developed capital markets prescribe lower disclosure standards. The US has the most rigid disclosure rules including related party transactions. Among them is obligation to disclose all managerial transactions with a company exceeding USD 120,000 in value.[400] Disclosure of individual compensations schemes of members of governance organ is another remarkable element that enhances the transparency of the US capital market.[401] Additionally, all transactions that managers launch with corporate shares must be disclosed within two days.[402] Moreover, the US accounting principles also require that transactions between a company and its managers must be disclosed in annual reports.[403]

In contrast to the USA's demanding disclosure requirements, EU and Germany in particular are more lax about transparency standards. It is doubtful whether according to the German law members of a managing organ are required to disclose the existence of an interest conflict or whether simple withholding from voting is sufficient to fulfil the duty of loyalty (Schramm, 2007, p.218). A concrete regulation in this respect could be found only in the German Corporate Governance Code.[404] Although no general provisions for related party transaction exist under the German law, some particular aspects have undergone a more detailed regulation. For instance, the Commercial Code (*Handelsgesetzbuch*) prescribes a disclosure of overall compensations of the members of governing entities.[405] Recently, the German legislator strengthened the disclosure of the remuneration of the management board members. Since August 2005 the listed companies have to disclose the remuneration of each individual member of the board identifiable by name.[406] However, the law still leaves room for evading this requirement in the cases when the general meeting passes a resolution exempting a company from the disclosure of remuneration on the personalised level for a period of five years. Such resolution must be approved by 75 % of share capital represented at the meeting. The German law has also enhanced the disclosure requirements in terms of the managerial transactions with corporate shares. Any trade with corporate shares by the

---

[399] See for example, Good Governance Practices of the Institute of International Finance mentions the disclosure of director's and officers compensation, OECD Principles.
[400] Regulation S-K, Item 404(a).
[401] Regulation S-K, Item 402.
[402] Securities Exchange Act 1934 - §16(a).
[403] US GAAP, SFAS 57.
[404] German Corporate Governance Code – 4.3.4.
[405] HGB Germany - §285(9).
[406] Vorstandsvergütungs-Offenlegungsgesetz – VorstOG (VorstOG).

members of governing entities, other managerial personnel or their relatives must be disclosed to the issuer and to the public, and the financial market supervisor BaFin (*Bundesanstalt für Finanzdiesnstleistungsaufsicht*) within five days.[407] The quantitative threshold of a transaction to be disclosed is fixed on the level of EUR5000 a year. Further improvements on the disclosure of related party transactions in the German practice can be expected through the International Accounting Standards (IAS) which have been mandatory for all the listed companies in the EU since 2005.[408]

Disclosure regulations in transition economies, even in comparison to less punitive standards in the EU, remain loose. Related parties are required to inform the supervisory board about transactions they participate in which potentially contain an interest conflict.[409] However, no requirement to notify the state supervisory authority has been found. Kazakhstan mandates notification of the supervisory board only, whereas Uzbekistan requires that, in addition to supervisory board, also a revision commission must be informed. Russian law amplifies the list through an external corporate auditor.

Regarding the disclosure of managerial compensation Russia has the widest ranging regulation. It is mandated that the compensation schemes of each member of a governing organ to be disclosed in annual reports of companies which make public offering of securities.[410] In contrast, Kazakh and Uzbek law remains silent with respect to the disclosure of managerial compensation. To some extent this aspect is also specified in the Corporate Governance Code of Kazakhstan and Russia.[411] The change in managerial shareholding of corporate shares must be published only in Russia.[412]

Although general law poorly regulates disclosure, information can be better revealed through mandatory reporting according to international standards, or by bringing national accounting standards in accordance with the international ones. In fact, Kazakhstan included the disclosure of related party transactions in its national accounting principles.[413] Additionally, for the last few years both Russia and Kazakhstan have launched the program of IFRS introduction, which may enhance the reporting standards in respect to related party transactions. Uzbekistan, at least at current stage, stays aside from the implementation of the

---

[407] WpH Germany – §15a; See Also German Corporate Governance Code – Chapter 6.6.
[408] IAS Directive (EG) Nr.1606/2002 of 19 July 2002.
[409] JSC Laws: Kazakhstan - §72, Uzbekistan - § 92, Russia - §82.
[410] Decree of the Financial Supervisory Authority on Information Disclosure by the issuers of securities, Section 8.2.3.
[411] Russia CG Code, Chapter 3, Section 5.1.3; Kazakhstan CG Code - Chapter 3 (Organization of activity of Board of Directors.
[412] Decree of the Financial Supervisory Authority on Information Disclosure by the issuers of securities, Section 8.6.1.
[413] Kazakhstan, National Accounting Standards, N 10.

international standards. Only banks must report according to IFRS. Moreover, even the national accounting standards of Uzbekistan do not regulate the related party transactions.

The present review shows that the disclosure standards in the three countries must be enhanced in order to assure the market participants about fair 'game' rules. On the other hand, the countries should not get into an over-regulation trap. Otherwise, instead of attracting lower cost capital the cost of disclosure may raise considerably, nullifying the effect of cheaper external capital.

2.2 Disinterested Board Approval

The approval by a party which does not have any direct interest in a transaction between managers and a corporation is the next remedy for self-dealing transactions. Usually, the interested managers are required to get an approval from an upper organ. In case when the manager is a CEO or a board member, the only superiors (an upper organ) who can give the consent are the disinterested members of the board. Only those directors who are not concerned with the transaction at all may be considered disinterested. In most big jurisdictions the board approval is either mandatory or strongly advisable (Hertig and Kanada, 2003, p.106). The aspect of independence plays in this respect a paramount role. Enriques (1998, p.33) states that "*degree of reliance of country's legal system on director approval in order to reduce agency costs should be a function of the degree of independence of the outside directors sitting in the board of that country's corporations*'.

According to the German law it is the supervisory board that approves all transactions of managing directors. As §112 of AkG states, the supervisory board represents corporations towards the managing directors on all occasions.[414] In the USA the law does not mandate the approval of transactions by independent directors, nevertheless they strongly encourage the board approval of conflicted transactions. Such an approval gives the interested managers a sort of protection from shareholder challenge. According to the Revised Model Business Corporation Act the approval gives business judgement protection, and as the Delaware regulation states, such approval shifts the burden of the proof of fairness (or unfairness) from the defending director to the challenger (Hertig and Kanada, 2004, p.107).

All the three transition economies mandate the related transaction approval by disinterested members of the supervisory board.[415] Only in those cases when all members are interested, or the required quorum cannot be achieved, the decision rights are shifted to

---

[414] AkG Germany - §112.
[415] JSC Laws: Kazakhstan - §73 (1); Uzbekistan - §93; Russia - §83 (2)(3).

shareholders. It is noteworthy that in the Russian law, the approval procedure is bound to the number of shareholders. In the companies where the number of shareholders reaches 1,000 or less self-dealing must be approved by the majority of disinterested directors. In companies with more than 1,000 shareholders[416], the approval of an independent disinterested director is required. Thus, the regulator explicitly indicated that ratification of independent directors is mandatory, otherwise decision making power must be shifted to shareholders.

In theory, the strategy of directors' approval sounds reasonable. Still, experience shows that it works in countries with long judicial traditions and established system of independent directors. All transition economies still miss both those elements necessary for the enforcement of approval. Moreover, the particular cultural and historical background in these countries stipulates the environment of low ethical standards, within which self-dealing becomes even more difficult to solve. In such circumstances one possible solution could be the import of business ethical standards and training for national directors according to the Western experience. This goal could be fulfilled if corporate boards consisted of at least one foreign independent director.[417]

2.3 Approval by Shareholders

Shareholders, being a party interested in the prevention of managerial opportunism, are also able to approve certain transactions, which is an alternative to the disinterested board approval. Although it seems to be a reasonable approach, direct participation of shareholders in corporate policy contradicts to the nature of a corporation, which is based on the principle of authority delegation. For one reason, shareholders cannot always have enough expertise to monitor and approve all corporate transaction. Another reason is that in case of widely held corporation with dispersed ownership not all shareholders have the incentive and ability to invest time and finance to participate in the decision making. It would require a lot of financial resources to educate dispersed shareholders about these transactions (Hertig and Kanada, 2004, p.110). Nevertheless, it may be assumed that even shareholders can recognize some rude violations on the side of management.

Under the German law a shareholder is never called to approve or ratify a conflicted transaction; instead the supervisory board covers all approval transactions. Enriques (1998,

---

[416] As above mentioned Russian law requires that companies with the number of shareholders of more than 1,000 should at least have 7 members in the supervisory board and in companies with 10,000 shareholders number of directors should be at least 9.

[417] An important aspect is that foreign directors do not stem from the former socialist countries, but represent totally different business environment.

p.41) explains it with the specifics of German shareholding and the role of banks in particular: '*The explanation for this can easily be found by putting together banks' dominance in shareholders meetings with their substantial representation in the Aufsichtsrat. In case banks are outvoted in the Aufsichtsrat, they may react by causing a shareholders' resolution to bring a liability suit against directors, or as a qualified minority, they may request the corporation to bring such suits. By simply threatening to do so, banks may make sufficiently rare the possibility of their Aufsichtsrat representatives being outvoted, and purposeless any shareholders' meeting intervention in this matter.'*

In the USA the approval of a self-dealing transaction is not compulsory either; shareholders' approval is required only for some particular cases. For example, the listing requirements of the NY Stock Exchange and the NASDAQ mandate the shareholder approval of equity compensation plans, including stock option plans. In contrast, transition economies mandate shareholders' approval in cases when the supervisory board is not eligible for that task. Additionally, the Russian and Uzbek law require shareholders' approval if the monetary value of a self-dealing transaction equals or exceeds two and five per cent of corporate assets respectively.[418]

2.4 The Prohibition of Conflicted Transactions

The easiest remedy for self-dealing of managers is simple prohibition of certain actions. A self-dealing transaction used to be prohibited by company laws in the past. Nowadays, only a handful of conflicted transactions are prohibited. In practice, to the prohibited transactions belong loan granting for directors and insider trading (Hertig and Kanada, 2004, p.111). Commentators still argue why exactly credit transactions with directors must be prohibited, and not some other conflicted dealings.[419] One of the arguments is that credits for directors are likely to divert the value. In the post-Enron era the US regulators issued the law which prohibits public companies from granting personal loans to their directors or executive officers.[420] The act allows loans which are in the normal course of business and on normal terms. Therefore, it is allowed to continue making normal consumer related loans at market rates to officers and directors (Kohlbeck and Mayhew, 2004). The German law, in contrast, allows public companies to give a loan to the supervisory and managing board members with

[418] JSC Laws: Russia - §83(4); Uzbekistan - §93.
[419] *See for example* Enriques, 1998 ; Kraakman et al., 2004.
[420] Sarbanes-Oxley Act, Sec.402.

the approval of the supervisory board and for the period of no-longer than three months.[421] No provision has been found in corporate laws of the three transition economies that ban credit transaction between corporation and officers.

The next conflicting transaction which is prohibited by the leading jurisdiction is insider trading. Insider trading is defined as '*trading in securities while in possession of material non-public information*' (Bainbridge, 2002, p.519). Under the word 'insider' one assumes individuals who due to their position possess internal information which is not publicly available. As a rule, insiders are corporate directors, executives and other managing personnel. The main argument brought up by the opponents of insider trading is that it destroys investor confidence in the securities market. Numerous corporate governance principles prescribe the prohibition of insider trading[422] and in most legislations of the world insider trading is prohibited.[423] Despite such a distinct position of legislators there are no striking empirical results that prove insider trading harmful (Hertig and Kanada, 2004, p.114). In fact, some scholars argue that, although considerable part of insider transactions are illegal, there are still types of insider trading that belong to the normal course of business and must not be prohibited.[424] The US Securities and Exchange Commission also differentiates between legal and illegal insider trading: '*The legal version is when corporate insiders — officers, directors, and employees — buy and sell stock in their own companies. When corporate insiders trade in their own securities, they must report their trades to the SEC.* (…) *Illegal insider trading refers generally to buying or selling a security in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, non-public information about the security.*'[425] The reason why insider trading should be prohibited is that managers' benefits of insider-trading are less visible than those resulting from most self-dealing transactions.

The regulation of insider trading in the USA has a long standing tradition and contains one of the harshest rules. Since as early as 1934 the Securities and Exchange Act bars any insider trading on undisclosed information in any security.[426] An insider may not share insider information with a third party or give any recommendations. Despite mandating the disclosure of trade with corporate shares by managers, there is a stricter rule which bans

[421] AkG Germany - §115 and §89.
[422] See for example OECD Principles of CG, Part III,B.
[423] A research by Bhattacharya, U. and Daouk, H. (2002) shows that insider trading is regulated in 87 out of 103 countries with capital market.
[424] See for example Merkt and Göthel, (2006); McGee (2004).
[425] Article on the official web page of SEC, http://www.sec.gov/answers/insider.htm
[426] Securities Exchange Act 1934 - §10.

short-swing profits realized by corporate insiders in any period less than six months. This rule applies to executives, directors and large shareholders who hold a stake larger than 10%.[427]

In Germany the regulation of insider trading has been undertaken since 1994. According to the German law insider information is described as any specific information which is not publicly available, and if it becomes known to the public, it may significantly affect the stock price of a concerned company.[428] Any trade with corporate shares based on undisclosed insider information is prohibited. An insider cannot buy securities in his own name or through a third party using the insider information.[429] Similarly to the USA, insider information may not be conveyed or any recommendations based on such information can not be given to anyone.

Except for repressive methods of banning such transactions by the insider trade regulation, the world jurisdictions also apply preventive methods of regulation. Thus, e.g. it is required to disclose any interim information which, if became known, would effect investors' decision to hold, buy or sell the securities. This so called *ad-hoc* publication is available in the German and the US jurisdictions.[430]

Among the three transition economies only the Kazakh law uses the exact wording – 'insider trading'.[431] The law defines 'insider' as a person who owns shares of an issuer or its affiliated party, or is a member of governing organs of an issuer. In Russia and Uzbekistan the law applies other terms: instead of insider information, 'business internal information' (*'slujebnaya informaziya'*) is mentioned.[432] It provides the list of parties which may posses the 'business internal information'. Among them are the governing bodies of an issuer, auditors, professional participants of the security market and employees of state entities. However, the laws do not include large shareholders in this list.

The current project of the Russian law on insider trading and market manipulation has been waiting for its approval by the State *Duma* (Parliament) for more than 5 years. Commentators argue that the acceptance of the new law is necessary because the current regulation of business internal information has multiple disadvantages. Thus, for example, the mentioned list of parties who possess internal information is short, excluding the members of supervisory board, large shareholders and a revision committee. The second disadvantage is that an insider can avoid the current regulation through third parties. Additionally, the

---

427 Securities Exchange Act 1934 - § 16(b).
428 WpHG Germany - §13.
429 WpHG Germany - §14.
430 In Germany WpHG - §15; In the US (1) Current Report (Form 8-K), based on the requirement of the Securities and Exchange Act §13(a)1; (2) New York Stock Exchange Listing Manual §§201.00; (3) Rule 10b-5
431 The Law on Securities market Kazakhstan - §56-1.
432 The Law on Securities Market: Russia- §31 and 32; Uzbekistan - §28; The law on Mechanism of Functioning of Securities Market, Uzbekistan - §28.

enforcement of law is poor and sanctions are not adequate. For example, administrative sanctions set a fine which is disproportionate to the amount that a violator can obtain from insider trading.[433] A research by EBRD (2004) for Uzbekistan has found that '*existing rules are not sufficient to prevent insider trading, since they do not prevent or punish the trading of shares where the seller or purchaser is using important information that has not been disclosed to the public'* (EBRD, 2004). The Kazakh law, in contrast, adopts the terminology of the Western countries, namely the 'insider information'. It defines insider information as confidential information that is not disclosed to the public.[434] Insiders and their affiliated persons are not allowed to trade with such information. They are not allowed to transfer information, nor make recommendations to the third parties. In conclusion, it ought to be stated that all the three transition economies need better elaborated laws on insider trading, complemented by appropriate enforcement mechanisms.

2.5 The Duties of Governing Entities

The determination of duties of the governing entities and the differentiation between their responsibilities within corporation, together with ensuring their enforcement in praxis, belongs to the main conditions of sustainable development. The safety of foreign and domestic investments depends to large extent on those aspects (Knieper, 2003). Although corporate law gives general description of the duties that managing entities owe to a company, it alone cannot incorporate all aspects in business. Pistor and Xu (2002) speak in this case about the incompleteness of law. In order to overcome this handicap the notion of fiduciary duties has been introduced. At first, fiduciary duties were introduced by the common law judges (Black, et al., 2006). According to these, managing entities should be loyal to a corporation (*duty of loyalty*) and act with care to the corporation (*duty of care*) in all situations. With the help of this notion judges found the way to screen the business situation that no one could foresee and categorize in statutes. Thus, the duty of loyalty contributes to the control of management conflicts and limits the risk of managerial diversion of assets (Hertig and Kanada, 2004, p.114). Screening the conflicting transaction lies in the domain of courts. That may explain why the definition of fiduciary duties is almost nonexistent in the US corporate statutes (including Delaware). Those statutes which define them leave the definition rather abstract (Black et al., 2006).

---

[433] Federal Financial Market Service. From the Development Strategy of financial market of Russian Federation. http://www.fcsm.ru/document.asp?ob_no=12208 (Stand: September 2007)
[434] The Law on Securities Market, Kazakhstan - §56-1, as amended in 2007.

The German legal system defines two principal duties of directors towards their companies: an explicit duty of diligence and an implicit duty of loyalty (Black et al., 2006). With respect to the former, the law provides for the duty of care and responsibility.[435] Like in the case of the duty of care in the USA, directors in Germany are protected by *Business Judgement Rule*, which means that courts will not file the suit against directors as long as there is a prove that a director acted to the benefit of the company on the basis of adequate information. In contrast, the latter duty (duty of loyalty) is not fixed in the German corporate law. Instead, it was developed on the judicial level. As a general rule, the duty of loyalty imposed on directors requires them to protect the interest of a corporation and to avoid undertaking any action that might injure it. Those directors who violate their duty of loyalty are liable for damages incurred to a corporation (Enriques, 1998). This short introduction of the fiduciary duties concept in Germany and the USA provides an important insight that the concept is impossible without independent and highly qualified judges.

It is therefore apparent that for the functioning of the fiduciary duty concept a high quality court system is indispensable. In transition countries courts may still not be in a position to play an effective role as in the USA. That is why the concept of fiduciary duties is questionable in transition environment. It can be assumed that transition economies should pay higher attention to the law on books and try to capture all possible actions and duties of directors. But this is hardly possible, which means that the concept of fiduciary duties and its judicial screening is crucial for transition economies as well (Pistor et al., 2002).

In fact, the current laws on the JSC in all the three transition economies mention the fiduciary duties of managers or at least the duties which can be to some extent associated with the fiduciary duties, however with differences in specification. The Uzbek law limits fiduciary duties of managers solely to the obligation of acting in the interest of a company.[436] The Kazakh law also provides a limited definition of director's fiduciary duties simply requiring that directors should act in good faith.[437] More elaborated law on this issue has Russia, requiring directors not only to follow best interests of a company, but also act reasonably and in good faith.[438] The comparative legal analysis of Black et al. (2006a) on the duties of the members of management organs concluded that with oversimplification the Russian notion of reasonableness is comparable with the common law duty of care, whereas the duty to act in a good faith and in the best interest of a corporation can be comparable with the common law

[435] AkG Germany - §93 for the Management Board and §116 for the Supervisory Board.
[436] JSC Law Uzbekistan - §88.
[437] JSC Law Kazakhstan - §62.
[438] JSC Law Russia - §71(1).

concept of the duty of loyalty.[439] Applying the same logic, it can be stated that both Kazakhstan and Uzbekistan miss in their regulation the concept of the duty of care. Referring to the duty of loyalty Uzbekistan restricts the law text to the duty to act in the interest of a corporation, whereas Kazakhstan, in accordance with the Russian law, mandates directors to act not only in the corporate interest but also in a good faith.

In the next step we will proceed with the review of legal strategies in cases when the approval of a conflicted transaction has been violated. Intuitively, it can be assumed that a detected conflicted transaction must either be voided or a culpable party must compensate the company for causing harm. As already noted, the US law does not mandate the approval of disinterested board members of a conflicted transaction. However, if approved by independent directors, concerned parties will have a judicial protection in case of suit, which means that if a transaction with the conflict of interest was fully disclosed and approved by non-interested directors, then the plaintiff has the burden of providing the proof that the transaction was unfair. In contrast, transactions which are not approved by independent directors, the burden of proof lies on interested directors and officers. In the USA, directors or officers are held liable to a company for damages incurred due to a failure to provide effective approval (Black et al., 2006). Similarly German directors are liable for failures in approval procedures. The evidence of failed approval of transaction does not automatically lead to the nullification of the transaction.

The three transition economies share similar wording referring to the violation of procedures of approval, thus the comments and recommendations can be applied to all of them. Details which are relevant only to a particular country will be explicitly indicated. All the three JSC laws state that a self-interested transaction concluded without following approval requirements can be invalidated and the interested person must compensate the company for the loss.[440] Only the Russian law names concrete parties which can challenge such transaction; they are corporation itself and shareholders. On the contrary, Uzbekistan and Kazakhstan do not indicate who can be the plaintiff. Another critical point in the laws is that it is unclear whether the persons who became shareholders after the transaction have the right to file the suit (Black et al., 2006). It is also not distinctly stated if non-compliance with the approval procedures is sufficient to invalidate the transaction, or if the company must incur the losses as well. Black et al. (2006) considers that it would be logical if the transaction was nullified only when losses are incurred.

[439] Black et al (ed.) 2006.
[440] JSC Laws: Russia- § 84; Kazakhstan- §74; Uzbekistan-§94.

3. The Second Agency Problem: Minority vs. Majority

The scope of strategies to regulate the transactions between controlling shareholders and a corporation does not differ much from those directed to regulate transactions between managers and corporations. Controlling shareholder may be considered in this case as “de facto directors”, as she has the right to nominate the directors, and thus to dominate the board. As previously discussed, the transition economies have concentrated ownership, and therefore these aspects are of particular interest for the three target countries. This chapter will review the treatment of the agency aspects by the law with individual shareholders, as well as shareholding of one company in another, which leads to formation of corporate groups.

3.1 Mandatory Disclosure

As in the case of conflicted transactions with managers, disclosure requirements for transaction involving controlling shareholders is an important remedy against self-dealing of major shareholders. Again, the US regulation is a leader according to the extent of information that must be disclosed. The US companies are obliged to disclose all transactions in which each a shareholder owning more than 5% of any class of voting securities has a material interest equivalent of $120,000 and more.[441] Additionally, the US GAAP accounting standards require companies to list transactions with beneficial owners that are ‘material’ from a value diversion perspective.[442] Finally, shareholders with 10% stake and larger are obliged to report any change in their ownership to the SEC within 10 days after the end of the calendar month in which the change occurred.[443]

In contrast, the German law does not require disclosure of transactions between a corporation and a controlling shareholder. However, the German law on corporate groups (*Konzernrecht*) mandates the opening of intra-group transactions of affiliated parties in the annual report.[444] According to the German law on corporate groups an affiliation between companies occurs in the face of the evidence of control or domination of one company over another. This is the case when one company owns either directly or indirectly a controlling stake of more than 50% or there is a domination agreement between independent companies.[445] Therefore, the German law does not provide provisions which mandate large

[441] Regulation S-K, Item 404(a).
[442] US GAAP, SFAS 57.
[443] The US Securities and Exchange Act 1934 - §16(a).
[444] According to AkG §312(1) the management board (*Vorstand*) of dependent company shall draw up a report on the relations between the company and affiliated enterprise.
[445] AkG Germany: §15-§18.

shareholders with the stake less than 50% to disclose transactions with an interest conflict in the absence of a domination agreement between them. No special provision in terms of the disclosure of trade with corporate shares undertaken by a large shareholder could be found in the German laws. A similar regulation is available only in regard to the disclosure of transactions which have takeover significance. When the ownership of shareholders exceeds or falls bellow the threshold of 5%, 10%, 25%, 50% or 75% stake in a listed company, they must notify the issuer and the financial supervisory authority (BaFin).[446]

Similarly to the disclosure of managerial transactions the laws in the three transition economies require the disclosure of related party transactions between a controlling shareholder and a corporation. In Russia and Uzbekistan a holder of 20% stake and in Kazakhstan a 10% shareholder must notify the board about a current and a potential transaction in which it has interest.[447] The same provisions are applicable to corporate groups or affiliated companies (Schramm, 2007). This aspect of disclosure is especially important for corporate creditors who can inspect resource transfers within a corporate group. However, to be accessible for creditors, the information should be disclosed not only to internal organs (the supervisory board) – as it is in Kazakhstan and Uzbekistan – but rather to external parties as well through periodic accounting reports.[448] The gradual introduction of the IAS in Russia and Kazakhstan can contribute to the improvement of disclosure standards in this respect.

Like in Germany, the three transition economies do not have a special regulation referring to the disclosure of trade with corporate shares by a controlling shareholder. Some weak substitution of this provision can be found in Russia, where the shareholder who obtains 5%, 10%, 15%, 20%, 25%, 30%, 50%, 75% must notify the issuer and the financial supervisory authority.[449] The Uzbek law requires that only investment institutes must disclose the trade with 15% stake of the issuer. [450] Any other owner must disclose the ownership that increases the 35% stake.[451] It is not clear from the Uzbek law if for example small purchase of 1% that increases 35% stake must be disclosed, the law also does not specify if sale of shares must be disclosed. According to the Kazakh capital market regulation, it is the issuer, and not the shareholder, who must disclose the information about obtaining the threshold of 10%.[452]

---

446 WpHG Germany - §21.
447 JSC Laws: Uzbekistan- §91; Kazakhstan-§71; Russia-§81(1).
448 According to §72 of Kazakh JSC law only notification of the supervisory board required; §92 of Uzbek JSC Law mandates the notification of internal audit organ and the supervisory board; § 82 of Russian JSC Law requires disclosure to the supervisory board, internal and external independent auditor.
449 The Law on Securities Market, Russia - §30.
450 According the Law on Mechanism of functioning of the securities market § 3, financial broker, investment company, investment fund, depository, asset managing company are grouped under the definition – investment institute.
451 Law on mechanism of functioning of the securities market Uzbekistan -§ 27.
452 Law on Securities Market Kazakhstan - §102(2).

The large number of positive amendments with respect to disclosure has been accomplished in the corporate law of the three transition economies. Nevertheless, it is advisory for all those countries to promote better disclosure principles of related party transactions with a controlling shareholder.

3.2 Approval of Transaction

In transactions with controlling shareholders also the approval authority can be given to disinterested directors. It is however doubtful that directors nominated by a controlling shareholder will fairly screen the transaction with the participation of that controlling shareholder. That is why most jurisdictions rely far less on this strategy to screen transactions between companies and their controlling shareholders. Instead, some jurisdictions mandate the approval of conflicted transaction with a controlling shareholder by disinterested shareholders. The trend to accept a disinterested shareholder's approval is more widespread in common law than in the civil law countries. An empirical research by Djankov et al. (2006) found that only a few civil law countries (18% of the sample) require the approval by disinterested shareholders, whereas the common law countries are more inclined to mandate a disinterested shareholder's approval (48% of the sample). Despite the statistical figures, the US regulation and the law of state Delaware in particular vest the disinterested board with the approval power. However, in such circumstances a transaction is vulnerable to shareholders' suit, that is why it is advised to obtain the approval of minority shareholders (Hertig and Kanada, 2004, p.121). The company law in Germany does not specify the rules on the approval of conflict-of-interest transactions involving controlling shareholders (Black et al. 2006). However, the German law articulates the approval mechanism of transactions with respect to corporate groups; the law of corporate groups requires the directors of corporate subsidiaries to approve transactions with corporate parents.[453]

The transition economies do not differentiate between the two types of a conflicting transaction. That is why the similar approval requirements are applied in case of transaction with a large shareholder. Primarily, it is disinterested directors who should approve the transaction. In case when all directors are interested the approval rights are shifted to disinterested shareholders.[454]

It is difficult to figure which approval strategy is better. Both mentioned schemes have a conflicting potential. The approval of directors makes observers doubt in their true

[453] AkG, Germany - §318.
[454] JSC Law Russia - § 83(4); Kazakhstan- §73(2); Uzbekistan- §93.

disinterestedness. The only solution could be screening of transactions by minority shareholders. However, this strategy also limits the control rights of shareholder majorities and may lead the business to a deadlock. The reason why minority approval functions in the US case, is that most corporations do not have a controlling owner, which does not stipulate the conflict of minority's power misuse.

3.3 Fiduciary Duties and Fairness Norms

As in the case of managerial transactions, the law concentrates mostly on standards strategies (ex post), rather than on rules (ex ante), to prevent a controlling shareholder's opportunism in conflicting transactions (Hertig and Kanada, 2004, p.123). The only case when the rules are implemented is the banning of an insider trading transaction of majority shareholders. Most world jurisdictions prohibit insider trading of controlling shareholders. The transition economies under discussion fail to provide a clear regulative base for insider trading. Unlike Kazakhstan, the laws in the Russia and Uzbekistan that contain sections similar to insider trading do not mention controlling shareholders as potential insider traders.[455] Therefore it can be theoretically assumed that insider trading of large shareholders in not prohibited. In the following section available *ex post* strategies will be scrutinized as a remedy for the self-dealing of controlling shareholders.

3.3.1 Exit Remedy: Forcing Corporate Dissolution

Giving minority shareholders the right to sell their shares back to controlling shareholders, or to liquidate a company if their interests were severely oppressed, is one way minorities can be protected. Most of the US jurisdictions, except Delaware, give the right to minority shareholders to dissolve the company when their interests are seriously violated. An example of such neglect could be the increase of controllers' salaries, rather than dividends payment to all shareholders.

Germany and transition economies do not vest minority shareholders with the right to dissolve a company. Especially in the context of transition economies – with still developing institutional environment – it can be expected that, having the right to dissolve a company, minority shareholders may endanger the business activity of a country by frequent misuse of their right, the purpose of which has little to do with real protection of minority shareholders.

[455] As mentioned previously Russia and Uzbekistan do not use definition of ‚insider trading'. Instead the notion of insider information is expressed by 'business internal information'.

Corporate dissolution is a rare remedy against controlling shareholders opportunism, because most courts either force controlling shareholders to buy the shares of minorities, or appoint a custodian to manage corporate assets (Hertig and Kanada, 2004, p.124).

3.3.2 Appointment of special auditor

A self-dealing transaction may often be sophisticated and thus not clear for every shareholder at the first glance. Supportive in this respect could be the assistance of a professional auditor, who would be appointed on request of shareholders. The German law provides provisions which allow shareholders holding 1% or an amount corresponding to EUR100.000 of the legal capital to ask the court to appoint a special auditor.[456] It is noteworthy that the costs of audit inspection are covered by the company itself. No similar right to appoint auditors for the purpose of inspection of particular transactions was found in the US regulation. Among the transition economies the right to appoint an external auditor is an exception rather than a rule. The reason might lie in the existence of an internal audit organ (‘*revisionnaya komissiya’*) (Schramm, 2007). According to the Russian and Uzbek law any shareholder with a stake of no less than 10% can request that an internal auditor conducts an irregular investigation of economic activities of a company.[457] Among the reviewed transition laws only Kazakhstan allows large shareholders with at least 10% stake to appoint an external auditor.[458] However, the shareholder should cover the costs of such audit inspection.

3.3.3 Compensations for Self-dealing

The other remedy for self-dealing transactions of controlling shareholders is to compensate the concerned shareholders. This model can be viewed on the example of corporate groups, in which a parent company compensates the subsidiaries (minor subsidiary owners) for following the general corporate policy and incurring the losses. Such a scheme can be observed in the German law on corporate groups (*Konzernrecht)*. According to § 302 AG, corporate subsidiaries are instructed to follow the general corporate policy, defined by a parent company. In case any losses occur for a subsidiary company, as a result of acting in the group’s interests, a parent company is obliged to compensate these losses.[459] If the parent company fails to compensate its subsidiary, minority shareholders may sue it (Hertig and

[456] AkG, Germany: § 142(2)
[457] JSC Laws: Russia- §85(3); Uzbekistan - §85(3)
[458] JSC Law, Kazakhstan: §14(2).
[459] AkG Germany - §302(1).

Kanada, 2004, p.124). Similar ideas concerning corporate groups can be found in the Russian and Uzbek corporate law. However, the similarities are quite superficial and the law on corporate groups is not as well elaborated as it is in Germany. The law allows to form a parent-subsidiary relation either through contractual tie up, or though the participation of one company in the equity capital of another one.[460] In both countries a parent company is liable for the losses incurred to a subsidiary due to the business line that the subsidiary was bound to. Similar aspects are regulated in §94(3) of Kazakh Civil Code (Schramm, 2007). In the USA a parent company, in general, is not liable for its actions with respect to a subsidiary company. However, there are exceptions: a court may hold the parent company liable when the subsidiary has become insolvent and cannot pay the debt (Black, 2006).

3.3.4 Ex Post Liability of Controlling Shareholders

The next method of avoiding the opportunism of controlling shareholders is to make them *ex post* liable for a conducted transaction. The US judges have strict standards (fairness tests) for evaluating self-dealing transaction by controlling shareholders and parent companies. If their self-dealing action is uncovered they can easily be held liable (Kraakman et al., p.126-127). In Germany controlling shareholders also owe duties of loyalty to minority shareholders (McCahery et al., 2005). From the paragraph § 117 *AkG* it can be interpreted that large (controlling) shareholders who instructed members of the supervisory or management board to undertake action that damaged a company or other shareholder are liable for the damage resulted from that action (Enriques, 2007).

The laws in Russia, Kazakhstan and Uzbekistan stipulate that if procedures of approving a transaction, which are the same as in case of manager self-dealing transactions, are violated by a controlling shareholder, then according the suit of a shareholder or a company such transaction can be nullified and interested parties are liable for incurred costs.[461] No other particular indication on ex-post liability of controlling shareholders was found in the three transition economies. In this respect it would be meaningful to provide in the law the fiduciary duties of controlling shareholders.[462]

[460] JSC Laws: Uzbekistan- §9; Russia - §6.
[461] JSC Laws: Russia- § 84; Kazakhstan- §74; Uzbekistan- §94.
[462] See for example proposal of Schramm (2003) in case of Kazakhstan.

3.3.5 Ex Post Liability of Directors

The final remedy which can be included in the *ex post* standards strategy is making liable the corporate remedies through which a controlling shareholder acts. Such intermediaries are a company's directors. The directors who approve a self-dealing transaction of controlling shareholders should be held liable. In the USA executive directors can be personally liable for breach of their duty of care if unfairness of the transaction they have approved is apparent. According to §117(1) AkG directors in Germany owe their company the duty of loyalty that requires them to disregard or oppose any attempts of a controlling shareholder to self-deal (Black and Cheffins, 2006). Additionally, due to the German law on corporate groups, subsidiary managers can be held liable if a transaction between a parent and a subsidiary company which they have approved has a value diverting character.[463] In the transition economies directors must act in the interest of a company, reasonably and in good faith. No particular ex post liability of directors is articulated in the laws of three countries for approving the value diverting transactions of controlling shareholders.

Another important remedy for the protection of minority rights is the ability of small shareholders to file a suit. The availability of such strong mechanism warns company directors that any wrongdoing will be legally prosecuted and hinder them from self-dealing, whether on their own or on the instruction of a controlling shareholder. Minority shareholders vested with such authority can claim the recovery of their rights in court, which belongs to fundamental elements of the minority rights.

The US legal environment is uniquely hospitable to litigation against directors (Black and Cheffins, 2006, p.1393). According to the US law a company itself or any shareholder can decide to file the suit against directors. A company in the name of directors usually does not choose to file a suit (Black et al., 2006); in which case shareholders themselves have the right, in the course of derivative action, to file a suit in court. The right to file a derivative suit gives a shareholder an opportunity to claim for damages incurred not to him directly, but to a corporation (Merkt and Göthel, p.506). Upon the derivative claim of a shareholder, the US court inquires if the corporation has independent directors who could take actions to bring the suit. If the court finds that there are such directors, it will not proceed with a shareholder claim. If no independence of directors is found, court will continue with the petition of a shareholder.

[463] AkG Germany - §318.

In Germany a shareholder holding 1%, or at least an amount of shares corresponding to Euros 100,000, can request a permission from court to enforce a claim for damages incurred to the company.[464] In order to control this power misuse by minority shareholders there are some conditions which the law requires to be fulfilled. First, a plaintiff must become a shareholder before learning about the damages that occurred. Second, the plaintiff initially requires a corporation to file a suit, which the latter refused to do. The third important condition is that the enforcement of the claim will not contradict the company's interests.

The JSC laws in the three transition economies state that two entities can file a suit against the management. The first entity is a company itself. In the Kazakh law, a company, based on the decision of the shareholders' meeting, can apply to court.[465] Thus, even if the rights of minority shareholders were violated, the claim by the company itself would not be probable because the majority will not vote for filing a suit. In Russia and Uzbekistan, a company on its own (without the authorization of shareholders' meeting) can file a suit.[466] However, the laws do not clearly define who has the right to file a claim in the name of the company (Black et al., 2006). It is unclear whether the supervisory board has this right.

The next entity who can file a suit against corporate governing entities are shareholders. The Russian and Uzbek laws provide for the possibility of derivative suit action. A plaintiff should have a minimal share of 1% of the total issued shares to have the claiming rights. Despite the derivative suit option in Uzbekistan, commentators consider that this strategy may not prove effective, as 'Uzbek courts might lack the sophistication to conduct a thorough investigation with respect to a party's liability and might not be sufficiently independent to issue a fair judgement' (Cigna, 2006). The Kazakh law does not provide for the minimal quantity of shares which should be held by a shareholder in order to file a suit. Thus, theoretically, any shareholder can apply to court. Schramm (2003) recommends to fix the minimal number of shares that a plaintiff must posses to be able to apply to court in order to avoid the misuse of that right. For example, a shareholder can use suits not for the primary purpose of achieving recovery for a company, but as a tool to pressurize the company into acquiring shares at an attractive price.

In this section no particular punishment measures as administrative and criminal punishments, important in connection with directors' liabilities, will be observed, since further considerations of those aspects are not relevant for this research.[467] Finally, it ought to

[464] AktG Germany - § 148.
[465] JSC Law Kazakhstan- §63.
[466] JSC Laws: Russia- §71(5); Uzbekistan-§88.
[467] For more about the liability aspects of governing entities see: Black et al (2006), Knieper, R., (2003), Merkt and Göthel (2005); Bainbridge (2002).

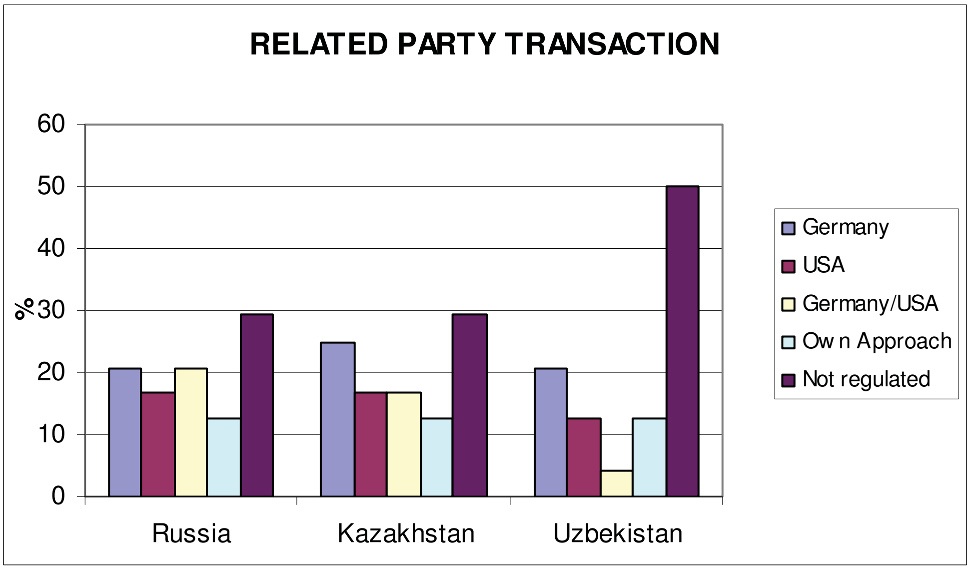
be noted that the empirical evidence of the cases in which directors would held liable for the breach of their duties is almost non-existent in the short history of the transition economies.[468]

4. Results

The cultural and historical background accompanied by weak institutional environment in the three transition economies imply that the related party transactions constitute perhaps the most significant corporate governance problem. That is why the regulation of those aspects and their enforcement must be approached with greater thoroughness. Apart from the qualitative and comprehensive law on books, a crucial role should be given to well trained and independent judges.

The review of the legal base has demonstrated that all the three countries have incomplete provisions on self-dealing. It can be seen in the Figure 12 below that a number of aspects of the related party transactions are not even available in the laws of the transition economies. The most dramatic situation appears to take place in Uzbekistan, where half of important provisions is missing. The regulations in all the three countries exhibit a deficit in the disclosure procedures and insider trading. The latter is even non-existent in the Russian and Uzbek laws. Generally, it can be stated that the elements of the German law available in the books of the transition economies prevail over those borrowed from the US law.

Figure 12: Related Party Transactions



Source: Own Depiction.

Note: The figure illustrates quantitative results of law comparison (See Appendix II, Table 7 and Table 8)

[468] See Knieper (2003); The statistical data of the National Committee on Corporate Governance (www.nccg.ru) indicates that out of 1635 cases involving shareholders that were brought before the Arbitration court of Moscow in 2004, none resulted in liability being placed on company managers or directors.

E. Index of Shareholder Protection

1. Introduction

The discussion of the corporate governance regulation is often based on the intuitive and suggestive analyses which although draw the general frameworks of corporate governance aspects fail to determine the scope of actual regulation and thus do not deliver the comprehensive results. For example, it is often assumed that the fact that the US has the most liquid securities market automatically leads to the insight that the rights of shareholders are protected at best there. Although this statement can be true, some additional approaches are required to conduct more precise comparative analyses.

One of the recently evolved methods of comparative studies in the law is the *leximterics*. It was invented by Cooter and Ginsburg (2003), who made an attempt to use the quantitative methods in the comparative analysis of the law. In this research we refer to the *leximetric* approach in order to assess the degree of shareholder protection throughout 5 countries – the USA, Germany, Russia, Kazakhstan and Uzbekistan. It is intended to determine with the help of this index, which legal system offer more powers or protection to the investors in the stock market.

There were already several attempts to implement *leximetric* approach with the purpose to measure the shareholder protection. We believe that although some of them deliver interesting results there is a space for improvement. The review of the existing indexes will be undertaken in Chapter 2. Based on the results we consequently propose our own index in Chapter 3, which allows conducting comparative analyses of multiple country groups that are divided not only according to the Common law or Civil law origin criteria but also provides an opportunity to compare the regulation in the transition economies against those in advanced economies. Finally in chapter 4 we provide *leximetric* results that are based on the analyses of Section A, B, C and D of this part.

2. Existing Indexes

The current available empirical literature on the corporate governance knows several indexes that attempt to capture the scope of shareholder protection. Perhaps the most known one is the Index developed by La Porta et al. (1998) in their article '*Law and Finance*'. It provides evidence that shareholders are better protected in common law jurisdictions than in countries with civil law origin. Their index consists of eight variables such as 'one share-one vote', 'proxy by mail allowed', 'shares not blocked before meeting', 'cumulative voting', 'oppressed minority', 'pre-emptive rights to new issues', 'percentage of share capital to call an extraordinary shareholder meeting' and 'mandatory dividends'. Later, multiple empirical studies have incorporated results of La Porta et al. (1998) in their analyses.[469] However, the index proposed by La Porta et al. was criticized in the literature. The one of the core criticisms is the limited number of variables.[470] Index does not comprise such important elements as the decision making power of shareholders, composition of the board, extent of director's self dealing or their disqualification.[471] The next critical point is that the discussed index is suffering from the US-bias.[472] Else, it does not differentiate between default and mandatory rules.[473] Finally the variables are too broad or vague. As an example, Lele et al. (2006) discuss the variable – 'proxy regulation'. Authors argue that single variable 'proxy voting' is not satisfactory, as many countries have some other ways of proxy voting.

Considering the all above mentioned critical points, Lele et al. (2006) have developed their own index of shareholder protection. The uniqueness of their index is that it comprises significantly more variables (60) and trace how the shareholder protection in the USA, UK, Germany, France and India has developed in the last 35 years. The researches found that in all studied countries shareholder protection has been improving in the last 35 years. Another illuminating result was that shareholder protection in the US is weaker than in the laws of other four countries.

Although the index of Lele et al. represents a considerable improvement in comparison to previous measurements of shareholder protection we believe that their index should be broadened as some still important aspects are not included. To name only few, for example, we are convinced that the co-determination rule belongs to the index, as the availability of other interests on the board affects the autonomy of shareholder interests. Further, we consider that procedural aspects of making proposal by shareholders to the agenda of the forthcoming general meeting require more detailed analyses and therefore more variables to be included such as 'holding requirements', 'timeliness of proposal', 'initiative or responsive proposal', 'cost of general proposal' and 'costs of proposing director candidate'. Alone the right of making proposal does not necessarily mean that shareholders are vested with such a power. The requirements to keep shares at least for one year in order to make a proposal or to

[469] See for example, Denis (2001), Licht, Goldschmidt, and Schwartz (2005)
[470] Braendle (2006).
[471] Lele, Mathias and Siems (2006).
[472] Berglöf, and von Thadden (1999), See also Lele, Mathias and Siems (2006).
[473] Spamann (2006).

make a proposal at least half a year prior to the meeting significantly restrict this shareholder's right to participate in the decision making process.

Additionally we believe that weights of some variables are defined too narrowly and they do not include important aspects, which require a variable to take an interim weight, e.g. 0.33, 0.5 or 0.75. For example, the variable 'cumulative voting' has only two weights (1 and 0). This is however not sufficient for comparative analyses. There are statutes that although nominally mandate 'cumulative voting' contain provision that nullify effect of proportionate voting. Such provision could be, for example, the rights of simple majority on the general meeting to remove the candidate that was elected by the minority shareholder. Another critical aspect in respect to cumulative voting provision is that their index does not differentiate between mandatory and 'opt-in' or 'opt-out' provisions.

Reconsidering all above mentioned points we constructed a new index that differs from Lele et al.'s index in two respects. Firstly it contains additional set of variables increasing their total number to 118. Secondly, some already existing variables were revised and new weights were added to them.

3. Developing of the broad shareholder protection index

The Shareholder Protection Index (SPI) shows how the shareholder protection is structured in the USA, Germany, Russia, Kazakhstan and Uzbekistan. It is the first attempt to incorporate the regulation in the transition economies into a *leximteric* index and compare shareholder protection with the advanced economies. The overall index is divided schematically into two sub-indexes. The first sub-indexes includes the elements that protects shareholders as a whole constituency against managers, whereas the other sub-index considers those provisions which help to alleviate the agency conflict between controlling and minority shareholders. The uniqueness of this research is that shareholder rights will be grouped into four main categories: (i) basic governance structure, (ii) significant corporate actions, (iii) takeover regulation and (iv) related party transactions. Each of these categories represents the main four pillars of corporate governance regulation in any country and the availability of particular provision in each of the mentioned groups contributes to the design of the total corporate governance frameworks within the country. Such division into the categories will provide the reader with an opportunity to compare the extent of shareholder protection referring to the particular aspects of corporate governance. For example, the high index of shareholder rights in respect to the basic governance structure does not automatically mean that the shareholders rights of the same country are also good safeguarded referring to the related party or takeover transactions.

The overall index consists of 118 variables divided as following: basic governance structure - 52 variables, significant corporate actions – 23, takeover regulation - 16 and related party transactions – 27. Thus in comparison to the index of Lele et al.'s, the list of variables was increase to 58 elements. The total list of variables can be found in the Appendix III.

The variables are derived from multiple regulation sources. The primary source for variables was the "hard" law. In fact the majority of variables are extracted either from corporate or capital market laws. Other important sources of references were listing requirements of domestic stock exchanges and corporate governance codes if available. It is also important to note that multiple aspects of corporate governance regulation in transition economies are regulated by the separate normative documents that although not included in the main statutes are crucial for consistent representation of the corporate governance frameworks. For example, many disclosure aspects in Russia are regulated through special decrees of the Financial Supervisory Authority. In Uzbekistan it is special presidential and governmental decrees that complete the regulatory base.

All variables (elements) of the index have the similar weights. Currently no empirical researches are available that can provide evidence that some elements of shareholder protection have superior role and consequently larger weight in comparison to other elements. Therefore all variables of the Shareholders Protection Index (SPI) are granted the equal weight. The maximal possible value of the variable is one and the minimal is zero. Value one is added to the overall index if particular provision that fosters shareholder rights exists in the jurisdiction. Absence of such provision results in no change of the country's overall index as that provision takes the value of zero. For some provisions there are more than only two weights exist. This is the case when the deviation from the maximal possible value does not necessarily lead to the absence of shareholder protection in the context of this particular provision. In such cases we apply interim weights such as ¾, ⅔, ½, ⅓ or ¼. The principles behind the granting interim value can be schematically divided into three cases.

The first case applies when the "hard" law does not articulate on the aspect, which could lead to the erroneous conclusion that with regard to this particular aspect the shareholder rights are not considered, although it is regulated for the publicly traded companies in listing requirements or simply the corporate governance code makes recommendation on it. For example, if the statutory law does not mandate the availability of the independent directors on the board it does not automatically mean that no independent directorship is practiced in the country. It could be possible that listing requirement or the Corporate Governance Code mandate or recommend independent directorship. Thus, it would be a mistake to apply the value of zero, if no provisions found in the "hard law", although such provision exists either in "hybrid" or "soft" laws.

The second case for the introduction of interim weights is the quantitative prescription with respect to procedures. Different voting thresholds for accepting a decision or holding requirement of shares to initiate an action may substantially influence the success with which the decision will be met in favour of shareholders. For example, if the law contains requirement that shareholder must keep shares in order to make a proposal to the meeting agenda, it would be wrong to give only one weight for the variable, because in one country the law may require only 1% of shares in order to make a proposal, whereas in another country the threshold could be fixed on the level of 25%, thus substantially deflating the proposal rights of small shareholders. In such case we grant several weights to the variable.

The third case of interim weight is reserved for the possibility to opt-out or opt-in from the rule by the choice on the shareholder meeting. Thus, there are cases when in one country the provision is mandated in favour of shareholders and variable takes the value of one, in another country the provision may not be articulated at all, which results in the value of zero, but there are also statutes when there is a choice either to apply the rule or refuse from it. Application of interim weights provides an opportunity to give a numerical value in such cases.

The proposed index encompasses only shareholder rights. The rights of other stakeholders (employees, creditors) are considered only as far as they have an impact on the rights of shareholders. For example, the co-determination rules (the representation of employees on the board) is a straight forward principle that protects the interests of employees. However, if such principle is incorporated in the country's statute than the position of shareholders is automatically hampered as they are no longer the sole constituency whose interests are considered. Therefore countries in that co-determination provision is not available are rewarded with weight of one, in opposite to jurisdiction that mandate co-determination and thus receive no score (zero value).

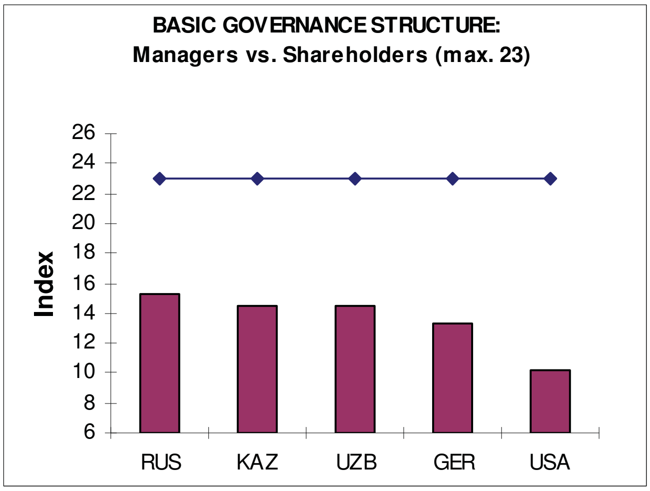
It is important to note that the highest shareholder protection index does not necessarily mean that such corporate governance system is the best available. The index is solely shows that in countries with higher index the shareholders have better rights (powers) than in countries that have lower one. To make the overall conclusion about the quality of corporate governance it is crucial to consider the interests of all other concerned parties and hence create similar index in respect to their rights. This is however not the purpose of this research, which otherwise will explode the time and volume frameworks.

4. Results

4.1 Basic Governance Structure

The index calculation with respect to the basic governance structure delivers at first glance paradoxical results (Figure 13). It appears that shareholders as general constituency are better protected in transition economies than in the USA and in Germany. In fact when we refer to such variable as representation of the executive directors on the board, their right to be chairman of the board, shareholder's rights to remove directors in mid-term and determine the remuneration of directors it becomes clear why the USA, where all these provisions are admissible not in favour of shareholder, have the lowest score. German regulation loses the points on the aspects of director independence, rights to remove directors and the availability of codetermination rule that automatically reduces the powers of shareholders to shape corporate policy. In contrast corporate laws in transition economies were designed keeping in mind most of these aspects and granting shareholders bigger powers.

Figure 13: Basic Governance Structure. Power of Shareholders as a general constituency

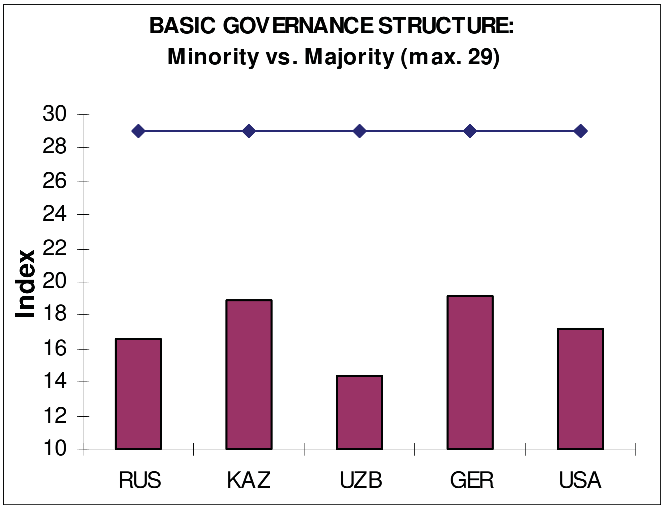


Source: Own Depiction

Note: The figure depicts the results of Index calculation based on the Appendix III, Table 1

The results with respect to minority shareholder rights demonstrate that in Germany and Kazakhstan small investors are better protected (Figure 14). This is mainly, due to the rights of small shareholders to participate in the decision making process. Thus for example, the right to call extraordinary meeting, proposal rights for the agenda, costs of calling the meeting and making proposal, holding requirements, timelines of proposal and claim against resolution, all this aspects are regulated in Germany and Kazakhstan in favour of small shareholders, although in Germany small shareholders are not protected by the cumulative voting rule and they in general have less information rights such as access to the list of shareholders or other corporate documents.

Figure 14: Basic Governance Structure. Power of minority shareholders as a general constituency



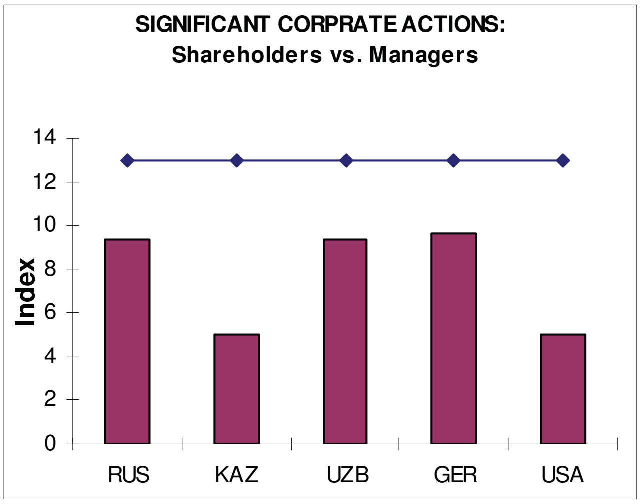
Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 2.

4.2 Significant Corporate Actions

Regarding the proposal and approval rights shareholders in Germany, Russian and Uzbekistan are vested with larger competencies than their counterparts in the USA and Kazakhstan (Figure 15). In the USA and Kazakhstan most significant corporate actions are in the domain of mangers, if shareholders' meeting is not explicitly determined as decision making body. Concerning the rights of minority shareholders the situation in transition economies is more favourable than in Germany and the USA (Figure 16). Transition economies score on the appraisal right and supermajority voting rule that are available for virtually all significant corporate actions, whereas in Germany only in case of particular transactions appraisal rights are provided and in the USA only mergers provide appraisal rights.

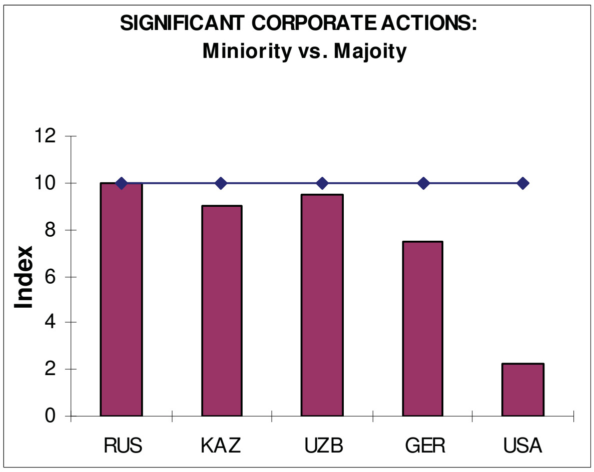
Figure 15: Significant Corporate Actions. Power of Shareholders as a general constituency



Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 3.

Figure 16: Significant Corporate Actions. Power of minority shareholders



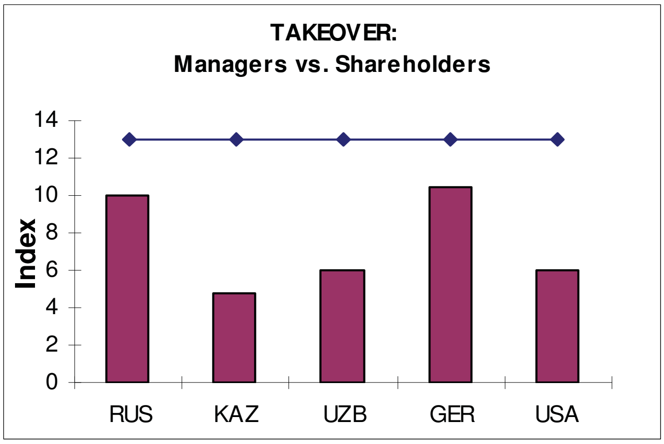
Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 4.

4.3 Takeover Regulation

In terms of takeover bid, German and Russian laws vest shareholders with greater participation rights and as result score higher than USA, which fixes the great decision autonomy by managers (Figure 17). Noteworthy that Russian law mentions the interests of employees in case of takeover. Unlike the USA, lower scores of Kazakhstan and Uzbekistan is not the reason of favouring managers in decision provision but rather it is consequence of omitted provisions that also reduce the shareholders power. Minority rights in respect to takeover regulation are less clearly regulated in transition economies (Figure 18). Although in Russia the law includes some provisions that are supposed to safeguard the interests of small investors according to western practice, these provisions are either not complete or their effectiveness under conditions of Russian institutional environment could be doubted. In contrast the law in Uzbekistan and Kazakhstan omit virtually all related aspects of minority rights in course of takeover transactions.

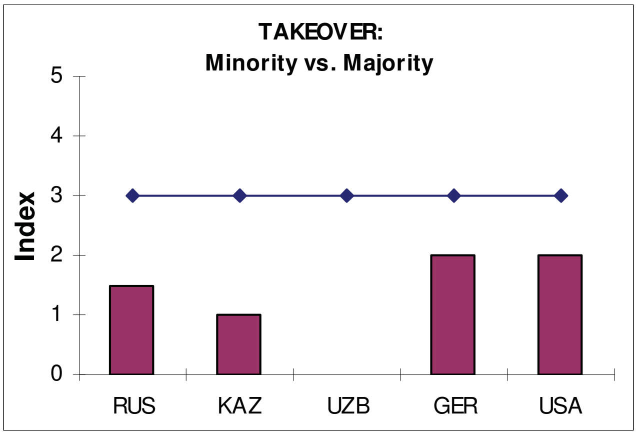
Figure 17: Takeover. Power of shareholders as a general constituency



Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 5.

Figure 18: Takeover. Powers of minority shareholders



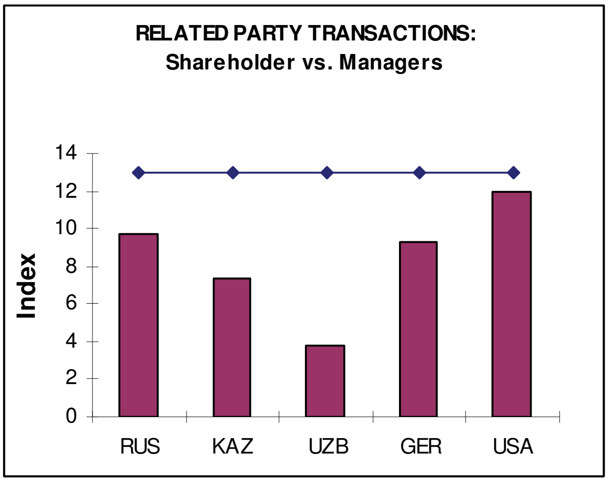
Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 6.

4.4 Related Party Transactions

Due to inertia from the Soviet times, cultural standards and weak institutional environment, the related party transaction can be expected to be the natural way of doing business in transition economies. Therefore, in order to boost the development of securities markets and investor confidence, the bigger attention must be devoted to regulation of such aspects as transparency and insider trading. The clear determining line must be drawn between the functions and liabilities of participating actors. The Figure 19 shows that particularly in respect to the related party transactions the USA regulation receives the highest score. In fact, the US corporate and capital market laws contain perhaps the most rigid and detailed disclosure provisions in the world. Moreover good insider trading rules and flexible judicial system with elaborated fiduciary duties make related party transactions difficult to conduct. Next follow Russia and Germany with almost equal scores, although it does not say anything about each single aspect. Thus for example, when Russian law contains more profound disclosure rules than German, its regulation of insider trading is virtually absent, which is not the case in Germany. Although Kazakhstan has better insider trading rules than in Russia, the weaker disclosure regulation puts it in the rank four. Considering the minority rights in course of related party transactions US maintains the leading position, followed by Germany (Figure 20). In transition economies the missing or poorly regulated aspects of disclosure, liability of large shareholder and right of small investors to claim the right in the court diminish their overall scores.

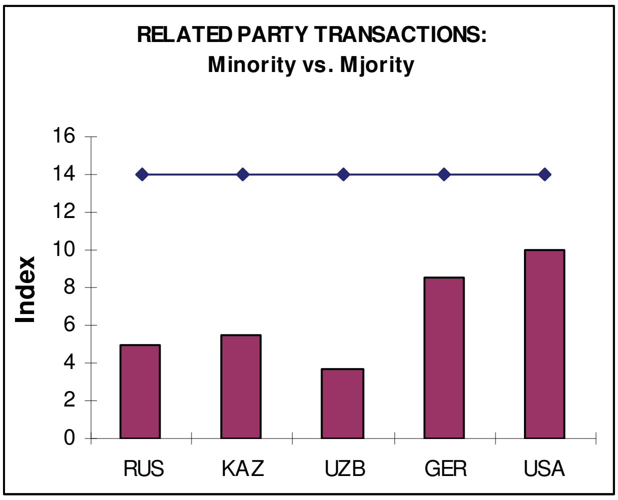
Figure 19: Related Party Transactions. Powers of Shareholders as general constituency



Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 7.

Figure 20: Related Party Transactions. Powers of minority shareholders



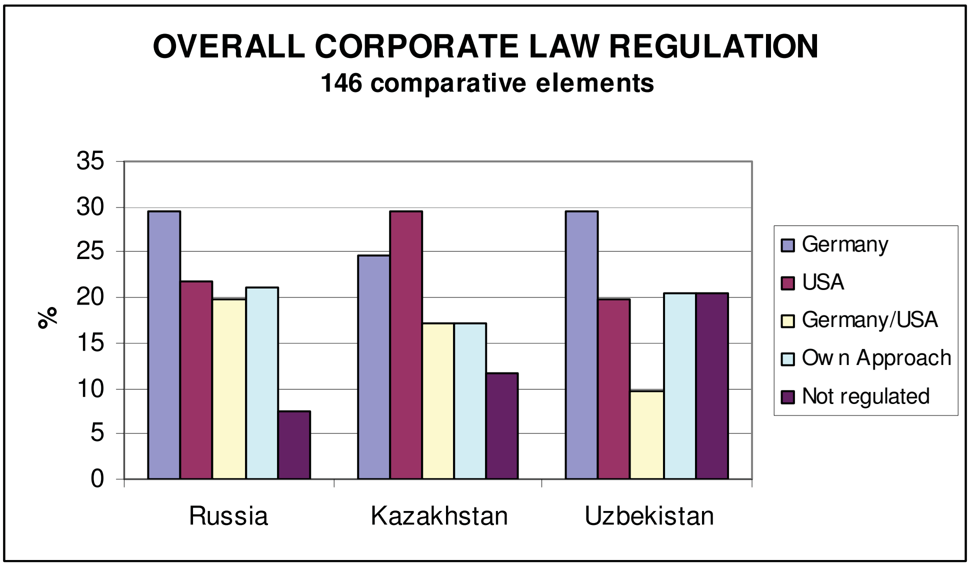
Source: Own Depiction

Note: The figure depicts the results of Index calculation based on Appendix III, Table 8.

3. Conclusion of Part II

In this part we conducted comparative analyses of the corporate governance related regulations. Although the JSC laws and capital market laws in transition economies at first glance appear to be quite similar, after close analyses the direction of law development towards the USA or German jurisdictions is evident (Figure 21). The regulations in Russia and Uzbekistan contain the larger number of provisions that are identical with German approach, whereas regulation in Kazakhstan resembles to a bigger extent the US laws. Nevertheless some degree of convergence can be observed in all countries, especially in provisions that are related to capital market regulation.

Figure 21: Overall Corporate Law Regulation

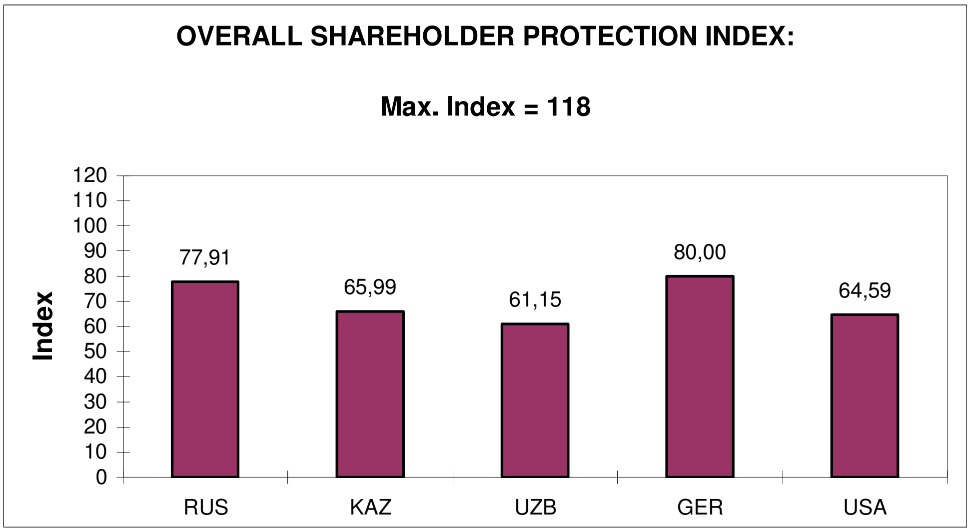


Source: Own Depiction

Note: This figure depicts the overall trend in the development of corporate governance regulation in transition economies compared with the USA and Germany (See Appendix II)

Another task of this part was to figure out by means of quantitative approach what regulation provides shareholders with larger power. The aggregate results in Figure 22 clearly demonstrates that German legal system provides shareholders with better protection with larger participation authority in the decision making process. In contrast the US shareholders have little participation power in corporate governance. The law instead strengthens their information and exit rights. Due to the high liquidity of the US capital market, any discontent with the managerial politics the shareholders can sell their stocks. Another, apparently, strong power of the US shareholder is the possibility to foster their rights in the court. However the recent evidence of court decisions indicates that even the right to bring the lawsuit is not always available for shareholders.[474]

Figure 22: Overall Shareholder Protection Index



Source: Own Depiction

Note: This figure depicts the overall Shareholder Protection Index (SPI) for five countries (See Appendix III)

The research of this part was concentrated mainly on the quality of the laws in books. It appeared that according to multiple criteria the laws in transition economies are of a good quality and in some cases are even better than in developed countries. We are aware of the fact that alone good laws are not sufficient. Another important factor that is paramount for good corporate governance is the enforcement of those laws. However, analyses of enforcement are not the subject of this work, as it will considerably explode the volume and time frameworks. It can be hoped that this part will stimulate the further researches in this field which will concern the aspect of enforcement of corporate governance related provisions in transition economies.

[474] The Economist (13.10.2007) writes about several recent cases of shareholder disqualification of bringing the suit

PART III: THE ROLE OF CORPORATE STAKEHOLDERS

A corporate governance model of a country will not be complete with only the overall governance structure of corporations and the legal rights of primary stakeholders (shareholders, managers, a board of directors) taken into consideration. A crucial role in the analyses of corporate governance model is played by other different stakeholders such as state, creditors, institutional investors, auditors and rating companies, which due to their legally determined functions and actual activities have an impact on the design of a country's corporate governance model. The mentioned stakeholders can, on the one hand, enhance the corporate monitoring and thus reduce the agency costs of investors. On the other hand, if they are themselves poorly regulated, they may hinder the development of a healthy corporate governance environment of a given country. For example, corrupted auditors or interventionist and an expropriating government may undermine investors' trust in market. The purpose of this chapter is to review the legal practices regarding particular stakeholders, to provide quantitative measures for their activities and evaluate their role in national corporate governance models.

1. Professional outside stakeholders

1.1 Creditors

1.1.1 Introduction

In the context of transition economies the review of the position of creditors in corporate governance is always associated with the role of banks, since they are the main external lenders to the corporate sector.[475] Therefore, in this section the focus will lie mainly in the role of banks.

Corporate governance literature observes the role of creditors and banks in particular as company monitors. A bank can monitor companies both as a creditor and a shareholder. The latter monitoring can proceed through direct shareholding as a beneficiary owner of stocks or on behalf of clients through proxy (depository voting rights).

There is no unequivocal opinion about the role of banks as shareholders. In their literature survey Dittus and Prowse (1995) figure out arguments both favouring the role of

[475] See Part I, Chapter 2.4.

banks as shareholders and those against it. Bank shareholding is endorsed by empirical findings which show that firms with close bank ties experience less liquidity problems, are more profitable, productive and have a higher market value. Moreover, comparing banks with other institutional investors such as pension funds or insurance companies, Edwards and Fischer (1994) argue that banks have additional information advantage through their access to firms' accounts, which shows all withdrawals and deposits that are important for evaluation of the financial situation of a firm. The empirical researches based on the bank-oriented financial systems of Japan and Germany unanimously conclude that a strong bank-firm relation may reduce the agency and information costs, and therefore constitutes an effective governance mechanism. Nevertheless, there are also a few arguments against bank equity holding discussed in the literature.

The first constraints of bank shareholding are potential subsidised loans to companies in which banks hold shares, which destructively effect a competitive environment. Other potential conflicts of interest include the ability of a bank to restrict the supply of credit to a company which is a competitor of an enterprise where the bank holds stake, or the ability to give privileged information about a borrower to competing affiliates. Another argument against banks' active role and representation on the board is that it may hinder an effective investment policy. For instance, a bank may reject a riskier project with a high expected revenue, instead choosing more conservative investments with lower risks and lower returns. Banks as large equity holders may also influence a firm's decision to take a loan or buy other bank's related products at premium prices. The equity stake held by the bank may hinder the ability of the firm to borrow on the competitive loan market. This problem maybe even more aggravated under the system with low competition in the banking sector.

In order to stipulate conditions for an efficient role of bank monitoring as creditors or as shareholders, and in general, to develop a healthy banking system, a particular environment should be created. Frequently mentioned criteria for such an environment are: (1) low state interference in the banking sector and low state ownership of banks, (2) high competition level in the banking and financial sector, (3) better supervision, (4) good laws on banks, bankruptcy and their enforcement and (5) banks' own corporate governance system.[476]

The privatization of banks is a necessary condition for their efficient role in corporate governance. State owned banks are bad at providing corporate control because of possible political interference in loan decisions. State banks may give preference to employment and political consideration, rather than to financial returns. Empirical studies by La Porta et al.

[476] Dittus and Prowse (1995), Barth et al. (2002), IFC (2007).

(2002b) found that the government ownership of banks is high in countries with low levels of per capita income, backward financial systems, interventionist and inefficient government, and poor protection of property rights. The results of Barth et al. (2002) have also demonstrated that government ownership of banks is negatively associated with good outcomes and positively linked with corruption. Therefore, for banks to play a role in corporate governance, their relations with the state should be restricted through privatisation.

High competition in the banking sector contributes to an effective relation between banks and firms. The higher the competition in the banking sector, the less is the probability that a conflict of interest in a system with bank shareholding will appear. Banks take care of their reputation in a competitive environment. For example, high competition in the banking sector of Germany and Japan results in lower potential for a conflict of interests.

A bank as an organization is also subject to its own principal-agent conflict, which must be targeted. One way to do so is to promote bank related corporate governance practices. The monitoring of banks could be another way. In this respect arises the question: who should monitor the monitors? It is important to create institutions which will supervise and control banks. Such supervision can be undertaken by banks' own shareholders, private sector institutions, such as audit and rating bodies, or by the public regulators. Applied separately, each of the remedies has its weakness and on its own it is not sufficient to provide good monitoring. Monitoring by shareholders is inefficient if the ownership of banks is dispersed because of the free-rider problem. On the other hand, large shareholders may undertake value decreasing transactions and loot the assets of the banks. The latter problem may have more dramatic consequences, since the whole financial system of a country can be put at risk. Monitoring by private sector institutions is not efficient in countries with poorly-developed capital markets, accounting standards and legal system (Barth, 2002, p.14). The critics of monitoring by the state supervisory authority underline that since supervisors do not invest their wealth in banks and, at the same time not being well compensated, they may simply lose an incentive for monitoring or even move to banking which may result in the interest conflict.

Despite passive monitoring of a debtor or a company in which a bank keeps shares, the bank can also promote corporate governance of companies. In the IFC survey (2007) the authors stated that evaluating corporate governance of companies and including them in a credit analysis banks can stimulate companies to comply with international good governance standards.

Referring to the previous discussion, we came to the conclusion that banks as beneficial shareholders can serve as an effective corporate controller if some conditional framework exists. In the following sections the review of environmental conditions will be undertaken. Also, while studying the role of banks in the corporate governance system it is important to keep in mind the political arguments of Roe (1994), which conclude that it is the legal restriction under the pressure of interested lobby groups that limited the role of banks, as e.g. in the USA. In this respect it is crucial study the laws that regulate maximal shares to be held in the capital of one company, and the representation of bank employees on corporate boards.

1.1.2 Russia

The review of Russian banking sector can be symbolically divided into two phases of history before and after the financial crisis of 1998. The first half of the 90s is known as the 'golden age' of private banks. In the first years of independence the market entry of new banks was extremely rapid. Within a few years the number of banks grew from a handful of state banks to about 2,400 banks (Dittus and Prowse, 1995, p.20). Most of them were small, some owned by one or several enterprises which were using them as a cheap source of credit. In comparison to developed countries, where banks own stakes in companies, in the Russian economy banks were owned by companies. Under such circumstances the term 'insider lending' got a new perspective.

Within one decade private banks grew into the largest, richest and politically most powerful institutions in the new Russian economy (Gustafson, 1999, p.77). They were the chief beneficiaries of the macroeconomic environment of the first independence years – weak Ruble and high inflation during the period of 1991-1995. The profits of Russian banks amounted to as much as 10% of the Russian GDP. Gustafson (1999) briefly describes the main activities of banks of that time as follows: '*The way banks earned money was straightforward: they converted low-interest Rubble deposits into dollars, then lent the dollars at high interest rates to finance short-term commodity exports. The banks made money from every link in the chain, first by charging high interest rates on the dollar loans, then converting the dollars back into depreciated Rubbles, which they returned to their depositors' accounts'*. In order to keep this scheme functioning low-interest rates were required. The author gives an explanation why low-interest rates were persisting and why depositors allowed using their deposits without indexation. First reason is that there were a lot enterprises which had their own 'pocket' banks, the shareholders of which were often top-managers of enterprises. Thus, the resources of the enterprises were kept in these banks and made them work for the managers' private interests. Second reason is that the Russian depositors were not aware of the notion of inflation and it took a while to perceive it. Third, the government agencies were another group of clients. Tax receipts, customer duties, and pension payments were held in banks and used as 'free loans' by the banks. By the time the August crash of 1998 came up to 90% of all government funds were processed through 'authorised' commercial banks. This explains why tax payments and government services were so severely disrupted by the banking crisis (Gustafson, 1999, p.84). The revealed environmental conditions allowed banks to evolve as powerful economic and political actors.

During the first years of reforms very little attention was granted to conservative banking activities: nearly 1% of bank loans were given for more than one year and lending to the business sector was ca. 11% of GDP. Instead, the role of banks in corporate takeovers during the privatization was substantial. Banks invested in stocks of firms from several main industries such as: production of exportable commodities, construction material and food. They began picking up shares in companies from the very beginning of the process. In the beginning banks were buying large bundles of privatization vouchers and exchanging them for equities. After the voucher privatisation banks continued to build up their shareholdings, acquiring blocks of shares through investment tenders, cash auctions, and purchases on the secondary markets. It is difficult to find exact information about the shares that the banks were holding. A research conducted by Blasi and Shleifer (1996) indicates 5% on average, which banks owned in large enterprises and financial industrial groups. Only the biggest banks had a share in large companies due to their economic power and political connections. Most of the companies in the banks' portfolio were export-oriented raw material producers, which were hardly influenced by structural changes in the economy during the first phase of transition (Kordasch, 1997, p.181). In contrast, the equity holding of medium-size banks was usually modest and rarely amounted to a controlling block. According to interviews of bank managers, Dittus and Prowse (1995) found that new private banks did not want to own companies and play an active role in corporate governance through ownership. The reasons were: (1) high costs of active shareholding, (2) small staff which restricts active shareholding up to several companies, (3) the lack of required skills to undertake supervision and restructuring, (4) 'moral obligation' – banks try to exclude the conflict of interest between ownership and independent credit appraisal, (5) lending and account relations already give the banks enough information on companies, which makes additional information access through the ownership redundant. Thus, there appeared a difference in the equity ownership of large and middle-sized banks.

The August crisis of 1998 eliminated the banks' superpower. The top-twenty commercial banks with two-thirds of the banking sector assets collapsed. Another hundred were on the edge of insolvency. The banking crisis paralysed the whole economy and especially the financial sector. By 1999 the number of banks decreased to 1,852 with only 4,453 branches. The collapse also had consequences for the equity markets. The shareholding of banks in the corporate sector decreased as well (Judge et al., 2004, p.306). The crisis proved the doubts about the banks' capability to conduct effective corporate control and to strategically manage their shareholding.

Today, the Russian banking system remains, on the one hand, highly fragmented with 1,243 banks (2007) and, on the other hand, extremely concentrated, since 30 biggest banks control 67% of the assets. During the last few years the industry has been significantly liberalized towards foreign investments. It is allowed for foreign banks to open subsidiaries, however not branches. Foreign capital is represented in 202 banks, whereas in 86 banks foreigners hold controlling stakes, as opposed to 65 a year earlier. The share of banks controlled by non-residents increased from 8.3% to 12.1% of the banking sector assets.

The role of state stipulated by the large ownership stake held in banks remains substantial. The state controls 32 credit organizations whose assets constitute 40.7% of total sector assets. Some banks, though not being formally state owned, remain under a decisive influence of state bodies and individual officials (Vernikov, 2007).

Compared to the countries of Western and Eastern Europe the banking sector remains small in relation to GDP (IFC, 2007). As of 1 December 2007 total assets of the banking sector was estimated to 18,947 billion Rubbles, which makes 57% of GDP. For example, in developed countries this ratio is often higher than 100%. A positive trend is observable in credits to juridical entities. Since 2004 credit to companies and organizations have increased from 18% to 26% of GDP in 2007. In general, there is a positive development trend in the Russian financial sector. EBRD evaluated the progress in the last two years with the mark 2.7 and 3.0 for banking and non-banking financial sectors respectively, which is average in comparison with all transition economies (See Table 20).

Table 20: Russian banking sector in figures

	2004	**2005**	**2006**	**2007**
Number of banks	1,478	1,356	1,293	1,243
Banks with controlling foreign stake	41	55	65	86
Total assets (% of GDP)	43	49	52	57
Investment in shares of resident corporations, except for banks (*bln Rubbles*)	101	129	195	355
Investment in shares of resident corporations *(% of assets*)	1.4	1.3	1.4	1.9
Deposits of households *(% of GDP*)	11.8	13.7	14.2	14.6
Total amount of credits (% of GDP)	24	29	32	39

Credits to juridical entities, excluding banks (% of GDP)	18	20	21	26
Index of banking sector reforms	2.0	2.3	2.7	2.7
Index of non-banking financial sector reforms	2.7	2.7	3.0	3.0

Source: EBRD Transition Report 2005, 2006, 2007 (from 1 to 4, 1 – no change, 4 – standards of market economy), Central Bank Data, The Central Bank of Russia.

The role of banks as beneficiary shareholders of corporate shares is negligible at the current stage of development (See Table 20). According to the instruction of the central bank investment in shares of one company must not exceed 10% of the bank's equity capital and the overall investment in shares of different companies must not exceed 25% of the bank's equity capital.[477] In 2007 banks invested totally 355 billion Rubbles in shares of resident companies (excluding banks), which constitutes 1.9% of total sector assets. For comparison, German banks invest approximately 4% of total sector assets in corporate stocks.[478] Only 22% of the total equity shareholding builds a controlling stake. In most cases (97%) controlling stakes are held by 30 largest banks. According to the data of the Central Bank investment in equities with a purpose of control is made only in shares of Russian credit organizations and of non-resident banks. Investment in shares of non-financial organizations (mainly in blue chips) is carried on with the purpose of further resale.[479] The law does not restrict the representation of bank members on the board.

With regard to banks' own governance system it can be assumed that, as 65% of the industry consists of open joint stock companies the standard corporate law regulation applies to them as well (IFC, 2007). In fact, Vernikov (2007) states that the model of governance of banks is similar in Russian companies and banks, although the banking transparency of ownership is higher and the role of business groups is less pronounced. In 2005 the Central Bank of Russia released the Corporate Governance Code for Russian banks. Although this code is not mandatory it is backed by the 'comply and explain' rule and provides overall guidance regarding the structure and the role of governing organs, transparency and disclosure standards, and the rights of various stakeholders (IFC 2007). In order to improve the quality of reporting all Russian banks since 2005 must prepare their financial statements according to the International Financial Standards (IFRS).

One strong monitor over the quality of corporate governance is a large blockholder. As a rule, Russian banks have one or two controlling shareholders. Only a few banks are listed or

[477] Bank of Russia, Instruction No. 1 of January 30, 1996, "On the Procedure for Regulating the Activities of Credit Organisations.
[478] According to the statistic date extracted from the web page of the Deutsche Bundesbank (Stand: 25.02.2008).
[479] Bank of Russia, Annual Report (2006).

have shares in free float.[480] This is explained by the reluctance of bank owners to disperse the ownership, as it may stipulate a takeover. In this light, it may be less worried about the monitoring of management and shareholders' rights, as big shareholders are intensively involved in banks' activities through representation on the board or even in management. The accent should be rather put on the rights of minority investors. With respect to monitoring it is also necessary to note a growing role of rating agencies. Many large Russian banks undergo the rating of the international rating agencies such as Moody's, Standard and Poor's and Fitch's rating, which function as strict monitors of banks. Also the domestic market of rating agencies gradually evolves.[481]

Apart from monitoring, the role of a bank as a direct promoter of good corporate governance practice among its clients is virtually non-existent. Banks rarely assess corporate governance practices of their clients in their credit risk analysis (IFC, 2007).

To sum up on the role of banks in Russian corporate governance it can be stated that at the current stage the banks perform mainly the role of creditors. Beneficiary equity holding is small, although the law does not impose any strict limitations on shareholding. The overall environment requires some improvements in the form of reduction of state ownership in the sector and promotion of competition among banks.

1.1.3 Kazakhstan

According to foreign experts' evaluation the Kazakh banking system is most advanced among the CIS countries. In the EBRD evaluation of banking sector for 2007 the Kazakh banking system scored the highest mark among CIS countries.[482] The banking sector is represented by 33 banks (2006) including 14 banks with foreign participation. According to the law foreign banks may not have branches but may establish subsidiaries, joint ventures, and representative offices. Investment in equity capital in the banking sector by foreigners is limited to 25%. The share of state in the banking sector is minimal, amounting only to 3.7% of the total sector assets. The total value of assets in the banking sector reached in 2006 the record level of 102% of GPD, which corresponds to the level of many developed economies. The banking sector is highly concentrated with 5 biggest banks controlling 81.6% of the whole assets in 2006.[483] Strong concentration of the banking system can be explained by a

[480] For example on the RTS Stock Exchange shares only of 3 banks are listed: *Sberban*, *Bank Vozrozhdenie, Bank VTB.*
[481] National Rating Agency, Expert RA, RusRating.
[482] Kazakhstan received mark 3.0. The highest mark in this scale is 4.0.
[483] Kaskomerzbank, Bank TuranAlem, Nardniz bank Kasahstana, ATF Bank, Alans Bank.

number of closures and mergers caused by rising capital requirements and strengthened supervision since the 1998 Russian crisis (IMF, 2003). Kazakhstan was among the first CIS countries to introduce a deposit insurance system (1999), securing trust of the population in the banking system, which is manifested in the growing level of deposits (see Table 21). On the assets side of banks a significant ratio is occupied by credits to companies and households. Due to the rapid growth of assets many Kazakh banks became borrowers on the international credit markets. Such heavy reliance on foreign credit markets had in 2007 a reverse affect on the Kazakh financial system. The credit crises in western countries led to the restructuring of credit portfolios of big creditors, which also resulted in cutting credits to borrowers such as Kazakh banks.

Table 21: Kazakh banking sector in figures

	2004	2005	2006
Number of banks	35	34	33
Including foreign banks	9	14	14
Assets of state banks (%)	3.7	3.1	2.0
Total assets of banking sector (% of GDP)	Na	60.6	101,7
Deposits (% of GDP)	Na	22	30,5
Securities (% of total assets)	Na	14.4	
Credits to companies (% of GDP)	Na	25.3	32.4
Credits to households (% of GDP)	5.6	8.8	15.8
Index of banking sector reforms	3.0	3.0	3.0
Index of non-banking financial sector reforms	2.3	2.3	2.3

Source: EBRD Transition Report 2005, 2006, 2007 (from 1 to 4, 1 – is no change, 4 – standards of market economy), Annual Report of the National Bank of Kazakhstan.

Unlike Russia, the Kazakh regulation largely restricts the role of banks as beneficiary owners in the corporate governance system. As a general rule, banks cannot invest in the charter capital or acquire an interest in corporate entities.[484] This does not apply to banks' participation in the charter capital of financial organizations, joint stock investment funds, foreign pension funds and insurance companies. Banks can invest in shares of firms from a non-financial sector, only if the firm is listed on the Kazakh Stock Exchange in the highest listing category 'A'. A bank is allowed to keep up to 10% of outstanding shares of one issuer or equivalent to 10% of the bank's equity capital.[485] A total amount of shares held by a bank cannot exceed 60% of the whole assets. In 2007 the investment portfolio of banks constituted 770 bln Tenge, of which almost 40% were invested in the republican securities. The share of

[484] The Law on Banks, Kazakhstan - §8(2).
[485] The Law on Banks, Kazakhstan - §8. As an issuer in this case, the law regards investment funds and non-financial firms.

stocks in the portfolio remains small, constituting in 2007 only 5.2%, from which 39.34 bln Tenge was invested in domestic stocks and 1.04 bln in foreign stocks. Considerably higher capital banks invest in corporate bonds, whereas the volume of foreign and domestic bonds was almost equally large: 138 and 139 bln Tenge, which makes 36% of the investment portfolio (FSA, 2008).

All Kazakh banks have a form of a joint stock company, which implies the application of the general corporate law standards for them. However, considering the role of banks in the economy, regulators have developed additional legal rules applicable mainly for banks. For example, Kazakh banks were first among companies to start reporting according to the IFRS since 2003. As a rule, they have one or several large blockholders. The largest shareholder keeps in average 30% of a bank's equity capital.[486] Therefore, safeguarding of general shareholder rights is stipulated by the monitoring of large owners. In contrast to Russian practice, more than half of banks are listed on the national stock exchange.[487] As borrowers on global capital markets Kazakh banks are subject to monitoring by strict evaluating procedures of rating bodies. Most banks have the credit rating of three biggest international agencies.

In conclusion, the role of banks in the Kazakh corporate governance system is legally restricted. Banks can keep corporate shares only in companies from the 'A'-listing category. The role of Kazakh banks is rather concentrated on their credit functions. The flourishing credit system and favourable sector conditions are reasons of an active role of banks as corporate monitors.

1.1.4 Uzbekistan

Compared to Russia and Kazakhstan, the financial sector in Uzbekistan remains considerably underdeveloped in terms of the range and quality of services offered. Both banking and non-banking financial sectors fail to provide effective intermediation. The low EBRD reform index for the banking and non-banking financial sectors indicates weak progress Uzbekistan has made in these fields (see Table 22).

As in all other economic sectors, the state plays a dominant role both as a direct owner of banks and as a regulator. Uzbekistan has a two level banking system with a hierarchically strong position of the Central Bank on the first level, and a number of subordinated commercial banks on the second level. The banking sector is characterized by a high degree

[486] Own calculations.
[487] Kazakhstan Stock Exchange (2008), www.kase.kz

of concentration with state banks holding a large share. In 2005 the assets of state owned banks amounted to 66% of total assets in the banking sector. Out of 28 banks on the market the biggest share belongs to the state owned National Bank of Uzbekistan (NBU) – 64%. Although a number of new private banks have emerged recently, the state share in the sector is dominant. The NBU together with other 11 banks with the state ownership controlled in 2005 almost 92% of the whole sector assets. Therefore, private banks and 5 banks with foreign participation control only 8% of all assets. [488]

The role of the state is stipulated not only by the large stake held but also through direct intervention in the banking sphere. Almost all routine operations of banks require a permission of the government. According to the Report of International Crisis Group heads of regional branches of banks are appointed only with the approval of local governors and a banker will have to show the loyalty to remain in his post (ICG, 2004, p.17).

Apart from the primary functions that conventional banking system fulfils in the economy, Uzbek banks have a range of functions that belong to the domain of governmental bodies. Among them is passing information to the tax authority about their clients and deducting tax debts from legal entities. For example, in case of insufficient credit on a firm's account a bank must sell available foreign exchange of the client and cover tax liabilities.

Additionally, the course of tight monetary policy hinders development of the banking sector. All cash payments by commercial banks should be first approved by the CBU (Central Bank of Uzbekistan), restricting the access to the clients' own cash resources. This sharp monitoring of cash operations, promoted as a mechanism targeting inflation, imposes additional transaction costs for market participants – banks themselves and enterprises. This makes legal transactions increasingly difficult, creating shadow economy. All these factors result in defective banking intermediation, as banking officials cannot make decisions solely on the basis of commercial realities.

Table 22: The Uzbek banking sector in figures

	2003	**2004**	**2005**	**2006**
Total number of banks	33	31	28	28
Banks with foreign participation	5	5	5	5
Assets of banking sector (% of GDP)	37.8	38	37	34.7
Credit (% of GDP)	32	27	22	na
Household deposits (% of GDP)	2.1	2,6	3,1	4
Assets of wholly or mostly state owned banks (%)	70.7	67.6	66	na

[488] There are also a few foreign banks which have representative offices: Deutsche Bank, Dresdner Bank, Commerzbank, JP Morgan Chase, Bankgesellschaft Berlin, Société Generale, Credit Commercial de France, Credit Suisse and Maybank.

Index of banking sector reforms	1.7	1.7	1.7	1.7
Index of non-banking financial sector reforms	2.0	2.0	2.0	2.0

Source: EBRD Transitional Report 2005 (from 1 to 4, 1 – no change, 4 – standards of market economy), Avesta Group, IMF, ADB 2005, 2007.

Apart from concentration, the Uzbek banking sector is distinguished by a high degree of segmentation. Activities of most banks are concentrated along one branch. For example, *Halyk Bank* focuses on households, *Galla Bank* on grain sector, *Asaka Bank* on automotive industry. Such a high degree of industry concentration and segmentation implies the risk concentration of credit portfolio, especially when most of banks' lending is made to member enterprises of an industrial association.

The role of banks as financial intermediaries remains significantly low. This can be illustrated by the ratio of total bank assets to GDP, which in 2006 equalled 35%, compared with 65% in Russia and 101% in Kazakhstan. One of the main reasons is the low level of household deposits, stipulated by the lack of trust and inappropriate incentive schemes, as e.g. negative real interest rates. Though increased in the last few years, household deposits remain low, reaching in 2006 the level of 4% of GDP, compared with 14% in Russia and 30% in Kazakhstan. A total amount of bank loans in 2005 was estimated on the level of 22% of GDP (ADB, 2007). Companies finance only 4.2% of their fixed capital investment trough bank loans, whereas 95.2% is covered by firms' internal resources and 0.4% is financed though capital markets (IFC, 2005).

After the overview of the banking sector from the perspective of conventional banking, the study will turn now to their role on the stock market. Having a universal banking system the Uzbek legislation allows commercial banks to invest in corporate stocks and there are only investment caps based on the banks' own equity capital. Nevertheless, their investments in corporate stocks remain negligibly small. Investments in securities made up in 2006 only 1.8% of the total bank assets, with bonds taking a considerable share (CER, 2007). According to the estimation of national experts the main activity of banks on the stock market is transactions with own shares, which are traded for nominal prices. This can be explained by the underdevelopment of the stock market and the state ownership both of banks and of large corporations. Large state owned banks as creditors of the corporate sector, which is also represented by multiple companies with substantial state ownership, lack incentive for strategic investment in the corporate sector due to the availability of other administrative control mechanisms over companies. On the other hand, moral hazard between a state owned company as a debtor and a state owned bank as a creditor increases the potential for failure to pay back the credit. This reduces the willingness of banks to invest in shares of large state owned corporations. Private banks, in their turn, are usually small and do not have enough capacity to monitor their investments in equities. Moreover, apart from direct shareholding, the role of banks as intermediates on the securities market is also small. In 2007 only 12 had licenses for intermediate operations and only 3 of them carried out depository and registry operations (CER, 2007).

The weakness of the bank's own corporate governance is another crucial reason of poor development of the sector. Despite the attempt to copy good corporate governance standards, as e.g. the introduction of mandatory reporting requirement according to the IFRS or the regulation of Corporate Governance in Banks, the dominating role of the state hinders any positive development.[489] As a result, legal protection of minority investors is neglected, whereas 'voting with feet' within the illiquid stock market is impossible without triggering large price movements (ADB, 2007).

The Uzbek law does not prescribe exact juridical form of banks as in Kazakhstan and Russia, however, it says that as a rule banks are founded in the form of joint stock companies.[490] Corporate governance of banks is highly affected by a tight monetary policy of the Central Bank. For instance, the increased equity capital of banks in the last periods is an evidence of the increase of undistributed profit. Due to the tight monetary policy the Central Bank restricts the freedom of commercial banks to decide freely on retained profit. If banks cannot decide about their profit, it makes investment in bank shares unattractive.

This brief review reveals that Uzbekistan has a quasi-banking system with weak performance of conventional banking business and strong concentration on administrative tasks, which makes the banks just another administrative body. Therefore, in spite of the fact that the Uzbek law does not restrict bank participation in the equity market, their role in the national corporate governance model remains negligible both as creditors and shareholders.

1.2. Institutional Investors

1.2.1 Introduction

In the second half of the 20th century new professional market participants evolved on the financial markets, gaining a permanently growing stake in total capitalisation of the corporate sector. These participants, defined by a generic term as 'institutional investors', include three main subtypes: insurance companies, investment funds and pension funds.

[489] Central Bank of Uzbekistan, Decree №595, December 2004 "On preparing consolidated financial reports by commercial banks", 2005; and Decree N 472, June 24 2000 "On Corporate Governance in Banks".
[490] The Law on Banks, Uzbekistan - §7.

Facing rapid development of institutional investors in the developed capital markets and their growing influence on corporate governance model of those countries it is justified to study the role of institutional investors in transition economies.

Institutional investors approach corporate governance in a different way than individual investors do. They normally have larger shareholding, which is an incentive to develop expertise over investments and to monitor them. The concentration of voting rights should enable them to actively monitor firm performance and initiate change in the management organs if corporate performance falls below expectations.

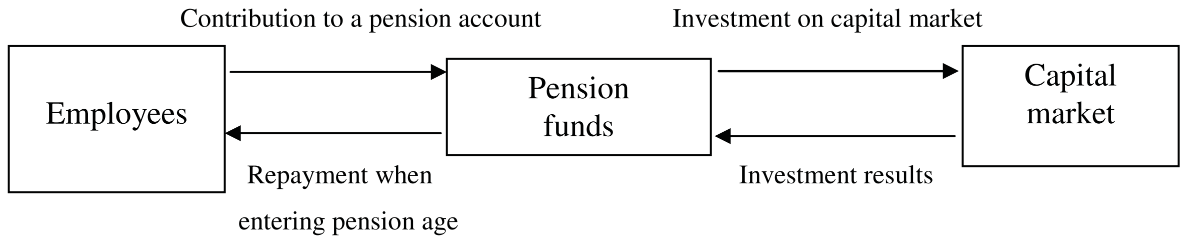
Three main institutional investor groups will be studied in this chapter: pension funds, investment funds and insurance companies. Hedge funds, which can also be included in this group, will be omitted in further analyses due to their still insignificant role in transition economies, unregulated nature and highly speculative investment activities. Initially accent will be put on legislative frameworks. Further, empirical evidence will demonstrate the results achieved in that field since independence. Based on the results, the research will analyse a particular role of these stakeholders and their further potential in corporate governance of each transitional country.

1.2.2 Russia

a) Pension Funds

All countries of former Soviet Union inherited a pay-as-you-go pension system. Under this scheme the pension contribution is collected from employees and distributed among pensioners. The model can function effectively as long as the proportion of employed population is higher than that of retired one. This is, however, not the case for many developed countries and some transitional economies, as the population structures shift to a bigger proportion of an elder generation. Two main reasons may explain such a shift: first, the post-war baby boom generation of the 60s is retiring within the next decade and the second reason is negative birth rate among the population of fertile age. Countries concerned with this demographic problem realize that the pay-as-you-go system cannot on its own effectively maintain minimal living standards of pensioners. This problem can be tackled either through changes in fiscal policy or through introduction of a pension system based on capital markets. For further analyses of the present research the second option, namely the capital markets based pension system is relevant. Under this system a new category of institutional investors called 'private pension funds' evolves. Schematically, the pension system based on capital markets (Accumulative Pension System) can be illustrated as in Figure 23:

Figure 23: Scheme of capital market based pension system (Accumulative Pension System)



Source*: Own illustration*

Given that pension funds represent long-term investors on the capital market, including corporate equities, it may be assumed that they can play a potentially important role in monitoring management. This is, for instance, the case in the USA and the UK. The rest of the world is catching up with ever growing attention of reformers to the capital market based pension system.

Considering the strong role of pension funds in corporate monitoring of most developed economies it is necessary to include analyses of pension systems of transitional economies into the present study. Surveys of the three sample countries will allow to analyse the role of pension funds in financial markets of transition economies, their role as corporate shareholders and the legal power they are entitled with.

Starting with Russia, the main argument against the old pay-as-you-go is a changing demographic situation, which may undermine the future well-being of pensioners. Thus, e.g. if currently almost two employees finance one pensioner (see Table 23), in 2020, due to the negative birth rate, the proportion is going to change into one-to-one relation. Because of this demographic shift it would be impossible to provide pensioners with sufficient provisions.

Table 23: A number of employed per one pensioner in Russia

1992	1994	1995	1996	1997	1998	2000	2001	2002	2003	2004
2.02	1.84	1.79	1.77	1.70	1.66	1.68	1.68	1.70	1.71	1.74

Source: State statistical committee (Goskomstat)

The Russian government facing these demographic problems was led to the decision to introduce the capital market oriented pension model. Since 2004 the non-state pension funds (NSPF) can participate in compulsory pension insurance schemes. Previously, the participation of NSPF was based only on a voluntary contribution of citizens. According to new reforms a monthly contribution of an employee (28% of the official salary) is divided into three parts: 14% goes to finance the state guaranteed minimal pension provision and the rest is divided into insurance and accumulating parts. The accumulating part (6% of official salary) is invested on capital markets. There are three options that employees have: (1) they can choose one of private managing companies, selected by the government, to manage pension funds,[491] (2) if no decision on particular managing company is made due specified date, the funds will be managed by a state managing company *Vneshekonombank* (Bank for Foreign Economic Affairs), (3) employees transfer money to non-state pension funds of their preference.

According to the data of State Pension Fund of Russian Federation, pension saving of households in July 2007 made up 431 billion Rubbles. Although pension savings have been growing very rapidly in the last few years, which is natural for the early stages of pension reforms, they still remain low in comparison to international experience. In 2006 it amounted to 1.6% of GDP in contrast with 72% of OECD countries (IET, 2007). Prognoses for 2012 predict that these figures will increase to 2 trillion Rubbles, as the repayment of funds will start in 2022-2027. Therefore, till the beginning of the repayment period pension funds will posses a considerable stock of capital.

Until recently most of the current pension savings were managed by the state managing company – *Vneshekonombank*, which, as specified by the law, can invest only in state securities. However, the situation is changing, as non-governmental pension funds have been enhancing their market participation. Currently there are 253 registered non-state pension funds, which have the status of non-commercial organizations.[492] The number of participants grew from 6.42 mln in 2006 to 6.62 mln in 2007. Pension funds cannot distribute the retained earnings among their shareholders. In order to invest accumulated provisions the non-governmental pension funds must hire a managing company which will professionally run the investment activities. The law determines the structure of investment portfolio of a pension fund as follows:[493]

- max. 5% in shares of one issuer and its affiliated companies,
- max. 10% in deposits and securities of one credit organization,
- max. 5% in securities of the asset management company and depositary,
- max. 10% of one issuer's capitalization,

[491] 55 private managing companies with a good rating, according to their past records were selected by the government.
[492] According to the data of the Federal Financial Markets Service, dated on: 01.01.2008.
[493] Federal Law № 111, "On Investment of Resources to Finance the Capitalized Part of the Work Pension of the Russian Federation" dated 24.07.2002, Russia - §28.

- max. 20% of portfolio can be invested in foreign securities,
- max 10% of all circulating bonds of one issuer.

Total investment portfolio of non-governmental pension funds in 2007 amounted to 340 billion Rubbles. The largest part of the assets is invested in corporate securities: 33.6% in bonds and 28.2% in shares. On average, a non-state pension fund invests 10% of its assets in shares. The third largest part of the investment instrument in the portfolio is state and municipal bonds that make up 21% of the investments (IET, 2007).

Shareholding caps of non-state pension funds are predefined by the law; NSPF can hold maximum 10% of one issuer's capitalization. Thus, the minority shareholding of the NSPF is defined by legislation. For a larger role in corporate policy several minority shareholders could join together with the purpose to promote their goals. Russian law mandates managing companies to pursue the property rights of shareholders, except for voting on a general meeting, whereas only voting on dividends is mandatory.[494]

The law also prescribes a code of professional ethics which safeguards the interests of individuals that contribute to a pension fund.[495] The code must be adopted by asset management companies, special depositories and brokers. Financial data of the Asset Management Company and depository is subject to regular external audit.

It can be concluded that, due to steadily growing assets, Russian pension funds are predetermined to play an important role on the securities market, which in turn will have an impact on the evolution of corporate governance model in Russia.

b) Investment Funds

Predecessors of modern investment funds appeared on the Russian market together with the launch of privatization in form of the Investment Privatization Fund (IPF). The applied privatization methods and lack of institutional frameworks limited the role of investment funds both in privatization and restructuring of enterprises. The process did not stipulate concentration of ownership by financial intermediaries such as investment funds. It was believed that investment funds would emerge spontaneously. However, this was not the case in Russia. Although some 600 voucher privatization funds (VPF) were founded, the extent of their participation in corporate ownership was restricted.

[494] *Ibidem* - §12(8).
[495] *Ibidem* - §36.

Initially the funds were allowed to acquire maximum 10% of shares in any enterprise. However, because of their high numbers, they had very small shares in companies. Finally, they lost the battles for corporate shareholding to insiders. Goldberg et al. (1996) distinguished four main problems from which the Russian Voucher Funds (VIFs) suffered: '(i) they lacked liquidity, (ii) they did not have access to company *registries* and were unable to establish ownership after having bought shares, (iii) there was insufficient time to revise the legal foundation to support them in their struggle with the incumbent directors, and (iv) the tax code discouraged them from restructuring their portfolios of enterprise shares, as heavy taxation was imposed on capital gains.' The concept of collective investments absolutely lost its reputation after several scandals about collective investment companies, which used fraudulent *Ponzi* pyramids to attract funds from citizens.[496] Thus, the first generation of Russian investment funds were unable to evolve as efficient mechanisms of corporate control.

Nevertheless, the potential for development of robust investment funds was apparent. On the one hand, favourable economic environment with average GDP growth of 8% resulted in average income increase and propensity to save. On the other hand, slow development pace of the banking sector, while having high unsatisfied demand of companies for financial resources, created the vacuum for an alternative way of financing. Thus, the next generation of investment funds started to evolve in Russia.

In the after-crisis time the law on investment funds was developed and adopted in 2001. It defines two types of investment funds: a joint-stock investment fund (JSIF) and an investment fund (unit trust). The difference lies in their juridical status; the investment fund is not a legal entity, it has rather the status of money (property) pool, which is managed by an asset management company. The lack of juridical status stipulates a taxation advantage, as they are not paying VAT and property tax. Unit trusts can be of an open, interval and closed type. This typology is based on shareholders' role and their ability to sell the funds' shares. The shares of an open unit investment fund are traded daily, investors of a closed fund may sell their shares only by the end of the contract period and in case of an interval fund the shares are traded only on specified days and not less than once a year.[497] Unlike funds, a JSIF has the status of a legal entity and can be only of an open type in a form of an open joint-stock company. Its shares are traded as shares of a traditional joint stock company.

[496] Charles Ponzi after whom this pyramidal scheme was named, was the first to invent collective investment based on the principal of attracting capital from new investors to repay the old shareholders. At the moment when the new wave of investors is lacking the whole pyramid breaks down.
[497] Law on Investment Funds N 156, Russia, dated 29.11.2001.

The law defines the structure of assets which investment funds can keep in their portfolios. Open and interval funds may invest maximum 15% and closed funds up to 35% of their assets in securities of one issuer. Assets of mutual funds should be handled by a private managing company. In the beginning of 2008 the National League of Managing Companies (NLU) reported 280 registered asset managing companies, which managed assets of 1065 mutual funds. Total amount of assets under the management constituted RUB 792 billion.[498] Despite the big quantity of managing companies their market share is highly concentrated. Top 10 of these companies manage 80% of all assets in the sector. In 2007 the total number of funds' shareholders was 1,642 thousand compared with 71 thousand in 2005.

Depending on their type investment funds have different governance structures. Shareholders of open and interval funds have no 'voting rights' on a shareholders' meeting because this body does not exist. Instead, they have the right of 'voting with feet'. Shareholders of open funds can sell their shares regularly (but not less than once in two weeks), those of interval funds can sell their shares on pre-specified date (at least once a year). In opposite to open and interval funds, closed funds and JSIC have a shareholders' meeting as a governing body. Shareholders of closed mutual funds can participate in general meetings and receive dividends but they cannot sell their shares back to the fund on a regular basis. All types of investment funds are committed to disclose information and define an asset management company as a body responsible for failing to disclose or disclosing erroneous information. For better transparency of investment fund activity the law prescribes a compulsory annual audit.[499]

The Russian law specifies who cannot be allowed to be a member of a board of directors of JSIF; for example, an auditor, depository and registry employees.[500] Thus, the potential for the conflict of interests is reduced by the law. In comparison to pension funds, the trustee assets managers can actively participate on shareholders' meetings of companies, whose assets they hold. They can vote on all issues on general meetings of companies in which they hold shares, although their voting power is restricted by the portfolio diversification rule (portfolio cap).[501]

[498] Official Web Page of the NLU, Stand: 12.04.2008.
[499] Law on investment funds, Russia - §49.
[500] *Ibidem* - §8.
[501] *Ibidem* - §11(3).

c) Insurance Companies

Insurance business is a slowly developing sector in most transitional economies and Russia is not an exception. However, due to the market size and rapid economic development in the last decade it can be assumed that the insurance market will profit from such trend. In the beginning of 2007 there were 916 insurance organizations on the market with total assets up to RUB 585 billion. Insurance companies invest on average 40-50% of their assets. The main investment of insurance organizations is made in securities of non-financial organizations and bank deposits, which in 2006 constituted 42% and 14% respectively. Investments in state securities make up 4.6% of the portfolio. Due to the growing assets of investment funds it can be assumed that they will foster development of the Russian securities market. Nevertheless, the world practice shows that insurance companies do not play an active role in corporate governance. The same scenario could be expected in Russia.

1.2.3 Kazakhstan

a) Pension Funds

In 1998 passing the law 'On pension provision in the Republic of Kazakhstan' the new capital market-oriented pension system was introduced in Kazakhstan. The new pension system is based on three pillars: (1) Solidarity pension provision – implies pension paid by the state and beneficiaries are those who started to work before 1998; (2) accumulating pension provision – employees contribute monthly a part of their salary to an accumulative pension fund, which is benefited by those who started to work after 1998; and (3) a voluntary contribution.

Unlike the previous regulation, the new law made the accumulating pension provision a compulsory element of the system. According to it all employees are obliged to contribute 10% of their salary to an accumulating pension fund. In case employees do not signal their decision about a particular pension fund their accumulations go to the State Pension Fund. Thus, new compulsory pension insurance accelerated the development of non-state pension funds (NSPF).

Initially, the reform process was accepted by citizens with big scepticism. This resulted in accumulation of most pension contributions on the account of the State Pension Fund. In 1998 78% of contributors were participants of it. However, in time the successes of private pension funds convinced participants with the robustness of the system. People developed more trust and understanding for non-state accumulative pension funds. Already in 2002 the percentage of contribution to the State Pension Fund decreased to 56%, and in 2003 it dropped to 28% of total accumulating contributions.

In order to consider non-state pension funds as active actors of the Kazakh model of corporate governance a review of the legislation is necessary. Collective pension funds are found in the form of joint stock companies and are of 2 types: open or corporate pension fund.[502] Open pension funds can obtain a contribution from any interested person, whereas corporate pension funds serve one or several companies which create such a fund. In 2007 15 pension funds were registered in Kazakhstan. Since the introduction of compulsory pension insurance strong positive development of the assets has taken place. The absolute value of assets increased from 70 bln Tenge in 2002 to 1,212 bln Tenge in 2007 (See Table 24).

Table 24: Development of non-governmental pension funds in Kazakhstan

	2001	2002	2003	2004	2005	2006	2007
Number of NSPF	14	16	16	16	15	14	15
Assets (% of GDP)	5.6	7.2	7.9	8.7	7.9	9	9.5
Assets (bln Tenge)	na	70	368	484	596	915	1,212
Number of contributors (mln)	na	3.1	6.1	6.9	7.1	na	na

Source: IMF 2004, Annual reports of the Agency for Market Supervision and Regulation, 2004-2007.

Assets of pension funds can be managed either by a Pension Assets Managing Company (PAMC) or a license for self-management can be obtained. A PAMC can be only in form a joint stock company. In 2007 13 PAMCs were active on the market, whereas 4 of the funds managed their funds autonomously.[503] In August 2006 the assets managed by these 4 funds constituted 55.82% of total sector assets.

Investment portfolios of pension funds consist mainly of government securities, bank deposits and corporate bonds (IMF, 2004, p.12). Investment in shares is permitted by the law and remains relatively modest due to the lack of supply. However, it is apparent that their weight among other assets is permanently growing. In 2001 only 2.4% of all assets were invested in domestic corporate shares, in 2004 it was 6.9% and in 2007 they reached 16%. Initially, corporate securities could not exceed 30% of all assets. It has changed in 2005 and since then equities may constitute up to 50% of all assets. This growing share is a positive sign of a potentially active role of pension funds in the corporate governance of Kazakhstan.

[502] The law 'On pension provision in the Republic of Kazakhstan' - §33.
[503] JSC "Accumulative Pension fund of the People's Bank of Kazakhstan", JSC „State Pension Fund", JSC „BTA", JSC „Kapital".

Detailed information on the assets structure of NSPFs for August 2006 can be presented as follows:[504]

- Long-term government securities – 20.8%;
- Short-term government securities – 7%;
- Equities of foreign issuers – 0.4%;
- Non-governmental bonds of foreign issuers – 8.82%;
- State securities of foreign countries – 0.87%;
- Equities of Kazakh JSC – 12.22%
- Bonds of Kazakh companies – 30.67%;
- Deposits and depositary certificates in the National Bank of Kazakhstan and in banks of second level – 16.61%;
- Shares of Kazakh investment funds – 0%.

Considering the fact that Kazakh pension funds may play an active role in corporate governance as monitors, it is important to analyse their own governance structure. Having a joint stock company form, pension funds have similar governance structure to all other companies of such form. The Kazakh law, however, forbids big block holding in pension funds. Maximal 25% stake can be owned by one shareholder, unless a special permission for a larger stake has been given by a regulating body.[505] The law makers have considered two special mechanisms of control. First, supervisory boards should be accomplished by an independent director.[506] Second, pension funds are rewarded for their work in 2 ways: (1) they receive up to 15 per cent of investment revenue and (2) max. 0.05 per cent of pension assets. From this amount pension funds pay to PAMCs. Additionally, as for other JSC, an annual audit ought to be conducted and a company is obliged to publish financial reports in mass media.

Compared to other CIS economies, the private pension system of Kazakhstan is more advanced. Compulsory contribution to pension funds has significantly accelerated the development of the Kazakh capital market and the equity market in particular. It can be expected that in time pension funds will be playing a growing role in the country's corporate sector, promoting development of the securities market.

[504] www.investfunds.kz, dated on: 01.08.2006.
[505] This rule does not concern corporate pension funds.
[506] The law 'On pension provision in the Republic of Kazakhstan' - §40.

b) Investment Funds

Investment funds became a participant of the Kazakh financial market relatively late. The law on investment funds was adopted only in 2004. It resembles the Russian law in many ways, although it is less profound and detailed. It allows founding investment funds of two types: a joint stock investment company (JSIC) or a unit investment trust. The latter can be of three different forms: open, closed and interval, with a similar differentiation of features as in Russian funds. In January 2008 there were 183 registered unit investment funds (of which 146 closed, 19 open and 18 interval). The aggregate assets of unit investment funds and JSICs constituted 199,527 million Tenge and 113,400 million Tenge respectively (FSA, 2008). In 2007 unit investment funds invested in stocks of domestic companies 6% of assets and in stocks of foreign issuers only 1,5% of the assets, whereas in the investment portfolio of JSICs the stocks of domestic and foreign issuers made up 0,5% and 10% respectively.

Assets of unit investment funds can be managed by Asset Managing Companies, whereas, unlike in the Russian law, Kazakh JSICs can receive a permission to manage their assets by themselves, however they cannot manage assets of other entities.[507] In order to escape the conflict of interests a managing company is not allowed to hold shares of a mutual fund. Through the assets structure rules, law makers regulate the diversification of portfolio. Thus, for example, interval or open funds cannot hold more than 15 per cent of their assets in securities of one issuer, except for state securities. JSICs and closed funds cannot posses more than 20 per cent of their assets in shares of one issuer.

The governance of Kazakh investment funds and unit trusts resembles that of Russian counterparts. A shareholders' meeting is the main governing organ of closed trust units and JSICs. Shareholders of open and interval trust units may only 'vote with feet'.[508] The responsibility for correct information disclosure lies on an Asset Management Company. A compulsory annual audit secures the transparency of investment funds. Although investment the portfolio of funds is still small in comparison to pension funds, a positive trend of the last few years predicts an active role of funds on the securities market.

c) Insurance Companies

The development of the Kazakh insurance market is in its embryo phase. The main reason is relatively low per-capita income and general lack of understanding of insurance

[507] The Law on Investment Funds, Kazakhstan - §5(7).
[508] Term „*vote with feet*" in corporate practice means selling the shares, if corporate policy does not go in line with shareholders interests.

schemes among the citizens (IMF, 2004). In July 2006 there were 39 insurance companies, with 4 companies offering life insurance services, registered in Kazakhstan. The exact structure of insurance companies is unknown. In 2007 the aggregate volume of investment portfolio made up 160.4 million Tenge, of which 10% was invested in state securities, 37% in corporate securities and 39% was held in bank deposits. Assets held in domestic stocks make up only 5% of all investments in corporate securities. The rest goes for purchase of corporate bonds (FSA, 2008).

For the last few years the Kazakh insurance industry has undergone considerable consolidation, which was conditioned by increased capital requirements and strengthened supervision by the National Bank of Kazakhstan (NBK). The growth impulse of insurance services comes mainly from gas, mining and transportation sectors. Despite the growth tendency of the industry and favourable macroeconomic conditions, and at the same time growing per capita income and savings, the role of insurance companies on the market of corporate shares is low. Consequently, their role as effective monitors of management and participants of corporate governance is in the current stage insignificant.

1.2.4 Uzbekistan

a) Pension Funds

During almost 15 years the pay-as-you-go pension system in Uzbekistan has been failing to support the well-being of the country's pensioners. Pension payments, defined by the state, have hardly sufficed to provide existence minimum to the pensioners. The low level of pensions can be explained by various factors. First significant factor is low official wages in the economy, which represent only a fraction of the real income of citizens. The Uzbek economy is known for large ratio of "shadow economy". There is a huge discrepancy between official wages paid and real income of employees, which can be explained by the fact that employers indicate low official wage rates, or in some cases they even reduce the exact number of employees, in order to reduce tax payment. Second reason, mentioned by experts, is the dispersed functionality of the state pension fund, the functions of which often do not correspond to its core tasks.[509] In a paper prepared by the Center for Economic Research authors point at one of the main disadvantages of the state pension fund. They argue that despite highly secure provisions, effective management of available pension funds is impeded

[509] See for example Uktam Abdurakhmanov from Center for Economic Research (interview in Internet)

by the inflexibility of the state pension fund due to its centralized supervision and management.[510]

The foregoing problems of the pay-as-you-go system will be deteriorated by a demographic shift in the oncoming periods. According to expert analyses from 2012 the growth rate of individuals who achieve retirement age will be exceeding the growth rate of citizens at working age. Therefore, expected expenditures of the state pension fund will be lower than its revenue, which will deteriorate the well-being of Uzbek pensioners even more.

In order to mitigate the current and future problems the government, inspired by the success of Russian and Kazakh pension reforms, has announced the introduction of an accumulating pension system in Uzbekistan, in addition to the existing system. However, the design of the Uzbek model differs to some extent from those in Russia and Kazakhstan.

Since January 2005 the state employees and those employed on a contract basis are obliged to contribute monthly 1% of their salary to individual cumulative pension accounts, with corresponding deduction of income tax. Entrepreneurs, peasants and other working individuals participate in the accumulating system on a voluntary basis. In comparison to Russia and Kazakhstan, where employees contribute 6% and 10% respectively, the Uzbek rate of 1% is considerably low.

An exclusive right to accumulate contributed funds has been granted to the state owned *Narodniy Bank* with the biggest network of branches. The interest rate on the accumulations is defined by *Narodniy Banks* with the approval of the Ministry of Finance. It is should not be expected that pension accumulations will be invested in real economic sectors. Most probable utilization of the funds will be covering the deficit of the state budget.

Despite the short history of the accumulating pension model in Uzbekistan, it can be already stated that the conducted reforms in the pension field will hardly contribute to the development of the capital market. Thus, the role of institutions of the pension system in Uzbekistan can be excluded from consideration under the national corporate governance model.

b) Investment Funds

The first collective investment organization appeared in Uzbekistan during mass privatization in the form of Investment Privatization Fund (IPF). Unlike Russia and Kazakhstan, IPFs are still present on the Uzbek market. This can be explained by the slow pace of privatization reforms and large amount of shares still to be sold to the private sector.

[510] Report of the Center for Economic Research , 2002 (summay)

In 2007 there were 11 investment funds and 2 IPFs with 55 thousand shareholders and assets amounting to 3.6 bln Sums (CER, 2007). In comparison to the previous years, the assets of funds have been diminishing, which led to the decrease of funds' operations on the securities market. Information about their performance and assets structure is very scarce. That is why it is difficult to analyse their investment in corporate equities and consequently their role in corporate governance. However, deducting the equity holding of other investors (other institutional investors, banks, the state and employees) from the total equity market capitalization, it can be stated that the equity holding of investment funds is very low.

According to the Uzbek legislation investment funds are founded in the form of a joint stock company and can be either of a closed or open type. Up to 10% of own capital can be invested in shares of one issuer and max. 10% of an issuer's capital can be acquired. The Uzbek law also restricts acquisition of foreign securities, which considerably handicaps the development of investment practices in Uzbekistan and deteriorates the attractiveness of collective (investment) funds for investors. The assets of both IPFs and investment funds must be managed by independent Asset Management Companies. In 2005 the number of registered companies reached 65. On behalf of an investment fund, an asset managing company participates in a shareholders' meeting of a JSC whose shares have been acquired by the investment fund.

Based on the analyses of both IPFs and investment funds it can be concluded that their role in the national corporate governance model in this stage of transition is negligible. Among multiple steps to reform and improve this particular segment, the enhancement of legislative base should be regarded as a priority. Laws and other normative acts about investment funds are inconsistent and scarce, leaving much space for free interpretation and interest conflicts. Considering positive development of investment funds in Kazakhstan and Russia the legislative base of these countries can be taken as a point of reference by Uzbek reformers.

c) Insurance Companies

The insurance sector is quite small and going through its emerging stage. There are 26 insurance companies in Uzbekistan. Segmentation of the sector is high, with each company focusing in one area, e.g. foreign trade, agriculture or small business. Among insurance transactions mandatory property insurance prevails over other forms. Life insurance as the main resource for long-term investment on the capital market is virtually absent (ADB, 2005, p.35). The main reasons of poor sector performance lie in high inflation rates, which generally undermine contractual savings. The total investment portfolio achieved 184.8 billion Sums, which is 75% of all assets (CER, 2007). Therefore, investment operations of insurance companies can be characterized as active. However, only 5 out of 26 companies operate on the securities market. The total ratio of insurance companies' operations with securities make up only 0.8% of the total trade volumes on the exchange. Further consideration of insurance companies as active participants in corporate governance model of Uzbekistan can be omitted due to their weak investment potential.

2. The state

2.1 Introduction

The role of state in governance processes may be observed from two perspectives: (1) state as direct shareholder and (2) as regulator. Scholars, almost unanimously admitted that state ownership is inefficient and hinders corporate development. Main argument against state shareholding is that it may have goals that are not aligned with those of corporation. Thus, for example, employment and social stability may be considered by the state as priority, instead of enterprise restructuring and shareholder's value maximization.

De Alessi (1980, 1982) defines general community as a collective owner of the state firm, however, with no direct claims to their residual income and incapable of transferring their ownership rights. Instead, ownership rights are exercised by some bureaucrats without incentive to conduct effective management. Vickers and Yarrow (1988) also observe lack of incentive as the major argument against state ownership. Shapiro and Willig (1990) add the state's ineffective price policy to this argumentation list. Shleifer and Vishny (1994) explain inefficiency of state ownership through possible political interventions. In OECD guidelines for corporate governance in state-owned enterprises, the authors mention that state enterprises are protected from two main mechanisms for management monitoring – takeover and bankruptcy, which function efficiently in private sector.

The above mentioned arguments define absolute state ownership as deficient. However, it is admitted that in some cases state ownership and intervention is unavoidable. This concerns enterprises that produce strategically important goods, regional industrial giants that employ the biggest part of population, and communal enterprises. For such cases, a specially developed governance principles (codes) should be implemented, regulating state shareholding, mechanism of participation in corporate governance and monitoring management. These governance principles should be implemented in the way which secures balance of interest between strategic goals of state and economic efficiency of corporation.

The historical heritage of transitional economies left no doubt about the fact that absolute state shareholding in all production factors and its economic subjects (enterprises) were the main reasons of the collapse of socialist system. On the edge of independence none of the countries doubted that first it is necessary to decrease the role of the state as a beneficiary owner of corporate shares. However, each country chose its own pace and method to diminish the state ownership. It was clear that a chosen reform process would affect future economic system and corporate governance models in particular. The following chapters present an overview of the state's role as a shareholder in the three transition economies. For each country the following aspects will be reviewed: size of the state shareholding, governance mechanisms of state assets and the development perspective of the state as an active stakeholder or shareholder in national corporate governance models.

2.2 Russia

Although the privatization process in Russia has been continuously proceeding since 1992, the state still possesses shares in numerous enterprises. As for 2006 there were approx. 3,997 joint stock companies with state shareholding. Initially, according to the Russian privatization program the end of privatization was planned for 2008. By this time all enterprises which are not included in the list of strategically important companies will have been sold to the private sector.[511] The list of companies from the strategic sector contains approx. 697 joint-stock companies. However, there is permanent political pressure from groups of interest to decrease the number of companies on this list.

The government participation in equity capital can be classified into 5 categories according to the shares owned: (1) 100 % shareholding, (2) more than 50 %, (3) from 25 % to 50 %, (4) less than 25 %, (5) "golden shares". (See the Table 25)

Table 25: State shareholding in Russian companies and the 'golden share rights'

	1999	2000	2001	2002	2003	2004	2005	2006
Unitary enterprises	13,786	11,200	9,394	9,846	9,275	8,820	8,293	6,533
JSC with state as shareholder	3,316	3,524	4,407	4,222	3,704	3,905	3,524	3,997
- 100%	382	61	90	99	160	273	413	1702

[511] Federal Law, N 787, 'On the list of companies producing strategic products', dated on: 17.07.1998.

- 50-100%	470	506	646	589	540	499	474	368
- 25-50%	1,601	1,211	1,401	1,382	1,235	1,183	1,093	814
- Less than 25%	863	1,746	2,270	2,152	1,769	1,950	1,544	932
'golden share'	580	-	750	958	640	284	259	181

Source: Institute of Economies in Transition, Economy of Russian Federation, 2005, 2007.

In 2006 among the companies with state shareholding the biggest group (45%) comprised companies with 100% governmental share. Since 2002 the number of companies with the state shareholding has constantly been reducing in all categories, except for companies with absolute state shareholding. It is noteworthy that the number of companies with absolute state shareholding first noted a drastic decrease – from 382 in 1999 to 61 in 2000 – and later was continuously increasing up to 1702 in 2006. Apparently, this trend is connected with the strong politics of nationalization, after the President Putin came to power, and with the corporatization of unitary companies.[512]

The least significant group is represented by companies in which government has a 'golden share'. Such ownership gives the state exclusive rights to block some important decisions, which can significantly change a corporate structure or its policy. In the last decade a clear decreasing tendency for such rights can be observed.

The division of JSCs with state shareholding throughout the economic sectors is illustrated in the Table 26. In 2003 the biggest group with state shareholding was a non-production sector amounting to 45.6% of all sectors. However, in the next years the trend showed the decrease of state shareholding in the non-production sector. In 2006 the biggest group with the state share was the industrial sector, which made up 45% of all companies, followed by the agricultural sector of 13.4%. This is explained by the orientation of the state towards industrial companies selling the stakes in the non-production sector.

Table 26: State shareholding in Joint Stock Companies through economic sectors

	2003	**2004**	**2005**	**2006**
Non-production sectors	1,918	1,781	685	405
Industry	1,350	1,253	2,078	1,797
Including:				
- Machinery	225	209	187	632
- Food industry	43	40	54	127

[512] Federal Law No.161-FZ on state and municipal unitary enterprises defines 'unitary enterprise' as commercial organization that has no right to property assigned to it by the owner. Only state and municipal enterprises can have the status of unitary enterprise. The property of a unitary enterprise can belong to the Russian Federation, to a subject of the Russian Federation or to a municipal unit.

- Metal industry	34	32	28	94
- Industry of construction materials	21	20	19	53
- Chemical industry	19	18	46	89
- Light industry	16	15	9	29
- Other industries	992	919	1,735	773
Construction	492	457	287	404
Transport and communication	383	356	459	353
Agriculture	46	43	229	534
Forestry	16	15	45	88
Total	**4,205**	**3,905**	**3,783**	**3,997**

Source: Institute of Transitional Economies (2005).

Another important issue in the corporate governance of firms with the state ownership is the management mechanism. In Russia the state shares are managed through the institute of representation and through contractual relations with commercial CEOs.[513] The role of a representative can be executed by government officials and other citizens of Russian Federation. In most cases the state shares are managed by civil servants (representatives of the ministries). The role of commercial managers is still very small because the incentive mechanisms are weakly developed. State salaries for managerial positions are normally much lower than the salaries for similar positions in private sectors (Radygin and Malginov, 2001, p.71)

Governance through representation has proved ineffective in Russia. The state employees from different ministries and agencies became formal representatives. Very often a single person needed to represent the state interest in 5 to 10 joint-stock companies, which could be based in different regions of Russia. Additionally to these technical restrictions, such obstacles for effective governance as the lack of required qualifications among the representatives and weak payment incentives are distinguished. All this resulted in low attendance on the board meetings and low level of reporting to the state bodies (Radygin and Malginov, 2001, p.71). In the mid 90s weak representation of the state led to multiple fraudulent transactions initiated by incumbent management.[514]

Nowadays, with further progress of privatization the state representation in managing organs and its role as a direct shareholder in the national model of corporate governance is

[513] Presidential decree ‘On some measures for ensuring the state management of the economy’, dated on: 10.06.1994.
[514] Among the common illegal deals, Radygina and Malginov name the decrease of state shareholding, its approval.

decreasing. Officially the end of privatization is planned for 2008. However, the current privatization success remains moderate. The number of actually sold companies is on average 3 times lower than the forecasted figures. For example, in 2003 only 630 equity packages were privatized despite 1,965 planned, in 2004 instead of 1,702 packages only 565 were sold.

During the whole privatization process the state shareholding in Russian corporations was gradually decreasing. In 1994 by the end of mass privatization process the state shares constituted 17%, in 1995 it decreased to 11% and in 1996 it was about 10%. However, recently it has begun to grow again. According to the report of analysts from *Alfa-Bank* in February 2006 the state's share in the whole market capitalization constituted 30% (190 billion USD). Thus, the state pushed managers down from their leading position as the biggest shareholders. The growing share of the state can be explained by two reasons: first, in the last period the government pursues strict line of enterprise consolidation in the strategically important sectors, creating new state owned holdings and acquiring small enterprises; second, most shares in state portfolio have gained significant value increases. The state gains such a big share in market capitalization due to the ownership of large stakes in several Russian industrial giants. Alone the state's 50.01 % of share in JSC *Gazprom*, constitutes USD 110 billion, which constitutes more than 50% of the total state's stake in the economy.

It can be concluded that, although the privatization process planned for the oncoming periods is supposed to reduce the number of companies with direct state participation to only 700-800 JSCs, the share of the state in some sectors and regions is still significant. Thus state plays significant role in the national corporate governace model both as direct shareholder and as regulator.

2.3 Kazakhstan

As the review of the privatization process showed, the state's role since the start of process has decreased significantly. The state ownership in Kazakhstan is divided into republican and communal. In January 2006 shares of 177 publicly and privately limited companies were in the republican property and shares of 243 publicly and privately limited companies in the communal property.[515] The Kazakh legislation provides the 'golden share' provisions as well. However, unlike Russia where only the state may be the owner of a 'golden share', in Kazakhstan any shareholder can be the owner of such rights, whereas one firm is allowed to issue only one 'golden share'. The Kazakh legislation also distinguishes a

[515] Decree of the Government of Kazakhstan, N 620 „On the approval of the programm on management of state assets for 2006-2008. Dated 30.07.2006.

special kind of companies, called ‘national companies’, in which the government retains a controlling stake. Such special categorization is stipulated by their strategic role in the economy, as they together produce 14% of GDP. Each national company is represented by all infrastructural sectors (e.g. the supply of electricity, transportation, telecommunication, post, etc.). There are currently 12 such national companies of a joint stock form in Kazakhstan.[516]

As in many other transitional economies, the governance of state assets is conducted through representative organs. Very often these functions are delegated to representatives of ministries or some other state agencies. The existing governance mechanism of state assets proved to be weak and inefficient, and this tendency could be observed in many other transitional economies. Thus, for example, the analysis of boards of directors demonstrated that for their effective work more independent directors should be attracted, whereas the representation through the government bodies should be avoided.

With the intention to improve the quality of corporate governance in state enterprises and enhance their economic performance a new regulation has been elaborated and introduced.[517] Following the regulation the joint stock company ‘Kazakh Holding on the Management of State Assets’ called *Samruk* and the ‘Sustainable Development Fund *Kysina* have been founded. The JSC *Samruk* was authorised to manage the shares of 5 national companies. This consideration was based on the experience of some developed countries in the management of state assets through holding, as e.g. Temasek (Singapur), IRI (Italy) or OelAG (Australia).

Consequently, the role of the state as an active participant through shareholding in the national corporate governance model can be regarded as negligible. Nevertheless, as in the case of Russia, the role of the state as a regulator will continue to affect the overall corporate governance architecture in Kazakhstan. This short overview reveals that the state seriously considers the corporate governance system of those enterprises in which it will maintain a controlling share. The transformation from a less effective system of representation to management holdings should increase the value of state assets. In this stage it is difficult to predict or evaluate the effectiveness of this reform. However, the attempt to reform less efficient governance structures can be treated as positive.

---

[516] Decree of the Government of Kazakhstan, N 182, CJSC «National Company «KazMunayGas“, OJSC «Kazakhstan company on management of electric network“, OJSC «Kazpost», CJSC «Food contract corporation», CJSC «National atom company «Kazatomprom», CJSC «National information technologies», CJSC «National company «Kazakhstan Railways», CJSC «State accumualting pension funds», OJSC «Kazakhtelecom», CJSC «International airport Astana», OJSC «National company «Kazakh information agency», OJSC «National company «Kazakhstan Engineering», dated on: 16.02.2004.

[517] Government Decree N177, Dated 23.02.2006.

2.4 Uzbekistan

In Uzbekistan the state is the largest shareholder in most medium and large-sized companies. As in all countries with features of administratively-planned economy, the state plays a dominant role in the life of enterprises both as a shareholder and regulatory body. In the beginning of 2007 JSCs with state shareholding constituted 70% of all JSCs in the republic, which included approximately 1,300 companies (CER, 2007). The total controlling stake of the state can be estimated as based on three variables: (1) actual state shareholding, (2) unsold shares, that remain under state control, (3) state shares that were transferred to the equity capital of holdings and associations. The actual state shareholding constitutes 36% of the whole market capitalization. Shares that were planned for sale but still were not placed constitute 28%. State assets that were integrated in equity capital of other organization, such as industrial associations are estimated at 20%. Summing up all three variables, the virtual state shareholding occurs to be 84% of the total capital of joint-stock companies. Irrespective of whether the state keeps large or minor shareholding in Uzbek companies, it continues to exercise controlling rights and has dominant voice in corporate governance (ADB, 2005, p.13). The importance of companies in which state holds shares is underlined by their role in the economy. Official data indicate that large-sized enterprises which are mostly state owned represent the core of the Uzbek economy, accounting for 66% of GDP and 47% of employment. The earliest data on the state shareholding and their classification in industrial enterprises is available for 2001 and presented in Table 27.

Table 27: Privatization of large and medium enterprises in Uzbekistan for 2001

	Industrial enterprises	Percentage of total	All sectors	Percentage of total
Large and medium	1,803	100	27,805	100
Corporatized	999	55	4,654	17
Of which:				
100% private	187	10	1,746	6
Up to 25,5% state owned	641	36	2,568	9
25,5%-50,5% state owned	10	0,6	102	0
Over 50,5% state owned	161	9	220	1
Uncorporatized	804	45	23,151	83

Source: ADB 2005.

It is shown that only 10% of all medium and large-sized industrial enterprises is under absolute private ownership. State shareholding up to 25.5% represents the largest group. It is noteworthy that in 2001 a little less than half of the industrial enterprises was not even corporatized. This statistical overview gives an unambiguous picture of the state dominance in the Uzbek corporate sector.

The management of industrial companies which constitute the largest group of joint-stock companies in the economy is carried out mostly through industrial associations and state-owned joint stock companies. Industrial associations are hierarchical constructions which involve companies organized along the branch line. In their origin the industrial associations resemble line ministries of the Soviet Union, which were responsible for setting and enforcing detailed plans for all aspects of enterprise activities in each particular branch of economy. Between 1993 and 1999 more than 50 industrial associations, including about 20 in consumer goods industries, were created. Industrial associations and state JSCs are entrusted with state shareholding of most of the member enterprises. State usually holds at least 25% of the shares of member enterprises and not less than 51% in industrial associations, retaining controlling rights over decision making process. Enterprises that comprise association do not have full authority over it, because the government have an ultimate right to appoint and remove association's chairperson. Moreover, the governance issue is deteriorated even further, as associations keeping the state share of its member enterprises must represent and act in best interest of the state. Therefore, the classical interest conflict of state shareholding and other non-state stockholders in member enterprises became more evident in the example of Uzbek industrial associations.

In their function and structure state joint stock companies (SJSC) are similar to industrial associations. They are also entrusted with shares of companies which are placed within them. In comparison to industrial associations, SJSCs receive some state shares of enterprises as a contribution to their authorized capital and they can issue shares on their own, with the state owning of 51% of the shares and the rest available for sale. There are also some cases when state joint stock companies are incorporated in national holding companies, whose authorised capital comprises state shares in a number of SJSCs.

State shareholding of 25% and more is managed by the institute of state representatives. Initially trustee managers received a veto right on all major decisions of the board of directors and on a shareholders' meeting, which persisted deteriorating corporate governance in enterprises with state shareholding. Later, in 2003 the veto right of state representatives was cancelled.[518] State trustees represent interests of the state both on a shareholders' meeting and on supervisory board meetings. Representatives cannot be elected or re-elected in a supervisory board, they can be only appointed either by a commission under the Prime Minister or by the state property committee. State representatives are committed to approve the decisions on dividend payments with state bodies, whereas law defines the annual profit rates according to which state representatives should approve (or disapprove) decisions on dividend payment. The Uzbek law places an accent on dividend payment, irrespectively of corporate needs, thus, e.g. in companies with the state share of less than 15% a representative is obliged to vote for dividend payment of at least 50% of profit.[519]

Summing up, it is evident that the government of Uzbekistan retained a large control over corporate sector through direct shareholding and indirect control through regulation. In spite of the fact that since 1999 annual privatization plans have been issued, little progress is being made in privatization of large and middle-size companies. As long as the government keeps large block holdings in most corporations of Uzbekistan, the dominant role of the state in national corporate governance model is unavoidable.

3. Peripheral Stakeholders: Auditors and Rating Agencies

Apart from traditional monitors of corporations such as a board of directors, large shareholders, creditors and the market for corporate control the monitoring can be conducted by professional controllers such as external independent auditors and rating agencies, also called peripheral stakeholders (McCarthy and Puffer, 2002). They engage in private information production to uncover superior information, contribute to the solution of asymmetric information and thus enhance the efficiency of capital market. This chapter provides a brief review of audit and rating services in the three transition economies and evaluates their role in national corporate governance models.

3.1 Russia

The Russian auditing legislation lists companies which are mandated to have their financial statements audited: all open joint stock companies, banks and other credit organizations, stock and commodity exchanges, insurance companies, investment funds and other companies with assets exceeding 200,000 times the average official minimum monthly

[518] Presidential decree N-3202, Uzbekistan, 2003.
[519] Decree of the Ministry of Finance, N33, 01/06-18/02, Dated 14.03.2005.

wages (equivalent of USD 18 million) for a reporting year, or with turnover exceeding 500,000 times the average official minimum monthly wages (equivalent of USD 44 million).[520] In order to ensure investors' trust regulators included criteria according to which auditors' independence must be determined.[521] Furthermore, in 2007 the Ministry of Finance adopted the Ethics Code for Auditors. PWC (2006) evaluates the Russian auditing legislation as comparable with international practices. According to the corporate law shareholders are entitled with the approval rights of auditors, whereas a supervisory board decides on payments for audit services.[522]

By the end of 2007 there were 6.5 thousand audit organizations and 0.9 individual auditors that had a license to conduct audit activities. The Russian audit market is characterized by high concentration according to geographical location. More than 42% of all auditors are located in Moscow and Saint Petersburg. According to the data of the Ministry of Finance in 2006 there were 80,265 companies which were subject to mandatory external audit.

Despite high numbers of auditors, commentators doubt the effectiveness of monitoring functions of external auditors. Iwasaki (2004) argues that the functions of external auditors are limited to scrutinising financial statements and expressing their technical opinion on the reliability of these statements: 'They appear suddenly on the eve of the general meeting and will never be seen by anyone else for one year after reading the audit report at the meeting' (p.520). Another problem of the audit market is scarcity of human resources. Thus, in 150 large audit firms which serve 50% of Russian market work 7,600 employees. This figure is clearly too low to supply the Russian market with qualitative and thorough audit service (Iwasaki, 2004, p.522).

A new market institution, which started evolving very recently in the transition economies and is able to enhance corporate monitoring, is a rating agency. The Russian market is the leader according to the number of rating agencies and their types. The classical credit rating market is represented by three international rating agencies: Standard and Poor's, Moody's and Fitch. This list is complemented by four national rating agencies: RusRating, AK&M, National Rating Agency and RA 'Expert'. However, the national ratings have less favourable position on the market in comparison to international agencies. This is because in the Russian law the evaluation of credit risks conducted by an international company is more preferable. For example, if a bank wants to work together with an insurance company, it

[520] Federal Law on Audit Activity, N 119, Russia - §7.
[521] *Ibidem* - §12.
[522] JSC Law, Russia - §86.

should have international rating. In the beginning of 2008 there were 84 issuers which had a credit rating.

Apart from a credit rating, increased attention to corporate governance aspects has been stipulated by the development of corporate governance ratings. In Russia such rating is made by Standard and Poor's and tree national organizations: the Russian Institute of Directors, RA 'Expert' and the Institute of Corporate Law and Governance. However, the number of companies which receive corporate governance rating is restricted to a few biggest companies listed on the stock exchanges. It can be concluded that, although the monitoring of Russian companies by auditors and rating agencies has improved in the recent years, it still remains fragile and cannot be considered as an absolutely efficient corporate governance mechanism.

3.2 Kazakhstan

Provisions on audit in Kazakhstan can be found in different laws, according to which the list of organizations for which an annual audit is mandatory includes joint stock companies, privately limited companies, banks, other credit organizations and insurance companies. In 2007 there were 139 active audit organizations in Kazakhstan and 500 certified individual auditors.[523] The law says an individual auditor can provide an audit service only within an audit organization, whereas the number of auditors in the organization cannot be lower than three.[524]

The development of the Kazakh audit market is hindered by two problems. Firstly, the market is highly concentrated, where four biggest international audit organizations virtually control the market. Secondly, there is a scarcity of professional licensed auditors, which hampers the market to respond adequately to a growing demand for audit services stipulated by the booming economy. Thus, it experiences the same problems as in Russia and is neither mature enough to strengthen corporate governance practices in the country.

With regard to rating agencies Kazakhstan represents a developing market. Three international credit agencies and one national *KzRating* provide companies with rating services. Almost 40 issuers had a credit rating in the beginning of 2008.[525] Recently, Standard and Poor's has issued a corporate governance rating for several Kazakh companies. It can be therefore concluded that in this stage of development rating bodies cannot be considered as efficient monitors of corporate governance practice.

---

[523] Information from the web page of the Ministry of finance of the Republic of Kazakhstan (Stand: August 2007)

[524] The law on audit, Kazakhstan - § 8 and § 9.

[525] http://www.cbonds.info (Stand: 14.04.2008)

3.3 Uzbekistan

The importance of audit services for an efficient corporate governance model has been recognized by the Uzbek authorities, who initiated wide ranging reforms in the last few years. On the one hand, the legislators strengthened the criteria according to which audit licenses are granted. On the other hand, with the purpose of creating favorable conditions to accelerate the development of audit services and increasing its share in the economy of the country, the income received from audit services is exempted from income-tax and single-tax payments till April 1, 2009.[526]

According to the law on audit, financial statements of privately limited companies, open joint stock companies with listed shares, banks, investment companies, exchanges and companies with foreign stake must be published after being audited.[527] In the joint stock companies shareholders are entitled with approval rights on corporate auditor, whereas a supervisory board decides on its remuneration.[528] With the purpose to fight corruption a new presidential decree limits the term during which an auditor can serve in one company to max. three consequent years.[529] Nevertheless, there are still significant problems to cope with, like auditor's independence, which are still poorly regulated. New minimal thresholds of equity capital are very high, which has led to a dramatic decrease of the number of auditors. According to the data of the Ministry of Finance in the beginning of 2008 there were 53 registered audit companies and 1,362 individual auditors. The market is highly concentrated, with most of the companies operating in the capital city (Tashkent), whereas in provinces very often one auditor has to serve 10 to 20 companies. Hence, in the case of Uzbekistan it can be concluded that auditors are not ready to provide healthy corporate monitoring.

The practice of providing international rating services started its development only since 2000, when a few big banks received a short-term rating in the national currency from the agency *Thomas BankWatch*.[530] As Uzbekistan does not have a country rating, domestic banks were able to receive only a short-term credit rating. Today only four Uzbek banks have international credit ratings. National rating practices started functioning in 1997 together with the launch of the inter-bank rating agency '*Axborot*-Rating' which grants credit ratings mainly to companies from the financial sector. Therefore, the role of rating agencies as active monitors of corporations can be excluded from the national corporate governance model.

[526] Decree of the President of the Republic of Uzbekistan dated 17.04.2006 #PP-325.
[527] Law on Audit, Uzbekistan - §16.
[528] JSC Law, Uzbekistan - §111.
[529] Decree of the President of the Republic of Uzbekistan dated 04.04.2007 #PP-615.
[530] Economic Review, № 10, Dated 8.10.2006.

4. Conclusion of Part III

This chapter has delivered a brief overview of the main actors of a corporate governance model. It can be generalized for all the three countries that the state continues to play a crucial role in the corporate sphere. In Russia and Kazakhstan despite the progress in privatization the state continues to hold direct controlling stakes in large companies. In Uzbekistan, the privatization was less extensive and as result the state dominates most corporations. In all three corporate governance models the state remains an active player in as indirect stakeholders, through very bride interventaion practices.

The role of banks has been observed from two perspectives: banks as an external source of finance and banks as shareholders. Both Russia and Kazakhstan achieved considerable success in reforming their banking sector, which can be measured by the annual growth of credits and deposits. Nevertheless, bank loaning to the corporate sector remains at low level in both countries. Uzbekistan, in contrast, has a weak banking system, the reason of which is large state shareholding in the banking sector and low level of liberalization. Measured by assets held in stocks and their share in total capitalization, it can be stated that the current bank position both in Russia's and Kazakhstan's corporate governance models is still weak. However, there is a large potential for their further development, considering favourable economic indicators. Nevertheless, it can be already stated that because of legal restrictions on bank shareholding in the corporate sector Kazakh banks will not play a crucial role in the corporate governance model as beneficiary owners.

Comparing the sectors of institutional investors in the three transition economies, it has been found that they differ with respect to development of each particular investor class, although it can be generalized that insurance companies are less capable to be active monitors of corporate governance practices.

The introduction of capital market-oriented pension system boosted the development of capital markets both in Russia and Kazakhstan. Having an earlier start-up phase Kazakhstan's pension funds managed to accumulate considerable stock of capital, a large stake of which is spent on investment in corporate stocks. Due to the later start and different design of the system Russian non-state pension funds have smaller assets and they are less active on the stock market. The assets of pension funds in Russia and Kazakhstan will continue to increase as pension payment will start in later periods. That is why it could be expected that pension funds will be significant players on the stock markets and thus put impact on the ownership structure and monitoring of corporations. As the accumulating pension system in Uzbekistan has started only recently, it is not possible to give quantitative nor qualitative estimation of its development. Nevertheless, critics predict that it will hardly have any influence on the corporate governance model in the near future.

The analyses of investment funds have revealed that Russia has the most advanced system of collective investors. It has more profound legal base and according to the size of assets it is larger than in Kazakhstan and Uzbekistan. Considering the prognoses of economic growth and taking the growth of households' savings into account it can be concluded that Russian and Kazakhstan investment funds may play a crucial role in the corporate governance models of the two countries. In contrast, there are little signs that the system of collective investment in Uzbekistan will boost the development of securities market and corporate governance.

Finally, the situation of peripheral stakeholders has been reviewed. All the countries have conducted deep reforms of the audit market and have achieved significant progress in this field. The analyses showed that the problems in this segment are similar for all countries. On the one hand, the audit market is highly concentrated with only few companies controlling the most of the market and highly unequal allocation of the auditors that work mainly in a few largest cities. On the other hand, there is a shortage of licensed auditors, which results in superficial audit controls and poor monitoring. Rating agencies are relatively new institutions in transition economies and as a consequence the rating market is very small. The number of companies that receive credit rating is very small, whereas the number of companies with corporate governance rating is limited only to a few listed companies. Therefore, at this stage of economic development the role of peripheral stakeholders can be neglected in corporate governance analyses.

PART IV: QUALITY OF CORPORATE GOVERNANCE AND FIRM VALUATION

1. Introduction

After drawing in previous parts the overall frameworks of corporate governance in transition economies it is time to study how the real practices of corporate governance look like on the firm level. The core question that this part addresses – does "good" corporate governance matter or does it have an impact on the valuation of companies? It could be assumed that firms that apply better governance standards are better valued by investors. In fact, several empirical studies that are mainly U.S.-based conclude that there is a positive correlation between governance practices and firms' values. However, limited number of researches exists that cover transition economies. The purpose of this part is to contribute to the research of the corporate governance practices in transition countries.

In the beginning the short literature overview of the empirical researches regarding the interrelation between governance and economic performance of the firm will be conducted. Chapter 3 introduces the methodological approach of the study. Chapter 4 delivers the empirical results of the study. Finally chapter 5 provides the descriptive results on corporate governance practices in Russia and Kazakhstan.

2. Literature Review

The numerous empirical studies devoted to the link of good corporate governance and firm's economic performance, measured by the market value or other indicators such as profitability and output, have been conducted in the last decade. Most of them focus on developed countries and on particular governance aspects such as board size, its composition, ownership, shareholder activism, executive compensation.[531] In contrast very limited number of works assess whether overall corporate governance predicts companies' value. Among them are most closely related works of Gompers, Ishii and Metrick (2003) who studied 1,500 large US companies during 1990s, Beiner, Drobetz, Schmid and Zimmerman (2004) made a

[531] On the study of link between board size and firm performance see Yermack (1996), on link between board composition and performance see Bhagat and Black (2000), Klein (1998), Mehran (1995), on Managerial share ownership and firm performance See Demsetz and Lehn (1985), Morck et al. (1988), McConell and Servaes (1990), on the link between blockholding and performance see Mehran (1995).

research for the sample of 109 Swiss firms in 2002, Black, Jang Kim (2005) conducted a study for 526 Korean public companies. Despite some differences in the methodology of data assessment all mentioned studies concluded that better overall corporate governance practices, hence better investor protection lead to higher valuation of firms. However, one of the main critique points on most studies is that they are limited to cross-sectional analysis and panel data analyses were rarely used (Black, 2005).

Few researches have been conducted in respect to transition economies. One of the first similar quantitative studies was carried out by Black (2001). The author finds a strong correlation between corporate governance practices measured by the Standard and Poor's Index and share prices of Russian firms. However this work was criticized for very small sample, the limited number of control variables and omission of potential endogenity. Later in 2006 the author repeats the study in cooperation with Love and Rachinsky, the results, however, are similar to those of the previous studies. They investigated 99 Russian firms during the time from 1999 to 2005. Therefore it was the first work of such type that included longer time-series and conducted fixed effects panel data analysis. However their model does not control for different corporate governance mechanisms.

Zheka (2006) investigates the relation between his own corporate governance index and firm performance for the large sample of 5,000 Ukrainian companies during 2000-2002. The author finds a positive correlation between better governance and net total revenue. The novelty of the research is that the social trust factors were included that may also determine the choice of corporate governance. Thus author includes such factors as political diversity, religion, ethnic diversity and methods of privatization. However, this work also does not include the corporate governance mechanisms that may substantially affect the outcome of the model.

3. Methodology

3.1 Model Construction and Data

This study encompasses 52 Russian companies listed on the RTS Stock exchange. The only selection criterion for the sample was to choose those companies that were listed throughout three years 2004-2006. Despite having such short time-series the analysis for three consequent years will allow us to track the development of the corporate governance and evaluate its trend in Russia. The decision to select listed companies is based on several assumptions. Firstly, listed companies better adhere to diverse good governance practices due to their dependence on capital markets which in its turn awards or punishes the companies through price mechanisms. Second, it is easy to estimate the market value of the listed company based on the market prices of shares. Third, according to the law listed companies are subjected to deeper disclosure requirements and therefore it is easier to collect required information on them. The primary data on these companies was extracted from the official internet web pages of the stock exchange, corporate web pages, annual and quarterly reports.

Multiple studies use the models that measure the impact of firm-level corporate governance practices on firm value by regressing Tobin's Q on a corporate governance index and including some additional control variables. The deficit of most studies is that they do not include alternative control mechanisms of the corporate governance that are often discussed in theory such as representation of outside directors, insider stock ownership, leverage degree, board size and large outsider ownership (Beiner et al. 2004). In order to cope with the problem of omitted variables the model includes different factors that in theory are also called Corporate Governance Mechanisms. Thus, apart from testing interrelation between corporate governance and firm valuation, we simultaneously examine hypotheses that representation of outside directors, share ownership by managers, smaller board sizes, availability of large controlling shareholder and higher leverage are associated with higher firm valuation.[532]

To control for various other factors that may also drastically affect the model outcome several exogenous control variables will be introduced, such as size of the company, state shareholding and industry effects. Assuming that the relations are linear we get following equation. Thus unlike previous studies the model includes 9 exogenous factors, which can to some extent resolve the problem of missed variables.

$$Tobin\text{'s } Q_i = \beta_0 + \beta_1 \cdot CGI + \beta_2 \cdot Stocksod + \beta_3\ Blockout + \beta_4\, Bsize + \beta_5\ LV + \beta_6\ Outsider + \beta_7 \cdot StateOwn + \beta_8 \cdot LnAssets + \beta_9 \cdot Industries + \xi i$$

Corporate Governance Mechanisms: Shares held by Management, Large external blockholding, Board size, Leverage effect and Representation of Outside Directors.

Control Variables: State ownership, Size of the firm, Industries.

[532] See Part I, Chapter 1.1 for more about the theory and empirical researches on the effect of corporate governance mechanisms.

3.2 Definition of Variables

This section provides detailed information on the variables that are used in the model. To start with Corporate Governance Index it is necessary to note that there are several ways of estimating it. It can be calculated based on the responses to a questionnaire, or researcher can simply apply already existing index calculated by rating and consulting companies or it can be estimated based on the available information on firm. The problem with the first method is that the employees of the company themselves evaluate the effectiveness of corporate governance practices in their own company which may result in biased data. In the second method, applying the existing indexes constructed by consulting companies there is also a problem of biased interest. It can be expected that consulting firms evaluate the companies of their particular interest and not randomly choose from the population. Taking into consideration disadvantages of both methods we estimate Corporate Governance Index (CGI) based on primary data extraction from the information available for companies in our sample.

The CGI consists of 29 variables divided into the following three sub-indices: (1) transparency, (2) shareholders' rights (3) governance structure. To be included in the index each variable must refer to a governance element that is not legally required and need to be considered as an international market practice of "good corporate governance".

Transparency. Better transparency and disclosure practices are associated with better corporate governance. The reason is that disclosure stipulates the external monitoring of corporate insiders and reduces the risk of being expropriated by corporate insiders. To evaluate the disclosure practices 16 elements were selected that in their turn can be divided in the subsections as on-line disclosure, quality of reporting and the information about directors:

1. Availability of the own web page (investor or consumer oriented)
2. The web page is available in foreign languages
3. Corporate Governance Practices are disclosed on-line in separate section
4. By-laws are available on the corporate web page
5. Regularity of the reports that are available on-line (quarterly, semi-annually)
6. Reporting according to IFRS or US GAAP
7. Quality of the financial report
8. Quality of the annual report
9. Corporate Governance Practices are disclosed in annual report
10. Publication of information on auditor
11. Disclosure of the related party transactions

12. Disclosure of the information about large shareholder
13. Resume of the executive officers and directors available
14. Independent Directors are indicated explicitly in the annual reports
15. Disclosure of the shareholding of the supervisory and management board
16. Disclosure of the compensation schemes of the CEO or the supervisory board

Shareholder Rights. As the review of the legal frameworks showed shareholders poses a big decision making power in transition economies and most of the relevant aspects are fixed in the laws. Therefore, this sub-index will include only those elements that are not mandated by the law but still facilitate better position for shareholders.

1. Own Corporate Governance Code
2. Timelines of Financial Report
3. Company's auditor is a recognized international company
4. Regularity of dividend payments
5. Special (extraordinary) shareholders meeting

Governance Practice. All codes of good corporate governance contain the big section that is devoted to the general management structure, constitution of main governance organs and various other practices that have a potential to reduce the agency costs. Therefore, our overall CGI will also include 8 elements that are related to the governance practices.

1. Compensations Committee
2. Audit Committee
3. Decree on Board of Directors
4. Performance based compensation to the directors
5. Performance based compensation to executive officers
6. Collegial executive board
7. Non-employment of the chairman on the board
8. Remuneration of directors with options

As a rule each element can take the value of 1 if it is practiced by the company and 0 otherwise. Due to their characteristics some elements have more than two weights. For example, the regularity of reporting can take the value of 1/3 if reporting is done only annually, 2/3 if reporting is done semi-annually and 1 if reporting is done quarterly.

Each sub-index is calculated as a sum of variables in the index divided by the number of the variables and multiplied by 33. Thus each sub-index has the value between 0 and 33. The Overall Corporate Governance Index is defined as the sum of the three sub-indices and can take the value between 0 and 99, with the better governed firms having higher scores.

Like in many other similar studies Tobin's Q is taken as measure of firm valuation. In the same manner like in the work of Black et al. (2005) it is calculated as the ratio of the market value of assets (ordinary shares plus book value of preferred shares plus the book value of debt) to the book value of assets. In order to neutralize the price fluctuation we compute market price of share as the mean of daily observations for each of three years (2004, 2005 and 2006). The data on shares' prices is extracted from the web page of the stock exchange (RTS). Although Tobin's Q as determinant of company's valuation is widely used in economic studies it is necessary to point out some deficits of it. Besides accidental fluctuations of stock prices due to the flexibility that most accounting standards grant to the companies, the same economic facts may be presented in different manner. One problem is hidden reserves. According to the way company regards its hidden reserves, the total figures of the balance sheet may be either pushed up if hidden reserves are not built or values are even overstated, or suppressed if hidden assets are important. Thus the researcher should always cautiously evaluate empirical results based on Tobin's Q.

The five corporate governance mechanisms that are included to the model are outside directors, share ownership by managers, smaller board size, availability of large controlling shareholder and leverage effect. Virtually all codes recommend that boards should have outside directors, which is connected with better objectivity and limited opportunities for self-dealing transactions. It is believed that firms with majority outside directors on the board have higher market valuation. To examine this hypothesis in Russia we add to our model a variable *Outsider* that is calculated as the ration of outside directors to the size of the board. The next control mechanism of interest in this model is the board's size. Adding the variable *Bsize* we check if large boards in fact induce lower firm valuation. The variable *Stocksod* represents the ratio of shares that executive officers and directors hold. According to the theory we expect that keeping shares by managers aliens their own private interests with interests of shareholders and thus has a positive effect on corporate valuation. Availability of large external shareholder implies that there is an investor who has enough incentive to monitor the corporate management. In order to control this influence in our sample we apply the variable *Blockout*, which is calculated as the percentage of shares held by the largest external shareholder. Finally, to examine the assumption that debt helps to discourage overinvestment of free cash flow by self-serving managers we add the leverage variable *LV* which is estimated as the ratio of liabilities (short- and long-term) to total assets.

To control for various other effects we include three more exogenous variables which are state shareholding, firm size and industries. Considering that state continuous to play a dominant role in transition economies it is necessary to control for the interrelation between state ownership and firm's value. For this purpose a dummy control variable *StateOwn* is included. It equals 1 if the state holds 5 per cent stake and larger, otherwise 0. To control for the size of company we introduce *LnAssets* variable, as measured by the natural logarithm of total assets. It could be assumes that larger firms are difficult to monitor and therefore they may have larger agency costs which results in lower firm valuation. Finally to control for differences among the companies from different industries we include 4 dummy variables: utilities, services, mining and other production industries.[533]

4. Empirical Results

It may seem at first glance that data set for three years can be pooled in one regression. However more close review of data shows that virtually each variable highly correlates with itself throughout three years (Table 28). This is due to the fact that most variables hardly change their values within such a short time range (3 years). This will considerably hamper the result of the model, if we pool the data.

Table 28: Correlation of each corporate governance mechanism with itself throughout the years

	2004-2005	2005-2006	2004-2006
CGI	0.84	0.80	0.69
Tobin's Q	0.90	0.84	0.69
LV	0.93	0.90	0.89
Blockout	0.95	0.90	0.84
Outsider	0.74	0.77	0.58
Stocksod	0.96	0.99	0.96

Source: Own Calculations

[533] Due to the special role of *mining* industry in the Russian economy we observe it separately from *other industries*: metal, chemical, food and machinery; *utilities* include energy sector and telecommunications; *services* include transport, finance, trade and other services.

In order to make the use of the three year samples and not violate the assumption of randomness of sample variables, we aggregate the data by calculating the average of three years, thus coming to the average sample. Due to some missing parameters for one company the overall size of the sample is reduced to 51 companies.

Prior calculating the coefficients for our initial model it is interesting to review the simple interdependence of each of the main variables on the bases of a correlation matrix (Table 29). It can be generally stated that there is no significant correlation among most exogenous variables. Thus collinearity is not a problem for the regression. The exception is the significant and negative relation (r= -0.674) between the size of shares held by the biggest shareholder and the total amount of shares under control of management organs. Keeping this in mind we will run a second regression with only one of those variables. This appears to be plausible if considering that the bigger the share block held by the large shareholder the fewer shares are left for the control by insiders. Noteworthy is a positive, however not a large one, interdependence between corporate value and number of shares held by managers (r=0.326). As expected the board's size is significantly correlated with the size of the company (r=0.503). Surprising outcome delivers our main variables Tobin's Q and Corporate Governance Index. As read from the table, there is not only a missing significant correlation, but also a negative value of the coefficient (r= -0.099). The result can be interpreted in two ways. First, the market does not award 'good' corporate governance by higher share prices; second, the companies with high market value do not adhere to 'good' governance principles that compose the index.

Table 29: Correlation Matrix

	TOBIN_S_Q	CGI	LV	OUTSIDER	BLOCKOUT	BSIZE	STOCKSOD
TOBIN_S_Q	**1,000**	-0,099	-0,016	0,094	-0,095	-0,285	0,326
CGI	-0,099	**1,000**	0,205	0,199	0,155	0,355	-0,043
LV	-0,016	0,205	**1,000**	0,201	-0,102	0,114	0,172
OUTSIDER	0,094	0,199	0,201	**1,000**	-0,037	-0,029	0,184
BLOCKOUT	-0,095	0,155	-0,102	-0,037	**1,000**	-0,001	-0,674
BSIZE	-0,285	0,355	0,114	-0,029	-0,001	**1,000**	-0,234
STOCKSOD	0,326	-0,043	0,172	0,184	-0,674	-0,234	**1,000**
MINING	0,089	0,079	-0,361	0,001	-0,024	-0,003	-0,143
INDUSTRY	0,024	-0,227	0,104	-0,195	-0,163	-0,195	0,195
SERVICES	0,153	-0,250	0,227	0,171	-0,042	-0,096	0,216
LNASSETS	-0,393	0,264	-0,110	-0,147	-0,006	0,503	-0,100
STATESHARE	-0,217	0,023	0,000	-0,056	0,075	0,228	-0,238

Source: Own Calculations

After tracking the simple interdependence of variables we therefore will review their overall impact on corporate valuation, which we assume reflects the effects of corporate governance.

$$Tobin\text{'}s\ Q_i = \beta_0 + \beta_1 \cdot CGI + \beta_2 \cdot Stocksod + \beta_3\ Blockout + \beta_4\ Bsize + \beta_5\ LV + \beta_6\ Outsider + \beta_7 \cdot StateOwn + \beta_8 \cdot LnAssets + \beta_9 \cdot Industries + \xi i$$

However, as it was already indicated by the correlation matrix we find no significant impact of good corporate governance on firm valuation (Table 30). This result does not support the conventional idea that better corporate governance in general leads to higher market valuation. However it goes in line with the assumption that some of the control variables included in this regression, and probably some more, overlay the supposed effect. It can be carefully assumed that based on the given measures of corporate governance there is no improvement in firm's value if firm adopts good governance principles in the defined manner. On the other hand it may be also questioned whether our CG-Index is poorly composed and that it does not include other good governance factors that could have value increasing effects in Russia.

Although statistical significance of the role of large shareholders is small (Prob.= 0.1284) the result can be still cautiously accepted, assuming that large shareholder may have a value creating effect by more close monitoring of the company than the minority shareholder would do. Also according to the prior discussion the shareholding of directors and officers have a positive impact on Tobin's Q.

Among available industries, coefficient of mining industry delivers acceptable significance level, which as expected shows higher valuation of mining companies by investors. Another industry that has a high significance level is utilities, which is represented by two sectors – telecommunication and energy. As our further descriptive analyses will show both industries have monopolistic and oligopolistic structures and the state keeps controlling share through the state holding company.

In accordance with the common sense the size of the company measured by natural logarithm of assets (LnAssets) negatively effects firm's value, as bigger companies are more difficult to monitor. On remaining variables such as leverage effect (LV), representation of outside directors and the size of the board, no significance effect on company's valuation could be tracked. Although insignificant, the negative coefficient of the state shareholding (StateShare) shows an expected reverse link between state ownership and companies' valuation.

Table 30: Results of regressions on different control variables

	(1)	(2)	(3)
Constant	**3.6146** **(0.0004)*** **	**3.8922** **(0.0001)*** **	**3.7020** **(0.0001)*** **
CGI	0.0003 (0.9799)	0.0054 (0.5743)	0.0042 (0.6183)
Stocksod	**0.0165** **(0.0139)** **	**0.0091** **(0.0434)** **	**0.0087** **(0.0314)** **
Blockout	0.0093 (0.1284)	---	
Bsize	0.0524 (0.2624)	0.0292 (0.5137)	
LV	-0.0267 (0.9597)	-0.1551 (0.7698)	
Outsider	-0.4301 (0.4731)	-0.3553 (0.5585)	
Lnassets	**-0.3150** **(0.0008)*** **	**-0.2935** **(0.0017)*** **	**-0.2625** **(0.0004)*** **
StateOwn	-0.0367 (0.8784)	-0.1152 (0.6298)	
Mining	**1.0258** **(0.0065)*** **	**0.8888** **(0.0155)** **	**0.8426** **(0.009)*** **
Other Industry	0.0693 (0.7929)	0.0932 (0.7282)	0.0771 (0.7555)
Services	0.2130 (0.5197)	0.3355 (0.3063)	0.2405 (0.4033)
Sample Size	51	51	51
Adjusted R2	0.2461	0.2340	0.2725
Prob (F-stat)	0.0180	0.0146	0.0023

Source: Own Depiction, The numbers in parentheses are probability values for two-sided tests. *, ** and *** respectively indicate significance levels at 10%, 5% and 1% levels and shown in boldface.

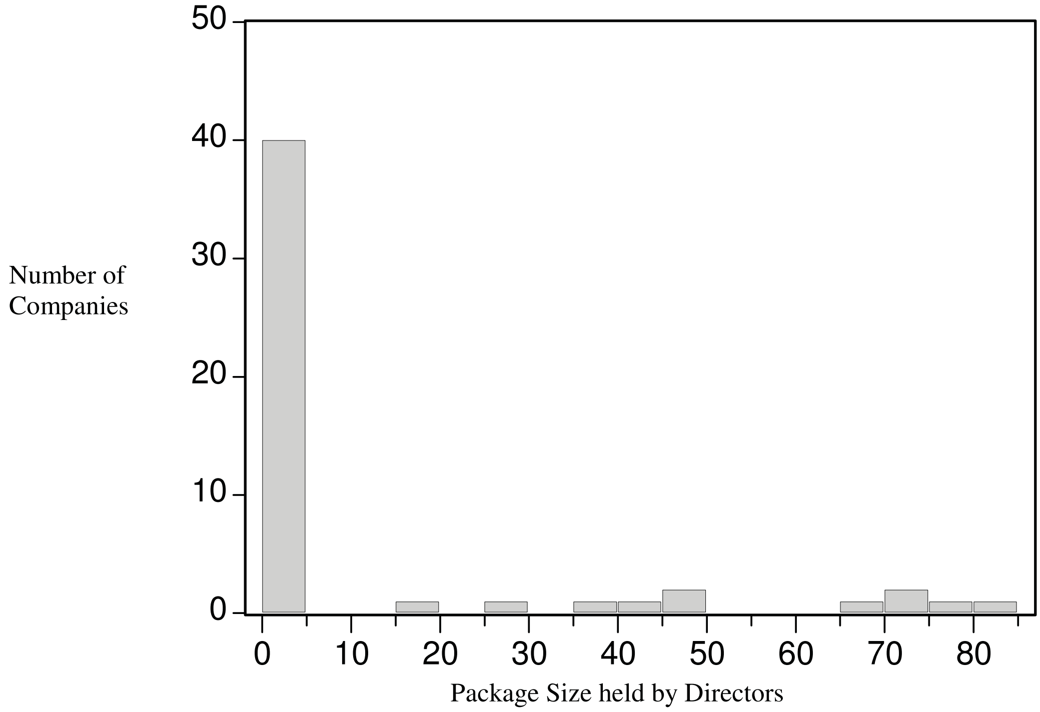
In all three regressions, not very low level of adjusted R-squared and good results of F-statistics show that the model delivers plausible information. Nevertheless, the outcome of the model should be observed with a portion of scepticism. First of all, the derived data from the financial reports maybe considerably biased by the flexibility and autonomy of each company's accounting method and therefore may complicate the direct comparison within the sample. Second, the problem of omitted variables may still exist and some important explanatory factors in the Russian environment could be missing. Third, the sample of 51 companies is rather small, which may not fully reflect the real situation with Russian joint-stock companies and one should cautiously rely on the model outcome. As a result of such small sample the industries are aggregated into four groups that do not allow to track the situation in particular industries (except mining). Last but not least, the main Index of the research – CGI is composed based on conventional standards of 'good' corporate governance, the biggest part of which reflects the disclosure practices. It can be therefore assumed that those standards that could be of a higher importance for Russian companies are missing in that index.

Critical questions that may arise in respect to the results of the model – Are they alienable with the good corporate governance model and its social convention or maybe under such circumstances only tiny shift of capitalists and oligarchs profit from such a model, neglecting the rest of population and other stakeholders. To our opinion there is no simple answer to that question. There are certainly improvements in the overall framework of corporate governance in Russia and that is what this work has figured out. However, at this stage we cannot state that Russia has achieved the optimal corporate governance model.

The regression analyses showed that managerial ownership plays an important role as the control mechanism in Russian companies. This is alienable with the practices in the western context and recommendations of the international organizations. But does this mechanism have the same disciplining functions in transition economies? In order to answer this question, we need to refer to the actual shareholding of managers in Russia. How big are those shares in average? Are the stakes extremely large that managers are virtually own and control corporations or they just keep small fraction of shares as in most western companies? The answer lies somewhere in between. In fact as our further descriptive statistics will demonstrate there are several companies in our samples where managers directly hold 50 per cent and more, but their number is minor, in most companies in our sample the direct shareholding of managers does not exceed 5 per cent (See Figure 24). This statistic could be misleading as there are cases when directors retain control via third companies (nominal shareholders), not holding directly substantial stakes. It is difficult to track such shareholding for all companies, because not every company reports their beneficial owners, who finally control the company. However, based on the information on those companies that report such data we can conclude that it is one of the practices in Russia to retain control through one or more off-shore companies. Due to its different nature, the managerial shareholding in the

Russian model of corporate governance cannot be regarded as an absolute cure for improvement.

Figure 24: Number of Companies with given packages held by directors



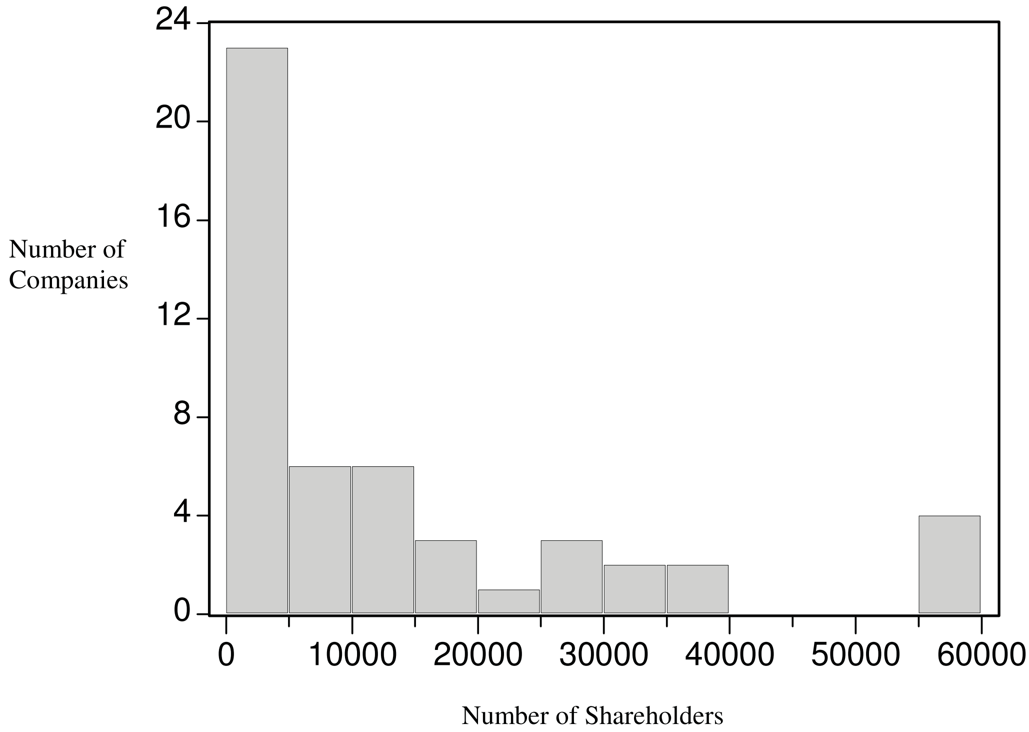
Source: Own Calculations

Another critical question that arises in this respect, what are the benefits for the society from such a model of corporate governance in which companies with directors' shareholding predominantly from the mining industry and some other industries with monopolistic structures have high values? One of the possible benefits for the society that is relevant in the context of corporate governance is the overall improvement of the investment climate in a county, development of the securities market and institutional investors that can allow ordinary people to plan their finances and invest in private pension and insurance schemes. If the Russian model would be dominated by the companies that are mainly controlled by managers who care only about their own 'pockets' then no institute of small shareholders would exist and companies would record very small number of shareholders in their ownership structure. Looking to the descriptive statistics of the sample we find that Russian companies have in average almost 23,000 shareholders, although the range varies between 9 and 337,000 shareholders.[534] In our sample, 23 companies have less than 5,000 shareholders, whereas the remaining 28 companies record more than 5,000 shareholders in their ownership

[534] For more on descriptive statistics see Appendix V.

structure (Figure 25). With few exceptions it can be stated that most companies have managed to create the bases for the development of small investors, which is a main condition for further development of securities market and investment practices in a country.

Figure 25: Number of Companies with Given Number of Shareholders



Source: Own Calculations

Finally, it is necessary to note that using corporate value (Tobin's Q) as an indicator that reflects the effects of good corporate governance we distance from our stakeholder oriented definition of corporate governance and consider only the aspect of shareholder value. This deficit does not allow us to analyse the situation with employees, suppliers, creditors, communes and etc. Therefore, it is not possible to make the overall judgement on the results of 'good' corporate governance.

5. Descriptive Analyses

This section reviews the general practices of corporate governance in 52 Russian (RTS) and 47 Kazakh listed companies, which makes respectively 55% and 65% of all listed companies. The analysis of corporate governance practices in Uzbekistan is omitted in this section because there are only 8 listed companies and the information on those companies is hardly available. The analysis will bear a descriptive character and provide a general trend in the development of corporate governance. Where required, the change throughout the time will be indicated and when not explicitly indicated the description refers to 2006. The review will pass through four relevant sections such as transparency, shareholder rights, governance practice and ownership structure. However it is noteworthy that it was not possible to collect all required information for all countries and companies under consideration. That is why in some cases the description will be limited to general statements.

5.1 Transparency and Disclosure

5.1.1 On-line Disclosure

It can be generally stated that Russian listed companies follow disclosure practices that are to bigger extent correspond to the standards established in the countries with developed securities markets. Out of the 52 companies in the sample all have web pages that are investor oriented. Among them 94% have the web pages in at least one foreign language and 90% of companies provide not only consumer oriented information on their web pages but also contain sections that target foreign investors. Almost every corporate web page (96%) include the section on corporate by-laws, where most important documents can be simply accessed. 68% of companies have a separate section on their web pages on which they provide detailed information on their corporate governance practices.

In Kazakhstan the disclosure practices are less sophisticated and transparent than in Russia. The poorer transparency starts already when reviewing the quality of web pages. Only 60% of the companies in sample have their own corporate pages, whereas only 36% have investor oriented pages and the remaining provide solely overall consumer information. Web pages that oriented towards foreign readers, hence those translated into a foreign language make up 36% of the sample. Corporate by-laws and similar documents can be found only in the 6% of pages and only 11% have the separate section on corporate governance.

5.1.2 Corporate reporting

In respect to the quality of corporate reporting Russian listed companies can be distinguished as leaders due to the high quality of reporting. A good proxy to evaluate the quality of the reports is their volumes. In very small number of companies (5%) financial statements are restricted to the basic data such as balance sheet, income statement and cash flow. All other companies prepare financial statements that are in average contain 38 pages and annual reports with 84 pages. In most cases reports include corporate governance chapter. For example, in 2004 approximately 77% of companies had corporate governance chapter in their annual reports whereas only 31% applied the rule “comply or explain”, but in 2006 these figure increased to 88% and 56% respectively. All reports contain information about auditors, related party transactions and large shareholders. However the extent of information differs among companies. Thus for example, many companies do not specify in whose favour nominal shareholders keep the shares. So that it is not possible to figure out the beneficial owner. In 2004 only 35% of companies provided information on beneficial owner, whereas in 2006 the number of such companies increased to 46%. As a rule financial statements are prepared in accordance with one of the recognized accounting standards. If in 2004 only 88% of the companies were reporting according to the IFRS or US GAAP. In 2005 and 2006 their number increased to 96%. Apart from annual reports virtually all listed companies publish their quarterly reports that can be obtained either from the corporate web page or from the RTS Web page.

The clear tendency of better corporate reporting can be observed in Kazakhstan. Throughout the years listed companies were improving the spectre of included topics in their reports and the depth of information provided. As a rule financial statements go beyond providing only the table data of balance sheet, cash flow and income statements. The average number of pages that financial statement contains is comparable with Russian practice and equals 38 pages. The situation is different with annual reports. It seems that Kazakh listed companies rely more on financial reporting and the annual reports constitute only an incremental data source. Annual reports are quite short and provide only very restricted amount of information which is partially can be already found in the financial statements. Only in 2% of companies the section on the corporate governance practices was found in the reports. Provision of information on auditors became a standard in all reports, so that in 2006 all companies informed about their auditors. Compared with 2004, when 21% of companies did not provide any information about their auditors this can be regarded as success. Another enhancement can be tracked in the disclosure of related party transaction. If in 2004 almost 36% of companies did not report this issue; in 2006 their number decreased to 23%. Much better situation than in Russia can be observed in respect to disclosure of information on large shareholders. From the 91% that provide such information virtually all inform about beneficial owner, so that the true shareholders’ structure can be depicted. Growing internationalization of Kazakh companies has resulted in closer adherence to one of the internationally recognized accounting principals. If in 2004 only 63% of companies used international standards, than in 2006 their number grew to 96%. Substantial improvements can be also noted in the field of interim reports. Although the standards of quarterly reports lie far behind the Russian standards, more listed companies started publishing quarterly reports. In 2006 their number achieved 96%, compared with 79% in 2004.

5.1.3 Information on Directors

The essential element of the disclosure is the information on directors of the firm. In general Russian firms provide very detailed information in this respect. As a rule not only the current position of directors are mentioned but also the previous employment places, as in accordance with the corporate governance code. In 2006 almost 92% of companies included in their reports detailed information on directors' recent employment and 98% provided information on director's shareholding. Less positive is the situation with a disclosure of the remuneration and compensation schemes. Absolutely all companies provide information only on general figures of the remuneration programmes and do not specify individual packages. In respect to directors' independence only half of the companies explicitly indicated outside director that were selected as independent monitors.

Similarly, in Kazakhstan the disclosure practices on director related information remain far behind the world standards. In the practice of the Kazakh companies it is not conventional to submit wide range of information on directors. From the observed sample, only 15% of companies report the information on previous employment places of directors, 19% provide the information on current employment places and the remaining companies limit their reporting to the simple statement of the name. The situation is not better with the publication of directors' stakes and remuneration. Only 2% of companies publish information on each director's shareholding and 6% inform about the aggregate shareholding of the board. As a rule remuneration schemes are provided in overall figures for all directors, so does 48% of companies, whereas only one company reports the salaries for each director individually. There is also poor adherence of the Kazakh companies to explicitly indicate the independent directors. Thus, only 13% of companies shows independent directors.

5.2 Shareholder Rights

The availability of the own corporate governance code is an indicator of company's willingness to improve its governance and better protect the interests of shareholders. In Russia, the number of companies that adopted own corporate governance code has been permanently increasing in the last few years. If, for example, in 2004 only 35% of companies had own code, in 2006 their number achieved 58%. In this respect Kazakhstan has better records. If in 2004 only 15% from the sample of Kazakh companies had own corporate governance code than in 2006 all of them already had own code.

Another considerable factor for shareholders is the time frames of financial reporting. Financial data that occurs too late makes little sense for investors, as events that took place during the gap between the end of financial period and the date of reporting may considerably alter the financial position of the company. That is why the earlier the reports are published, the better are the interests of shareholders protected. In 2006 only 17% of Russian companies published their reports in the first quarter of the year, most of them (67%) published their report in the second quarter and the remaining 16% made a disclosure in the second half of the year. In Kazakhstan as well the biggest fraction of companies (43%) publish their reports in the second quarter of the year, 28% do publication in the first quarter and the remaining 29% report quite late – in the second half of the year.

The next proxy of a good shareholder position is the involvement of the international auditors. It is considered that due to their experience, long-lasting history and image, internationally recognized auditors are better monitors of corporations. Therefore, we include this criterion along with other elements of shareholder rights. Among the sample group of 52 companies, only 3 companies apply to local auditors, whereas the rest of companies (94%) attracts the auditors from the group of big four auditors. In Kazakhstan the share of companies that apply to local auditors is higher than in Russia making up 40% of the sample.

Very often the main purpose of the investment in stocks is the expected increase of their value and forthcoming dividends. Therefore, it could be stated that companies whose shareholders are regularly awarded with dividends care better about their shareholders. From 2004 to 2006 approximately 80% of Russian firms from the sample were regularly paying dividends. From the information disclosed by Kazakh companies it is difficult to track the history of dividend payment throughout the years. It can be generally noticed that companies with preferred shares pay at least dividends on such type of shares.

One main channel for shareholders to express their position is the general meeting. The more often meeting is held, the more frequently opinions of shareholders is articulated. Therefore, we take special (extraordinary) shareholders meeting as another proxy for better care on shareholder rights. In 2004 only 38% of companies conducted at least one special shareholders meeting, whereas in 2006 this figure grew to 65%. Similarly, the special shareholders meetings became popular communication mechanism in Kazakhstan. Thus, in 2007 almost 60% of companies has conducted at least one such meeting.

5.3 Governance Practice

This sections review the overall governance practices in transition economies. Listed companies in Russia maintain relatively large supervisory boards that comprise in average 10 seats, whereas the biggest board in the sample has 17 seats and the smallest 7 seats. To note also a positive trend of outside directors' representation on the board. If in 2004 almost 20% of directors did not have outside directors than in 2006 their number decreased to only 6%. In average Russian firm have 3 outside directors. Noteworthy also is the increasing number of foreign directors on the board.[535] The number of firms with at least one foreign director grew from 34% in 2004 to 48% in 2006.

The boards of Kazakh companies are small in comparison with the boards of Russian companies. The average board contains 4-5 seats, whereas the largest board includes 11 and the smallest 3 seats. Every fifth company has a foreign director on its board. Less clear is the practice with the representation of outside directors, because most Kazakh companies do not directly report on the status of directors and due to the lack of CV data it is hardly possible to figure out his/her independence.

In accordance with the recommendations of the national corporate governance code Russian firms create functional committees on the board. The most frequent one is audit committee which could be found in 76% of firms in 2006, compared with 50% in 2004. Less popular among Russian firms is compensation committee which could be found in 51% of firms in 2006 in contrast to 36% in 2004. The reporting about the meetings of the supervisory board is less consistent. Among the sample firm only half of the companies reported on the number of board meetings. In average, in 2006 there were conducted 35 board meetings, whereas as a rule most of them were in form of voting in absentia. From the available

[535] Foreign Director – citizens of foreign countries that are not former Soviet republics.

information for Kazakh companies it can be stated that the committee structure of the board still belongs to the exceptional cases and only few companies have audit committees.

Also in accordance with the code recommendations the remuneration of management in Russian companies is performance based, whereas the practice of putting the firm performance in interrelation with the salary is more widely used for executive officers than for directors. Thus, for example, in 2006 almost 60% of firms reported such practice to be applied for their executive officers and only 42% of firms apply it for directors. Despite its growing character in the last few years, stock option plans still remain the rare method of remuneration. In 2006 only 8% of the firm used stock option plans. The restrictive information policies on managers' remuneration in Kazakh companies make it difficult to meet the assumption about adherence to the recommendation on payment in accordance with economic performance of companies.

5.4 Ownership Structure

The ownership of Russian listed companies remains highly concentrated. Although the average share of the largest shareholder has decreased from 53% in 2004 to 49% in 2006 there is slightly trend of ownership consolidation. In year 2004 the mean number of shareholders in our sample constituted 25,500 whereas in 2006 this figure decreased to 22,500. Noteworthy is the huge discrepancy in terms of shareholders' number. For example, the maximal number of shareholders in 2006 made up 330,000 and the minimal only 4.

The state continues to play a significant role as a shareholder in listed companies. Thus in 21% of firms the state was directly holding in 2006 a stake bigger than 5%. Important is that in many other companies, especially from the telecommunication and energy sectors, the state was holding controlling stake indirectly through the main corporation in the holding group. Important development can be observed with the "golden shares". In 2006 only 4% of the firms from the sample were still issuing such special right shares. Managers' direct shareholding appears to be relatively small as the mean value equals 11%. But these figures may not express the real shareholding of managers as in multiple cases managers keep the stakes through the nominal shareholders that are very often located in off-shore countries.

As already mentioned the Kazakh companies provide better disclosure in respect to the ownership structure. Unlike Russian companies, it is easier to determine in most cases the beneficial owners of the Kazakh companies. The ownership in the Kazakh listed companies remains highly concentrated. The biggest shareholder holds in average 65% of shares. The state does not dominate the ownership of listed companies as in Russia. Only in 3% of companies state is the largest shareholder and there are only 10% of companies in which state has direct shareholding. Almost 15% of companies has foreign controlling shareholder. Generally most of the listed companies belong to the company group and they are controlled by the domestic firms. Interesting that 12% of companies have physical person as the main shareholder and the half of them is represented in management.

5.5 Conclusion of Part IV

This part presented empirical study of corporate governance practice on the firm level. The research was divided into a quantitative model analysis and descriptive part. The first part of the study was devoted solely to the experience of the Russian companies, whereas the descriptive analysis included the experience of Russia and Kazakhstan. Uzbekistan was excluded from the empirical research due to the restricted number of listed companies and the very scarce information on them.

The results of the regression panel analysis demonstrated that, as contrary to the earlier prediction, better corporate governance practices, measured by self-constructed Corporate Governance Index, does not matter and no higher valuation for firms that adhere to good standards can be observed. Some control mechanism such as the director's ownership and availability of large shareholder have a positive effect on the value of the company. However their nature in the environment of transition economies differs from their counterparts in western countries. We concluded that effect of adherence to 'good' corporate governance standards is overlayed by such factor as existence of the large shareholder, in form of state owned holdings and directors, as well as belonging of the companies to the profitable industries such mining, telecommunication and energy. It was also noted that Tobin's Q could be not an appropriate measurement of good corporate governance model, if we apply stakeholder based approach.

The descriptive part of analysis delivered the general picture of corporate governance practices in transition economies. It appeared that the Russian companies tend to be more transparent in many respects than the Kazakh companies. Apart from the weak disclosure on the beneficial ownership of firm and individual remuneration schemes of managers, the experience of Russia can be compared with those of developed capital markets. Although Kazakhstan has achieved a significant progress in various fields of corporate governance some improvements could be wishful. Finally it can be concluded that the overall trend of convergence can be observed and it can be assumed that it will be further strengthening with a time.

Conclusions, Policy Recommendations and Outlook

This section provides the summary of the research outcome on the study of corporate governance in transition economies. In the beginning the general comparative assessment of each part of the research will help to draw the profound picture of corporate governance development. Afterwards based on the assessment results the proposals for further improvement are made. Finally, some general proposal for further research will be summarized in the last section.

Corporate governance is a relative new research field, especially in transition economies. The main purpose of this dissertation was to contribute to the study of the subject in transition economies. In the essence of the research stays the holistic approach, so that corporate governance problematic was discussed from the interdisciplinary perspectives including economic, cultural, politic and legal frameworks. The broad definition of corporate governance is taken to the reference in this study, so that unlike the Anglo-Saxon definition that considers mainly shareholder interests, we took account of other stakeholders such as state, creditors, employees, institutional investors, auditors and rating bodies.

The review of the theory has demonstrated that in the core of corporate governance research stays the principal-agent conflict. The shape of firm's ownership structure determines between what parties the conflict can be expected. Thus in case of dispersed ownership the conflict arises between managers and shareholders, whereas concentrated ownership is a precondition for interest conflict between large and minority shareholders. After investigation of the overall ownership structure in transition economies it can be concluded that the shareholding is to the bigger extent is concentrated there. In Russia and Kazakhstan the main stakeholders are insiders and corporate groups, whereas in Uzbekistan due to the slow privatization paste the state remains the main stakeholder. This implies that in the corporate governance models of these countries the conflict area lies between controlling and minority shareholders.

In order to cope with the agency conflict the theoretical works propose different control mechanisms such as board supervision, remuneration, liabilities, large shareholders, takeovers, product and labour market competition. Despite plausible theoretical models, empirical studies fail to provide unambiguous approval of the effectiveness of proposed mechanisms. The review of the existing studies on transition economies showed that most of the proposed mechanisms will have hardly any success in transition environment due to the concentrated ownership in most companies. The only control mechanism that could be efficient is the large shareholder, who may have enough incentives to monitor corporate managers. Nevertheless the potential conflict with minority shareholders remains unresolved.

Brief review of the macroeconomic situation showed that all three countries report positive results of the consistent economic policy with the moderate and controlled inflation, growing revenues from the export of raw materials and increasing of FDI. The overall business climate can be evaluated as favourable in Russian and Kazakhstan stipulated by successful liberalization reforms and growing demand on the mineral resources. In contrast, the experience of Uzbekistan represents a sort of amalgamation between market economy and socialistic way of governance, which considerably hinders the reform success in the country.

The analysis of the cultural aspects was based on the review of corruption index which is a proxy for ethical standards in a country. Although this is a good instrument for quantitative studies there are much more differences can be extracted from the review of cultural issues. The brief review of the cultural frameworks with application of the cultural dimensions has delivered the evidence that despite the long-lasting common history there is a great deal of divergence between countries. Such aspects as ethnical origin, cultural peculiarities, traditions and religion may have a substantial impact on general way of doing business in a country and thus must be inevitably included in any comprehensive corporate governance research.

Perhaps the most relevant aspect in the study of corporate governance is the legal environment. Multiple researches deliver unequivocal results of positive interrelation between protection of investor rights and the development of financial system in a country. Moreover safeguarding the interests of other parties such as employees and creditors is also relevant for the good corporate governance environment. To facilitate decent legal system a country needs on the one hand good laws on books and on the other hand functioning enforcement mechanisms. Part II of the research provided analysis of the laws on books in three transition economies. The scope of investigation went from the corporate and securities market laws to the review of corporate governance codes and listing requirements. This approach allowed us to figure out, interests of which of the following constituencies – managers, shareholders, minority shareholders, employees and creditors are protected and to what extent. Another goal was here to detect in which direction the corporate governance model of three transition economies is moving, whether to the direction of Anglo-Saxon model which is capital market based, putting shareholders value into the centre of the system, or is it continental-European model which considers the interests of various stakeholders. The comparison was initiated on two levels. On the one hand the state of law was compared among transition countries, and on the other hand transition laws were compared with legal practices in the USA and Germany. It appeared that Russian and Uzbek corporate and capital market regulations are oriented toward German provisions, whereas Kazakh legal frameworks of corporate governance are comparable with the US regulation. It was also found that there is large degree of convergence in corporate and capital market regulations throughout the world, which can be generally described as capital market oriented.

The innovative part of this work is the construction of the shareholder protection index (SPI), which measures the degree to which the interests of shareholders in each country are protected. The index contains 118 variables distributed unequally throughout 4 important sections of corporate governance: (i) Basic governance structure, (ii) Significant corporate actions, (iii) Takeover regulation and (iv) Related party transactions. Each section went through two main conflicts of corporate governance, for which a separate sub-index was constructed. On the one hand it is the conflict between managers and shareholders and on the other hand it is the conflict between controlling and minority shareholders.

Analysis of legal environment delivered illuminating results. It can be generally stated that the regulative basis in respect to shareholder rights is of a very good quality in transition economies. It appeared that according to the SPI the interests of shareholders are at best safeguarded in Germany. Even the laws in Russia and Kazakhstan score higher indexes than the USA. This means that in general shareholders in Germany, Russia and Kazakhstan have more possibilities to participate in decision making process and thus in shaping corporate policy. In contrast the US legal base provides shareholders with profound information and investigation rights, whereas participation in decision making process is limited. Additionally the US shareholders are vested with the good rights to claim their interests in court and due to the high liquidity of the market to easily "vote with feet". Thus the balance of power in the corporations of three transition economies and Germany is shifted towards shareholders, whereas in the US the mangers retain the power. Noteworthy also that transition countries have introduced in their laws most relevant provisions that protect the interests of minority shareholders, whereas the interests of employees are hardly mentioned throughout all books, apart from some minor provisions in Russian law. The SPI index itself does not allow to answer the question about the best corporate governance system. It solely delivers the information on how good the interests of (minority) shareholders are protected.

The results of this part should be regarded cautiously as it lets us to conclude only about one of the two main components of robust legal system, namely the laws on books. In contrast this research does not elaborate on perhaps more important issue – law enforcement. To be able to provide comprehensive and encompassing comparative analysis of legal frameworks the law on books must be complemented by the study of enforcement issues.

The study of corporate governance based only on the description of the general economic, legal and cultural frameworks would be incomplete without the review of the individual role of various stakeholders. Such stakeholders as state, banks, investment funds, pension funds, insurance companies, auditors and rating bodies constitute the corporate governance model of a country. Ignoring those actors may end up in wrongful conclusions and policy design.

The political interests of diverse lobby groups can promote the laws that favour one stakeholder at costs of another. This could in turn explain why some stakeholders are more active on the market and thus have greater autonomy to effect corporate governance model within the country, while the other stakeholders are almost non-existent. To trace the actual role of each above mentioned stakeholder, in Part III we undertook the review of the regulatory base in their respect. It was found that the state as direct shareholder plays insignificant role in Kazakhstan and in Russia, although in Russia during the recent few years the state has increased its shareholding in some strategic industries. In contrast in Uzbekistan, state remains the main shareholder of most joint-stock companies. In all three countries the state retains control through its regulatory mechanisms. This could be considered as a common practice all over the world, as long as the state, represented by politicians does not misuse its regulatory power to promote the interests of some minor interest groups, instead of promoting the interests of the whole society.

At the same manner like the state, the role of banks was observed from the bipolar perspective - on the on hand banks as creditors and on the other banks as shareholders. An overall positive trend can be identified with the banks being corporate creditors in Russia and Kazakhstan. Although bank credits still remain very low in comparison to other sources of finance, there is a significant increase in the recent years, stipulated by the improvements in reform processes and economic progress. In Uzbekistan banks remain under the strict control of the state both as shareholder and regulator, what results in poor performance of the banks and their passive role as firm creditors. Measuring overall banks' shareholding it can be stated the current role of banks in the corporate governance models of three transition economies remains low. However, there is a large potential for their further development in Russia and Kazakhstan, considering the favourable economic indicators. Nevertheless, it can be already now stated that because of legal restrictions on bank shareholding in corporate sector, Kazakh banks will not play a crucial role in the corporate governance model as beneficiary owners.

The analyses of the institutional investors as corporate shareholders demonstrated that with an exception of insurance companies that hold in all three countries very small stakes, there is difference of development across the countries. Thus it appeared that due to the well developed privately financed pension system in Kazakhstan, the pension funds play very active role on the capital markets. Russia has the most advanced system of collective investment measured by its size and the comprehensive regulatory base. In contrast, in Uzbekistan due to its small and illiquid securities market only weak signs of institutional investors' activities can be observed.

Apart from the stakeholders who can hold corporate shares, there is a group of peripheral stakeholders such as audit and rating companies that do not act as shareholder of the company but their functions are rather concentrated on external monitoring of firms. The results showed that auditors are perhaps one of the most important external monitors of the company. However their role in three transition economies is restricted due to the small number of audit companies in comparison to much higher number of firms and shortage of the licensed audit professionals. In contrast the role of rating bodies is negligently small. Only very few number of companies receive corporate governance ratings in Russia, whereas in Kazakhstan and Uzbekistan such ratings are non-existent.

After the global description of corporate governance in transition economies, the concluding part of the research deals with the empirical investigation of the firm based corporate governance. The main task was to study if firms in transition economies implement any corporate governance practices and if yes, do those firms are better awarded by the market. To study those aspects two methods of research were applied – quantitative regression analysis and descriptive statistics. It was found that firms in Russia and Kazakhstan practically apply good standards, which are consistent with an international practice. However, the regression analysis on Russian listed companies did not deliver significant results on the relation between 'good' corporate governance, measured by the self-created Corporate Governance Index and firm valuation (Tobin's Q). There are several reasons that could explain unexpected outcome of the model. On the one hand the choice of Tobin's Q as dependent variable to check the effect of good governance could be false, because it reflects only the shareholder value approach, neglecting the interest of all other stakeholders. Another reason could be that our Corporate Governance Index is wrongly comprised, including some unimportant variables and omitting those that could be of larger significance in the context of transition economies. Last but not least, some other factors could play more significant role than simple adherence to 'good' governance standards. Thus, it was found that directors shareholding and large blockholding by external shareholders, as well as belonging of a company to the mining industry is associated with higher company valuations. It can be assumed that in the ologopolistic or monopolisitic environment with the large stakes held by only few parties the good practices of corporate governance are poorly anticipated by market and small shareholders, and instead only high expeted yields matter. Nevertheless, one should not undermine the importance of corporate governance in transition economies. Adherence to the good standards of corporate governance contributes to the development of securities markets, improves trust of the investors into the market, facilitates foundation of new investor classes (investment funds, pension funds, insurance companies, etc.). All these factors have an overall positive macroeconomic effect.

Studying such a broad topic as general aspects of corporate governance, it is difficult to come up with the detailed policy recommendations on specific aspects. That is why this section will be solely concentrated on proposing some general reform directions, which maybe required in order to achieve more efficient system of corporate governance. First of all it is important to notice that many fields of corporate governance are intensively interrelated and any minor changes in one field can have an impact on other fields. For example, the changes in the takeover regulation may considerably affect the overall ownership structure of firms in a country and thus induce the shift of principal agency conflict. That is why it is important that any policy changes are clearly weighted against all their possible outcomes. It is also crucial not to omit the national specifics of the country and blindly copy regulations from abroad. If some rules in fact may have a universal character and match in all environments, there maybe some unique aspects that must be considered based on which the domestic regulation should be adjusted. As an example one can take a country with strong collectivistic life spirit and with deeply rooted family-based values and ways of doing business. It is unarguable that in collectivistic societies the regulation of the related party transaction should take another form than in individualistic societies.

Corporate governance matters in those economic frameworks where the investors and target companies are vested with the right of free choice, which is not restrained by the interference of the state institutions. The economic efficiency is attainable if both providers of resources and the companies act in the competitive environment with equal opportunities for each. Therefore to stimulate efficient corporate governance model it is essential to foster economic liberalization and promote the competition in all spheres of the economy.

The freedom of rights *per se* is not sufficient because it is more important how good those rights are enforced and protected, which is possible if sustainable, free of corruption judicial system is on place. The review of transition economies has shown that all suffer dramatically from the high corruption, which can be generally considered as a proxy for ethical standards and ways of doing business. It can be stated that high corruption undermines the trust of both domestic and international stakeholders in the opportunity to do the business with maximal possible outcome. Thus, the elimination or at least reduction of the corruption should stay in the list of most urgent reforms in all three countries.

The first step towards the fight with corrupted system could be the improvement of monitoring mechanisms such as free media which could stipulate some degree of transparency both on political, macroeconomic and firm levels. All three countries score low in the rankings of free media, which signalizes that improvements are required. Free media alone will pay little if no or little professionally educated journalists exist. Therefore, an additional attention should be paid for educational institutions that offer degrees in journalism.

Although it was mentioned that the laws on books are in general of a good quality in three countries, some particular aspects need revision. Uzbek laws represent the most needed case for improvements. It is reported that different laws, presidential and parliamentary decrees often contradict with each other. Additionally, omitted syntaxes such as numbering of provisions in the current law on joint stock companies aggravate its understanding. Both Kazakhstan and Uzbekistan need to strengthen their disclosure regulations and lift up their standards at least to the level of Russia. One of the minor transparency problems in Russia is the absence of the detailed information on the individual remuneration plans of managers. All countries have weak regulation of self-dealing transactions, involving minority shareholders, which is especially important for company groups.

To promote a secure investment environment, the interference of the state into the corporate sector should be diminished. It is meant here all forms of state actions that favour one stakeholder at costs of others. Nevertheless state intervention itself is important for design of corporate governance system, if it promotes the overall interests of the society.

Extremely high shareholding of the state in country's major companies may considerably hamper the development of the financial system. The development of securities markets is dictated by the presence of multiple shareholder groups with diverse interest. However, if the state is the only major shareholder in most corporations, no further prospect to achieve liquid and broad securities market is attainable. Therefore, in Uzbekistan where the state holds the largest stake in corporate sectors, only their full or partial privatization can launch the development of corporate governance. Companies that will remain under the state control are recommended to follow up the corporate governance standards that were specially developed by OECD for state owned firms.

To promote the monitoring of firms the institutions of private monitoring should be created. Although main monitoring entities such as the audit companies, rating agencies and financial analysts already exist in the sample countries their role in the governance models remain weak. Therefore the government should concentrate on creating incentives for further development of those stakeholders and at the same time improve the legal base that regulate their activity.

With different reform paste and success degree Russia, Kazakhstan and Uzbekistan adopt the best practices standards and develop their own. Among three countries Russia can be distinguished as the one with most advanced reforms and outcomes. In contrast, Uzbekistan appeared to have the lowest progress in the improvement of firm level governance. Regarding the chosen development models, it can be noticed that Russia and Uzbekistan took the way towards Western European model of corporate governance, whereas Kazakhstan represents an amalgamation of Anglo-Saxon and Western European models. Nevertheless, the recent system transformations throughout the world predict some degree of convergence between the models, with particular elements remaining unique in each country.

Although in our empirical model we did not find the relation between good governance practices and company valuation we are convinced that the strength of the good corporate governance has the aggregate character. It creates favourable economic environment, promotes the good ways of doing business in a country and ensures the trust of various stakeholders in a market.

Due to its broad character this research omitted some important aspects such as law enforcement, systematic study of the capital markets and opinion research of the corporate sector. Other aspects were studied only superficially limiting the review only to problem statement. Among them are cultural frameworks, political internal and external pressures, the state of technical development, role of different stakeholder and many more. To have the overall and deep picture of the corporate governance development in transition economies it is desirable that these and many other aspects should be considered more detailed in further researches.

Literature

Abramov, A., (2005), ‚Problems of competitiveness of Russian securities market', Economic Issues, Vol 12.; <*Проблемы конкурентоспособности Российского Фондового Рынка*>, Вопросы Экономики 12, 2005.

ADB, (2005), 'Policy and institutional environment for private sector development in Uzbekistan', <http://www.asiandevbank.org/Documents/Reports/PSA/UZB/UZB-PSA.pdf> Assessed April 2006.

ADB, (2006), 'Evaluation Report, Uzbekistan'.

ADB, (2007), 'Uzbekistan: banking sector diagnostic review'.

Adolff, J., Meister, B., Randell, C., Stephan, K.-D., (2002), 'Public company takeovers in Germany', Verlag C.H. Beck München, City & Financial Publishing.

Alam, A., and Banerji, A., (2000), 'Uzbekistan and Kazakhstan, a tale of two transition paths', World Bank Policy Research Working Paper No. 2472, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=632542>, assessed April 2006.

Alchian, A., (1950), 'Uncertainty, evolution, and economic theory', *Journal of Political Economy,* Vol. 58, pp.211-221.

Allen, F., and Gale, D., (1999), 'Corporate governance and competition', Wharton School Working Paper 99-28, <http://fic.wharton.upenn.edu/fic/papers/99/9928.pdf>, Assessed July 2007.

Amihud, Y., Kahan, M., and Sundaram, R., (2004), 'The foundations of freeze out laws in Takeovers', <http://www.bus.wisc.edu/finance/pdfs/Seminar/Spring2004/Feb13.pdf>, Assessed September 2007.

Armour, J., (1999), 'Share capital and creditor protection: efficient rules for a modern company law?', ESRC Centre for Business Research, University of Cambridge, Working Paper No. 148.

Arrow, K., (1974), *The Limits of Organization*, Norton, New York.

Assman, H.-D., Schneider, U.(ed.), (2006), Werpapierhandelsgesetz'. Kommentar, 4th edition.

Aukutsionek, R., and Kapeliushnikov (2001), Ownership Structure of Russian Industrial Enterprises in 2001, *The Russian Economic Barometer*, Vol. 10, No.3, pp.10-17.

Avilov et al (1999), 'General principles of company law for transition economies', *Journal of Corporation Law*, 24, 190-293, <http://papers.ssrn.com/paper.taf?abstract_id=126539> Assessed December 2006.

Bainbridge, S., (2002), 'Corporation Law and Economics', New York Foundation Press.

Barberis, N., Boycko, M., Shleifer, A., Tsukanova, N., (1995) ‘How does privatization work? Evidence from the Russian shops’, NBER Working Paper W5136

Barth, J., Caprio, G., and Levine, R., (2002), ‘Bank regulation and supervision: what works best?’, University of Minnesota, Carlson School of Management, World Bank Policy Research Paper No. 2725, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=269488>, assessed October 2006.

Baums, T. and Schmitz, R., (1999), Shareholder Voting in Germany, Working paper Nr. 76.

Baums, P., (2001), ‚Ausschuss von Minderheitsaktionären’, Peter Lang, Frankfurt am Main, Berlin, Bern, Bruxelles, New York, Oxford, Wien.

Baums, T., (2002), ‘Changing patterns of corporate disclosure in continental Europe: the example of Germany’, Law Working Paper N°. 04/2002.

BDO, (2007), ‘Russian securities market, The results of 2006’, <Рынок российских ценных бумаг. Итоги 2006 года>, <http://www.bdo.ru/media/press/journal/рынок_российских_ценных_бумаг.pdf>, Assessed March 2007.

Bebchuk, L., Cohen., A., and Ferrell, A., (2004), ‘What matters in corporate governance?’, Harvard Law School John M. Olin Center Discussion Paper No. 491, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593423>, Assessed August 2007.

Beinert, D., (2000), ‘Corporate acquisitions and mergers in Germany’, Kluwer Law International, The Hague-London-Boston.

Beiner, S., Drobetz, W., Schmid, M., Zimmerman, H., (2004), ‚Corporate Governance, Unternehmensbewetung und Wettbewerb – eine Untersuchung für die Schweiz’, WWZ/Department of Finance, Working Paper No. 9/04.

Berglöf, E., and Claessence, S., (2004), ‘Corporate governance and enforcement’, World Bank Policy Paper Research Working Paper No.3409; <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625286>, assessed February 2006.

Berglöf, E., and Pajuste, A., (2003), ‘Corporate governance in Central and Eastern Europe’, in Cornelius, P and Kogut, B., (ed.), *Global Competitiveness and Corporate Governance*, Oxford University Press.

Berglöf, E., and Pajuste, A., (2005), ‘What do firms disclose and why? Enforcing corporate governance and transparency in Central and Eastern Europe’, *EFA 2005 Moscow Meetings Paper* , <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=676689>, Assessed January 2007.

Berglöf, E., and von Thadden, E., (1999), ‘The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries’, Conference Paper, Annual World Bank Conference on Development Economics, Washington D.C., <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183708>, Assessed October 2005.

Berle, A., and Means, G. (1932), *The Modern Corporation and Private Property,* New York: Harcourt, Brace & World, 1968.

Bhagat, S., and Black, B., (2000), 'Board independence and long-term firm performance, Stanford Law School, John M. Olin Program in Law and Economics, Law and Economics Working Paper No. 185.

Bhattacharya, U. and Daouk, H., (2002), 'The world price of insider trading', *Journal of finance* 57, 75-108. , <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=200914> Assessed November 2007.

Black, B., and Kraakman, R., (1996), 'A self-enforcing model of corporate Law', *Harvard Law Review, Volume* 109, 1911-1982, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=10037>, Assessed January 2007.

Black, B., Kraakman, R., and Tarassova, A., (1998), 'Guide to the Russian Law on Joint Stock Companies', Kluwer Law International , The Hague 1998.

Black, B., Kraakman, R., and Tarassova, A., (2000), 'Russian privatization and corporate governance: what went wrong?, *Standford Law Review*, Vol. 52, pp.1731-1808.

Black et al., (2006 a), 'Comparative analysis on legal regulation of the liability of members of the management organs of companies', report to Russian Center for Capital Market Development, European Corporate Governance Institute Law, Working Paper No. 103/2008, <http://ssrn.com/abstract=1001990>, Assessed March 2007.

Black, B., and Cheffins, B., (2006 b), 'Outside director liability across countries', ECGI - Law Working Paper No. 71/2006, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=438321>, Assessed October 2007.

Black, B., Jang, H., Kim, W., (2005), 'Does corporate governance predict firm's values? Evidence from Korea', < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311275>, Assessed May 2007.

Black, B., (2001), 'The legal and institutional preconditions for strong securities markets', *UCLA Law Review*, Vol. 48 pp.781-858

Blasi, J., and Shleifer, A., (1996), 'Corporate Governance in Russia – An Initial Look', in R. Frydman, C.W. Gray and A. Rapaczynski (eds.*), Corporate Governance in Central Europe and Russia, Vol. 2: Insiders and the State*, Budapest/London/New York, pp.78-108.

Blommestein, H., (1997), 'The new financial landscape and its impact on corporate governance', in: Balling, Hennessy, E., O'Brien, R., (eds.) *Corporate Governance, Financial Markets and Global Convergenc*e, Kluwer Academic Publishers.

Boeri, T., and Giancarlo, P., (1998). 'Privatization and corporate governance: some lessons from the experience of transitional economies', *in* Balling, M., Hennessy, E., and O'Brien, R., (eds.), *Corporate Governance, Financial Markets and Global Convergence.* Dordrecht: Kluwer Academic Publishers. p.73-86.

Boeri and Giancarlo Perasso, Privatization and Corporate Governance: Some Lessons from the Experience of Transitional Economies. In: Balling, Hennessy and O'Brien, Corporate Governance, Financial Markets and Global Convergence, 1997

Bolton, P., und von Thaden, E., (1998), ‘Blocks, liquidity and corporate control’, *Journal of Finance* Vol.53, pp. 1-25.

Booth, R., (2006), ‚Capital requirements in United States corporation law’, in: Lutter, M., (ed.), Das Kapital der Aktiengesellschaft in Europa, *Zeitschrift für Unternehmens- und Gesellschaftsrecht*, Sonderheft 17.

Bratton, W., and McCahery, J., (1999), ‘Comparative corporate governance and the theory of the firm: the case against global cross reference’, *Columbia Journal of Transnational Law*, Vol. 38, No. 2, 1999 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=205455> Assessed 10 July 2006

Braendle, U., (2006), ‘Shareholder protection in the USA and Germany – on the fallacy of LLSV’, German Working Papers in Law and Economics: Vol. 2006, Article 18.

Broadman, H., (2001), ‘Lessons from the corporatization and corporate governance reforms from Russia and China’, International Conference on “Corporate Governance Development in Vietnam.

Brown, R and Shkurupiy, K., (2000), Corporate Governance in the former Soviet Union: The failure of the self-enforcing model, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963183>, Assessed on June 2006

BTI (Bertelsmann Transformation Index) (2008), Country reports of Russia, Kazakhstan and Uzbekistan.

Buiter, W., (2000), ‘From predation to accumulation?’, The 2nd decade in Russia, SITE Working paper no.156.

Burkart, M., Gromb, D., und Panuzi, F., (1997), ‘Large shareholders, monitoring and the value of the firm’, *Quarterly Journal of Economics*, Vol. 112, pp.693-728.

Butikov, I.,(2006), ‚Verantwortung und die Kontrolle im System der Unternehmensführung’, in Sell und Krylov (eds.), *Corporate Governance. Unternehmensverfassung im Ost-West Dialog*, Peter Lang.

CER (Center for Economic Research, 2002), 'Pension system reforms and opportunity analysis for creating non-state pension funds in Uzbekistan’, Report 2002/05.

CER, (Center for Economic Research, 2006), ‘Problems of corporate governance introduction in Uzbekistan’, Center for Economic Research Working paper 2006/01, Tashkent.

CER, (Center for Economic Research, 2007), Investment potential of securities market of Uzbekistan: obstacles and activisation ways, Working Paper of the Center for Economic Research, 2007/07, Tashkent 2007, <‘Инвестиционный потенциал фондового рынка Узбекистана: сдерживающие проблемы и пути активизации>, Рабочий доклад.

Cigna, G.P., (2006), ‘Corporate governance in Eurasia: where do we stand?’, *Butterworths Journal of International Banking and Financial Law,* December 2006, <http://www.ebrd.net/country/sector/law/articles/eurasia.pdf>, Assessed September 2007.

Clyde, P., (1997), 'Do institutional shareholders police management?', *Managerial and Decision Economics*, Vol. 18, No. 1, pp. 1-10.

Coase, R., (1937), The nature of the firm, *Economica,* New Series, Vol. 4, No. 16, pp. 386-405.

Coffee, J., (1984), 'Regulating the market for corporate control: a critical assessment of the tender offers role in corporate governance', *Columbian Law Review*, Vol. 84, 1145-1221.

Coffee, J., (1999), 'Privatization and corporate governance: the lessons from securities markets failures', *Journal of Corporation Law*, Vol.25, pp. 1-39, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=215608>, Assessed June 2007

Cooter, R., and Ginsburg, T., (2003), 'Leximetrics: why the same laws are longer in some countries than others', Illinois Law and Economics Working Papers, No. LE03-012, June, 2003.

Core, J., Wayne, R., Guay, W., and Larcker, D., (2003), 'Executive equity compensation and incentives: a survey', FRBNY Economic Policy Review.

Crotty, J., and Jabome, G., (2004), 'Corporate governance in transition economies: a synthesis of the evidence', <http://www.abs.aston.ac.uk/newweb/research/publications/docs/RP0402.pdf> Assessed August 2006.

Dailly, C., Dalton, D., and Connel, A., (2003), Corporate governance: Decades of dialogue and data, *Academy of Management Review*, vol.28, no.3, pp.371-382.

Dallago, B., (2002), 'Corporate governance, governance paradigms and economic transformation', manuscript, Department of Economics, University of Trento.

Davis, P., (2002), 'Institutional investors, corporate governance and performance of the corporate sector', *Economic systems*, Vol. 26, pp. 203-229.

Davis, P., and Hopt, K., (2004), 'Control transactions' in : Kraakman, R., Davies, P., Hansmann, H., Hertig, G., Hopt, K., Kanda, H., Rock, E. (*eds*.), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford University Press.

Davis, P., and Steil, B., (2004), *Institutional Investors*, The MIT Press.

De Alessi, L., (1980), 'The economics of property rights: a review of the evidence', Research in Law and Economics 2.

De Alessi, L., (1982), 'On the nature and consequences of private and public enterprise', *Minnesota Law Review* 67 (1).

Demsetz, H., and Lehn, K., (1985), 'The structure of corporate ownership: causes and consequences', *Journal of Political Economy, Vol.* 93, 1155-1177.

Denis, D., (2001), 'Twenty-five years of corporate governance research and counting', *Review of Financial Economics*, vol.10, pp.191-212.

De Soto, H., (2001), 'The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Eeverywhere Eelse', New York: Basic Books.

Dittus, P., and Prowse, S., (1995), 'Corporate control in Central Europe and Russia: should banks own shares?', World Bank Policy Research Working Paper No. 1481, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=569199>, assessed in November 2006.

Djankov, S., (1999), 'Ownership structure and enterprise restructuring in six newly independent states', *Comparative Economic Studies*, pp. 75-95.

Djankov, S., Glaeser, E., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A., (2003), 'The new comparative economics', *Journal of Comparative Economics,* Vol.31, pp. 595–619.

Djankov, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A., (2006), 'The law and economics of self-dealing', NBER Working Paper No. W11883, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875734>, Assessed February 2007.

Dolgopyatova T., and Uvarova O., (2005), 'Evolution of the property realtions in Russian industry: factors, tendencies and the influence on the company activities', <*Эволюция отношений собственности в Российской промышленности: факторы, тенденции и влияние на деятельность предприятий.*>.

Dorsneifer, F., (2006), 'Germany', in: Dornseifer, F., (ed.), in: *Corporate Business Forum in Europe. A Compendium of Public and Private Limited Companies in Europe*, Sellier. European Law Publisher.

Du Plessis, J.-J., McConvil, J., and Bagaric, M., (2005), 'Principles of Contemporary Corporate Governance', Cambridge University Press.

Earle, J., (1998), 'Post-Privatization Ownership Structure, and Productivity in Russian Industrial Enterprises', <http://www.ecgi.org/conferences/economic_performance/documents/pap_tab6.pdf>, Assessed March 2006.

Easterbrook, F., and Fischel, D., (1991), 'The economic structure of corporate law', Harvard University Press, Cambridge, Mass.

EBRD (2004), 'Corporate governance law assessment projects report on the quality of corporate governance legal regimes in early transition countries.', <http://www.ebrd.com/country/sector/law/etc/etccg.pdf> Assessed September 2007.

EBRD (2005, 2006, 2007), Transition Reports.

Edwards, J. and Fischer, K., (1994), *Banks, Finance and Investment in Germany,* Cambridge University Press.

Engert, A., (2006), Capital requirements in United States corporation law, in: Lutter, M.(ed.), Das Kapital der Aktiengesellschaft in Europa, *Zeitschrift für Unternehmens- und Gesellschaftsrecht*, Sonderheft 17.

Enriques, L., (1998), 'The law on corporate directors' self-dealing: a comparative analysis', <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=135674>, Assessed September 2007.

Fama, E., (1980), 'Agency problems and the theory of the firm', *Journal of Political Economy,* Vol. 88, pp.288-307.

Fama, E., and Jensen, M., (1983a), 'Agency problems and residual claims', *Journal of Law and Economics*, Vol. 26 , pp. 327-359

Fama, E., and Jensen, M., (1983b), 'Separation of ownership and control', *Journal of Law and Economics*, 26 June, 301-325.

Farina, V., (2005), 'Corporate disclosure determinants: a cross-country investigation' MPRA Paper 5676, University Library of Munich.

Filatotchev, I., Buck, T. and Zhukov, V., (1998), 'Restructuring strategies of privatised firms in Russia, Ukraine and Belarus: theory and empirical evidence', CREEM Discussion Paper no.7, University of Nottingham Business School.

Fox, M., and Heller, M., (1999), Lessons from fiasco in Russian corporate governance, Working Paper 282.

FSA (2008), 'Report of the financial supervision authority of Kazakhstan on current situation of the financial market', January 2008, <http://www.afn.kz/cont/publish348350_4719.pdf>, Assessed April 2008.

Gevorgyan, R., and Melikyan, N., (2004), 'The effect of ownership type and concentration on performance of joint stock companies in Armenia', 2004, http://www.armpolicyresearch.org/ConferencesSeminars/pdf/Gevorkyan%20and%20Melikyan.pdf.

Goergen, M., Martynova, M, Renneboog, L., (2005), 'Corporate governance convergence: evidence from takeover regulation', Law Working Paper N° 33/2005, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=709023>, Assessed September 2007.

Gompres, P., Ishii, J., Metrick, A., (2003), 'Corporate governance and equity prices', *Quarterly Journal of Economics, Vol. 118, No. 1, pp. 107-155.*

Gray, C., (1996), 'In search of owners. Lessons of experience with privatization and corporate governance in transition economies', World Bank Policy Research Working Paper No. 1595.

Grossman, S., und Hart, O., (1988), 'One share-one vote and the market for corporate control', *Journal of Financial Economics,* Vol. 20, pp.175-202.

Gustafson, T., (1999), '*Capitalism Russian-style*', Cambridge University Press.

Hansmann, H. and Kraakman, R., (2004), ‘The basic governance structure’, in: Kraakman, R., Davies, P., Hansmann, H., Hertig, G., Hopt, K., Kanda, H., Rock, E. (eds.), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford University Press 2004.

Hermalin, B., and Weisbach, M., (2001), ‘Boards of directors as an endogenously determined institution: a survey of the economic literature’, *Economic Policy Review,* <*http://www.business.uiuc.edu/weisbach/finsurvey.pdf*>, Assessed November 2006

Hertig, G., and Kanada, H., ‘Related party transactions’, (2004) in: Kraakman, R., Davies, P., Hansmann, H., Hertig, G., Hopt, K., Kanda, H., Rock, E. (eds.), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford University Press.

Holderness, G., (2003), ‘A survey of blockholders and corporate control’, FRBNY Economic Policy Review.

Hopt, K., (1998), ‘The German two-tier board: experience, theories, reforms’: in Hopt, K., Kanda, H., Roe, M., Wymeersch, E., Prigge, S., (eds.), *Comparative Corporate Governance. The State of the Art and Emerging Research*, Oxford University Press.

Hopt, K., and Leyens, P., (2004), ‘Board Models in Europe, Recent Developments of Internal Corporate Governance Structure in Germany, the United Kingdom, France, and Italy’, European Corporate Governance Institute, Law Working Paper No 18/2004, <http://www.ecgi.org/wp>, accessed on November 15 2007.

IET, (2007), ‘Russian economy: trends and perspectives’, Institute for the Economy in Transition, October 2007, Monthly Bulletin, Moscow, 2007.

IFC, (2005), ‘Uzbekistan, investment climate survey’.

IFC, (2007), ‘Russia banking sector corporate governance survey: A snapshot on improvements made.’, International Finance Corporation, Moscow (mimeo), <www.ifc.org/ifcext/rbcgp.nsf/AttachmentsByTitle/Survey2006Rus.pdf/$FILE/Survey2006Rus.pdf>, Assessed February 2008.

IMF, (2003), ‘Republic of Kazakhstan: selected issues and statistical appendix’, Country Report No. 03/211.

IMF (2004), ‘Republic of Kazakhstan: financial system stability assessment—update including reports on the observance of standards and codes on the following topics: Banking Supervision and Anti-Money Laundering and Combating the Financing of Terrorism’.

IMF (2002), ‘At the outset of the reform: publication of association of pension funds of Kazakhstan’, <http://www.world-pensions.com>, Assessed May 2006.

IMF (2007), ‘Republic of Kazakhstan. Staff report for the 2007 Article IV Consultation’, IMF Country Report No. 07/235, July 2007.

ICG, International Crisis Group, (2004), ‘The failure of reform in Uzbekistan: ways forward for international community’, Asia Report N°76.

Ionzev, M., (2002), ‘Joint Stock Company. Legal Bases. Property Relations. Management and Control. Protection of Shareholder Rights’, <*Ионцев М. Г. Акционерные общества: Правовые основы. Имущественные отношения. Управление и контроль. Защита прав акционеров. - М.: «Ось - 89», 2002.-512 с.*>

Iwasaki, I., (2004), ‘The governance mechanism of Russian firms. Its self-enforcing nature and limitations’, in Shuchi Ikemoto and Ichiro Iwasaki (eds.), *Corporation Governance in Transition Economies, Part 1: The Case of Russia*, IER Discussion Paper Series, The Institute of Economic Research, Hitsubashi University, Tokyo, Japan.

Jensen, M., and Meckling, W., (1976) ‘Theory of the firm: Managerial behaviour, agency costs, and ownership structure’., *Journal of Financial Economics,* Volume 3, 305-360.

Jensen, M. and Ruback, R., (1983), ‘The market for corporate control: the scientific evidence’, *Journal of Financial Economics,* Vol. 11, pp.5-50.

Jensen, M., (1993), ‘The modern industrial revolution, exit, and the failure of internal control systems’, *Journal of Finance* 48, pp. 59-77.

Johnson, S., La Porta, R., Lopez-de-Silanes, F., Shleifer, A., (2000), ‘Tunneling’, Harvard Institute of Economic Research, Discussion Paper N1887, <http://ideas.repec.org/p/nbr/nberwo/7523.html>, Assessed December 2006.

Judge, W. and Naoumova, I., (2004), ‘Corporate governance in Russia: what model will it follow?’, *Corporate Governance: An International Review*, Vol. 12, No. 3, pp. 302-313, < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=557312> Assessed in February 2007.

Kapelushnikov, R., (2001), ‘Largest and predominant owners in Russian industry.’, *Problems of Economic Transformation*, Vol.43, no.12, pp.63-92.

Kapelushnikov, R., (2005), ‘Ownership concentration and corporate governance’, <*Капелюшников Р.И. Концентрация собственности и корпоративное управление, WP1/2005/03. – М.: ГУ ВШЭ, 2005.*>

Klein, A., (1998), ‘Firm performance and board committee structure’, *Journal of Law and Economics, Vol.* 41, pp. 275-299.

Knieper, R., (2003), ‚Sorgfaltspflichten und Haftung in den Aktiengesellschaften der Transformationsstaaten’, *Wirtschaft und Recht in Osteuropa*, 20 September, 257-288.

Kohlbeck, M., and Mayhew, B., (2004), ‘Related party transactions’, University of Wisconsin – Madison, AAA 2005 FARS Meeting Paper, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=591285>, Assessed October 2007.

Komulainen, T., Kprhonen I., Korhonen, V., Rautava, J. And Sutela, P., (2003), ‘Russia: Growth Prospects and Policy Debates’, BOFIT Discussion Paper no.3, Bank of Finland Institute for Economies in Transition

Kordasch, S., (1997), ‚Privatisierung in Russland: eine Gesellschaft auf der Suche nach effizienteren eigentumsrechtlichen Strukturen', Frankfurt am Main, Lang.

Kraakman, R., Davies, P., Hansmann, H., Hertig, G., Hopt, K., Kanda, H., Rock, E., (2004) 'The Anatomy of Corporate Law: A Comparative and Functional Approach', Oxford University Press.

Kropff, B., and Semler, J., ‚Münchener Kommentar zum Aktiengesetz', Verlag C.H. Beck/ Verlag Franz Vahlen, München 2004.

Kuznezov, P., and Muravjev, A., (2001), 'Ownership structure and firm performance in Russia: the case of blue chips of the stock market'.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., (2002, a), 'Investor protection and corporate valuation', *Journal of Finance* 57, pp.1147-1170.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., (2002, b) , 'Government ownership of banks', *Journal of Finance* 57, pp.265-301.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R., (1997), 'Legal determinants of external finance', *Journal of Finance,* 52, 1131-1150.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., (1998), 'Law and Finance', *Journal of political Economy, Volume* 106, 1113-1155.

La Porta, R., Lopez de-Silanes, F., and Shleifer, S., (2003), 'What works in securities laws', NBER Working Paper N 9982.

Lele, P., and Siems, M., 'Shareholder protection: a leximetric approach', Centre for Business Research, University of Cambridge Working Paper No. 324, June 2006. <http://www.cbr.cam.ac.uk/pdf/WP324.pdf>, Assessed January 2008.

Licht, A., Goldschmidt, C., and Schwartz, S., (2005), 'Culture, law, and corporate governance', *International Review of Law and Economics*, Vol. 25, pp.229-255, <http://www.sciencedirect.com/>, Assessed October 2007.

Lieder, J., (2006), ‚Der Aufsichtsrat im Wandel der Zeit', Jenaer Wissenschaftliche Verlagsgesellschaft, 2006.

Lindquist, R., (1956), 'Corporations: director's rights of inspection of books and records', California Law Review, Vol. 44, No.2 May.

Lommer, S., (2005), ‚Das Auskunftsrecht des Aktionärs in Deutschland und die Informationsrechte der Gesellschafter der US-amerikanischen Public Business Corporation', Shaker Verlag, Aachen 2005.

Lutter, M., (ed.), (2006), ‚Das Kapital der Aktiengesellschaft in Europa', *Zeitschrift für Unternehmens- und Gesellschaftsrecht*, Sonderheft 17, De Gruyter Recht, Berlin.

Malherbe, S., (2003), 'Pension funds as institutions of governance: harnessing domestic institutional investors in emerging markets and developing countries to turn corporate governance codes into conduct', OECD Development Center.

Manne, H., (1965), 'Mergers and the market for corporate control', *Journal of Political Economy* Vol. 75, pp. 110-126.

Mayer, C., (1990), 'Financial systems, corporate finance and economic development', in Hubbard, R., (ed.), *Asymmetric Information, Corporate Finance and Investment*, University of Chicago Press, Chicago.

McCarthy, D. and Puffer, S., (2002). 'Corporate Governance in Russia: Towards a European, U.S., or Russian model?', *European Management Journal, 20*(6), pp.630-640

McCarthy, D. and Puffer, S. (2003), 'Corporate governance in Russia: a framework for analysis,' *Journal of World Business, 38*(4), 397-415.

McCahery J. and. Vermeulen, M, (2005), 'Corporate governance crises and related party transactions: a post-Parmalat agenda', <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf>, Assessed November 2007

McConnell, J., and Servaes, H., (1990), 'Additional evidence on equity ownership and corporate value', *Journal of Financial Economics*, Vol. 27, pp. 595-612.

McGee, R., (2004), 'Insider trading regulation in transition economies', <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=538702>, Assessed November 2007.

McGee, R. and Preobragenskaya, G., (2004), 'Problems of implementing International Accounting Standards in a transition economy: a case study of Russia', <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=459363>, Assessed July 2007.

McKinsey & Co. (2000), Investor Opinion Study of June 2000.

Medvedev, R., (1997), ‚Chubays and Vaucher: from the history of Russian provatization', <*Медведев, Р., ‚Чубайс и ваучер: Из истории рос. Приватизации', М. Импэто 1997*>

Mehran, H., (1995), 'Executive compensation structure, ownership, and firm performance.', *Journal of Financial Economics, Vol.* 38, no. 2, pp. 163-84.

Merkt, H., and Göthel, S., (2006), ‚US-amerikanisches Gesellschaftsrecht', Verlag Recht und GmbH Frankfurt am Main.

Modigliani, F., and Miller, M., (1958), 'The cost of capital, corporation finance and the theory of investment', *American Economic Review*, Volume 48, 261-297.

Morck, R., Shleifer, A., and Vishny, R., (1988), 'Management ownership and market valuation', *Journal of financial economics*, 20, pp. 293-315.

Murphy, K., (1998), Executive Compensation, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=163914>, assessed February, 2006

Nellis, J. (2001), 'Privatization and enterprise reform in transition economies: a retrospective analysis', Working Paper Center for Global Development, Washington D.C.

Nenova, T., and Hickey,C., (2006), 'Self-dealing, public policy for private sector', World Bank.

Nörr, R., et al., (2003), 'Takeover law in Germany: a handbook and practitioners' guide', C.H.Beck, Munich.

OECD (2003), 'Transparency and disclosure questionnaire. Uzbekistan', Euroasian corporate governance roundtable.

OECD (2004), Principles of Corporate Governance, http://www.oecd.org/DATAOECD/32/18/31557724.pdf, assessed April 2005

Oesterle, D.,(2002), 'The law of mergers and acquisitions', Second Edition, St.Paul. Minn., West Group.

Oman, C., Fries, S. and Buiter, W., (2003), 'Corporate governance in developing, transition and emerging–market economies', OECD Development Policy Brief No. 23.

Owen Report, (2003), Report of the HIH Royal Commission,

http://www.hihroyalcom.gov.au, Assessed December 2005.

Peltzer, M., (2004), Deutsche Corporate Governance, Ein Leitfaden, 2.Auflage., München.

Pistor, K., Raiser, M. and Gelfer, S., (2000), 'Law and finance in transition economies.' *Economics of Transition*, 2000, 8(2), 325-368.

Pistor, K. and Xu, C. (2002), 'Fiduciary duty in transitional civil law jurisdictions. Lessons from the incomplete law theory', Law Working Paper N°. 01/2002, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343480>, Assessed September 2007.

Pistor, K., and Spicer, A., (1997), 'Investment funds in mass privatization. Lessons from Russia and Czech Republic.' World Bank Group, Note 110.

Pivovarsky, A. (2003), Ownership concentration and performance in Ukraine's privatised enterprises, IMF Staff Papers, vol.50, no. 1, pp. 10-42.

Poluyahtov, I.(2005), ‚Practice of corporate governance: related party transactions' in: *Operative governance and strategic management,* 6/2005 (28). <'Практика корпоративного управления: сделки со связанными сторонами', в *Оперативное Управление и Стратегический Менеджмент,* 6/2005 (28).

Pomfret, R., (2000), The Uzbek model of economic development, 1991-1999., *Economics of Transition*, Vol. 8, No.3.

Posegga, S., (2006), ‚Squeeze-out. Unter besonderer Berücksichtigung möglicher Missbrauchsfälle sowie der Besonderheit der Bemessung der Barabfindung', Peter Lang.

PriceWatrehouseCoopers, (2006), ‘Doing Business in the Russian Federation’, <www.pwc.com>, Assessed November 2007.

Radygina A., and Malginov, G., (2001) ‚State ownership in Russian corporations’, AMP USA, <*Радыгин, А. Д., Мальгинов Г. Н. ‚Государственная собственность в российских корпорациях: Проблемы эффективности управления и задачи государственного регулирования’.*

Ripin, R. and Winker, C., (2006), United States of America, in Loos, A., (ed.) ‘Directors’ Liability: A Worldwide Review’, Kluwer Law International, 2006.

Roe, J., (1994), ‘*Strong managers, weak owners. The political roots of American Corporate finance’*, Princeton University Press, 1996.

Roe, J., (2003), ‘*Political Determinants of Corporate Governance: Political Context, Corporate Impact*’. Oxford: Oxford University Press.

Rock, E., Kanada, H., and Kraakman, R., (2004), ‘Significant corporate actions’, in: Kraakman, R., Davies, P., Hansmann, H., Hertig, G., Hopt, K., Kanda, H., Rock, E. (eds.), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford University Press.

Roth, K. and Kostova, T., (2003), ‘Organizational coping with institutional upheaval in transition economies’. *Journal of World Business*, 2003, 38(4), 314-330.

Sauer, K., (2004), ’Haftung für Falschinformation des Sekundärmarktes’, Peter Lang.

Schmitz, R., (2004), ‚Die Haftung des Vorstands gegenüber den Aktionären. Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht’, Peter Land, Band 62.

Schramm (2003), ‚The hystory and perspectives of Kazakhstan’s joint-stock companies law’, <*Ханс-Иоахим Шрамм, История и перспективы казахстанского права акционерных обществ*>. http://www.cis-legal-reform.org/publication/index.html , assessed October 2007.

Schramm, H.-J., (in publication), ‚Kapitalgesellschaftsrecht in den Transformationsstaaten der GUS. Eine funktionale und vergleichende Analyse des Rechts der Kapitalgesellschaften in Russland, Georgien, Kasachstan, der Ukraine und Usbekistan vor dem Hintergrund westlicher Modelle und den besonderen Umständen der Transformation einer Gesellschaftsordnung’, Habilitation work.

Sell, A, (2004), ’Fortschreibung der Corporate Governance durch die OECD’, in: Sell, A., and Krylov, A., (ed.) Corporate Governance als Erfolgsfaktor im internationalen Wettbewerb, Moskau

Sell, A, (2007), Internationale Corporate Governance-Modelle. Wie weit geht die Konvergenz?, in Heiko Pleines (Ed.): Corporate Governance in post-sozialistischen Volkswirtschaften, Ibidem-Verlag, Stuttgart 2007.

Shapiro, C. and Willig, R., (1990), 'Economic rationales for the scope of privatization', in: Economy of Public Sector Reform and Privatization, London, Westview Press.

Shleifer, A., und Vishny, R., (1986), 'Large shareholders and corporate control', *Journal of Political Economy, Vol.* 94, pp. 461-488.

Shleifer, A., und Vishny, R., (1994), 'Politicians and firms', *Quarterly Journal of Economics* 109 (4).

Shleifer, A., and Vishny, R., (1997), 'A survey of corporate governance', *Journal of Finance*, Vol. 52, No.2, pp.737-783.

Shleifer,A., and Wolfenzon, D., (2002), 'Investor protection and equity markets', *Journal of Financial Economics,* 66, 3-27.

Smith, A., *The Wealth of the Nations*, 1776, Cannan Edition, Modern Library, New York, 1937.

Stelzer-O'Neill, B., (2000), ‚Investmentfonds im Privatisierungsprozess Länderstudien: Polen, Rumänien, Kasachstan und Usbeksitan', GTZ.

Stigler, G., (1958), 'The economies of scale', *Journal of Law and Economics,* Vol. 1, pp. 54-71.

Stiglitz, J., (1985), 'Credit market and the control of capital', *Journal of money, Credit and Banking*, Vol. 17, pp. 133-152.

Stiglitz, J., (1999), 'Quis Custodiet Ipsos Custodies? Corporate Governance Failures in Transition.', World Bank Annual Conference on Development Economics--Europe, June. Paris.

Stulz, R., (1988), 'Managerial control of voting rights. Financial policies and the market for corporate control', *Journal of Financial Economics'*, Volume 20, 25-54.

Szbakin, (1994), Investment funds: view from inside, in: "Economy and Organization of Industrial Production", *<Жабкин, инвестиционные фонды: взгляд изнутри, в: «Экономика и Организация Промышленного Производства», 1994.>*

Teljukina, M.V. (2005), "Commentary to the Federal Law on the Joint Stock Companies", translated from Russian "Kommentariy k Federalnomu sakonu "Ob akzionernih obshestvah", WoltersKluwer,

Thaeter, R., and Brandi, T., (2003), ‚Öffentliche Übernahmen. Recht und Praxis der Übernahme börsennotierter Unternehmen', C.H. Beck, München.

Tirole, J., (2006), *The Theory of Corporate Finance*, Princeton University Press.

Tricker, R., (1994), International Corporate Governance, London, Prentice-Hall, 98-100.

UN Report (2005), United Nations Economic and Social Commission for Asia and the Pacific. International Conference on Strengthening Regional Cooperation for Managing

Globalization, Moscow, Russian Federation 28-30 September, 2005. Recent Developments in Improving the Investment/Business Climate in Selected Countries of Central Asia.

Vickers, J., and Yarrow, G., (1988), 'Privatization: an economic analysis', MIT Press Series on Regulation of Economic Activity, No 18 (Cambridge, MA: MIT Press)

Vernikov, A. (2007) Evolution of corporate governance in Russian banks: Conference paper, 8th International Scientific Conference "Economic Modernization and Social Development", Moscow: State University – Higher School of Economics, April 4, 2007. <http://new.hse.ru/sites/mbd/programs_doc/J1/Верников.pdf>, Assessed October 2007.

Wahal, S., (1996), 'Public pension fund activism and firm performance', *Journal of Financial and Quantitative Analysis, Vol.* 31, pp. 1-23

Weisbach, M., (1988), 'Outside directors and CEO turnover", *Journal of Financial Economics,* Vol. 20, pp. 431-460.

Welp, O., (1999), *Problemkreise der Privatisierung im Rahmen einer Systemtransformation', Lang*, Peter Frankfurt.

Wirth, G., Arnold, M., and Greene, M., (2004), 'Corporate Law in Germany', Verlag C.H. Beck, Munich.

Wohlwend, C., (2001), ‚Die Hauptversammlung im Wandel der Kommunikationsformen. Eine Vergleichende Untersuchung des US-amerikanischen und deutschen Rechtes', Peter Lang, Europäische Verlag der Wissenschaften.

World Bank Group, (2006), 'Doing Business 2007: How to Reform.' Washington, D.C., World Bank Pubn.

World Bank, (2007), Report on the observance of standards and codes, Republic of Kazakhstan, accounting and auditing, <http://www.worldbank.org/ifa/rosc_aa_kaz_eng.pdf>, Assessed July 2007.

The World Factbook, Statistical date extracted from the CIA portal https://www.cia.gov/library/publications/the-world-factbook.

Xu, X., and Wang, Y., (1997), 'Ownership structure, corporate governance, and corporate performance: the case of Chinese stock companies', World Bank Policy Research Working Paper No. 1794.

Yakovelev, A., (2004), 'Evolution of corporate governance in Russia: governmental policy vs. real incentives of economic agents, *Post-Communist Economies* 16(4), pp. 387-403.

Yermack, D., (1996), 'Higher market valuation of companies with a small board of directors.', *Journal of Financial Economics*, 40, pp.185-211.

Zetzsche, D. (2005), 'Shareholder interaction preceding shareholder meetings of public corporations – A six country comparison', *European Corporate and Finance Law Review*, Volume 2:1, 105. < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=624241> Assessed 19 October, 2007.

Zheka, V., (2006), 'Corporate governance and firm performance in Ukraine', Centre for Economic Reform and Transformation, Discussion Paper 2006/05.

Laws and Regulation Literature

Russia

Russian Corporate Governance Code (RCGC), dated 05.04.2002

RTS Listing Rules, RTS Stock Exchange, available on http://www.rts.ru/.

The Law of Russian Federation on "Competition and Limitation of Monopolistic Activity in Commodity Markets", N 948-1, dated 22.03.1991.

Bank of Russia, Instruction No. 1 of January 30, 1996, "On the Procedure for Regulating the Activities of Credit Organisations

The Law of Russian Federation on "Investment of Resources to Finance the Capitalized Part of the Work Pension of the Russian Federation", N 111, dated 24.07.2002

The Law of Russian Federation on "The list of companies producing strategic products", N 787, dated 17.07.1998.

The Law of Russian Federation on "Investment Funds", N 156, dated 29.11.2001.

The Law of Russian Federation on "State and Municipal Unitary Enterprises", No.161, dated 14.11.2002.

Civil Code of Russian Federation, N 51, 30.11.1994

The Law of Russian Federation on "Audit Activity", N-119, dated 07.08.2001

Decree of the Financial Supervisory Authority on "Information Disclosure by the Issuers of Securities", N 6560, dated 26.04.2005.

Kazakhstan

The law of the Republic Kazakhstan on "The Securities Market", N 461-II, dated 02.07.2003

The law of the Republic Kazakhstan on "The Joint Stock Companies", N 415-II, dated 13.05.2003

The law of the Republic Kazakhstan on "The Investment Funds", N 576-II, dated 07.07.2004

Listing requirements of the Kazakh Stock Exchange

Kazakh Corporate Governance Code, dated 31.05.2005.

The decree of the Government of Kazakhstan N 620 „On the approval of program on management of state assets for 2006-2008“, dated 30.06.2006.

The law of the Republic Kazakhstan on “Accounting and Financial Reporting”, N 234-III, dated 28.02.2007.

The law of the Republic Kazakhstan on “Banks and Banking Activity”, N 2444, dated 31.08.1995.

The Law of the Republic of Kazakhstan on “Pension Provision in the Republic of Kazakhstan”, N 136-1, dated 20.06.1997.

The Law of the Republic Kazakhstan on “Audit Acitvity”, N 304-1, dated 20.11.1998

Civil Code of the Republic Kazakhstan, N 409-1, dated 01.07.1999

Decree of the Government of Kazakhstan on “The Approval of the Programm on Management of State Assets for 2006-2008”, N 620, dated 30.07.2006.

National Accounting Standards of the Republic Kazakhstan

Uzbekistan

The Law of the Republic Uzbekistan on “Securities and Stock Exchange”, N 918-XII, dated 02.09.1993.

The Law of the Republic Uzbekistan on “Mechanism of Functioning of Securities Market”, N 218-I, dated 25.04.1996

The Law of the Republic Uzbekistan on “Stock Exchange and Stock Exchange Activity”, N260-II, 29.08.2001.

The Law of the Republic Uzbekistan on “Joint Stock Companies and Protection of Shareholders Rights”, N 223-I, dated 26.04.1996.

The Law of the Republic Uzbekistan on “Securities Market”, N 163, dated 22.07.2008.

The Law of the Republic of Uzbekistan on “Accounting”, N 279-I, dated 30.08.1996.

Decree of the Central Bank of Uzbekistan “On preparing consolidated financial reports by commercial banks”, N 595, dated December 2004.

Decree of the Central Bank of Uzbekistan “On Corporate Governance in Banks”, N 472, dated 24.06.2000

The Law of the Republic Uzbekistan “On Audit Acivity”, N 734-XII, dated 09.12.1992

The Law of the Republic Uzbekistan “On Banks and Banking Acitivity”, dated 25.04.1996.

Decree of the President of the Republic Uzbekistan “On Further Modernization of Audit Organizations and Increase of Their Reposnibility of the Service Quality”, N 615, dated 04.04.2007.

Decree of the Presidnet of Republic Uzbeksitan “On On some measures for ensuring the state management of the economy”, dated 10.06.1994.

Decree “On Information Disclosure by Issuers” N 1127, dated 18.04.2002.

Germany

Das Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), dated 22.09.2005.

German Corporate Governance Code, dated 06.06.2000

Gesetz über den Wertpapierhandel (WpHG), dated 26.07.2004.

Umwandlungsgesetz, dated 28.10.1994

Aktiengesetz, dated 06.09.1965

Börsengesetz, dated 16.07.2007

Vorstandsvergütungs-Offenlegungsgesetz – VorstOG (VorstOG), dated 03.08.2005

Wertpapiererwerbs- und Übernahmegesetz (Takeover Act), dated 20.12.2001

Handelsgesetzbuch (HGB), dated 01.10.1900

USA

Delaware General Corporation Law (DGCL)

The Securities Act 1933

Securities and Exchange Act 1934

SEC Rules

SEC Concept Release: International Accounting Standards, Securities and Exchange Commission, Release NOS. 33-7801, 34-42430, International Series No.125

Sarbanes-Oxley Act, dated 20.07.2002

Appendix I. Country Information (2005)

	Russia	Kazakhstan	Uzbekistan
Total Area (sq km)	17,075,200	2,717,300	447,400
Total Population (millions)	144.0	15.2	26.6
Ethnic Groups	Russian 79.8%, Tatar 3.8%, Ukrainian 2% etc.	Kazakh 53.4%, Russian 30%, Ukrainian 3.7%, Uzbek 2.5%, German 2.4%	Uzbek 80%, Russian 5.5%, Tajik 5%, Kazakh 3%
Religion	No country-wide census or statistics available	Muslim 47%, Russian Orthodox 44 %, Protestant 2%, other 7%	Muslims 88%, Eastern Orthodox 9%, others 3%
GDP per capita (PPP US$)	10,845	7,857	2,063
Life expectancy at birth	65.0	65.9	66.8
Adult literacy rate (%aged 15 and above) 1995-2005	99.4	99.5	99.4

Source: Human Development Report 2007/2008; The World Factbook, data extracted from the CIA portal https://www.cia.gov/library/publications/the-world-factbook.

Appendix II. Comparison of Regulation

A. BASIC GOVERNANCE STRUCTURE

The sign '*' shows the tendency of the provision. For example, 'Germany*' means that particular provisions in transition economy is close to the German regulation.

Table 1: Managers vs. Shareholders

	Gross Structure and Composition of the Board	**RUSSIA**	**KAZAKHSTAN**	**UZBEKISTAN**
1	1. One or Two-tier Board structure	Germany	Germany	Germany
2	2. Board of directors (supervisory board) is mandatory in all cases	Own approach	USA/Germany	Own Approach
3	3. CEO membership on the board of directors (the supervisory board)	USA	USA	Germany
4	4. CEO chairmanship on the supervisory board	Germany	Germany	Germany
5	5. Membership of other executive managers (except for CEO) on the board	USA	Germany	Germany
6	6. Default term of directors (supervisory board) in the office	USA	Own approach	USA
7	7. Removal of the board of directors (supervisory board) members in the mid-term without cause is allowed	USA/Germany	USA/Germany	USA/Germany
8	8. Staggered board can be created	Own Approach	Own Approach	Own Approach
9	9. Number of votes required to remove directors in the mid-term	Own approach	Own approach	Germany
10	10. Removal rights of the management board (Who can remove?)	Own approach	USA	Own approach
11	11. Removal of executive directors (management board) without a cause	USA	USA	USA
12	12. Election rights of the executive directors (CEO, members of management board)	Own approach	USA/Germany	Own approach
13	13. Minimal term of the officers is fixed by the law (management board)	USA	USA	Germany
14	14. Quorum for the meeting of the board (the supervisory board)	USA/Germany	USA/Germany	Own approach
15	15. Default minimal number of board seats for all companies	Germany	Germany	USA
16	16. Apart from default minimal number of seats for all companies the laws estimates minimal number of board seats for larger companies (*larger number of shareholders, larger number of employees*)	Germany	USA	Germany

17	17. Maximal board size is defined by the law	USA	USA	USA
18	18. Law mandates minimal number of independent directors on the supervisory board	USA/Germany	Own Approach	USA/Germany
19	19. Listing Requirements mandate the minimal number of independent directors on the supervisory board	Own approach	Not regulated	Not regulated
20	20. Corporate Governance Code prescribes independent directors	USA/Germany	USA/Germany	Not regulated
21	21. Committees are required by listing requirements	Own approach	Not regulated	Not regulated
22	22. Committees are recommended by the Code	USA/Germany	USA/Germany	Not regulated
23	23. Internal audit organ is mandated by the law	Own approach	USA/Germany	Own approach
24	24. The minimal number of board meetings is estimated by the law	USA	USA	USA
25	25. Corporate employees are prohibited from sitting on the board (supervisory board)	USA	USA	Germany
26	26. Representation of corporate employees on the board (mandatory Co-determination principles)	USA	USA	USA
27	27. Decision rights on remuneration of board members (the supervisory board)	Germany	Germany	Germany
28	28. Decision rights on remuneration of executive officers	Own approach	Own approach	Own approach
29	29. Law mandates that the payment to board members (supervisory board) and executive officers should be reasonable in relation to duties	USA	USA	Germany
30	30. Mandatory ownership of shares by directors	USA/Germany	Own Approach	USA/Germany
31	31. Performance based remuneration (e.g. stock option plans, incentive schemes, etc.)	Own approach	Own Approach	Own approach
32	32. Corporate Governance Code: Disclose and Explain Rule	USA/Germany	Own approach	Not regulated
33	33. Blocking shares before shareholder meeting	USA	USA	USA

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II and national regulations of each country, Section A,Chapter 1.

Table 2: Protecting Minority Shareholders

		RUSSIA	**KAZAKHSTAN**	**UZBEKISTAN**
34	1. Cumulative (proportional) voting rights	Own approach	Own approach	Own approach
35	2. There are mechanisms that protect the removal of representative of minorities	USA	Not regulated	Not regulated

	who were elected by cumulative voting			
36	3. The articles may allow minority shareholder to appoint his representative to the board (supervisory board)	USA	USA	USA
37	4. Limitation of voting rights	Own approach	Own approach	Own approach
38	5. One share – one vote	Germany	Germany	Germany
39	6. Golden shares (veto power)	Own approach	Own approach	Own approach
40	7. Right to call special shareholders meeting (*overall right, ownership threshold*)	Germany*	Germany*	Germany*
41	8. Enforcement: shareholders can call the meeting themselves or have a right that the court will enforce it; or court has discretion to call the meeting	Germany	Germany	Germany
42	9. Costs of calling the special meeting	USA	Germany	USA
43	10. Agenda setting power of shareholder on the annual meeting (threshold)	Germany	Germany	USA
44	11. Power to propose director candidate (threshold)	Own approach	USA/Germany	Own approach
45	12. Holding requirement for the eligibility to make proposal	Germany	Germany	Germany
46	13. Timeliness of shareholder proposal (minimal period before the meeting prior to which proposal can be submitted)	USA*	Germany	USA*
47	14. Initiative or responsive proposal (Proposal can be made before or after the note about shareholder meeting was sent by management)	Own Approach	Germany	Own approach
48	15. Length of shareholder proposal (availability of restriction)	Germany	Germany	Germany
49	16. Costs of proposal on the general issue made by shareholders if directors or other authorised person call the meeting	Not Regulated	USA/Germany	Not regulated
50	17. Costs of proposing director candidate	Not Regulated	Germany	Not Regulated
51	18. Right to access the register of shareholders	USA*	USA	USA*
52	19. Information rights: right to access other corporate documents: (1) protocol of supervisory and management boards' meeting, (2) protocol of general meting, (3)	USA*	USA*	USA*

	accounting and financial data, (4) ownership documents (licenses)			
53	20. Information and inspection rights of a single director	Not regulated	Not regulated	Not Regulated
54	21 Regularity of reporting (quarterly, semi-annually, annually)	USA/Germany	USA/Germany	Own Approach
55	22. Listed companies must provide reporting according to the internationally recognized accounting standards (IFRS or US GAAP)	USA/Germany	USA/Germany	Own approach
56	23. Managerial personal liability for failures in the disclosed information	Germany	Germany	Germany
57	24. Communication and coordination among shareholders	Germany*	Germany*	Germany*
58	25. Default rule for quorum on shareholders meeting	USA	USA	USA*
59	26. Quorum for special shareholders meeting	USA	USA	USA
60	27 Proxy Voting (voting though representation)	USA/Germany	USA/Germany	USA/Germany
61	28. Proxy Voting through executive officers	USA/Germany	Own Approach	USA/Germany
62	29. Facilitation of the voting rights	Own approach	Own Approach	Own Approach
63	30. Claims against resolution	Germany	Germany	Germany
	NUMBER OF COMPERATIVE CRITERIA **(Basic Governance Structure) = 63**	**Germany – 14** (22.2%) **USA – 19** (30.1 %) **Germany/USA – 11** (17.5%) **Own approach – 16** (25.4%) **Not regulated – 3** (4.8 %)	**Germany – 18** (28.6 %) **USA – 16** (25.4 %) **Germany/USA –12** (19.1%) **Own approach- 13** (20.6%) **Not regulated – 4** (6.3%)	**Germany - 18** (28.6%) **USA – 15** (23.8 %) **Germany/USA – 5** (7.9 %) **Own approach-16** (25.4 %) **Not regulated – 9** (14.3 %)

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II, Section A,Chapter 2, Percentage is calculated based on the maximal number of criteria 63

B. SIGNIFICANT CORPORATE ACTIONS

Table 3: Manager vs. Shareholder

		RUS	KAZ	UZB
64	1. Power to propose merger	Germany	USA	Germany
65	2. Approval of a big merger	USA/Germany	USA/Germany	USA/Germany
66	3. Approval of a small merger	Own approach	Own approach	Own approach
67	4. Right of creditor to require pre-emptive credit reimbursement when corporation starts reorganization process	Own approach	Own approach	Own approach
68	5. Mandatory independent expertise in course of merger transaction	Not regulated	Not regulated	Not regulated
69	6. Extent to which law provide provisions in respect to merger and consolidation	USA	USA	USA
70	7. The main source of regulation of corporate divisions	Germany	Germany	Germany
71	8. Approval rights to corporate division	Germany*	Germany*	Germany*
72	9. Approval rights to amendments in the articles of association	Germany	Germany	Germany
73	10. Information about subscribed capital must be included in the articles of association	USA	USA	USA
74	11. Information about board structure is included in the articles of association	Germany	USA	Germany
75	12. Sales approval of all or substantially all assets (75 % of all assets)	USA/Germany	Own approach	USA/Germany
76	13. Sales approval of smaller assets (25-50 %)	Germany	Own approach	Germany
77	14. Decision making rights to increase of authorised capital	Own approach	USA	Own approach
78	15. Possibility of capital increase by means of reserves	Germany	USA	USA
79	16. Available forms of capital reduction	Germany	USA	Germany

80	17. Decision making rights to capital reduction	Germany	USA	Germany
81	18. Decision making rights to share repurchase (for purpose of capital reduction)	Own approach	USA	Own approach
82	19. Decision making rights to share repurchase (not for the purpose of capital reduction)	Germany	USA	Own approach
83	20. Quantitative restriction on share repurchase	Germany	Germany	USA
84	21. Law mandates that repurchased shares must be cancelled	Own Approach	USA/Germany	Own Approach
85	22. Decision making power on dividend payment	Germany*	Germany*	Germany*
86	23. Interests of employees must be considered in course of merger	USA	USA	USA
87	24. Types of shares: bearer and registered	USA	USA	Germany
88	25. Types of shares: with par value or without par-value	USA	USA/Germany	USA
89	26. Minimal par value of share is fixed	USA	USA	Germany
90	27. Only balance sheet profit may be distributed in form of dividends	Germany	USA	Germany

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II, Section B,Chapter1.

Table 4: Protecting Minority Shareholders

	Majority vs. Minority	**RUSSIA**	**KAZAKHSTAN**	**UZBEKISTAN**
91	1.Supermajority requirements for merger	Germany	Germany*	Germany
92	2. Supermajority requirements for corporate division	Germany	Germany*	Germany
93	3. Supermajority requirements for sale of all or substantially all assets	Germany	USA	Germany
94	4. Supermajority requirements for charter amendment	Germany	Germany*	Germany
95	5. Appraisal rights in course of merger	USA/Germany	USA/Germany	USA/Germany
96	6. Appraisal rights in course of corporate division	Germany	Germany	Germany
97	7. Appraisal rights in course of charter amendment	Own approach	Own Approach	Own approach

98	8. Subscription (Pre-emptive) rights	Own approach	Own Approach	Own Approach
99	9. The informative rights of shareholders about share repurchase	USA/Germany	USA/Germany	USA/Germany

		NUMBER OF COMPARATIVE CRITERIA **(Significant Corporate Actions) = 36**	**Germany – 18** (50 %) **USA – 6** (16.7 %) **Germany/USA – 4** (11.1 %) **Own Approach – 7** (19.4 %) **Not Regulated – 1** (2.8 %)	**Germany – 9** (25 %) **USA – 16** (44.4 %) **Germany/USA – 4** (11.1 %) **Own Approach – 6** (16.7 %) **Not Regulated – 1** (2.8%)	**Germany - 17** (47.2 %) **USA – 6** (16.7 %) **Germany/USA– 4** (11.1 %) **Own Approach–8** (22.2 %) **Not Regulated –1** (2.8 %)

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II, Section B,Chapter 2, Percentage is calculated based on the maximal number of criteria 36

C. TAKEOVER

Table 5: Managers vs. Shareholders

	PROTECTION OF SHAREHOLDERS (BIDER vs. SHAREHOLDERS)			
100	1. Regulation of the Takeover: by Special Takeover Law, by JSC Law or by Securities Law	USA	USA	USA
101	2. Partial offer is prohibited	USA/Germany	USA/Germany	Not regulated
102	3. Minimal acceptance period that bidder must provide to target shareholders is fixed by the law	USA/Germany	Not regulated	Not regulated
103	4. Two-tier offer is explicitly prohibited by the law	Germany	USA	USA
104	5. Greenmail is available	USA/Germany	USA/Germany	USA/Germany
105	6. The bidder must publish the decision about planed purchase of controlling stake	Own approach	USA/Germany	USA/Germany
106	7. The publication threshold of tender offer is as low as in the USA (5%) or as high as in Germany (30 %)	Germany	Germany	Own approach
107	8. Must the acquisition of smaller stakes (not through tender offer) be disclosed by shareholder	Germany/USA	Germany/USA	Germany/USA
108	9. The threshold for disclosure of acquired small stakes is as low as in the USA and Germany (5%)	USA/Germany	Own approach	Own approach
109	10. Liability of the bidder for publication of wrong information	USA/Germany	Not regulated	Not regulated
110	11.Must bidder in offer disclose information about her future plans regarding employees	USA	USA	USA
111	12. The managers must give recommendations about the takeover,	Germany	Not regulated	Not regulated

	considering the interests of employees			
112	13. Decision rights power on takeover offer	Own approach	Own approach	Not regulated
113	14. Restricted transferability of shares is allowed by the law	Own Approach	Own Approach	Own Approach
114	15. Decision rights on managerial compensation after takeover bit was submitted (post-bid protections strategy)	Germany	USA	USA
115	16. Decision rights on share repurchase after takeover bid	Own approach	USA	Germany*
116	17. Decision rights on the increase of share capital after bid was submitted	Own approach	USA	Germany
117	18. 'Poison Pills' in classical western meaning, as defence mechanism is represented in legal system	Germany	Germany	Germany
118	19. Employee Stock Option Plans (ESOP) is explicitly regulated by JSC Law	USA/Germany	Not regulated	Not regulated
119	20. Cross-shareholding of affiliated companies allowed	USA/Germany	USA/Germany	USA/Germany
120	21. Some restrictions in respect to cross-shareholding (e.g. voting rights) are available	USA	USA	USA

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II and national regulations of each country, Section C,Chapter1.

Table 6: Protecting Minority Shareholders

121		1.Mandatory Bid rule (*if some controlling stake was acquired, the mandatory offer to all shareholders must be made*); for example 30 %	Germany	Germany	Not regulated
122		2. Squeeze-out is regulated by corporate law	USA/Germany	Not regulated	Not regulated

		NUMBER OF COMPARATIVE CRITERIA (Takeover) = 23	**Germany – 6** (26.1 %) **USA – 3** (13.1 %) **Germany/USA – 9** (39.1 %) **Own Approach – 5** (21.7 %) **Not Regulated – 0** (0 %)	**Germany – 3** (13.1%) **USA – 7** (30.4 %) **Germany/USA – 5** (21.7 %) **Own Approach – 3** (13.1 %) **Not Regulated – 5** (21.7 %)	**Germany - 3** (13.1 %) **USA – 5** (21.7 %) **Germany/USA – 4** (17.4 %) **Own Approach– 3** (13.1 %) **Not Regulated – 8** (34.7 %)

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II and national regulations of each country, Section C,Chapter 2, Percentage is calculated based on the maximal number of criteria 23

D. RELATED PARTY TRANSACTIONS

Table 7: Managers vs. Shareholders

			RUSSIA	KAZAKHSTAN	UZBEKISTAN
123		1. Disclosure of transactions between managers and company	USA*	USA*	USA*
124		2. Disclosure of managerial transactions with corporate shares	USA/Germany	Not regulated	Not regulated
125		3. Disclosure of manager's compensation	Not regulated	Not regulated	Not regulated
126		4. Disclosure of insider information (ad-hoc publication). Any information that is not known to public and may have an effect on shares price must be disclosed	USA	Germany	Not regulated
127		5. Approval of the related party transaction between manager and corporation	Own approach	Own approach	Own Approach
128		6. Regulation of insider trading	Poorly regulated	USA/Germany	Poorly regulated
129		7. The short-term trade with corporate stock by insider prohibited	Germany	Germany	Germany
130		8. Directors' Duty of Care	USA/Germany	Not regulated	Not regulated
131		9. Directors' Duty of Loyalty	USA/Germany	USA/Germany	Not regulated
132		10. Credits to managing personal (Directors and Executives)	Germany*	Germany*	Germany*
133		11. Violation of approval rules of self-dealing transaction leads to nullification of transaction	Own approach	Own approach	Own Approach
134		12. The conflicting party must be compensated for the losses	USA/Germany	USA/Germany	USA/Germany

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part I and national regulations of each country I, Section D, Chapter 1.

Table 8: Protecting Minority Shareholders

			RUSSIA	KAZAKHSTAN	UZBEKISTAN
135		1. Disclosure of transactions in which large shareholder has material interest	USA*	USA*	USA*
136		2. The large (controlling) shareholder must disclose the trade with company's shares	USA/Germany*	Not regulated	Not regulated
137		3. Approval of transaction between large shareholder and corporation	Own approach	Own approach	Own approach
138		4. Insider trading by controlling shareholders	Not regulated	USA/Germany	Not regulated
139		5. Appointment of independent auditor to inspect	Not regulated	Germany*	Not regulated
140		6. Compensation by parent company for the losses of affiliated company	Germany	Germany	Germany
141		7. Liability of controlling shareholder for self-dealing transactions	Not regulated	Not regulated	Not regulated
142		8. Fiduciary duties of controlling shareholder	Not regulated	Not regulated	Not regulated
143		9. Liability of directors for approving self-dealing transaction of controlling shareholder	Not Regulated	Not Regulated	Not Regulated
144		10. Class action suits	Germany	Germany	Germany
145		11. Procedural rights of minority shareholder to file the suit against director (executive officer) for the personal damages	Germany	USA	Germany
146		12. Disinterested directors approve transaction with controlling shareholder (physical person)	USA	USA	USA

		NUMBER OF COMPARATIVE CRITERIA (Related Party Transactions)= **24**	**Germany – 5** (20.8 %) **USA – 4** (16.7%) **Germany/USA – 5** (20.8%) **Own Approach – 3** (12.5%) **Not Regulated – 7** (29.2%)	**Germany – 6** (24.9 %) **USA – 4** (16.7%) **Germany/USA – 4** (16.7%) **Own Approach – 3** (12.5%) **Not Regulated – 7** (29.1%)	**Germany - 5** (20.8%) **USA – 3** (12.5) **Germany/USA – 1** (4.2%) **Own Approach – 3** (12.5 %) **Not Regulated– 12** (50%)

Source: Own Calculations.
Note: Data is calculated based on the analysis of Part II and national regulations of each country, Section D,Chapter 2, Percentage is calculated based on the maximal number of criteria 24

		TOTAL NUMBER OF COMPARATIVE CRITERIA = 146	**Germany – 43** (29.5%) **USA – 32** (21.9%) **Germany/USA– 29** (19.9%) **Own Approach– 31** (21.2%) **Not Regulated–11** (7.5%)	**Germany – 36** (24.7%) **USA – 43** (29.5 %) **Germany/USA–25** (17.1%) **Own Approach–25** (17.1%) **Not Regulated–17** (11.6%)	**Germany - 43** (29.5 %) **USA – 29** (19.9 %) **Germany/USA–14** (9.6 %) **Own Approach–30** (20.5 %) **Not Regulated– 30** (20.5%)

Note: Data is calculated based on the analysis of Part II and national regulations of each country, Percentage is calculated based on the total number of criteria 146

Appendix III. Index of (Minority) Shareholder Rights

A. BASIC GOVERNANCE STRUCTURE

Table 1: Managers vs. Shareholders

		RUS	KAZ	UZB	USA	GER
1.	**1.CEO membership on the board of directors (the supervisory board)** *Equals **1** if acting CEO cannot be member of the supervisory board; Equals **0** if it is possible*	**0**	**0**	**1**	**0**	**1**
2	**2.CEO chairmanship on the board** *Equals **1** if CEO cannot be chairman of the board; Equals **0** otherwise*	**1**	**1**	**1**	**0**	**1**
3	**3.Membership of other executive managers (except for CEO) on the board** *Equals **1** if other executive directors except for CEO cannot be members of the board or they maximal number is restricted to 50 % of the board, Equals **½** if the listing requirements restrict the number of executive directors on the board; Equal **0** if most of the board can be compiled by executive directors*	**1**	**1**	**1**	**0,5**	**1**
4	**4.Co-determination Rule (Representation of Employees)** *Equals **0** if co-determination rule is mandated by the law, equals **1** otherwise*	**1**	**1**	**1**	**1**	**0**
5	**5.Removal of the supervisory board in mid-term** *Equals **1** if removal of supervisory board members in mid-term without a cause is possible,* *Equals **0** otherwise*	**1**	**1**	**1**	**1**	**1**
6	**6.Staggered (classified) Board** *Equals **1** if staggered boards are not allowed; Equals **0** otherwise*	**1**	**1**	**1**	**0**	**0**

7	**7.Default number of votes required to remove directors (supervisory board) in mid-term** *Equals **1** if simple majority of vote casts required, Equals **0** otherwise*	1	1	0	0	0
8	**8.Removal rights of the management board** *Equals **1** if shareholders have default right to remove executive officers, Equals **0** if board have such right*	1	0	1	0	0
9	**9.Removal of management board without a cause** *Equals **1** if removal without cause is possible, Equals **0** if an important reason is required*	1	1	1	1	0
10	**10.Default term of directors (Supervisory Board) in office** *Equals **1** if the default term is one year or shareholders can define it; Equals **0,5** if there is more than 1 year and less or equal to 5 years; Equals **0** if there is more than 5 years*	1	1	1	1	0,5
11	**11.Quorum for the meeting of the board of directors (supervisory board)** *Equals **1** if supermajority requirement; Equals **0,5** if simple majority is required; Equals **0** if otherwise*	0,5	0,5	1	0,5	0,5
12	**12. Default minimal number of board seats** *Equal **1** if law estimates default minimal number of board seats for all companies; Equals **0,5** if default minimal number is estimated for large companies only; Equals **0** if no default minimal number of seats exists*	1	1	0,5	0	1
13	**13. The maximal board size** *Equals **1** if law defines maximal possible board size; Equals **0** otherwise*	0	0	0	0	1
14	**14. Independent directors** *Equals **1** if according to law at least 1/3 of the board must be independent; Equals **0,67** if listing requirements mandate independent directors; Equals **0,33** if only corporate*	0,33	1	0	0,67	0,33

	*governance code prescribes independent directors; Equals **0** otherwise*					
15	**15. Board Committees (audit, remuneration, etc.)** *Equals **1** if listing requirements of stock exchange mandate creation of the board committees; Equals **1/2** if only Corporate Governance Code prescribes board committees; Equals **0** otherwise*	**0,5**	**0,5**	**0**	**1**	**0,5**
16	**16. Internal audit organ (not a board committee)** *Equals **1** if law mandates creation of internal audit organ; Equals **0,5** if company is free to decide on creation an internal audit organ; Equals **0** otherwise*	**1**	**0,5**	**1**	**0**	**0**
17	**17. Minimal number of board meetings** *Equals **1** if law estimate minimal number of board meetings; Equals **2/3** if only listing requirements estimate minimal number of board meetings; Equals **1/3** if minimal number of board meetings are estimated by Code*	**0**	**0**	**0**	**0**	**1**
18	**18.Decision rights on remuneration of board members (the supervisory board)** *Equals **1** if according the law shareholders estimate remuneration; Equals **0** if board estimates*	**1**	**1**	**1**	**0**	**1**
19	**19.Decision rights on remuneration of executive officers** *Equals **1** if according the law shareholders approve remuneration; Equals **0,5** if this is limited (only for stock option plans); Equals **0** if board estimates*	**0,5**	**0**	**0**	**0,5**[536]	**0,5**
20	**20.Law mandates that the payment to board members (supervisory board) and executive directors should be reasonable in relation to duties** *Equals **1** if law states that payment to directors and executives should be reasonable; Equals 0 otherwise*	**0**	**0**	**1**	**0**	**1**

536 According to Listing Rules of NYSE and NASDAQ

21	**21.Performance based remuneration:** *Equals **1** if performance based remuneration of directors and managers (e.g. stock options, shareholding of directors other incentive schemes) is fostered by the law; Equals 0 otherwise*	**0**	**1**	**0**	**1**	**1**
22	**22.Corporate Governance Code**: *Equals **1** if companies must disclose and explain whether they comply with a corporate governance code; Equals **0** otherwise*	**1**	**0**	**0**	**1**	**1**
23	**23. Blocking shares before shareholder meeting:** *Equals **1** if shareholder must not deposit their shares prior to the general meeting, equals **0** otherwise*	**1**	**1**	**1**	**1**	**0**[537]
	SUM:	***15.83***	***14.50***	***14.50***	***10.17***	***13.33***

Source: Own Calculation
Note: The sum is calculated as the total number of points for the country

Table 2: Protecting Minority Shareholders

		RUS	KAZ	UZB	USA	GER
24	**1.Cumulative voting rights** *Equal **1** if Cumulative voting is mandatory and protection against removal of minority directors is available; Equals **0,67** if there is Opt in rights but in case cumulative voting is accepted protection against removal exists; Equals **1/3** if there is cumulative voting rule but no protections against removal of minority candidate; Equals **0** if no cumulative voting is available*	**1**	**0,33**	**0,33**	**0,67**	**0**
25	**2.The Rights of large minority shareholder to appoint own representative to the board (supervisory board)** *Equals **1** if every minority shareholder with particular shareholding (10%, 20%) may appoint*	**0**	**0**	**0**	**0**	**0,5**

[537] According to the EU Directive since 2009 all EU countries must abolish the shares blocking provisions prior to meeting

	*own director; Equals **0,5** if articles may provide for such option; Equals **0** otherwise.*					
26	**3.Limitation of voting rights (Vote Capping)** *Equals **1** if no voting caps exist; Equals **½** if voting caps available only for non-listed companies or only if particular laws prescribe them; Equals **0** otherwise*	**0**	**0,5**	**0**	**0,5**	**0,5**
27	**4.One share – one vote rule principle** *Equals **1** if principle is mandated by the law; Equals **0,5** if it is default rule and corporation can depart from this rule; Equals **0** otherwise*	**1**	**1**	**1**	**0,5**	**1**
28	**5.'*Golden Share*' Rights (Veto Rights)** *Equals **1** if No „golden share" provisions exist; Equals **0,5** if 'golden shares' can be issued only for the state in some restricted cases or if the state representative may acquire veto rights by governmental decree; Equals **0** if ordinary shareholder can have 'golden share' rights*	**0,5**	**0**	**0,5**	**1**	**1**
29	**6.Votes required to call for special (extraordinary) shareholder meeting** *Equals **1** if max 5 % of shares required to call for special meeting; Equals **0,5** if more than 5 % but less than 10 % required; Equals **0** otherwise*	**0,5**	**0,5**	**0,5**	**0**	**1**
30	**7.Enforcement:** *Equals **1** if shareholders can call the meeting themselves or have a right that the court will enforce it; Equals **0** if court has discretion to call the meeting*	**1**	**1**	**1**	**0**	**1**
31	**8.Costs of calling extraordinary meeting** *Equals **1** if corporation bears the costs of extraordinary meeting; Equals **0** if shareholder bears the costs of meeting; Equals **0,5** if shareholder meeting decides upon compensation the shareholder for calling the meeting*	**0,5**	**1**	**0,5**	**0,5**	**1**
32	**9.Agenda setting power: (Eligibility Threshold)** *Equals **1** if shareholder who holds 1% or less of the capital can put an item on the agenda of*	**0,5**	**0,5**	**1**	**1**	**0,5**

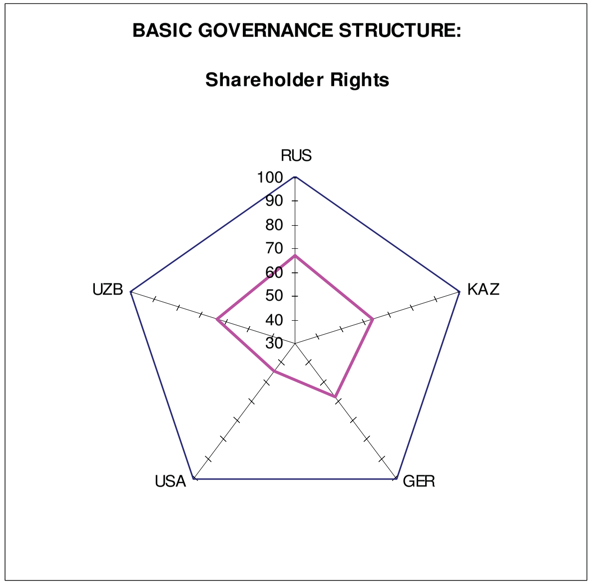
	*the forthcoming meeting; Equals **0.5** if there is a hurdle of more than 1 % but equal or less than 10 %; Equals **0** otherwise*					
33	**10.Power to propose director candidate** *Equals **1** if shareholder who hold 1% or less of the capital can propose a director candidate; Equals **0.5** if there is a hurdle of more than 1 % but less than 10 %; Equals **0** otherwise*	**0,5**	**1**	**1**	**1**	**1**
34	**11.Holding requirement of shares for the eligibility to make proposal:** *Equals **1** if there is no minimal holding time; Equals **0,5** if minimal holding time is 3 month or less; Equals **0** otherwise*	**1**	**1**	**1**	**0**	**1**
35	**12.Timeliness of shareholder proposal (minimal period before the meeting prior to which proposal can be submitted)** *Equals **1** if the timeliness is short (max 30 days before the meeting); Equals **0,5** if timeline is long as default rule but articles may define shorter time-line; Equals **0** if mandatory provision makes timeline long (cannot be less than 3 months)*	**0,5**	**1**	**0,5**	**0**	**1**
36	**13.Initiative or responsive proposal** *Equals **1** if shareholder can send proposal after managers have sent the agenda note to shareholder in all cases; Equals **0,5** when in some cases (voting in absentia) shareholders can not send responsive proposal or the responsive proposal rights can be restricted by articles; Equals **0** if shareholder can sent the proposal only before the note*	**0,5**	**1**	**0,5**	**0**	**1**
37	**14.Costs of proposal** *Equals **1** if shareholders do not have to pay for their proposal; Equals **0** otherwise or if the issue is not regulated*	**0**	**1**	**0**	**1**	**1**
38	**15.Costs of proposing director candidate** *Equals **1** if corporation covers the costs, equals **0** otherwise*	**0**	**1**	**0**	**0**	**1**
39	**16.Right to access the register (list of shareholders)**					

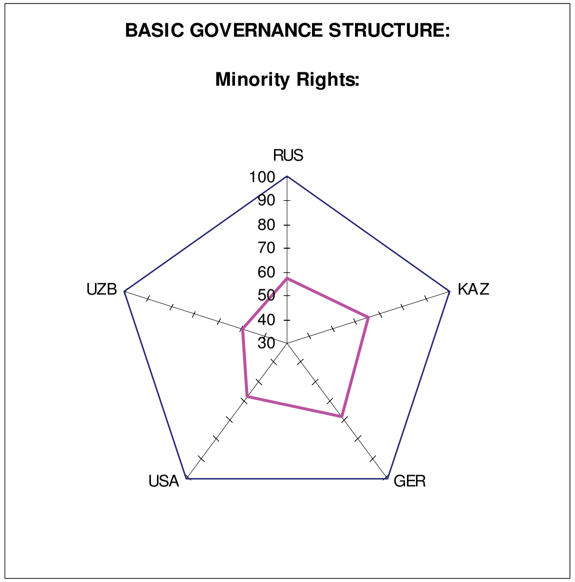
	*Equals **1** if right of inspection can be used by a single shareholder; Equals **0,5** if threshold of up to 10 % stake is fixed; Equals **0** otherwise*	**0,5**	**1**	**0,5**	**1**	**0**
40	**17.Right to access other corporate documents: (1) protocol of supervisory and management boards' meeting, (2) protocol of general meting, (3) Accounting data, (4) ownership documents on corporate property (licenses)** *Equals **1** if all above mentioned documents can be inspected. Possibility to access each particular document without restriction adds **0,25** to the weight of index; When particular document is accessible only if some additional condition fulfilled (e.g. ownership threshold) than only **0,125** to be added; Equals **0** if the access to corporate documents is not possible*	(1), (2), (3), (4) **0,75**	(1), (2), (4) **0,75**	(2), (4) **0,5**	(1), (2), (3), (4) **1**	**0**
41	**18.Inspection rights of the board of directors (supervisory board):** *Equals **1** if each particular director has right to access any corporate document; Equals **0,5** if only supervisory board as the whole entity is eligible to conduct inspection of corporate documents; Equals **0** if no inspection rights are available*	**0**	**0**	**0**	**1**	**0,5**
42	**19.Regularity of Reporting** *Equals **1** all companies that make public offering must prepare quarterly reports; Equals **0,5** if only listed companies must prepare quarterly reports, Equals **0** otherwise*	**1**	**0,5**	**0**	**1**	**0,5**
43	**20.Managerial personal liability for primary market disclosure** *Equals **1** if law provides provisions on defining managerial liability for defect information; Equals **0,5** if the only in some restricted number of cases executive officer can be held liable; Equals **0** otherwise*	**0,5**	**0**	**0**	**1**	**0,5**
44	**21.ANNUAL REPORT: Managerial personal liability for misguiding information** *Equals **1** if law provides provisions on defining managerial liability for defect information; Equals **0,5** if the only in some restricted number of cases executive officer can be held liable; Equals **0** otherwise*	**0,5**	**0,5**	**0,5**	**1**	**0,5**

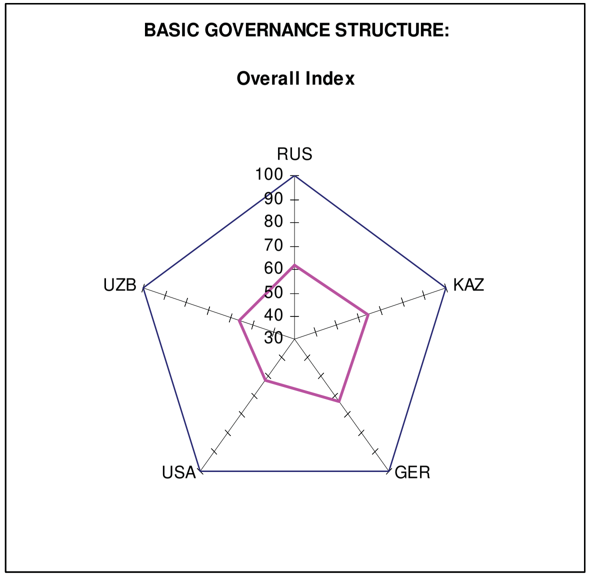
45	**22.INTERIM REPORT: Managerial personal liability for misguiding information** *Equals **1** if law provides provisions on defining managerial liability for defect information;* *Equals **0,5** if the only in some restricted number of cases executive officer can be held liable;* *Equals **0** otherwise*	**0,5**	**0,5**	**0,5**	**1**	**0,5**
46	**23.CURRNET REPORT (ad-hoc): Managerial personal liability for misguiding information** *Equals **1** if law provides provisions on defining managerial liability for defect information;* *Equals **0,5** if the only in some restricted number of cases executive officer can be held liable;* *Equals **0** otherwise*	**0,5**	**0,5**	**0**	**1**	**0,5**
47	**24.Communication among shareholders** *Equals **0** if application to other shareholders is connected with large costs (affected by proxy rule); Equals **0,5** if not affected by proxy rule but still no special means to ease communication (e.g. shareholder forum) exist in country; Equals **1** shareholder forum for communication exists which considerably reduces the costs of communication*	**0,5**	**0,5**	**0,5**	**0**	**1**
48	**25.Quorum on the general shareholder meeting** *Equals **1** if minimal possible quorum is 50 % of outstanding shares; Equals **0,5** if the quorum can be as low as 1/3; Equals **0** otherwise*	**1**	**1**	**1**	**0,5**	**0**
49	**26.Quorum on the extraordinary shareholder meeting** *Equals **1** if minimal possible quorum is 50 % of outstanding shares; Equals **0,5** if the quorum can be as low as 1/3; Equals **0** otherwise*	**1**	**1**	**1**	**0,5**	**0**
50	**27.Proxy Voting (Representation)** *Equals **1** if any person can be appointed as proxy; Equals **0,5** if there are restriction on the lists of person that can be authorised to represent the votes; Equals **0** if no representation is possible*	**1**	**0,5**	**1**	**1**	**1**

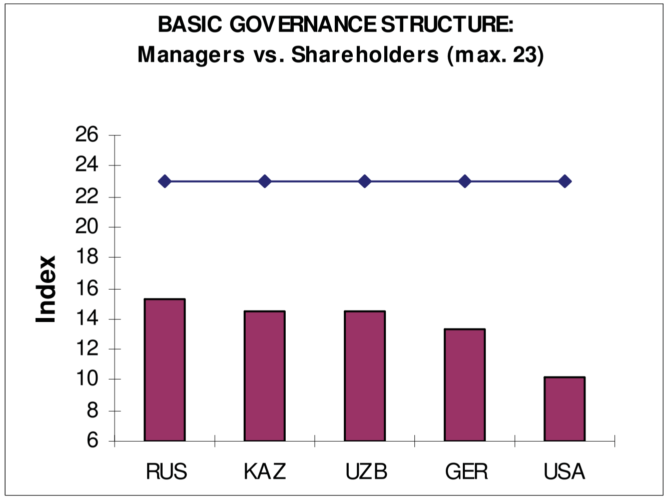
51	**28.Facilitation of the voting rights** *Equals **1** if postal voting or proxy solicitation is provided by company in all cases; Equals **0,67** if shareholders have simplified way of authorising the third party (e.g. bank); Equals **0,33** if mangers can decide to conduct voting in absentia by distributing voting bulletins to shareholder; Equals **0** otherwise*	**0,33**	**0,33**	**0**	**1**	**0,67**
52	**29.Claim against resolution** *Equals **1** if every shareholder can file a claim against a resolution of the general meeting because she/he regards it as void; Equals **0.5** if at least threshold of 10 % stake must be achieved in order to file the claim against resolution; Equals **0** if this kind of shareholder action does not exist*	**1**	**1**	**1**	**0**	**1**
	SUM	***16.58***	***18.91***	***14.33***	***17.17***	***19.17***
	TOTAL SECTION SCORE	**31.91**	**33.41**	**28.83**	**27.34**	**32.50**

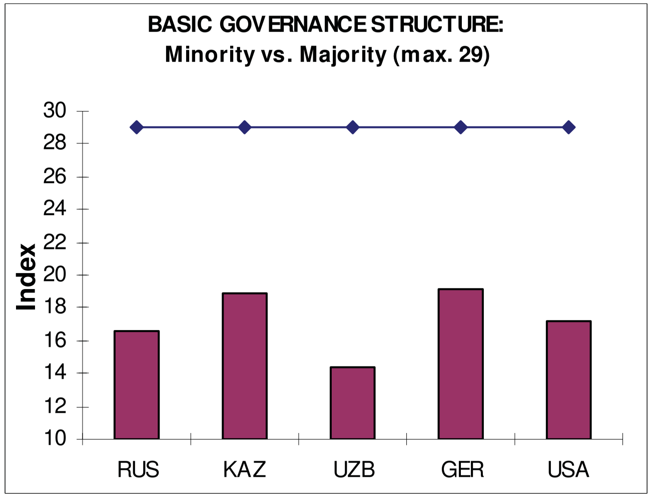
Source: Own Calculation
Note: The sum is calculated as the total number of points for the country











Source: Own Calculations; Note: Figures depict the overall sum of points throughout countries calculated based on results in Table 1 and Table 2.

B. SIGNIFICANT CORPORATE ACTIONS

Table 3: Managers vs. Shareholders

		RUS	KAZ	UZB	USA	GER
53	**1. Power to propose merger** *Equals **1** if shareholder has the right to propose merger; Equals **0** otherwise*	1	0	1	0	1
54	**2. Approval of mergers** *Equal **1** if shareholders must approve all merger transactions; Equals **0,5** if shareholder approve only large mergers; Equal **0** if they do not have such power*	1	1	1	0,5	0,5
55	**3. Right of creditor to require pre-emptive credit reimbursement if corporation starts reorganization process** *Equals **1** if creditors may not require pre-emptive credit reimbursement; Equals **0** otherwise*	0	0	0	1	1
56	**4. Independent expertise** *Equal **1** if independent expertise in course of merger is mandatory; Equals **0** otherwise*	0	0	0	1	1
57	5. **Approval of corporate division** *Equals **1** if decision making power belongs to shareholders; Equal **0,5** that decision making power belong both to board and shareholders; Equals **0** otherwise*	1	1	1	0	0,5
58	**6. Approval of amendments in the articles of association**: *Equals **1** if shareholders must approve amendments; Equals **0,5** if approval is to be done by board and then by shareholder; Equals **0** otherwise*	1	1	1	0,5	1
59	**7. Information about subscribed capital is included in the articles of association** *Equals 1 if information on subscribed capital is included in articles, equals 0 otherwise*	0	0	0	0	1

60	**8. Information about board structure is included in the articles of association** *Equals **1** if information on board structure is included in articles; Equals **0** otherwise*	**1**	**0**	**1**	**0**	**1**
61	**9. Approval of sales of all or substantially all assets** *Equals **1** if selling 50 % and more of assets requires shareholder approval; Equals **0,5** if more than 80 % sale must be approved; Equals **0** otherwise*	**1**	**0**	**1**	**1**	**0,5**
62	**10. Decision rights on increase of authorised capital** *Equals **1** if shareholders decide as default rule; Equals **0,5** if shareholders can appoint board of directors or executive officer for particular time to decide on the issue; Equals **0** otherwise*	**1**	**0**	**1**	**0**	**0,5**
63	**11. Decision rights on capital reduction** *Equals **1** if shareholders decide on capital reduction; Equals **0** otherwise*	**1**	**0**	**1**	**0**	**1**
64	**12.Decision rights on dividend payment** *Equals **1** if the general meeting can effectively influence the amount of dividend; Equals **0,67** if prior to general meeting the annual net income can be distributed on the discretion of management to build up revenue reserves, and the general meeting is not bound by the proposal of management board; Equals **0,33** if shareholder may not appropriate dividends higher than managerial proposal; Equals **0** if only the board that decides about the dividend*	**0,33**	**1**	**0,33**	**0**	**0,67**
65	**13. Interest of employees in course of merger** *Equals **0** if interests of employees must be considered; Equals **1** otherwise*	**1**	**1**	**1**	**1**	**0**
	SUM:	***9,33***	***5***	***9,33***	***5***	***9,67***

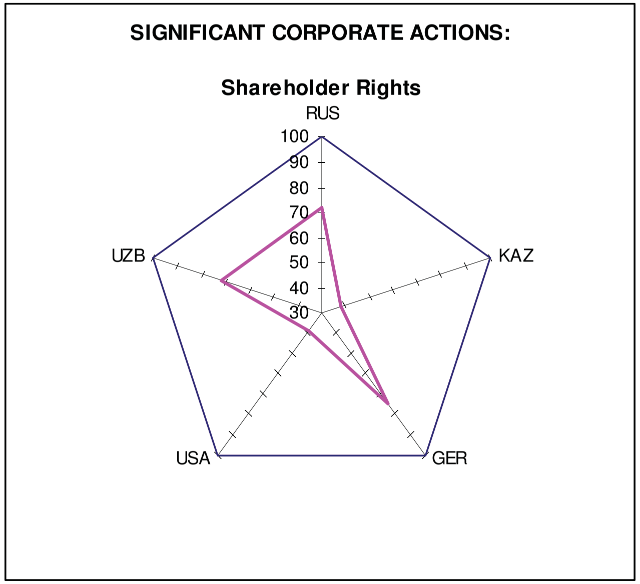
Source: Own Calculation
Note: The sum is calculated as the total number of points for the country

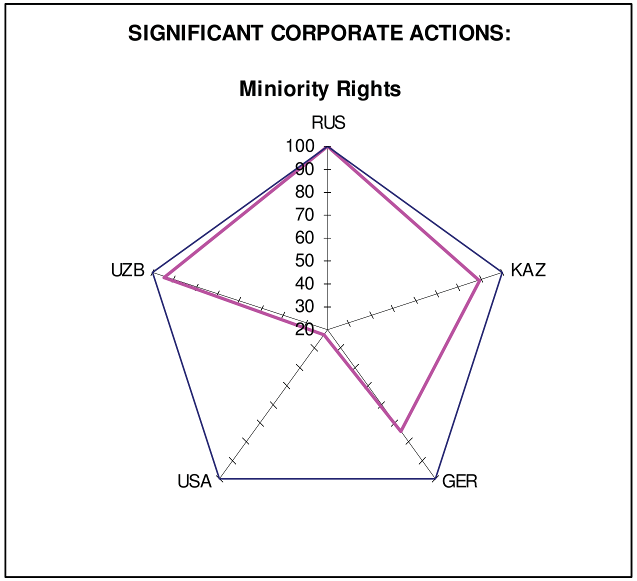
Table 4: Protecting Minority Shareholders

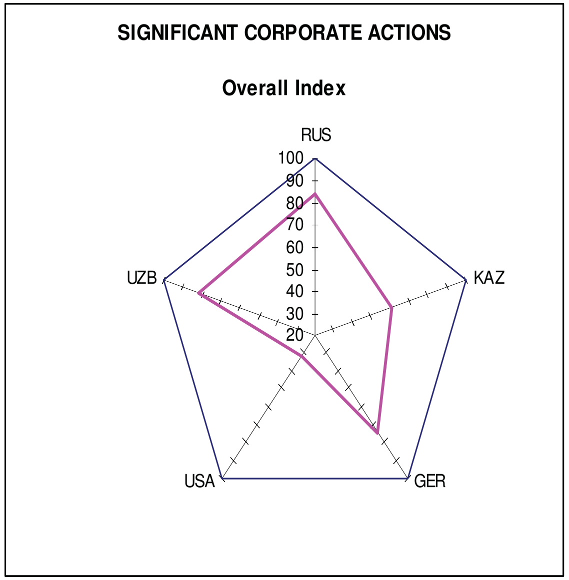
		RUS	KAZ	UZB	USA	GER
66	**1. Supermajority requirements for merger** *Equals **1** if there is supermajority requirement for merger; Equals **0** otherwise*	**1**	**1**	**1**	**0**	**1**
67	**2. Supermajority requirements for corporate division** *Equals **1** if there is supermajority requirement for corporate division; Equals **0** otherwise*	**1**	**1**	**1**	**0**	**1**
68	**3. Supermajority requirements for sale of all or substantially all assets**: *Equals **1** if there is supermajority requirement for sales of all or substantially all assets; Equals **0** otherwise*	**1**	**0**	**1**	**0**	**1**
69	**4. Supermajority Requirements for charter amendment**: *Equals **1** if there is supermajority requirement for charter amendment; Equals 0 if no such requirement exists*	**1**	**1**	**1**	**0**	**1**
70	**5. Appraisal rights for merger**: *Equals **1** if appraisal right in course of merger is available; Equals **0** if they do not exist*	**1**	**1**	**1**	**1**	**1**
71	**6. Appraisal rights for corporate division** *Equals **1** if appraisal right in course of division is available; Equals **0** if they do not exist*	**1**	**1**	**1**	**0**	**1**
72	**7. Appraisal rights for charter amendment**: *Equals **1** if appraisal right in course of charter amendment is available; Equals **0** if they do not exist*	**1**	**1**	**1**	**0**	**0**
73	**8. Appraisal rights for sales of assets**: *Equals **1** if appraisal right in course of sales of assets is available; Equals **0** if they do not exist*	**1**	**1**	**1**	**0**	**0**
74	**9. Pre-emptive rights**:					

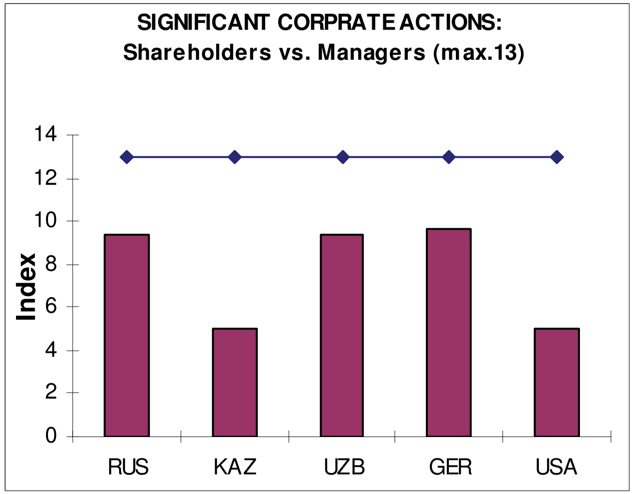
	*Equals **1** if pre-emptive rights exists without restrictions; Equals **0,75** if majority of shareholders can exclude pre-emptive rights; Equals **0,5** if the managers can exclude pre-emptive rights or if pre-emptive rights are restricted to some group of securities; Equals **0,25** if as default rule pre-emptive rights do not exist; Equals **0** if not such rights exist*	**1**	**1**	**0,5**	**0,25**	**0,5**
75	**10. The informative rights of shareholders about share repurchase** *Equals **1** if shareholder must be informed about forthcoming share repurchase; Equals **0** otherwise*	**1**	**1**	**1**	**1**	**1**
	SUM:	***10***	***9***	***9,5***	***2,25***	***7,5***
	TOTAL SECTION SCORE:	**19.33**	**14**	**18.83**	**7.25**	**17.17**

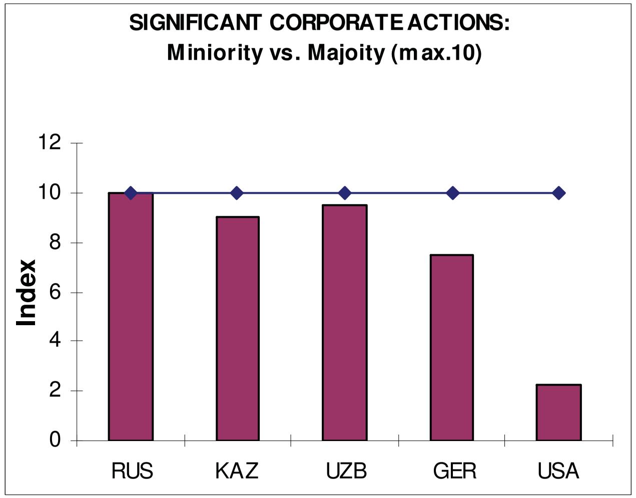
Source: Own Calculation
Note: The sum is calculated as the total number of points for the country











Source: Own Calculations; Note: Figures depict the overall sum of points throughout countries calculated based on results in Table 3 and Table 4.

C. TAKEOVER TRANSACTIONS

Table 5: Protecting Shareholders

		RUS	KAZ	UZB	USA	GER
76	**1. Partial offer** *Equals **1** if partial offers are prohibited; Equals **0** otherwise*	1	1	0	1	1
77	**2. Minimal acceptance period** *Equal **1** if the law fixes minimal period that bidder must provide to target shareholders; Equals **0** otherwise*	1	0	0	1	1
78	**3. Two-tier offer** *Equals **1** if two-tier offer is explicitly prohibited; Equals **0** otherwise*	1	0	0	0	1
79	**4. Disclosure of intention to acquire large stake** *Equals **1** if the law mandates the publication of plan to acquire controlling stake; Equals **0** if no such provisions exist or it is optional for bidder to publish such information*	0	1	1	1	1
80	**5. Disclosure of acquisition of small stakes prior to tender offer (e.g. 5%, 10%, 15%, 20%)** *Equals **1** if publication is required when 5 % stake is achieved, , Equals **0,75** if to be published when stake between 5 and 10 % bought; Equals 0,5 if to be published when stake between 10 and 20 % is acquired; Equals **0,25** if to be published when stake between 20 and 30 acquired; Equals **0** otherwise*	1	0,75	0	1	1
81	**6. Liability of bidder for providing inaccurate information** *Equals **1** if law defines bidder's liability for inaccurate information in the offer; Equals **0** otherwise*	1	0	0	1	1
82	**7. Interests of employees must be considered** *Equals **0** if management of target company must give recommendations about takeover prospects*					

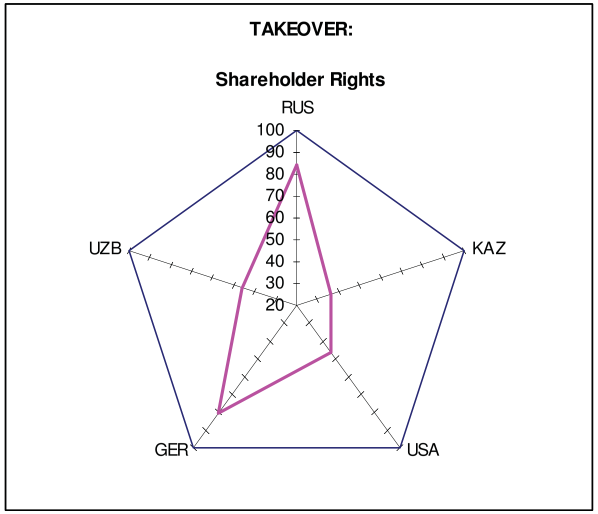
	*considering the interests of employees; Equals **1** otherwise*	**0**	**1**	**1**	**1**	**0**
83	**8. Decision right power about takeover** *Equals **1** if shareholder has residual right to decide on takeover,* *Equals **0,5** if shareholders can authorise managers to take decision on takeover for particular period of time; Equals **0** otherwise*	**1**	**0**	**0**	**0**	**0,5**
84	**9. Golden Parachutes (*pre-bid protection strategy*)** *Equals **0** if there is an opportunity for managers of target company to receive very high compensation after successful takeover; Equals **1** if such Golden Parachutes are restricted*	**0**	**0**	**1**	**0**	**1**
85	**10. Restricted transferability of shares (pre-bid protection strategy)** *Equals **1** if no restriction on transferability of shares is possible, Equals **0** otherwise*	**1**	**1**	**1**	**0**	**0**
86	**11. Decision rights on managerial compensation after takeover bid was submitted (post-bid protection strategy)** *Equals **1** if shareholders decide on the issue; Equals **0** otherwise*	**1**	**0**	**0**	**0**	**1**
87	**12. Decision rights on share repurchase after takeover bid (post-bid protection strategy)** *Equals **1** if shareholder have right to decide on share repurchase after takeover offer was made; Equals **0** otherwise*	**1**	**0**	**1**	**0**	**1**
88	**13. Decision rights on increase of share capital after bid was submitted (post-bid protection strategy)** *Equals **1** if shareholders are authorised to decide; Equal **0** if board of directors*	**1**	**0**	**1**	**0**	**1**
	SUM:	***10***	***4.75***	***6***	***6***	***10.5***

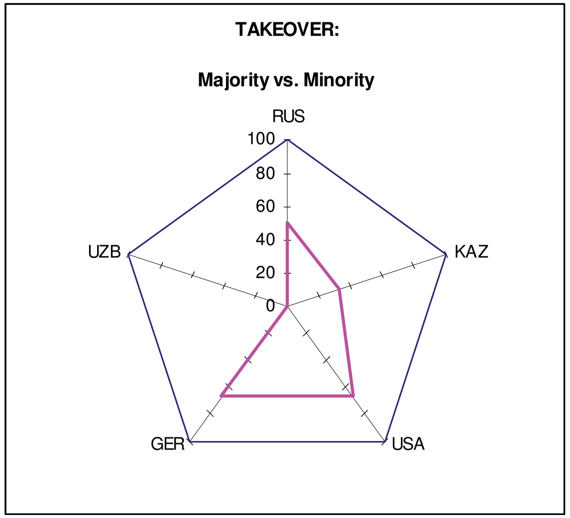
Source: Own Calculation
Note: The sum is calculated as the total number of points for the country

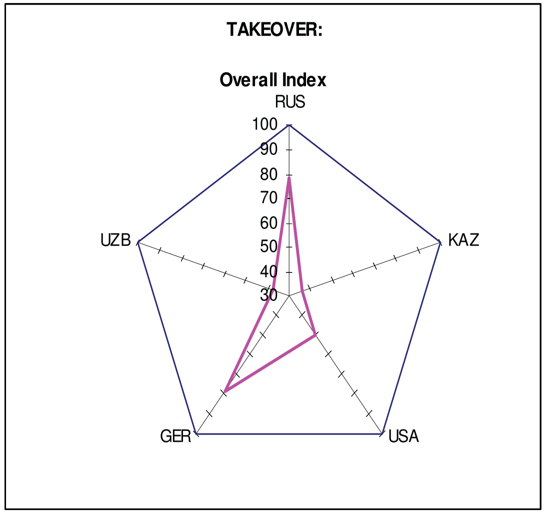
Table 6: Protecting Minority Shareholders

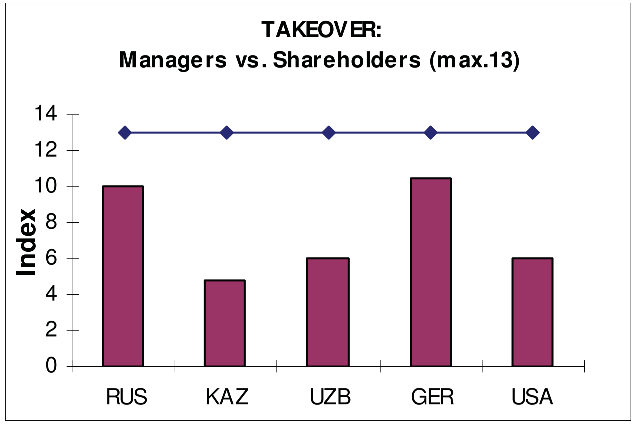
		RUS	KAZ	UZB	USA	GER
89	**1. Mandatory public offer (before obtaining controlling stake):** *Equals **1** if there is a mandatory public offer for purchase of 10 % or less of the shares; equals ½ if the acquirer has to make public offer for acquiring more than 10 % but less than 30 % of shares; equals **0** otherwise*	**0**	**0**	**0**	**0**	**0**
90	**2. Mandatory Bid Rule: (after obtaining controlling stake)** *Equals **1** if controlling stake was acquired a minority shareholder has right to require purchase of his shares by the controlling shareholder or the law mandates controlling shareholder make a mandatory bid to remaining shareholders; Equals **0** otherwise*	**1**	**1**	**0**	**1**	**1**
91	**3. Squeeze-out (in the USA known as freeze-out) is included in the law?** *Equals **1** if controlling shareholder with the stake of 90 and higher can buy out minority shares,* *Equals ½ if despite availability of squeeze-out regulation some supportive rights of squeeze-out are missing (e.g. right to sue for wrong information or the fairness of price),* *Equals **0** otherwise*	**0,5**	**0**	**0**	**1**	**1**
	SUM:	**1,5**	**1**	**0**	**2**	**2**
	TOTAL SECTION INDEX:	**11.5**	**5.75**	**6**	**8**	**12.5**

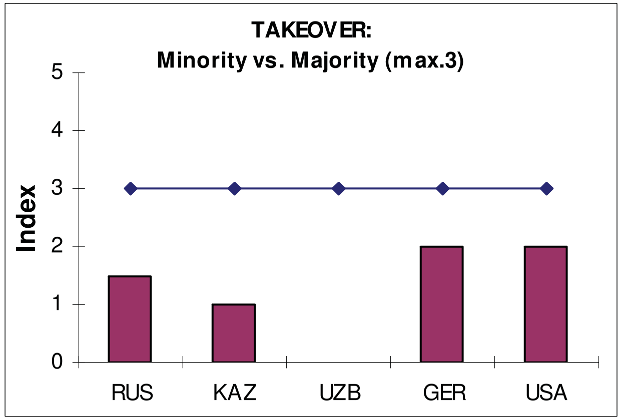
Source: Own Calculation
Note: The sum is calculated as the total number of points for the country











Source: Own Calculations; Note: Figures depict the overall sum of points throughout countries calculated based on results in Table 5 and Table 6.

D. RELATED PARTY TRANSACTIONS

Table 7: Managers vs. Shareholders

		RUS	KAZ	UZB	USA	GER
92	**1. Mandatory disclosure conflict of interest transaction between managers and company** *Equals **1** if required by the law* *Equals **½** if required by Corporate Governance Code only* *Equals **0** otherwise*	1	1	1	1	0,5
93	**2. Addressees of disclosure of interests conflict between managers and company** *Equals **1** if transactions between managers and company must be disclosed to company and state supervisory authority* *Equals **2/3** if disclosure to external auditor is mandatory* *Equals **1/3** if only internal governance body (board, internal auditor) must be notified; Equals **0** if no disclosure requirements are mandated*	0,67	0,33	0,33	1	0,33
94	**3. Disclosure of managerial transactions with corporate shares** *Equals **1** if managerial transaction with corporate shares must be disclosed; Equals **0** otherwise*	1	0	0	1	1
95	**4. Disclosure of managers' compensation according to the law** *Equals **1** if detailed managerial compensation must be disclosed,* *Equals **½** if overall figures must be disclosed; equals **0** otherwise*	1	0	0	1	1
96	**5. Disclosure of insider information (ad-hoc publication). Any information that is not known to public and may have an effect on shares price must be disclosed.**	1	0,5	0	1	0,5

	*Equals **1** if the if ad-hoc reports are mandated by the law for all companies that make public offering of new shares, equals ½ if current reports are mandatory for listed companies only, Equals **0** otherwise*					
97	**6. Managerial transaction with corporation must be disclosed according to internationally recognized accounting standards (IFRS and USGAAP)** *Equals **1** if all listed JSC must report according to recognized international accounting standards (IFRS and USGAAP);* *equals **½** if some companies apply international accounting standards or only national accounting standards require disclosure of related party transactions; Equals **0** otherwise*	**1**	**1**	**0**	**1**	**1**
98	**7. Approval of Related Party Transactions with Manager (Director)**: *Equals **1** if disinterested shareholders are qualified to approve the transaction when quorum of disinterested board members cannot be provided, Equals **½** if law requires the approval of shareholders without prescribing their independence if the board may not be qualified, Equals **0** otherwise*	**1**	**1**	**1**	**0**	**0**
99	**8. Regulation of insider trading** *Equals **1** if there is a prohibition of insider trading,* *Equals **0,5** if similar provision exist but not elaborated* *equals **0** otherwise.*	**0,5**	**0,5**	**0,5**	**1**	**1**
100	**9. Notion of insider trading** *Equals **1** if notion of insider trading includes all main parties that may have conflict of interests (executive officers, directors, shareholders, other managing personal, etc.) Equals **0** if some parties are omitted*	**0**	**1**	**0**	**1**	**1**
101	**10. The possibility for insider to share insider information or give recommendations** *Equals **1** if law bans any sharing of insider information or giving recommendations to third*					

	*party; Equals ½ If the law prohibits either only the sharing of insider information or only giving recommendations to the third party; Equals **0** otherwise*	**0,5**	**1**	**0,5**	**1**	**1**
102	**11. Short term profits realized through trade with corporate shares for insiders (manager)** *Equals **1** if there is prohibition for short term (up to 6 months) trade with corporate shares for insiders, equals **0** otherwise*	**0**	**0**	**0**	**1**	**0**
103	**12. Duty of care** *Equals **1** if the concept of duty of care was incorporated into the law;* *Equals ½ if concept of care is weakly elaborated; Equals **0** otherwise*	**1**	**0**	**0**	**1**	**1**
104	**13. Duty of loyalty** *Equals **1** if the concept of duty of loyalty was incorporated into the law;* *Equals ½ if concept of loyalty is weakly elaborated; Equals **0** otherwise*	**1**	**1**	**0,5**	**1**	**1**
	SUM:	***9.67***	***7.33***	***3.83***	***12***	***9.33***

Source: Own Calculation.
Note: The sum is calculated as the total number of points for the country.

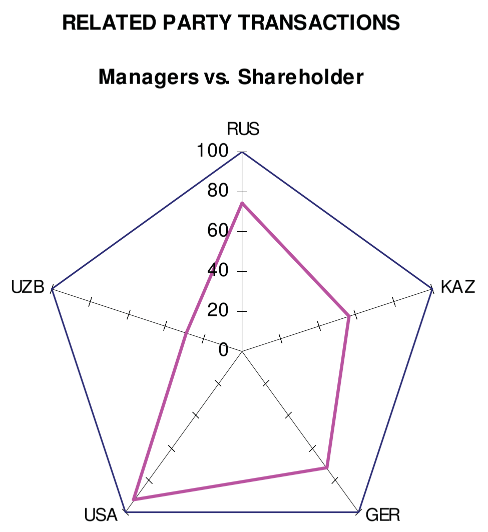
Table 8: Majority vs. Minority Shareholders

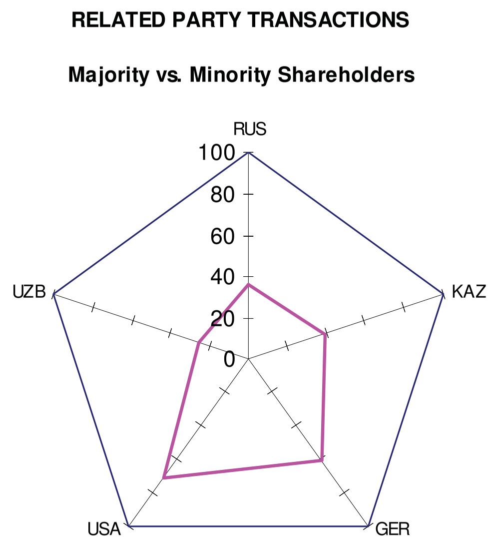
		RUS	KAZ	UZB	USA	GER
105	**1. Disclosure of transactions of large shareholder with corporation** *Equals **1** if transactions with large shareholders must be disclosed;* *Equals ½ if only intra-group transaction must be disclosed;* *Equals **0** otherwise*	**1**	**1**	**1**	**1**	**0,5**
106	**2. Addressees of disclosure of interests conflict with large shareholder** *Equals **1** if transactions between large shareholder and company must be disclosed to company and state supervisory authority;* *Equals **2/3** if disclosure to external auditor is mandatory;* *Equals **1/3** if only internal governance body (board, internal auditor) must be notified; Equals **0** if no disclosure requirements are mandated*	**0,67**	**0,33**	**0,33**	**1**	**0,33**
107	**3. Disclosure of transaction with large shareholders according to accounting principles** *Equal **1** if accounting principles mandate disclosure of transactions with large shareholders; equals ½ if some companies apply international accounting standards or only national accounting standards require disclosure of related party; equals **0** otherwise*	**0,5**	**0,5**	**0**	**1**	**1**
108	**4. Disclosure by large shareholder trade with corporate shares** *Equals **1** if any trade with corporate shares must be disclosed by controlling shareholder;* *Equals ½ if disclosure is requires only when it has takeover significance (e.g. 5, 10, 15, 20, 25 % etc); Equals **0** otherwise*	**0,5**	**0**	**0**	**1**	**0,5**
109	**5. Approval of transaction between large shareholder and corporation**:					

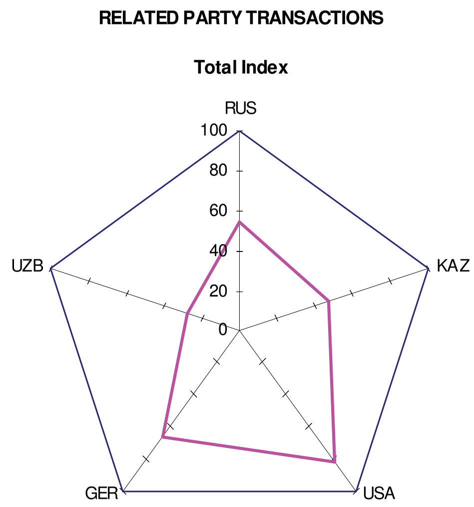
	*Equals **1** if disinterested or minority shareholders must approve transaction in all cases; Equals **½** if disinterested shareholders must approve when board is disqualified, Equals **0** otherwise*	**0,5**	**0,5**	**0,5**	**0**	**0**
110	**6. Insider trading by controlling shareholders** *Equals **1** if existing regulation prohibits insider trading by controlling shareholder, equals **0** otherwise.*	**0**	**1**	**0**	**1**	**1**
111	**7. Liquidation as exist right** *Equals **1** if minority shareholder can require liquidation of the company when their rights severely violated, equals **0** otherwise*	**0**	**0**	**0**	**0**	**0**
112	**8. Appointment of independent auditor to inspect** *Equals **1** if law any shareholder has the right to request appointment of special auditor;* *Equals **2/3** if in order to be able to request appointment of special auditor shareholder must possess at leas 1 % of shares;* *Equals **1/3** if the application is subject of ownership threshold up to 10%;* *The total index to be halved if shareholder bears the costs of audit* *Equals **0** when there are no such rights for shareholders*	**0,33**	**0,17**	**0,33**	**0**	**0,67**
113	**9. Compensation by parent company** *Equals **1** if parent company is liable for losses that daughter company experienced due to following its instructions; equals **0** otherwise*	**1**	**1**	**1**	**0**	**1**
114	**10. Liability of controlling shareholder for self-dealing transactions** *Equals 1 if there are remedies for making controlling shareholder liable for self-dealing, equals 0 otherwise*	**0**	**0**	**0**	**1**	**1**
115	**11. Fiduciary Duties of controlling shareholder**					

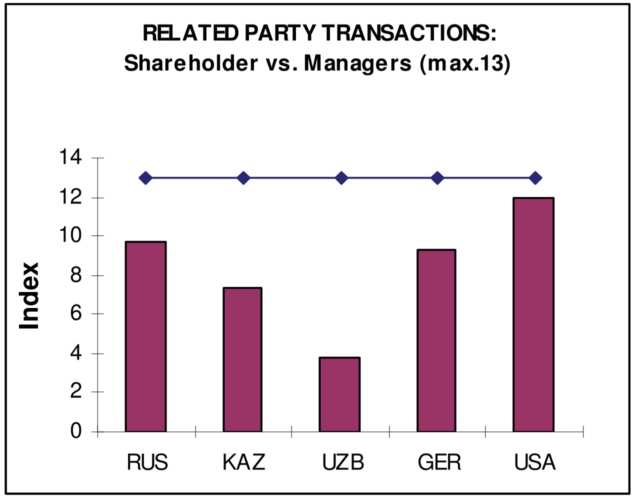
	Equals 1 if law controlling shareholder has fiduciary duties against other shareholders, Equals 0 otherwise	**0**	**0**	**0**	**1**	**1**
116	**12. Liability of directors for approving self-dealing transaction of controlling shareholder:** *Equals 1 if explicit regulation in this respect exists, equals 0 otherwise*	**0**	**0**	**0**	**1**	**1**
117	**13. Class action suits** *Equals **1** if law allows class actions suits; equals 0 otherwise*	**0**	**0**	**0**	**1**	**0**
118	**14. Rights of minority shareholder to file the suit against director (executive officer) for the personal damages** *Equal **1** if each shareholder can file the suit, **1/2** if threshold is stipulated , equals **0** otherwise*	**0,5**	**1**	**0,5**	**1**	**0,5**
	SUM:	***5***	***5.5***	***3.66***	***10***	***8.5***
	TOTAL SECTION INDEX:	***14.67***	***12.83***	***7.49***	***22***	***17.83***

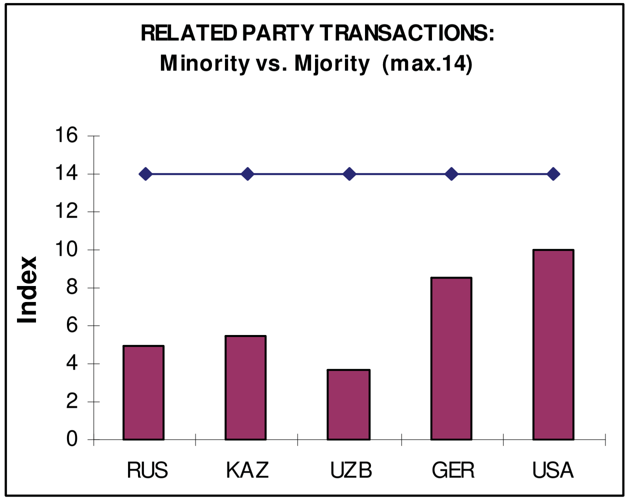
Source: Own Calculation
Note: The sum is calculated as the total number of points for the country



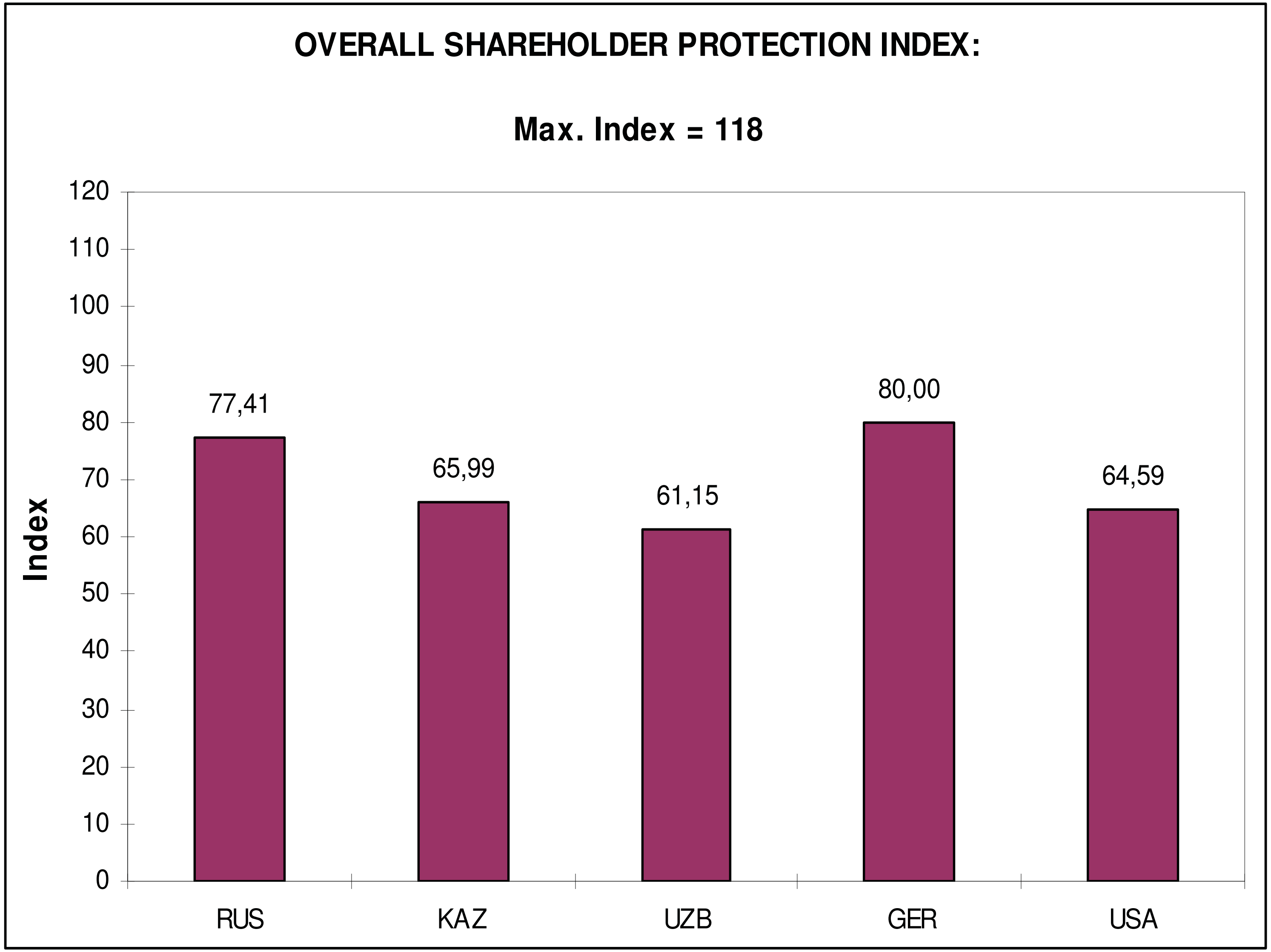








Source: Own Calculations; Note: Figures depict the overall sum of points throughout countries calculated based on results in Table 7 and Table 8.



Source: Own Calculations

Appendix IV. The Role of Stakeholders

	Russia	**Kazakhstan**	**Uzbekistan**
State as regulator	high	high	high
State as shareholder	high	low	high
Banks as creditor	low	middle	low
Banks as shareholder	low	low	low
Pension Funds	low	high	low
Investment funds	low	low	low
Insurance Companies	low	low	low
Auditors	low	low	low
Rating Companies	low	low	low
Employees	middle	low	low

Source: Own Estimations

Appendix V. Information on Empirical Study

Table 1: Summary of Variables

Endogenous variable	
Tobin's Q	Ratio of market value to book value of assets. Market value of assets is computed as market value of equity plus book value of assets minus book value of equity
Corporate Governance Mechanisms	
CGI	Index includes 29 different elements of corporate governance and takes the value between 0 and 99
Stocksod	Percentage of equity owned by officers and directors
Blockout	Percentage of equity owned by the larges shareholder
Bsize	Number of directors on the board of the company
LV	Leverage, measured as the ration of total liabilities to total assets
Outsider	Outsider membership on the board, measured by the percentage of board seats held by non-officers and non-shareholder
Control Variables	
LnAssets	Firm size, measured by the natural logarithm of book value of total assets
StateOwn	Dummy variable: 1 if state holds the 5% or bigger stake; 0 otherwise
ADR	1 if company issues American or Global Depositary Receipts; 0 otherwise
Industry	4 dummy variable: mining, other production industries, services, utilities

Table 2: Descriptive Statistics

Variable	**Mean**	**Median**	**S.D**	**Max**	**Min**
Q	1.42	1.22	0.71	3.74	0.28
CGI	63.46	66.21	11.9	80.78	30.94
LV	0.45	0.41	0.2	0.92	0.06
Outsider	0.29	0.27	0.16	0.74	0.00
Blockout	44.25	50.67	22.53	88.33	0.00
Bsize	10.12	10.33	2.64	17.00	5.00
Stocksod	11.66	0.17	23.92	80.33	0.00
LnAssets	10.83	10.58	1.45	14.75	8.45
ROA	0.12	0.1	0.09	0.35	-0.09
Number of Shareholders	22,833	7,140	52,976	336,823	9

Source: Own Calculations based on the sample of 52 Russian listed companies