

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)**Corporate Governance Country Assessment
HUNGARY****February 2003**

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This Corporate Governance Assessment was completed as part of the joint World Bank-IMF program of Reports on the Observance of Standards and Codes (ROSC). It benchmarks the country's observance of corporate governance against the OECD Principles of Corporate Governance and is based on a template developed by the World Bank. This assessment was undertaken on the basis of the template and report prepared by Hargreaves Risk Management for the World Bank. Acknowledgments are due to the Ministry of Finance, National Bank of Hungary, Ministry of Justice, Hungarian Financial Supervisory Authority (PSZÁF), Court of Registration, Budapest Stock Exchange, KPMG, Central Clearing House and Depository, Budapest (KELER), Association of Investment Enterprises (BEVASZ), the Association of Investment Fund Managers (BAMOSZ), Investor Protection Fund (BEVA), Chamber of Hungarian Auditors, and leading local experts on legal, accounting and auditing issues, academics, state-owned companies, capital market issuers, and institutional investors. Olivier Frémond and Alexander Berg of the Corporate Governance Unit Private Sector Advisory Services of the World Bank drafted the final report. The ROSC assessment was cleared for publication by the Ministry of Finance on February 7, 2003.

I. EXECUTIVE SUMMARY

This report provides an assessment of the corporate governance policy framework and enforcement and compliance practices in Hungary. Hungary has already invested considerable resources in upgrading its legislation to meet EU Directives, and the legislative and regulatory framework dealing with corporate governance issues is robust.

The major issues identified by this review include: (i) the general weakness of the supervisory board, which causes some non-compliance with several OECD Principles; and (ii) a conflict between law and practice in the area of share registration, particularly the problems related to the ability of all shareholders to attend meetings and exercise their voting and other rights. Strengths and weaknesses are highlighted, and policy recommendations are made where appropriate.

Policy recommendations may be grouped under three categories: legislative reform, institutional strengthening and voluntary/private initiatives. The report recommends the creation of a “share registration working group” to synchronize law and practice in the area of shareholder record keeping and voting. It also makes recommendations to be implemented as part of a Company Law update. Finally, the report promotes private sector initiatives and capacity building to build on legislative progress on corporate governance reform. It recommends development of a Hungarian corporate governance code of best practice. The code should be prepared by a BSE-coordinated task force made up of public and private sector representatives. Key issues the code would address include supervisory board roles and institutional investor responsibilities. The report also proposes that an Institute of Directors be created train supervisory board members, disseminate best practice, and promote dialogue between the public and private sectors. Together, these measures give issuers the choice to implement best practice and investors a benchmark against which to measure corporate governance in Hungary.

II. CAPITAL MARKETS AND INSTITUTIONAL FRAMEWORK

Hungary has posted robust economic performance since 1997, with GDP growth averaging about 4.5 percent per year, unemployment down to six percent, and inflation to seven percent by end-2001. Hungary’s overall development framework and its successful implementation are based on its drive to join the European Union (EU). Hungary expects to accede by 2004.¹

Hungary has been a preferred location among Central European countries for foreign direct investment (FDI), and has captured up to 40 percent of all FDI in the region. There are 25,000 firms with foreign capital operating in Hungary, producing about 32 percent of Hungary’s GDP, 45 percent of them manufacturing value-added products and employing 25 percent of private-sector workers.² In the early 1990s, Hungary opted for a privatization program through FDI. Ownership of the most significant state-owned companies was transferred to foreign investors.

Hungary’s capital markets reflect this economic success and level of inward investment. Market capitalization at the end of 2001 was USD 10.4 billion, or 19.8 percent of GDP.³ However, the

¹ World Bank, “Hungary - Country Assistance Strategy Progress Report,” April 2002.

² KPMG web site.

³ Source: *World Development Indicators*, see Annex C. A recent study based on tax return data indicated that the book value of listed companies made up almost 15 percent of total equity of Hungarian enterprises.

market has shared in recent international declines; market capitalization has fallen from 36.6 percent of GDP since 1997. Banks provide over 75 percent of financing.

The Budapest Stock Exchange (BSE) is the dominant exchange.⁴ As of August 2002, it listed 50 firms - 24 as Category "A" and 26 as Category "B." "A" has higher listing requirements and represents 93 percent of market capitalization. Three companies - Matav, MOL, and OTP - account for 66 percent of total capitalization. Most turnover in Hungarian shares occurs abroad; 43 issues are listed in London and represent over 58 percent of 2001 turnover. KELER (Central Clearing House and Depository) acts as the BSE's central depository and clearing house.

Hungarian private law is part of the civil law system. The Companies Act (CA) of 1997 contains general rules on all forms of business associations/company structures and sets the rules that apply to them. The most widely used and modern company forms are the limited liability company (*korlátolt felelősségű társaság*, or "kft."), which comprises most Hungarian companies, and the company limited by shares (*részvénytársaság*, or "rt."). Only an rt. may issue shares, and thus be listed at the stock exchange. By 2001's end, Hungary had 150,194 active kft. and 3,926 rt. An rt. may be private or public (i.e. if any or all of its shares have been offered to the public.)⁵

The other key law affecting listed companies is the Capital Markets Act (CMA), enacted January 1, 2002. It governs all activities, products and institutions related to capital markets (except for insurance company and pension fund regulation), and replaces several fragmented laws and regulations. The CMA was the product of a thorough legislative reform aimed at creating a more flexible and favorable legal environment, correcting inefficiencies and flaws in the legal framework, and bringing Hungarian legislation in line with EU laws.⁶

The capital markets supervisor is the Hungarian Financial Services Authority (HFSA). Created in April 2000, it is modeled on the FSA in the UK, as a consolidated supervisor. It oversees every sector of the financial and securities markets. The HFSA is independent and self-financing, and is sufficiently empowered and staffed to carry out its supervisory functions. However, it lacks authority to issue legally binding regulations, and thus will face difficulties in responding quickly to corporate governance violations not spelled out in law or regulation.

All companies registered in Hungary are under the Court of Registration's legal supervision. The Court maintains the company register and provides public access to company information. The registry is fully computerized, and is working towards full electronic filing. The Court also exercises supervisory powers to enforce compliance with the CA and may exercise sanctions.

The BSE has finished a first draft of corporate governance guidelines providing listed firms and investment service providers with best practice recommendations. HFSA supports this initiative.⁷

⁴ There is also an over-the counter market, but its turnover is practically zero.

⁵ A public offer is defined as any offering that fails to meet the criteria of a private placement.

⁶ The CMA complies with all relevant EU regulations and directives, except for the Settlement Finality Directive, which will be the basis of a separate law, currently under preparation. Further harmonization will be necessary with new unpublished directives, such as the insider trading and investment services directives and rules aimed at standardizing national accounting regulations.

⁷ The BSE expects to officially publish its Corporate Governance Guidelines in early 2003.

III. REVIEW OF CORPORATE GOVERNANCE PRINCIPLES

This review assesses Hungary's compliance with each OECD Principle of Corporate Governance. Policy recommendations may be offered if a Principle is less than fully observed.⁸

Section I: The Rights of Shareholders

Principle IA: The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to: (1) secure methods of ownership registration; (2) convey or transfer shares; (3) obtain relevant information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; (5) elect members of the board; and (6) share in the profits of the corporation.

Assessment: Partially observed

Description of practice: Most basic shareholder rights are protected under the law and practice.

Shares of public companies have been issued in bearer and registered form. However, since December 2001, only registered shares may be issued. The CMA also provides that only dematerialized shares may be issued to the public, and public companies must transform all their shares into dematerialized and registered shares by the end of 2004. Shares must be recorded in each company's share register (*részvénykönyv*), which must be maintained by the management board.⁹ The charter can require that shareholder rights may only be exercised if the shareholder was recorded in the register at least 60 days prior to the General Meeting (AGM). Although BSE listing rules require listed companies to change the 60 day requirement to between five and ten days, some shareholders report that some companies use the 60-day provision to prevent their attendance at AGMs.¹¹ Amendments to the CA to remove this 60-day requirement are expected to be submitted to Parliament shortly.

Share registration rights of owners of convertible bonds are also somewhat restricted. Convertible bondholders must wait 60 days for registration of their ownership after conversion.

The CMS recognizes nominee ownership, and an investment service provider (custodian) or the central depository may (upon written agreement with the ultimate shareholder) exercise shareholder rights in the custodian's own name but on the shareholder's behalf. The share register will then list the nominee rather than the shareholder.¹² The nominee may only exercise shareholder rights with securities deposited with it or registered in its securities account. Upon a request from a shareholder, the company, the HFSA, or any other person with a "valid concern," the nominee is required by law to reveal the identity of the shareholders it represents.

However, the CA, the CMA, and practice conflict in the area of shareholder record keeping and shareholders' ability to exercise their rights. According to the CA and CMA, the share registry

⁸ **Observed** means that all essential criteria are met without significant deficiencies. **Largely observed** means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the Principle, practices, and enforcement diverge. **Materially not observed** means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means no substantive progress toward observance has been achieved.

⁹ In Hungary's two-tier board structure, the management board is typically referred to as the "board of directors." We use the term "management board" for the international reader, to avoid confusion with the supervisory board.

¹⁰ AGM (Annual General Meeting) is used in this report as an internationally-accepted convention.

¹¹ The BSE reports that it is actively enforcing the listing requirements.

¹² For foreign nominees, beneficial owners must be registered with the nominee in the share register.

must be continuously updated with information from KELER to allow owners to take part in corporate actions. In practice, issuers provide the necessary information and require the results of the registration procedure only before major corporate events (AGMs or dividend payments).

Convey or transfer shares. Public company shares are freely transferable.¹³ According to the CA, transfers must be reported within eight days to the board or entity keeping the register. Practice deviates, since book entries transfer dematerialized securities in securities accounts.

Clearing and settlement of dematerialized shares is efficient and modern, and KELER fares well against international benchmarks of central depositories. Clearance and settlement practice complies with all ISSA G30 recommendations, and include T+3 clearance and settlement.¹⁴ Systemic settlement risk appears low.

Obtain relevant information on the corporation on a timely and regular basis. Any person may at any time gain access to the company documents at the court of registration.

Participate and vote in general shareholder meetings. All shareholders can participate at the AGM of shareholders, the decision-making body of a public company. See Principle IC.

Elect members of the board. The AGM usually appoints and removes the directors of both boards on the basis of simple majority of voting rights present at the AGM. The law has no provisions on cumulative, or block or proportional voting to elect board members. See VA.

Share in the profits of the corporation. Shareholders are entitled to dividends. The AGM decides on distribution upon management board proposal, subject to supervisory board approval.

Policy recommendations: The CMA modernized capital markets law, but some problems remain. The confusion caused by CA Section 229 (the “60 day” rule) and the informality of registration before an AGM or other corporate action are inconsistent with Hungary’s well-designed legal framework. A “share registration working group” created under KELER’s leadership and made up of custodians, legal experts, and perhaps the tax authority, could work to synchronize law and market practice regarding shareholder record keeping for corporate actions.¹⁵

The recommendations can be formalized in Company Law amendments, the CMA, KELER procedures, and listing rules. The same group could also consider the adoption of KELER as a Central Registry for all listed shares (or all Category “A” shares) with an appropriate phase-in.

<p>Principle IB: Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes, such as: (1) amendments to the governing documents of the company; (2) the authorization of additional shares; and (3) extraordinary transactions that in effect result in the sale of the company.</p>
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Assessment: Observed

¹³ Under the CA, only private companies may attach preemptive rights or other restrictions on the transfer of shares.

¹⁴ KELER introduced T+3 settlement on November 18, 2002.

¹⁵ The group could make recommendations on: removing the 60 day requirement for AGM participation; setting a legal “date of record” for corporate actions, including AGMs and dividends; legally formalizing the roles of the custodian, KELER, and the share register, and the creation of shareholder list for corporate actions (including AGMs); removing impediments to conversion of convertible bonds; standardizing documents (e.g. powers of attorney) for proxies, voting instructions, etc.; establishing processes to make voting by beneficial owners easier, and to improve compliance with ownership disclosure rules.

Description of practice: The AGM has authority over key decisions, including amending the company charter, appointing, removing and setting board member¹⁶ and auditor remuneration, changing share rights, mergers and takeovers, and approving dividends. Most AGM resolutions are made by simple majority, but some important decisions may require a special supermajority vote of 75 percent of shareholders present. The BSE Listing Rules also require that the issuer's charter stipulate that a resolution for delisting should require a 75 percent supermajority vote.

Authority for capital increases may be delegated to the management board. The charter must state the term of authorization (maximum five years, but renewable) and the maximum value by which the board may increase the company's capital (up to 25 percent/year). In such cases, the board may amend the company charter by registering the capital increase. This is an exception from the rule that amendments to the charter are under the AGM's exclusive competence.

Principle IC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general them. (1) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. (2) Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations. (3) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

Assessment: Partially observed

Description of practice: Every shareholder may participate at the AGM, may make proposals and (unless his shares are non-voting) may vote. The general quorum requirement is that shareholders representing at least 50 percent of voting rights must be present; only the charter may set a higher requirement. If a quorum is not reached at the first meeting, no quorum applies to the second meeting. Shareholders report that some firms are not investor-friendly and hold meetings at intentionally inconvenient times and places. As a result (and due to investor passivity), second meetings (with no quorum) are frequent. Current law does not appear to comply with the EU Second Directive, which requires a quorum for second extraordinary meetings.

Shareholders representing at least ten percent of voting rights may at any time file a request to the management board to convene an AGM. If the board fails to comply within 30 days, the shareholders may petition the Court of Registration to (within another 30 days) convene the AGM. The company pays for meetings. However, the Court will not convene a meeting unless the shareholders requesting it advance the costs and prove that the meeting arrangements will be acceptable. The resulting AGM will then decide who will bear the costs. The issue of costs has resulted in infrequent applications of the Court of Registration's powers. The Court has only called five AGMs, and reports fewer occasions when they have appointed an auditor.

An announcement must be published - usually in a daily newspaper - at least 30 days before the meeting. Shareholders may submit written questions to the board about agenda issues. The board must respond to requests made at least eight days before the AGM. Shareholders may place items on the agenda, but the board may exclude items. However, the board must comply with requests made within eight days of receiving the AGM notice from shareholders with at least ten percent of voting rights. If the AGM fails to discuss this item, shareholders may request the Court of Registration to order discussion. There are no rules requiring the agenda's re-circulation after new items are added, but the BSE reports that most companies do republish the agenda.

¹⁶ As noted above, the company charter can delegate the right of appointing the management board to the supervisory board.

Shareholders may vote in abstentia and be represented by proxy. Company charters may allow voting to occur in writing. Documents may be produced electronically with electronic signatures.

In practice, reports suggest that management (and/or controlling shareholders) create obstacles for other shareholders to vote. A few examples of tactics employed include use of the “60-day rule” to prevent certain shareholders from registering for the AGM, convening the AGM at a distant branch office, and convening the second AGM one hour after the first meeting.

Policy recommendations: Tighten legislation so that meetings occur at reasonable times and places. A quorum should be added for second meetings where key issues (e.g. capital increases) will be addressed (per the Second Directive); consideration should be given to requiring a reasonable delay for second meetings. Require the agenda’s recirculation (or online posting) if shareholders add new items. The risk of paying for an extraordinary meeting appears to be a great disincentive to outside directors calling a meeting. These costs should be minimized, or imposed only on the shareholders calling the meeting by a supermajority AGM vote.

Principle ID: Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

Assessment: Largely observed

Description of practice: Since July 2001, shareholders have primary responsibility for disclosing ownership details to the company and HFSA if their holdings exceed certain limits. Disclosure thresholds are the five percent level and multiples thereof up to 50, 75, and 90 percent. Issuers must disclose their ownership structure in flash and annual reports. The CMA requires nominees/custodians to disclose ultimate owners. HFSA and BSE have actively imposed sanctions for non-compliance, although there have been no major cases of insufficient disclosure. Cross-holdings are also prohibited. Shareholder agreements must be disclosed. Changes to share rights must also be disclosed in the annual report. However, the law and listing rules do not require the disclosure of voting caps or other voting restrictions in the annual report.

Policy recommendations: Voting caps should be disclosed in the annual report to increase transparency. Facilitating the disclosure of ownership information by nominees should be a key focus of the “Share Registration Working Group” (see above).

Principle IE: Markets for corporate control should be allowed to function in an efficient and transparent manner.

Assessment: Largely observed

Description of practice: The Hungarian market for corporate control is highly regulated. New takeover rules were enacted in 2001 to eliminate legislative loopholes identified in the Borsodchem case (see Annex F). Acquisitions resulting in a change in control (a threshold of 33 percent of voting rights defines control) must be approved by HFSA.¹⁷ Transactions above the threshold must include a public purchase offer. The CMA provides a broad definition on

¹⁷ If the company is widely held (no shareholder owns over ten percent of voting rights, except for the acquirer) the threshold of the obligation of public offer is 25 percent. The CMA broadly defines acquisition of control, apparently in line with applicable EU regulations. Control includes the traditional method of acquiring voting rights to participate in AGM decision-making and exercising options to buy, repurchase or buy in future shares with voting rights, or exercising voting rights based on usage rights.

acquisition of control, which appears in line with EU regulation. HFSA tries to enforce takeover rules, but most efforts appear aimed at compliance with ownership disclosure requirements.

The company law attempts to prevent voting caps from being used as a takeover obstacle; voting caps automatically phase out after ownership by one shareholder reaches 50 percent.

Policy recommendations: Closely monitor the EU debate on takeover rules and tender offers, and adjust the regulatory framework as required.

Principle 1F: Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights

Assessment: Materially not observed

Description of practice: Shareholder activism in Hungary depends on each shareholder's degree of control. Typically, public companies operate with the controlling influence of one or two shareholders, who tend to monopolize AGMs. General sentiment appears to be that institutional investors use "exit" rather than "voice" to influence the management of the companies in their portfolio. Foreign investors tend to give their proxies to management, and do not always exercise their right to vote. As a result, institutional investors think of themselves as "visitors" at many AGMs. They are not typically present, and do not play an active role in voting.

Policy recommendations: Pension funds should be obliged by regulation to disclose their voting policy. Voting should be made as easy as possible. Awareness of successful international experiences of shareholder activism should be raised. Those drafting a code of best practice may also want to consider the question of investor responsibility.

Section II: The Equitable Treatment of Shareholders

Principle 1IA: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same class should be treated equally. (1) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. (2) Votes should be cast by custodians or nominees in a manner agreed upon with the share's beneficial owner.

Assessment: Largely observed

Description of practice: Companies may issue ordinary, preferred, employee, and interest-bearing shares. Preferred shares (which must be registered and rarely have voting rights) may be issued up to 50 percent of registered capital, and include "golden" and veto shares.

Shareholders and board members may file petitions to the relevant court challenging unlawful company decisions, including AGM and management or supervisory board resolutions. If a board decision violates the law or minority rights, shareholders with ten percent (in some cases, five) may also petition the Court of Registration. If a company fails to sue a manager, board member, or auditor (because the AGM ignored or could decide on a proposal), members with at least ten percent of votes may, within 30 days of the AGM, bring suit in the company's name. The company advances legal costs, but litigating shareholders must reimburse costs if the suit fails.

Some have expressed concerns that many magistrates lack expertise in corporate governance matters. Not all court decisions are published, and publication is two years behind.

Holders of common shares do not necessarily have equal voting rights, and Hungary does not follow the principle of “one-share one-vote.” A company’s charter may impose a cap on voting rights exercisable by a single shareholder. Preferred shares with multiple voting rights may be issued, with each share having up to ten times the voting rights of ordinary shares. Voting caps are not uncommon, and are in place at blue chips such as Pannonplast, MOL, and OTP.

Changes in voting rights require a supermajority shareholder vote. Decisions resulting in changes to rights attached to existing shares may only be made by the AGM, and only if affected shareholders agree by a $\frac{3}{4}$ supermajority in advance. This also applies to the issue of new shares, which might dilute existing shareholders’ rights. The company charter (available at the Court if Registration) and prospectus must detail rights attached to shares. Notice of an AGM that will rule on a share issue must detail information on the capital increase (public or private issue), subscription minimum, draft amendment to the charter, and details of in-kind contributions.

The new CMA regulates in detail the voting of shares held by custodians/nominees. The nominee relationship is established by a written contract with the shareholder.

Some custodians insert clauses into their client contracts requesting the right to vote the shares they hold on behalf of clients. They use this right to be able to attend “interesting” AGMs and gain useful information, particularly where they hold more than five percent of the shares.

Policy recommendations: As institutional investors often request moves towards “one-share, one-vote,” policymakers should consider moving further toward this principle by phasing out golden shares and veto shares and removing the possibility for issuance of preferred shares with multiple voting rights (except in the case of non-payment of dividends).

The “Share Registration Working Group” should review obstacles to nominee voting of shares, striving to standardize and simplify voting by beneficial owners. The Group should review current practice and issue best practice recommendations as part of the legal revision process and code of best practice. All court decisions should be published as quickly as possible.

Principle IIB: Insider trading and abusive self-dealing should be prohibited.
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Assessment: Largely observed

Description of practice: The CMA prohibits insider trading. Regulations reportedly comply with applicable EU standards. Insider information, the types of prohibited dealing, and the concept of “insider” are well-defined; the information must not have been published, and its dissemination would significantly influence share price. Along with prohibitions on deals, the act imposes reporting obligations on insiders, who must report to HFSA details on any company share trades within two days. Insider dealing is criminalized; no convictions have yet been reported.

The AGM must approve sale/purchase agreements when their value exceeds ten percent of the company’s registered capital. No quorum or majority requirements apply. The law prohibits other conflicts of interest (see Annex F). Violation should result in immediate termination. Executive officers are liable for violations; the company may file damage claims within a year.

Policy recommendations: The level of fines that HFSA can impose for violations of reporting obligations should be greatly increased.

Principle IIC: Board members and managers should be required to disclose material interests in transactions or matters affecting the corporation.

Assessment: Partially observed

Description of practice: Under the CMA and the BSE Listing Rules, public (and listed) companies must disclose information about management and supervisory board members and the auditor. They must disclose director holdings in company shares and, under the extraordinary reporting obligations, changes to such holdings. Special disclosure obligations apply to banks; executive officers of credit institutions must report their institutional shareholdings to the board.

Hungarian accounting regulation appears to be lax in the reporting of related party transactions, relative to the rules and definitions set out in IAS (International Accounting Standard) 24.¹⁸

Policy recommendations: Related party transactions should form an important focus of corporate governance and accounting reform efforts. An Accounting and Auditing ROSC should be carried out to review the differences between IAS and Hungarian accounting regulation.

Section III: Role of Stakeholders in Corporate Governance

Principle IIIA: The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

Assessment: Largely observed

Description of practice: Hungarian Company and Labor Law provide a favorable environment for trade unions to carry out activities at large companies. If a company has over 200 employees, employees may appoint one-third of the supervisory board members. According to published EU reports, Hungary is highly aligned with EU Directives on environmental law and regulation.

Policy recommendations: Creditor rights were not reviewed in this assessment. A Creditor Rights ROSC is recommended to assess creditor rights and the insolvency framework in detail.

Principle IIIB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

Assessment: Largely observed

Description of practice: The rights of other stakeholders are not expressly stated under the law or in voluntary codes of practice but are supported by disclosure and transparency. The competent authorities enforce rights if a violation is noticed or pointed out. Under the Environmental Act and other environmental laws and regulations, companies must disclose activities that cause pollution and must report on certain contamination standards, such as ground water pollution. They must also disclose their clean-up measures and policies to prevent future contamination.

Principle IIIC: The corporate governance framework should permit performance-enhancement mechanisms for stakeholder participation.

Assessment: Largely observed

¹⁸ GAAP 2001 accounting standards survey, IFAD website (www.ifad.net). According to the survey, "...there are no specific rules requiring disclosures of ... transactions with related parties other than parties with investment relationships (IAS 24)".

Description of practice: Profit sharing schemes are the most common incentives, although there is no legal provision for them. Attempts have been made to introduce share options, mainly as part of management incentive schemes. As share options qualify as an in-kind benefit subject up to 40 percent income tax, they are less popular in Hungary than elsewhere.

Policy recommendations: Careful attention should be paid to international debates on the use/abuse of stock options; Hungary should tailor its regulatory framework to the new consensus.

Principle IIID: Where stakeholders participate in the corporate governance process, they should have access to relevant information.

Assessment: Largely observed

Description of practice: Stakeholders enforce their right to company information.

Section IV: Disclosure and Transparency

Principle IVA: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and the governance of the company. Disclosure should include, but not be limited to, material information on: (1) The financial and operating results of the company. (2) Company objectives. (3) Major share ownership and voting rights. (4) Members of the board and key executives, and their remuneration. (5) Material foreseeable risk factors. (6) Material issues regarding employees and other stakeholders. (7) Governance structures and policies.

Assessment: Largely observed

Description of practice: Hungary has a comprehensive system of information disclosure. Companies must present all information investors need to make informed decisions. Public companies must adhere to CMA requirements, providing (i) a securities prospectus/offering document; (ii) regular disclosure of information; and (iii) disclosure of extraordinary (material) information. Listed companies must also follow the BSE's more detailed disclosure rules. Companies must submit financial statements (and notes), and the auditor's report to the Court of Registration and the Department for Company Registration and Company Information Service at the Ministry of Justice. Financial and consolidated financial statements filed at the Court of Registration are public. Disclosure requirements are closely aligned with EU Directives.¹⁹

Issuers must prepare quarterly or semi-annual, unaudited "flash reports" for the HFSA and BSE, and publish them in a national daily newspaper and exchange gazette or public HFSA-approved electronic system.²⁰ They must produce annual and consolidated annual reports with audited financial statements, publishing announcements as to when and where they may be inspected. They must also publish and send HFSA extraordinary information within a day of occurrence. Financial statements include balance sheets, income and cash flow statements, and notes.

Business objectives, major share ownership and voting rights, executive employee and board member aggregate remuneration, and "major risk factors in the company's financial management" must be disclosed. Companies generally need not disclose their risk management policies, material issues regarding employees and other stakeholders, or governance structures and policies. Audit fees (but not auditor consulting fees) must be disclosed.

¹⁹ According to the Ministry of Finance, disclosure requirements fully comply with Council Directive 80/390/EEC of 17 March 1980, as amended. However, the CMA is not aligned with the most recent amendment to EU capital markets and securities law (Directive 2001/34/EC of 28 May 2001, on the admission of securities to official stock exchange listing and on information to be published on those securities), because the CMA was drafted before the Directive was published.

²⁰ Category "A" companies must file quarterly flash reports, and Category "B" companies must file on a semi-annual basis.

Over the period 1997-2001, the BSE took action 61 times for violations of disclosure rules, issuing 36 warnings and 25 fines that totaled HUF 6.75 million (USD 27,000).

Policy recommendations: HFSA, together with BSE, should increase its review and enforcement of disclosure content, and continue its zero-tolerance policy toward late filings. Sanctions (fines and civil liability) should be reviewed. The disclosure of governance policies and material risk factors should be added to reporting obligations and a code of best practice.

Principle IVB: Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

Assessment: Partially observed

Description of practice: Most listed companies reportedly produce financial reports according to IAS. BSE listing rules require Category “A” issuers must to prepare annual reports using IAS or GAAP; Category “B” issuers may continue to use Hungarian standards (and 23 out of 26 continue to do so). Because Hungary plans to join the EU in 2004, all Hungarian listed companies must meet the June 2002 Regulation and use IAS from 2005 onwards.²¹

Although they are not now particularly relevant for large listed companies, Hungarian accounting regulation varies in some important details from IAS (including the disclosure of related party transactions – see Principle IIC).

The standards of audit for Hungarian listed companies are considered by market participants to be relatively high. Most listed companies are audited by one of the large international network firms, as are all major banks. According to the Chamber of Auditors and interviews with local firms, International Standards on Auditing (ISA) are being used by the “Big Four” firms.

National Audit Standards were formulated based on ISA, and became mandatory for all auditors in 2001. According to the Hungarian Chamber of Auditors, national standards are close to full compliance with international standards. The institutional framework is still being developed.

Policy recommendations: Meeting the 2005 deadline for IAS compliance will challenge the few listed companies not yet using IAS. Regulation and informal communication should push rapid conversion; an Accounting and Auditing ROSC is advised to assess IAS compliance.

Principle IVC: An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

Assessment: Partially observed

Description of practice: All publicly traded companies must be audited by an independent auditor. The AGM appoints and removes the auditor. The CA, the Act on the Chamber of Hungarian Auditors and the audit profession’s Ethical Standards define auditor independence. Most listed companies are audited by Big Four firms, who are held to ISA independence criteria.

²¹ Signaling their commitment to IAS, the Chamber of Auditors, Ministry of Finance and Association of Hungarian Accounting Professionals set up the Foundation for Development of Hungarian Accounting to translate IAS, explanatory notes and future amendments into Hungarian, as well as to serve as a resource for professionals during the implementation of IAS.

The Chamber of Hungarian Auditors governs auditor conduct. However, until recently there was no auditing review panel to monitor the profession on compliance to applicable rules and standards. In December 2002 the Chamber set up a Quality Assurance Committee to review audit work and ensure auditor adherence to National Standards. Initially, the committee plans to emphasize support rather than strict control of auditors during audit reviews. Later, an auditing review panel of 100-150 professionals will function based on a peer review model.

Policy recommendations: The Accounting and Auditing ROSC should address the system of auditor practice review, including quality assurance arrangements. Also, see recommendations on audit committees below.

Principle IVD: Channels for disseminating information should provide for fair, timely, and cost-effective access to relevant information by users.

Assessment: Observed

Description of practice: Information channels are well established.²²

Section V: The Responsibility of the Board

Principle VA: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

Assessment: Partially observed

Description of practice: Hungarian law calls for a two-tier structure for public companies, consisting of a management board and a supervisory board. In practice, the true governing body is the management board. The AGM typically appoints and removes directors of both boards and sets their remuneration, greatly reducing the supervisory board's power.

The supervisory board may sometimes participate in operations decisions, making the company's governing system a truly two-tier system. In such cases, the supervisory board appoints and sets the board of directors' and auditor's remuneration, and exercises veto power over some company transactions, as listed in the charter. If the company charter authorizes the supervisory board to exercise these rights, the board remains accountable to shareholders. If the supervisory board does not approve an agreement or other transaction when so empowered, the management board, or any executive officer may convene an AGM, where a decision to overrule the supervisory board may be taken by $\frac{3}{4}$ supermajority vote. The supervisory board must report its decisions to the AGM; it always acts in a derived capacity, as the shareholders' quasi-representative.

Management board. The management board oversees day-to-day operations. It takes decisions collectively, sets its own rules, and decides on issues not reserved for the AGM. Its size ranges from three to eleven members. It must meet at least annually, but as it must report to the AGM once a year and three times to the supervisory board, this presupposes more frequent meetings.

Supervisory board. The supervisory board exercises control over management on behalf of shareholders. Employees appoint 1/3 of the up to 15 supervisory board members. The board must

²² Note that listed companies must publish all their annual, interim (flash) reports and ongoing (material, or ad hoc) notifications through the website of the BSE at www.bse.hu.

examine all reports on the company's operations and finances and all proposals to be submitted to the AGM, which may not approve financial reports without the board's written report.

The supervisory board is fairly weak, as its main power is to refer issues to the AGM. If the board finds violations of laws or regulations, the company's charter, or the AGM's resolutions, or should it decide that the management board's operation is contrary to the company's or shareholders' interests, it can convene an extraordinary meeting and "propose an agenda". Supervisory board members are entitled to participate at AGMs with a right of consultation.

Policy recommendations: A voluntary corporate governance code should be developed to suggest the roles, responsibilities, operation, structure, and qualifications of both boards. The code should recommend committee structure within supervisory boards, specialized committees on areas like audit and finance, risk policy, and management nomination and compensation. It should address criteria for board member independence and procedures for ensuring disclosure of conflicts of interest—and for ensuring that independent directors are present on key board committees. Listed companies should have to disclose their level of compliance with the code.

Principle VB: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

Assessment: Largely observed

Description of practice: Both boards are accountable to the AGM. Neither can be "instructed" by shareholders. Therefore, in theory, both boards have a legal duty to all and not to any one shareholder. The Supreme Court has ruled that the appointment of a director must always be "personal" as opposed to defining the position of the director as a person in a certain relationship with the shareholder (e.g. member of the shareholder's board). In practice, large shareholders appoint directors who are connected to them and who defend their specific interests on the board.

Board members are jointly and severally liable for damages caused by violation of their duties under the law, and for non-compliance with AGM decisions or the charter, unless they can show that they acted with due care (see Annex H for details).

Policy recommendations: Develop a code of best practice; see Principle VA. The group preparing the code should investigate the costs and benefits of imposing a "duty of loyalty"-type obligation to all shareholders on both boards, as a supplement to their duty to the company.

Principle VC: The board should ensure compliance with applicable law and take into account the interests of stakeholders.

Assessment: Largely observed

Description of practice: Both the supervisory board and auditor have duties to ensure compliance with applicable laws. The supervisory board must detect problems at the management board level and inform shareholders to resolve discrepancies. Employee seats on the supervisory board allow employee access to information and protect their interests.

Policy recommendations: Develop a code of best practice; see Principle VA.

Principle VD: The board should fulfill certain key functions, including (1) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance and overseeing major capital expenditures, acquisitions and divestitures. (2) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. (3) Reviewing key executive and board remunerations, and ensuring a formal and transparent board nomination process. (4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions. (5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law. (6) Monitoring the effectiveness of the governance practices under which it operates and making changes as needed. (7) Overseeing the process of disclosure and communications.

Assessment: Materially not observed

Description of practice: The board's general duties are laid out in the CA. The following general observations can be made about board responsibility:

- 1) Responsibility for strategic planning is diffuse in theory, concentrating authority at the management board in practice. The management board shares the responsibility to set strategy with the AGM, which may reserve the right to make strategic decisions.
- 2) Company risk policy is regulated only for financial institutions. There are no specific legal provisions on the board's duties on annual budgets, corporate performance, or business plans.
- 3) In theory, the boards play little role in succession planning; the AGM typically appoints members of both boards. Formally, boards influence the appointment of key executives only through "consultation" at the AGM. However, since the management board sets the agenda, it plays the only real role in its own succession planning.
- 4) The AGM sets remuneration for members of both boards. However, the AGM is unlikely to be able to establish a transparent nomination process, and the real work will be done by the management board, which will nominate new supervisory board members on the agenda.
- 5) The AGM may not make a decision unless it reviews the supervisory board's written opinion; and the supervisory board relies on the input of the board of directors (which must report on company performance to the supervisory board at least quarterly).
- 6) In practice, the supervisory board's weakness leaves the management board in charge of many governance functions, with little oversight.
- 7) Liability for non-disclosure of information has not been clearly established.

Policy recommendations: Develop a code of best practice; see Principle VA. The weaknesses outlined above should be a focus of the code. Liability for information non-disclosure should be as explicit as possible within the law, perhaps including US-style executive report certification.

Principle VE: The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management: (1) boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination, and executive and board remuneration. (2) board members should devote sufficient time to their responsibilities.

Assessment: Partially observed

Description of practice: There are no regulations or voluntary codes regulating board independence. Judicial practice refers to "internal" and "external" board members, but no distinction is made under the regulations. Some provisions do regulate board member objectivity. In practice, many companies try to appoint some, but not a majority, of "independent" directors.

A person may be an executive officer (including a board member) in no more than three companies; he must disclose his duties at other companies when appointed. An executive officer must inform the other companies of his most recent appointment within 15 days.

Audit committees are not required under Hungarian law. In some cases, executives and auditors have formed informal committees to oversee the audit process. Some large financial institutions have promoted an audit-type committee panel consisting of supervisory board members and internal and external auditors. These committees manage and monitor the audit process, evaluate its results, and communicate findings to the board.

Since shareholders usually appoint as directors persons somehow related to them, they do monitor board member performance. The CA requires boards to meet at least yearly to approve the annual report but does not contain specific requirements for meeting frequency.

Policy recommendations: Audit committees should be implemented, and the creation of other supervisory board committees should be explored in the development of a code of best practice.

Principle VF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

Assessment: Observed

Description of practice: Supervisory board members may ask management board members and senior employees for information and must receive access to company books (subject to a duty to keep business secrets). They may solicit expert opinion when matters require special expertise.

IV. SUMMARY OF POLICY RECOMMENDATIONS

This section sets out recommendations to improve listed companies' compliance with the OECD Principles. The next step is to develop a detailed action plan, to be formulated in cooperation with the Hungarian authorities and in consultation with the private sector and other stakeholders.

Legislative reform: Annex B details the policy recommendations developed above. One area requires special focus. A "share registration working group" to remove inconsistencies between law and practice in the area of share record keeping for corporate actions. In a number of areas, abuses were reported. A "date of record" concept should be instituted.

Since the code of best practice's drafting may also result in legislative recommendations, it is desirable for the legislative process to wait for the conclusion of the code process. *Priority: high*

Institutional strengthening: HFSA should continue to strengthen its capabilities to enforce corporate governance provisions of securities law. To that end, it should be given the authority to issue its own regulations. Staff should be trained to gain awareness of corporate governance issues and possible abuses. New emphasis should be placed on related party transactions. Issuers must continue to focus on the transition to IAS. *Priority: medium*

Voluntary/private initiatives: While Hungary's legal framework protects shareholder rights and meets EU criteria, its rules for boards of directors risk divergence with international trends. The voluntary code of best practice should be completed and disseminated. Listed companies should be required to disclose their level of compliance with the code. This approach provides choice for issuers and investors. In an increasingly global economy, competition for capital is intense, and good corporate governance can make a difference in how Hungarian firms are viewed. After a few years, issuer compliance with the voluntary provisions of the code could be reviewed. If necessary, key provisions of the code could be embedded in legislation or the Listing Rules. At the same time, it is recommended that training in the code be provided for supervisory board members, for example through an Institute of Directors. *Priority: high*

Annex A: Summary of Observance of OECD Corporate Governance Principles

PRINCIPLE		O	LO	PO	MO	NO	Comment
I. THE RIGHTS OF SHAREHOLDERS							
IA	Basic shareholder rights			X			<ul style="list-style-type: none"> Inconsistency between law and practice of updating registry from KELER. Some voting disallowed as a result.
IB	Rights to participate in fundamental decisions.	X					<ul style="list-style-type: none"> Some authority for capital increases can be delegated to board.
IC	Shareholders AGM rights			X			<ul style="list-style-type: none"> Some reports of companies setting meetings that are difficult to attend.
ID	Disproportionate control disclosure		X				<ul style="list-style-type: none"> Shareholders required to disclose at five percent +levels; Companies disclose ownership in annual reports.
IE	Control arrangements should be allowed to function.		X				<ul style="list-style-type: none"> Strong takeover rules with squeeze-out provisions.
IF	Cost/benefit to voting				X		<ul style="list-style-type: none"> Institutional investors tend to use exit over voice.
II. EQUITABLE TREATMENT OF SHAREHOLDERS							
IIA	All shareholders should be treated equally		X				<ul style="list-style-type: none"> Voting caps can be employed Multiple voting rights, Golden shares, and veto shares complicate voting rights
IIB	Prohibit insider trading	X					<ul style="list-style-type: none"> Strong definitions of insiders and inside information. AGM must approve large transactions.
IIC	Board/Mgrs. disclose interests			X			<ul style="list-style-type: none"> Limited disclosure of related part transactions under Hungarian accounting regulation.
III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE							
IIIA	Stakeholder rights respected		X				<ul style="list-style-type: none"> 1/3 of supervisory board seats reserved for employees
IIIB	Redress for violation of rights		X				
IIIC	Performance enhancement		X				<ul style="list-style-type: none"> Employees can own shares and options.
IIID	Access to information		X				<ul style="list-style-type: none"> Based on public disclosure; see section IV below.
IV. DISCLOSURE AND TRANSPARENCY							
IVA	Disclosure standards		X				<ul style="list-style-type: none"> Disclosure standards quite completed. No disclosure of material risk factors.
IVB	Standards of accounting & audit			X			<ul style="list-style-type: none"> Most listed companies use IAS. All companies must meet new EU standard (IAS in 2005)
IVC	Independent audit annually			X			<ul style="list-style-type: none"> Most listed companies use Big 4 (and ISA). Review/oversight body being created in 2002
IVD	Fair & timely dissemination	X					
V. RESPONSIBILITIES OF THE BOARD							
VA	Acts with due diligence, care			X			<ul style="list-style-type: none"> Two-tier board (one-tier optional), but few active sup. boards. Supervisory role poorly defined.
VB	Treat all shareholders fairly		X				<ul style="list-style-type: none"> Fair treatment principle often violated in practice. No barriers to preferential treatment.
VC	Ensure compliance w/ law		X				<ul style="list-style-type: none"> Board required to comply with all legal requirements.
VD	The board should fulfill certain key functions				X		<ul style="list-style-type: none"> Board and management nomination and remuneration left to "AGM", effectively to management board. Unclear liability for non-disclosure of information.
VE	The board should be able to exercise objective judgment			X			<ul style="list-style-type: none"> Two-tier board means supervisory board is non-executive.
VF	Access to information	X					<ul style="list-style-type: none"> Law grants access to information and special expertise.

Annex B: Summary of Policy Recommendations

I. THE RIGHTS OF SHAREHOLDERS		
IA	Basic shareholder rights	<p>Create a “share registration working group” under the leadership of KELER composed of custodians, legal experts, and perhaps the tax authority, to synchronize law and market practice for shareholder record keeping for corporate actions. The group would be well positioned to make recommendations on:</p> <ul style="list-style-type: none"> • Removing the 60 day requirement for participating in the AGM; • Establishing a legal “date of record” for all corporate actions, including AGMs and dividends; • Formalizing in law the roles of the custodian, KELER, and the share register, and the creation of shareholder list for corporate actions (including AGMs); • Removing impediments to the conversion of convertible bonds; • Standardizing documents (including powers of attorney) for proxies, voting instructions, etc.; • Establishing processes to make voting by beneficial owners as easy as possible; • Establishing processes to make voting by beneficial owners as easy as possible, and to improve compliance with ownership disclosure rules. <p>The recommendations can be formalized in amendments to the Company Law, the CMA, KELER procedures, and BSE listing rules. The same group could also consider the adoption of KELER as a Central Registry for all listed shares (or all Category “A” shares) with an appropriate phase-in.</p>
IB	Rights to participate in fundamental decisions.	NA
IC	Shareholders AGM rights	Tighten legislation so that shareholder meetings take place at reasonable times and reasonable places. A quorum should be added for second meetings, where key issues (e.g. capital increases) will be addressed, per the Second Directive. Require a reasonable delay for these second meetings. Add requirements for the recirculation of the agenda (or posting on a web site) if new items are added to the agenda by shareholders.
ID	Disproportionate control disclosure	Voting caps should be disclosed in the annual report to increase transparency. Facilitating the disclosure of ownership information by nominees should be a key focus of the “Share Registration Working Group” (see above).
IE	Control arrangements should be allowed to function.	Closely monitor EU debate on takeover rules and tender offers, and adjust the regulatory framework as required.
IF	Cost/benefit to voting	Pension funds should be obliged by regulation to disclose their voting policy. Voting should be made as easy as possible. Raise awareness of successful international experiences of shareholder activism. Those drafting a code of best practice may also want to consider questions on investor responsibility.
II. EQUITABLE TREATMENT OF SHAREHOLDERS		
IIA	All shareholders should be treated equally	<p>Policymakers should consider moving further toward “one-share, one-vote”, by (1) Phasing out the Golden Shares, and (2) Removing the possibility for companies to issue preferred shares with multiple voting rights (except in the case of non-payment of dividends). The “share registration working group” should work to review any obstacles to the voting of shares by nominees, with the goal of standardizing and simplifying the voting of shares by beneficial owners. The Group should review existing practice in detail and issue best practice recommendations to be incorporated in the legal revision process (as required) and the code of best practice. All court decisions should be published as quickly as possible.</p>
IIB	Prohibit insider trading	The level of fines that can be imposed by HFSA for failure to comply with reporting obligations should be greatly increased.
IIC	Board/Mgrs. disclose interests	Related party transactions should form an important focus of corporate governance and accounting reform efforts. An Accounting and Auditing ROSC should be carried out to review the differences between IAS and Hungarian accounting regulation.
III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE		
IIIA	Stakeholder rights respected	Creditor rights ROSC recommended.
IIIB	Redress for violation of rights	NA
IIIC	Performance enhancement	Careful attention should be paid to the on-going international debate on the use and abuse of stock options, and Hungary should carefully tailor its regulatory framework to the new consensus.
IIID	Access to information	NA
IV. DISCLOSURE AND TRANSPARENCY		
IVA	Disclosure standards	HFSA, in cooperation with the BSE, should increase its review and enforcement of disclosure content, and continue its zero-tolerance policy toward late filings. Fines should be increased. The disclosure of material risk factors should be added to regular reporting obligations.
IVB	Standards of accounting & audit	Meeting the January 2005 deadline for full IAS compliance will be a large task for those few listed companies that do not yet use IAS. Regulation and informal communication should be used to push the conversion as rapidly as possible. An Accounting and Auditing ROSC is recommended to review actual compliance with international standards.
IVC	Independent audit annually	Conduct an Accounting and Auditing ROSC. See recommendations on audit committees below.

IVD	Fair & timely dissemination	NA
V. RESPONSIBILITIES OF THE BOARD		
VA	Acts with due diligence, care	A voluntary corporate governance code should be developed to recommend the roles, responsibilities, operation, structure, and qualifications of both boards. The code should recommend committee structure within supervisory boards, specialized committees on areas like audit and finance, risk policy, and nomination and compensation of management. It should address criteria for determining board member independence and procedures for ensuring disclosure of conflicts of interest—and for ensuring that independent directors are present on key board committees. The code could be prepared by a BSE business advisory task force of public and private sector representatives and should be adapted to Hungarian financial market conditions. Listed companies should have to disclose their level of compliance with the code.
VB	Treat all shareholders fairly	Develop a code of best practice; see Principle VA. The group preparing the code should investigate the costs and benefits of imposing a “duty of loyalty”-type obligation to all shareholders on both boards, as a supplement to their duty to the company.
VC	Ensure compliance w/ law	Develop a code of best practice; see Principle VA.
VD	The board should fulfill certain key functions	Develop a code of best practice; see Principle VA. The weaknesses outlined in the assessment should be a focus of the code. Liability for information non-disclosure should be as explicit as possible within the law, perhaps including US-style executive report certification.
VE	The board should be able to exercise objective judgment	An audit committee structure should be put in place, and the creation of other committees of the supervisory board should be explored, as part of the effort to develop a code of best practice; see Principle VA.
VF	Access to information	NA

Annex C: Markets and Market Participants

Hungary's capital markets are large and deep relative to those of many of its neighbors. Market capitalization, value traded, and turnover relative to market capitalization are generally higher than those of comparison countries, based on standard market indicators. Market capitalization at the end of 2001 was over 19 percent.

Hungary and Selected ECA Countries 2001 Equity Market Statistics

	Market Capitalization		Value	Turnover	# of Listed Companies	S&P/IFC
	US\$	% of GDP	Traded % of GDP			Ratio
Hungary	10,367	19.8	9.4	3.8	57	-10.3
Czech Republic	9,151	16.2	6.2	3.7	94	-13.7
Croatia	3,089	15.6	1.0	0.3	62	-3.5
Poland	25,931	14.9	6.1	1.9	230	-24.9
Slovenia	2,778	14.8	4.1	3.4	38	2.0
Bulgaria	506	4.0	0.6	1.0	399	-7.5
Romania	1,114	2.8	0.3	0.8	60	-25.3
Slovak Republic	538	2.6	2.6	17.7	844	21.3
Macedonia, FYR	2	0.1	1.3	..	2	..

Source: World Development Indicators. All figures for year-end 2001. Value traded and turnover are for calendar year 2001.

The ownership and trading of shares reflects the large foreign interest in Hungary. Non-resident investors held 72.9 percent of exchange-traded shares at the end of 2001.¹ The government held 8.5 percent, non-financial corporations 6.1 percent, and the financial sector share held 6.3 percent of shares. Retail investor shareholdings have declined over time, to 6.2 percent of exchange-traded shares at the end of 2001, compared to 6.9 percent at the end of June. Roughly 200,000 individuals own shares, or approximately two percent of the population. The majority of household financial assets consists of HUF denominated bank deposits and government bonds. The negative trends of international and domestic equity markets, unfavorable changes in capital gains taxes, political intervention in some segments of the economy, and a boom in the property sector have combined to make stock market investments less attractive.

Hungary's institutional investors are relatively advanced. At the end of 2001 total assets of Hungarian investment funds amounted to nearly HUF 700 billion (USD 2.5 billion), of which 28.5 percent was invested in equities. At the end of the third quarter of 2001, 24 private pension funds and 99 voluntary pension funds operated in the market. The total assets of private pension funds amounted to HUF 245.8 billion (USD 0.87 billion). Like investment funds, the portfolios of private pension funds are dominated by government bonds (more than 80 percent), while less than 13 percent of total assets were invested into Hungarian equities. Total assets of voluntary funds amounted to HUF 256.6 billion (USD 1.04 billion), 80 percent of which was invested into

¹ National Bank of Hungary, official data.

government bonds. The share of equities in the portfolios was 11.4 percent at the end of the quarter. At the end of the third quarter of 2001, 24 stock insurance companies and 38 mutual insurance companies were in business. Insurance companies had investments of HUF 639.7 billion (USD 2.27 billion), with 5.8 percent invested in equities.

Annex D: Corporate Governance Institutions

Budapest Stock Exchange

The Budapest Stock Exchange (*Budapesti Értéktőzsde*, or BSE) is the dominant stock exchange.¹ As a small, open economy, its markets are heavily influenced by international market sentiment.

As of August 2002, 50 companies were listed on the BSE, including 24 Category “A” and 26 Category “B.” Category “A,” which has higher listing requirements, represents almost 93 percent of market capitalization. Three companies (Matav, MOL, and OTP) represent 66 percent of total capitalization. The majority of the turnover in Hungarian shares takes place outside of Hungary; 43 issues are listed in London, which represented more than 58 percent of total turnover in 2001.

In the past few years, the number of new listings has decreased, while delistings have increased. From 1997 to 1999, 34 new issuers were listed, but only one company was listed in each of the last two years. Over the same period, 21 issuers delisted their shares from the BSE. The resulting decline in the number of listed companies is explained by several factors. The completion of privatization left no more large companies that could aspire to listing. Despite the BSE’s efforts to attract new issuers, small and mid- size companies have not considered listing as a real alternative, and no significant IPOs have taken place in recent years. Finally, old rules that required mandatory listing for large companies have been repealed.

New issues have taken the form of capital increases via private placements rather than public offerings. Based on HFSA data, in 1998, public offerings comprised seven percent of total new issues. This proportion declined in 1999 to three percent, and in 2000 to one percent. Large companies consider it cheaper to issue bonds or apply for bank loans than to raise funds through new share issues. Medium-sized and small companies consider the advantages of being public limited and stock exchange listing to be expensive, although the Hungarian government and BSE are working to ameliorate the latter situation.² The general market environment makes raising funds through public offerings difficult. In a recent BSE survey, issuers without strategic shareholders expressed fears of hostile takeovers, and “extreme and fundamentally unjustified falls in stock prices” that could endanger a company’s reputation.

The BSE is organized as a self-regulatory organization. Its rules are compulsory for investment service providers falling under the scope of the CMA (including credit institutions and financial enterprises providing investment services if they trade on the BSE). Violations of BSE rules trigger BSE sanctions that may ultimately result in suspension of the trading rights of the relevant investment service provider.

The BSE has completed a first draft of its Corporate Governance Guidelines, a set of recommendations aimed primarily at listed companies. The Guidelines are under review by

¹ There is also an over-the counter market, but its turnover is practically zero.

² To ease such cost issues, the Hungarian government and BSE are working together on a capital market promotion package, which will include the abolition of the capital gains tax for individuals as of January 2003. The BSE has also abolished the introductory fee for newly listed companies.

academic, business and financial sector professionals and listed company representatives, and are expected to be officially published in early 2003.

State Supervisory Authority for Financial Organizations (HFSA)

The capital markets supervisor is the State Supervisory Authority for Financial Organizations (HFSA). HFSA was created in April 2000 according to the model of the FSA in the UK as a consolidated supervisor, and it has oversees every sector of the financial and securities markets. The independence of HFSA is comparable to that of the National Bank of Hungary (NBH). HFSA is financially self-supporting, and it independently manages the budget assigned to it. Although the general rules of administrative procedure apply to HFSA, there is no possibility to administratively challenge its decisions (only judicial review is available). Claim for damages against HFSA are limited to HFSA decisions that violate an express provision of law and where a direct causal link may be established between the decision and the damage.

The HFSA has sufficient powers to carry out its supervisory functions. However, it lacks authority to issue legally binding regulations, and thus, will face difficulties in responding quickly to corporate governance violations not spelled out in law or regulation

The president of HFSA is appointed for a six-year term by the Parliament, following the nomination of a candidate by the Prime Minister. The Prime Minister appoints the deputy presidents of HFSA, following a nomination from the president of HFSA. The remuneration of the president and deputy presidents of HFSA are equal to that of the president and deputy presidents of the NBH.³ The president and deputy presidents may only be recalled for certain specific reasons, and the reasons must be published. The President is assisted by a 15-member supervisory council.

HFSA employs about 510. Salaries are at levels established at the NBH, and are considered to be competitive with the private sector. As an integrated supervisor, HFSA is working toward common supervision processes for all supervised institutions.

HFSA has prepared recommendations and methodology guidebooks for financial institutions that are designed to present good practices in a number of areas, including internal audit, risk management, governance and risk management in groups.

Enforcement of company and securities laws is relatively strong in Hungary, and compliance with legal and regulatory provisions has significantly improved over the last few years, mainly because of stricter regulatory review and stringent application of fees and charges. HFSA has been particularly active in conducting audits of market participants in every sector of the financial and capital market. Sanctions are published in the HFSA-approved gazette (*Magyar Tőkepiac*) and the reports of HFSA (which are publicly available on-line). HFSA has a qualified staff of lawyers and economists, who track down cases of non-compliance and follow through the cases from detection to the court phase. In major court cases, HFSA hires lawyers from the market, to ensure that it has the best available capacity.

³ Act 124 of 1999 on the Hungarian Financial Supervisory Authority.

KELER (Central Clearing House and Depository)

KELER (Central Clearing House and Depository, Budapest) acts as a central depository and clearing house for the BSE.⁴ Hungary maintains a “two-level” shareholder record keeping system. Each investment service provider tracks the ownership positions of its clients, and provides individual securities accounts. The investment service provider registers his client’s dematerialized securities, complies with his transfer instructions, informs the accountholder of every transaction and the balance registered on the account, and deposits these shares with KELER.⁵ KELER in turn provides clearing and settlement services to the investment service providers.⁶ Investment companies also have securities and payment accounts at KELER. Banks keep their securities accounts at KELER, although their payment accounts are held by the NBH. A true Delivery Versus Payment (DVP) system has been in place at KELER since September 1999. Since May 2002, KELER has novated stock exchange trades. The securities side of the transactions is settled within the KELER, whereas the cash leg of their transaction runs through the RTGS system of the National Bank of Hungary. KELER has an account at the NBH to settle transactions involving banks. The DVP system operates using these accounts and accounts held at other financial institutions (for example other depositories and clearinghouses). All publicly traded shares will have to be deposited with KELER (transformed into dematerialized shares)⁷ no later than December 31, 2004.

Court of Registration

All companies registered in Hungary are subject to the Court of Registration’s legal supervision.⁸ The Court of Registration maintains the company register and provides open access to company information. The register contains the charter and founding documents of companies as filed at registration, and all subsequent amendments.⁹ It also contains data on pending court cases and liquidation proceedings against the company.¹⁰ The registry is fully computerized, and is working towards full electronic filing.

In addition to maintaining the companies’ register, the court of registration also exercises supervisory powers to enforce compliance with the CA. Any party with a legitimate interest in correcting the data of the register or restoring the lawful operation of the company (including the attorney public and the competent supervisory body) may file a claim for legal supervisory proceeding. The court of registration may exercise a number of sanctions.

⁴ Licensed in accordance with Section 336 of the Capital Market Act.

⁵ CMA, Section 140(2)

⁶ CMA, Section 139

⁷ CMA, Section 408.

⁸ The CA of 1988 established the registration system, and the operating rules of the courts of registration are set out in the Companies Register Act.

⁹ Companies Register Act, Section 12. Thus the register contains up-to-date information on the name, seat, company form, scope of activities, registered capital (including capital increases or capital reductions), ownership structure, managers, auditors, the supervisory board, minutes of AGMs, tax ID numbers, and the decisions of various supervisory authorities, if applicable.

¹⁰ Companies must state if they are public or private, the share types and share classes (including the number and face value of bearer and registered shares, number and face value of convertible bonds and bonds securing subscription rights, and ISIN numbers), the means of publication of information, and acquisition of significant holdings in the company.

The company registration system was established by the CA of 1988. The rules concerning the operation of the courts of registration are set out in the Companies Register Act. According to this act (and the CA), any company is created upon its registration in the companies register (i.e. registration does not have an ex post facto effect). During the period between execution of the constitutional document (in case of public company limited by shares, the charter) and registration, the entity operates as a so-called “pre-company”.

Every company must be registered in the company register, a public register providing access to information. The information contained therein is regarded as authentic unless proven to the contrary. The register contains the constitutional documents of the companies as filed at the time of registration and every subsequent amendment to them. Thus the register contains up-to-date information on the name, seat, form of the company, its scope of activities and its registered capital (including the potential capital increases or capital reductions), its members (shareholders) and their quota (shareholding), the managers, the particulars of the supervisory Board and the auditors, as well as the decisions of various supervisory authorities, if applicable. Such decisions typically include approvals of provision of services if the relevant service is subject to authorization such as the provision of investment services, or approvals of mergers by the Competition Office. The register also contains data on pending court cases, liquidation proceeding against the company or if a voluntary winding up is initiated.

In addition to the general rules set out in Section 12 of the Companies Register Act, Section 13 sets forth additional requirements with respect to each company form. Companies limited by shares must state if they are public or private, the share types and share classes, indicating the number and face value of bearer and registered shares, any limitation on the transfer of shares (this is only possible in the case of private companies), number and face value of convertible bonds and bonds securing subscription rights, the means of publication of information, acquisition of significant holding in the company and data on the founder in the case of one-man companies (indicating whether or not the founder assumes unlimited liability for the obligations of the company).

The court of registration maintains the register. If the application of the company fails to contain all the necessary data or the company fails furnish all the necessary documents, the court of registration orders submission of additional information. If the company does not comply with its obligations to provide and publish information, the court of registration may ultimately reject the application for registration. The company may file an appeal against a decision rejecting registration. There is no appeal against registration; however, if the registered data are unlawful, under Section 46 of the Companies Register Act, the attorney public may initiate court proceeding against the company for the repeal of the registration.

In addition to keeping the companies' register, the court of registration also exercises supervisory powers to enforce compliance with the CA. Sections 49 to 55 of the Companies Register Act set out the rules of the legal supervisory proceeding. In addition to the attorney public and the competent supervisory body, anyone who has a legitimate interest in correcting the data of the register or restoring the lawful operation of the company may file a claim for a legal supervisory proceeding. In the framework of this proceeding, the court of registration may exercise the following sanctions:

1. call on the company in writing to comply with the applicable laws and regulation;
2. impose a monetary fine on the company;
3. Suspend the implementation of, or repeal the unlawful decision of the company;
4. convene the governing body;
5. suspend the operation of the company;
6. or terminate the operation of the company if its lawful operation may not be ensured.

Further, under Sections 56 to 58 of the Companies Register Act, the court of registration may terminate the company and delete it from the companies register ex officio, if it learns that the company does not operate at its site of business.

Shareholders representing at least ten percent of the voting rights may at any time file a request to the management to convene the General Meeting. Should the management Board fail to comply with such request within 30 days, the shareholders may file a petition to the court of registration that will (within another 30 days) convene the General Meeting.

Shareholders representing at least ten percent of the voting rights may file a petition to include any subject matter on the agenda of the next General Meeting. This right must be exercised within eight days of receiving the invitation to the General Meeting. If the General Meeting fails to discuss this item, the shareholders may request the court of registration to order the discussion of the matter by the General Meeting.

Similarly, not later than 30 days from the most recent General Meeting, ten percent of shareholders may file a petition requesting the court of registration to order that the General Meeting must order an audit of the annual report of the company or of any other event that has occurred within the previous two years.

Finally, if the AGM fails to bring a claim in the name of the company against a shareholder, manager, board member or auditor (or ignored a petition to do so), members representing at least ten percent of the votes may, within 30 days of the General Meeting bring a lawsuit themselves, in the name of the company.

Should the charter of a public rt. limit the voting rights to be exercised by a single shareholder to ten percent, or should none of the shareholders hold more than ten percent of the voting rights, the above rights of minority shareholders may be exercised by shareholders representing more than 5 percent of the voting rights. The charter may always set a lower number of voting rights that entitles the minority shareholders to exercise the above rights.

Hungarian Chamber of Auditors

The Chamber of Hungarian Auditors is the professional body governing auditor conduct. It is empowered to perform regulatory oversight of the audit profession. Audits may only be performed by members of the Chamber and audit companies registered by the Chamber. Auditors who are not members of the Chamber are allowed to make clarification and evaluation about the operation and finances of companies, give expert opinion, and provide professional

training, but cannot perform audits.¹¹ Legal supervision of the Chamber is exercised by the Minister of Finance. The Minister monitors whether the Chamber's rules and resolutions conform to legal regulations.¹² The Chamber can impose sanctions on members who violate rules of professional ethics. The Ethics Committee with the participation of the disciplinary commissioner performs investigations regarding ethical conduct. If the Chamber determines that ethical offense has taken place, penalties can include a written reprimand, a fine, or exclusion from the Chamber. A member can petition the court to seek redress for resolutions adopted the Chamber that violate the provisions of the law, other legal regulations, the Statutes of the Chamber or other self-government regulations.¹³

Chamber revenues come from membership fees, contributions of audit companies, and fees for Chamber professional services.¹⁴ The Chamber has no right to enact laws, but can give opinions on such acts and other statutes that regulate the activities of auditors and affect the duties and operation of the Chamber. The Chamber develops, continuously supplements, modifies and publishes national auditing standards, monitors their observation, and works to harmonize national standards with ISA.¹⁵

Until recently, there was no auditing review panel to monitor the auditing profession with regard to compliance to the applicable rules and standards. In December 2002, the Chamber set up a Quality Assurance Committee to review audit work and ensure adherence of auditors to National Standards. In the first phase, the committee plans to lay emphasis on support rather than to strict control of auditors during audit reviews. Later an auditing review panel of 100-150 professionals will function according to the peer review model.

The Chamber of Auditors carries out member training to set up various institutions, such as the mentoring system for the support of young auditors and the Quality Assurance Committee (audit review panel), to review and provide professional support for auditors, and thus maintain professional and ethical conduct.

The auditors' report is legally binding on the auditor. The auditor is liable for damages caused by their misleading statements according to the Civil Code, and ultimately, if the laws and regulations relating the conduct of auditors are violated, the violations may trigger criminal law consequences. The Rules of Hungarian Chamber of Auditors (Sections 14-15) require registered auditors to sign a contract with an insurance company, in which they specify the insurance coverage with regard to the auditor's client portfolio. The minimum insurance coverage is HUF five million (USD 20,000), and the minimum period of the insurance is one year. When the auditor's membership is suspended, he does not have to secure his liability insurance coverage.¹⁶ Most multinational auditor companies have complex insurance contracts that also cover the liabilities of their subsidiaries. According to published reports, large auditor company insurance

¹¹ Act on the Chamber of Hungarian Auditors, Section 27

¹² Act on the Chamber of Hungarian Auditors, Section 64 (1)

¹³ Act on the Chamber of Hungarian Auditors, Section 67 (1)

¹⁴ Act on Chamber of Hungarian Auditors, Section 57

¹⁵ Act on the Chamber of Hungarian Auditors, Section 3

¹⁶ Act on the Chamber of Hungarian Auditors, Section 5(f)

coverage ranges from HUF five to ten billion (USD 20-40 million), while smaller company contracts cover about HUF 15 million (USD 60,000).¹⁷

Companies have no regulatory requirement to employ internal auditors and may determine their own rules and procedures regarding the internal auditor function. However, financial institutions and investment service providers must employ at least one internal auditor who reports directly to the supervisory board.

There appear to have been only two recent cases when auditors were sued. The only important case was Postabank. In December 2000, the Hungarian Government sued three former auditors of Postabank Rt.: Prudencia Auditor and Consulting Kft., Arthur Andersen Tax and Consulting Kft., and Deloitte & Touche Auditor and Consulting Kft. The case is still pending. In another minor case, the auditor of a local bank was banned from the audit profession for a period of three years.

Other Organizations

According to the Hungarian accounting regulations “accounting services” consists of two activities: bookkeeping services and auditing activities. Auditing activities can only be performed by the members of the Chamber of Hungarian Auditors (see above in reference to the Chamber of Hungarian Auditors). Several professional organizations for accounting professionals operate in Hungary (for example Association of Hungarian Accounting Professionals), but those providing bookkeeping services are not legally obliged to join them.

However, individuals who wish to provide bookkeeping services must be registered in the register of bookkeeping service providers (if he/she is not a member of the Chamber of Hungarian Auditors). According to Government Decree 93/2002. (V. 5.) on the registration of bookkeeping service providers, a special unit of the Ministry of Finance is responsible for managing the tasks in connection with registration.

¹⁷ Information from the weekly newspaper HVG, January 20 and 26, 2001

Annex E: Company Law Overview

Ownership Registration

Shares of public companies have been issued in bearer and registered form.¹ However, since December 2001 only registered shares may be issued. The CMA also provides that only dematerialised shares may be issued to the public, and public companies must transform all their shares into dematerialized and registered shares (as opposed to printed bearer shares) by the end of 2004.²

Registered shares must be recorded in each company's share register (*részvénykönyv*), which must be maintained by the management board.³ The board may enter into an agreement with a licensed clearinghouse, investment service provider or other financial organization to maintain the register.⁴ Should a shareholder refuse to register its data in the share register, the shareholder's ownership rights may not be exercised.⁵ The charter can require that shareholder rights may only be exercised if the shareholder was registered in the share register at least 60 days prior to the General Meeting (AGM).⁶ Although BSE listing rules require listed companies to change the 60 day requirement to between five and ten days, some shareholders report that some companies use the 60-day provision to prevent their attendance at AGMs.⁷ Amendments to the CA to remove this 60-day requirement are expected to be submitted to Parliament shortly.

Nominee ownership is recognized in the CMA, and an investment service provider (custodian) or the central depository may (on the basis of a written agreement with the ultimate shareholder) exercise shareholder rights in the custodian's own name but on behalf of the shareholder. The share register will then list the nominee rather than the shareholder. For foreign nominees, beneficial owners must be registered with the nominee in the share register. The nominee may only exercise shareholder rights with securities deposited with it or registered in its securities account. Upon a request from a shareholder, the company, the HFSA, or any other person with a "valid concern", the nominee is required by law to reveal the identity of the shareholders he represents.

Dematerialized shares are credited to the securities account kept by the investment service provider with which the shareholder has an agreement for such services.⁸ The account holder is

¹ CA, Section 179(1).

² CMA, Section 6(3). Per Section 7(3), dematerialized shares are registered shares that do not have a serial number and the name and other data of the securities owner is contained in a securities account. The issuer may issue a certificate that contains all the data set out in shares except for the name of the shareholder and this certificate must indicate that it is not a security but merely a document related to the dematerialized security.

³ CA, Section 198. In Hungary's two-tier structure, the management board is typically referred to as the "board of directors". We use the term management board for the international reader, to avoid confusion with the supervisory board.

⁴ CMA, Section 149. The share register must contain: the shareholder's name, the address or seat, the number of shares by share forms (ordinary or preferential, etc.) and by series (share series mean the same type, form and class of shares issued at the same time which grant identical rights to the shareholders), and any other data required by the law.

⁵ CMA, Section 149(3).

⁶ CA, Section 229.

⁷ The BSE reports that it is actively enforcing the listing requirements.

⁸ CMA, Section 140.

deemed the owner of the shares until the contrary is proven⁹ and the evidence of ownership is the account statement.¹⁰

However, the CA, the CMA, and current practice appear to conflict in the area of shareholder record keeping and the ability of shareholders to exercise rights. According to the CA and the CMA, the share registry must be continuously updated with information from KELER, to allow owners to participate in corporate actions. In practice, issuers provide the necessary information and require the results of the registration procedure only before major corporate events (AGMs or dividend payments). Updating the registry takes KELER five days. If dividends are to be paid on day 'E', the day of registration is E-5. Shareholders on day E-5 are entitled to dividends, and their name must be updated in the register. KELER performs the matching of owners against the shares on day E-4, and requires ownership information from the chain of sub-custodians. This information is also needed for determining tax implications of dividend payment. On days E-3 and E-2 the share register is updated, and on day E dividends – with due taxes already subtracted – can be distributed to the investors. The transaction fee of the registration (matching owners with shares) is HUF 50,000 (USD 200) for the company.

The rights of owners of convertible bonds are also somewhat restricted. Companies may issue convertible bonds up to 50 percent of their registered capital.¹¹ However, it is doubtful whether convertible bondholders can effectively exercise their rights and step into a shareholder position on the basis of current law and regulation, because bondholders must wait 60 days for the registration of their share ownership after conversion. This poses an obstacle to the effective use of convertible bonds, and may not be necessary, since the issue of convertible bonds is already subject to approval by shareholders.

Share Transfer

Shares of public companies are freely transferable.¹² Transfers must comply with the takeover rules set out in the CMA. Shareholders in some companies may face restrictions on share transfers because of licensing requirements.¹³ In these cases, the share register must contain the data relating to both the nominee and the shareholder. The same applies if the nominee is a foreign entity.¹⁴

According to the CA, registered shares may only be transferred upon registration of the new shareholder in the share register.¹⁵ Transfers must be reported within eight days to the board or the entity keeping the share register.¹⁶ However, this requirement is not in line with current

⁹ CMA, Section 138.

¹⁰ CMA, Section 142(2)

¹¹ CA, Section 199

¹² Under the CA, only private companies may attach preemptive rights or other restrictions on the transfer of shares.

¹³ Capital Market Act, Section 106. For example, a PSZÁF license is necessary for acquisition of shares in a credit institution or financial enterprise under the Banking Act, in investment service providers and other financial organizations under the Capital Market Act, and in insurance companies under the Insurance Act.

¹⁴ Capital Market Act, Section 152(2)

¹⁵ CA, Section 198(6)

¹⁶ CA, Section 198(3)

practice, since dematerialized securities are transferred by book entries within securities accounts.¹⁷

The clearing and settlement of dematerialized shares is efficient and modern, and KELER fares well when compared to international benchmarks of central depositories.¹⁸ Hungarian clearance and settlement practice complies with most ISSA G30 recommendations, with one significant exception: the settlement cycle has not reached T+3, reportedly because of slow cross-border settlements by international investors. KELER believes its settlement system could easily attain T+3, should its members request it. Settlement risk in the system appears to be low.

Obtain relevant information on the corporation on a timely and regular basis

A shareholder may at any time gain access to the company documents. Company charters and amendments, including information on the auditor and board of directors, are publicly accessible at the companies register. Public and listed companies also have considerable other regular disclosure obligations; see Principle IVA and Annex B for more information. Shareholders may access the information in the share register at any time.

Participate and vote in general shareholder meetings

Every shareholder is entitled to participate at the AGM of shareholders, the decision-making body of a public company.¹⁹ This right includes the right to make proposals and (for voting shares) the right to vote. See Principle IC below.

Elect members of the board

The AGM usually appoints and removes the directors of both the supervisory board and the management board, on the basis of simple majority votes of voting rights present at the Meeting. The power to appoint and remove the management board may be delegated to the supervisory board. Hungarian law has no provisions related to cumulative or block voting or proportional voting to elect members of either board. However, shareholders may pool their votes; the thresholds for exercising minority rights are set for the shareholders jointly and not individually. See Principle VA.

Share in the profits of the corporation

Shareholders are entitled to dividends, their share in the net profits of the company.²⁰ The AGM decides on the distribution of dividends, based on a proposal of the management board that must be formally approved by the supervisory board. The payment of dividends is prohibited if share

¹⁷ CA, Section 138. The rules on transfer of dematerialized shares are set out in Chapter XIII of the Capital Market Act.

¹⁸ See ISSA Market Compliance Report for Hungary at <http://www.issanet.org/projects/rec2000-hu.html>. Jointly with IBM, KELER has been awarded the widely acknowledged 'Best Application Integration Solution 2001 Award' from the eAI Journal (Enterprise Application Integration Journal – said to be the most highly regarded journal in this field) for its IBM MQSeries Integrator based settlement system.

¹⁹ CA, Section 18

²⁰ CA, Section 225

capital would decrease below the level of registered capital. The actual payment of dividends may only take place if the shareholder of registered shares is registered in the share register. If the company has issued preferred shares or employee shares granting priority to dividends, these must be taken into account when the dividend is paid. The BSE Listing Rules require that the charter of an issuer should stipulate that any corporate decision to distribute dividends must be made 20 days before the actual distribution takes place. The company is responsible for making tax withholding on dividend payments, with important implications for shareholder record keeping for nominee holders.

Fundamental Corporate Decisions

The AGM has exclusive competence over the following decisions:²¹

- Drawing up and amending the company charter
- Appointing, removing and setting the remuneration of the members of the boards and the auditor²²
- Changing the form of company from private to public or vice versa
- Mergers and takeovers
- Winding up the company
- Approving the financial report, and deciding on use of after-tax income (dividends)
- Issuing convertible bonds or bonds granting subscription rights
- Changing rights attached to certain series of shares or transformation of share forms or classes, and transforming share types (i.e. bearer into registered and certificated shares into dematerialized shares)
- Acquiring or disposing of treasury shares
- Approval of transactions where their value exceeds ten percent of the company's registered capital.²³
- Deciding on payment of advances on dividends
- Any other issue designated by the charter.

Most resolutions of the AGM are made by simple majority, but certain decisions may require a special supermajority vote of 75 percent of shareholders present.²⁴ These include decisions on amendments to the charter, increases or decreases of share capital, changes to the company form, transformation or termination of the company, changes to the rights attached to share series, share forms or share classes, and the issuance of convertible bonds. The BSE Listing Rules also require that the charter of the issuer must stipulate that a resolution for delisting should be subject to a 75 percent supermajority vote.

²¹ CA, Section 233

²² Section 33 of the Company Law allows the General Meeting to delegate the task of appointing the Management Board to the Supervisory Board.

²³ CA, Section 224(3)

²⁴ CA, Section 19

The authority for capital increases may be delegated to the management board.²⁵ The charter must stipulate the term of such authorization (maximum five years, but renewable) and the maximum value by which the board may increase the company's capital (up to 25 percent per year). In such cases, the board may amend the company's charter by appropriately registering the capital increase. This is an exception from the general rule that amendments to the charter belong to the exclusive competence of the AGM.

The decision on the conversion from public rt. into a private rt. is valid only if it was formerly approved by a $\frac{3}{4}$ majority of the shareholders who individually control less than one percent of the voting rights.²⁶

Public companies may buy back their own shares.²⁷ The decision to buy back shares is made at the AGM, unless immediate action is necessary to protect the company from "immediate and gross jeopardy".²⁸ The company may not hold more than ten percent of its shares as treasury shares, including shares whose beneficial owner is the company and shares received as collateral. The company may not exercise voting rights in respect of the treasury shares and must dispose of them within a year. The company is prohibited from financing the acquisition of its shares by any person, including the undertaking of a guarantee. Should the company fail to sell the treasury shares, it must redeem such shares by decreasing its registered capital. It is the management board's responsibility to dispose of the treasury shares.

Meeting Participation

Every shareholder is entitled to participate at the AGM, the main decision-making body of the company. This right includes a right to make proposals and (unless the shareholder has non-voting shares) the right to vote.²⁹ The conditions of exercising voting rights must be set out by the charter of the company (subject to mandatory provisions of the law).³⁰ In any event, registered shareholders may not exercise their voting rights before they are registered in the share register.³¹ The general quorum requirement is that shareholders representing at least 50 percent of voting rights must be present at the meeting; the charter may only set a higher requirement.³² If the AGM fails to meet the quorum requirement at the first meeting, no quorum requirement applies to the second meeting.³³

It is the management board's duty to convene the AGM.³⁴ The AGM must be convened at least once a year but may be convened at any time if necessary.³⁵ The AGM may be suspended once,

²⁵ CA, Section 246. Such authorization may not be given for a capital decrease.

²⁶ CA, Section 238(2)

²⁷ CA, Section 189. A company may only buy back its own shares if it uses its assets in excess of registered capital, and only if the par value of the shares has already been paid up.

²⁸ CA, Section 189(4). In such cases, the board must report on the repurchase at the next AGM.

²⁹ CA, Section 18

³⁰ CA, Section 229 (4)

³¹ CA, Section 198(4)

³² CA, Section 236

³³ CA, Section 236(2)

³⁴ CA, Section 234

for a maximum of 30 days.³⁶ The invitation must identify all matters that will be addressed by a AGM. A new item may only be added to the agenda if all shareholders are present and they unilaterally agree on adding the item.

The CA lays down guarantees to protect the meeting participation rights of minority shareholders. Shareholders representing at least ten percent of voting rights may at any time file a request to the management board to convene a AGM. Should the board fail to comply with the request within 30 days, the shareholders may file a petition to the court of registration to (within another 30 days) convene the AGM. Similarly, within 30 days of the most recent AGM, ten percent of shareholders may file a petition requesting the court of registration to force the AGM to order an audit of the annual report of the company or of any event that has occurred within the previous two years. Should the charter of a public rt. limit the voting rights to be exercised by one shareholder to ten percent, or if no shareholders hold more than ten percent of the voting rights, shareholders representing more than five percent of the voting rights may exercise the above rights. The company's charter may set an even lower limit for exercising minority shareholders' rights.

The costs associated with meetings (annual general and extraordinary meetings) are born by the company. However, the Court of Registration will not convene a meeting unless the shareholders requesting the meeting advance the costs and prove to the Court that the meeting arrangements will be acceptable. The resulting AGM will then decide if the company or the convening shareholders will bear the costs. The question of costs has resulted in infrequent applications of the powers of the Court of Registration. The Court has only called five AGMs, and reports fewer occasions when they have appointed an auditor.

The company must keep minutes of the AGM, which must be signed by the chairperson and the person keeping the minutes.³⁷ The minutes must indicate the name and seat of the company, date, and place of the meeting, and the names of the chairperson of the meeting, the person keeping the minutes, the persons counting the votes, and the person countersigning the minutes. There is no requirement as to who may be elected to count the votes, but one of the shareholders present at the meeting will be elected to countersign the count, declaring by his signature that the procedure complied with the applicable rules. The minutes must contain every significant event of the meeting, the proposals and the number of votes in favor of them, the votes against the proposals and the number of persons abstaining from voting. The attendance sheet, the minutes of the meeting and the announcements containing the meeting notices must be submitted to the competent Court of Registration within 30 days of the meeting.³⁸ The Court of Registration will review compliance with the applicable rules. Meeting minutes of listed companies also must be submitted to the BSE.

³⁵ The management board must also convene a AGM (and simultaneously notify the supervisory board) within eight days if the share capital of the company decreases to two-thirds of registered capital, the share capital falls below HUF 20 million (USD 80,000), or if the company defaults on its payment obligations and its assets do not cover its obligations.

³⁶ CA, Section 237. In this case, a notice requirement would not apply.

³⁷ CA, Section 239

³⁸ CA, Section 239(3)

The regulatory authorities may supervise AGMs if necessary. Representatives of HFSA and the BSE attended the most recent AGM of Pick Rt.

Information about meetings

A public announcement must be published at least 30 days prior to the meeting, in accordance with the charter of the company (usually in a daily newspaper). The announcement should contain the name and seat of the company, date and location of the AGM, date and location of the repeated AGM if the first meeting does not have a quorum, the agenda of the meeting, and the voting rules (per the charter). The invitation to the AGM must contain the subject matters and proposals on which the meeting will make a resolution; a new item may only be added to the agenda if all shareholders are present and they unilaterally agree on adding the item. There is no binding provision as to where AGMs should be held. If the AGM discusses the financial reports of the company, the reports of the board and the supervisory board must also be published, according to the rules of publishing the meeting notice (in the forum specified in the company's charter, and 15 days before the meeting).³⁹

Opportunity to ask questions of the board

Shareholders may submit written questions to the board about any issue on the agenda. The board must provide the requested information if the question was submitted eight days before the AGM.⁴⁰ The only limitation on the access of information of shareholders is the board's obligation to keep professional/business secrets. However, the information must be provided if the AGM orders the board to do so.

Shareholders may place items to the agenda but the board of directors may exercise a discretionary power and decide to exclude the proposed item from the agenda. However, the board must comply with a request from shareholders holding at least ten percent of voting rights made within eight days of receiving the invitation to the AGM.⁴¹ This right may be exercised. If the AGM fails to discuss this item, the shareholders may request the court of registration to order the discussion of the matter by the AGM.

There are no rules requiring the recirculation of the agenda after new items have been added. However, the BSE reports that in practice most companies do republish the amended agenda.

Voting in Absentia

Shareholders may vote in absentia and be represented by a proxy.⁴² One shareholder may only appoint one proxy, but the same person may act as proxy for several shareholders. Management

³⁹ CA, Section 228(3)

⁴⁰ CA, Section 228

⁴¹ Section 230, CA. The requirement applies jointly and not to each individual shareholder. If the charter limits the number of exercisable votes to ten percent of the voting rights or if no shareholder controls more than ten percent of voting rights, then mandatory threshold to place an item on the agenda is five percent of voting rights.

⁴² CA, Section 221

and supervisory board members and the auditor may not be appointed as proxies.⁴³ Otherwise, the general rules of the Hungarian Civil Code on representation apply, and a shareholder may appoint anyone to represent him at the AGM. The appointment may be valid either for one AGM or for a specific period (maximum 12 months). The appointment relating to a certain AGM remains in force if the meeting is suspended or postponed. The appointment should be either a written document signed by the shareholder and two witnesses or it must be in the form of a notarized document. Foreign documents may be accepted if they are apostilled by the competent Hungarian embassy or consulate.⁴⁴ A company's charter may provide that voting may take place in writing. Since September 1, 2001, written documents may also be produced electronically with electronic signatures.⁴⁵

In practice, reports suggest that management (and/or shareholders with controlling interests) create obstacles for other shareholders to vote.⁴⁶

Equitable Treatment

Voting rights are proportionate to the monetary contribution of the shareholder, unless the charter imposes restrictions on certain preferential shares.⁴⁷ Share types (*részvényfajták*) that may be issued include ordinary, preferred, employee, and interest-bearing shares. Preferred shares (which must be registered) may be issued up to a maximum of 50 percent of the company's registered capital. Preferential shares are not necessarily non-voting shares; their rights must be set out explicitly by the company charter.⁴⁸ Preferred shares with voting rights are relatively rare. Preferred shares may further be divided into the following share classes (*részvényosztályok*):

- Preferred shares granting priority to dividends (both voting and non-voting);
- Preferred shares granting priority in a liquidation;
- Preferred shares granting special voting rights (the CA provides “veto shares” and shares granting multiple voting rights);
- Preferred shares granting priority to dividend and in liquidation.

Golden shares (*aranyrészvény*) were employed during the privatization process to retain State control over major strategic decisions of privatized companies.⁴⁹ The special rights attached to the golden shares provide the government with the right to veto some board or AGM decisions. Ten of the 56 listed companies have issued a golden share. Golden shares may only be held by the State. Golden shares are required to reach quorum, and apply to all resolutions of the AGM.

⁴³ CA, Section 221

⁴⁴ Section 195(5) of Act III of 1952 Under Hungarian law, the power of attorney relating to a certain act or transaction must comply with the same formal requirements as the transaction itself. However, Section 221 of the CA simplifies the rules relating to a proxy appointment.

⁴⁵ In accordance with Act XXXV of 2001

⁴⁶ A few examples of tactics employed include: Convening the AGM at 8.00 a.m. on a workday, convening the AGM at a distant branch office of the company and convening the second AGM one hour after the first meeting.

⁴⁷ (Section 183(4) of the CA)

⁴⁸ CA, Section 183(4)

⁴⁹ Golden shares were regulated under the privatization Act of 1995 (although the State Privatization Agency and its predecessor issued such shares prior to that act)

The AGM may issue preferred “veto shares”. Any resolution of the AGM should be subject to the approval of a majority of the veto shareholders⁵⁰. The absence of the veto shareholder does not affect the quorum provisions. The charter of the company may limit the decisions subject to veto share approval.

Shareholder Redress

Any shareholder or board member may file a petition to the competent court challenging an unlawful decision of the company, including resolutions by the AGM, board of directors or supervisory board.⁵¹ The court (an ordinary court, not the Court of Registration) can change company decisions if they violate any laws or the company charter. The case will be brought against the company as defendant. It must be filed within 30 days of learning about the unlawful decision, but within 90 days of its occurrence. The court will either approve the decision or annul it if it finds that it violated the law. The effect of the court decision is binding on all shareholders.

Some concerns have been expressed that many magistrates have a lack of expertise in shareholder rights and other corporate governance matters. Court decisions are not all published in Hungary, and those that are, are two years behind.

If a board decision is unlawful or violates the minority shareholder rights, shareholders representing ten percent (or in certain cases five percent) may also petition the court of registration. If a company fails to bring a lawsuit against a manager, board member or the auditor (because the AGM ignored or could not reach a decision on a proposal on the agenda), members representing at least ten percent of the votes may, within 30 days of the AGM bring a lawsuit in the name of the company.⁵² The company advances legal costs, but if the suit fails, these costs must be reimbursed by the shareholders who filed the suit.

Enforcement of company and securities laws is relatively strong in Hungary, and compliance with legal and regulatory provisions has significantly improved over the last few years, mainly because of stricter regulatory review and stringent application of fees and charges. HFSA has been particularly active in conducting audits of market participants in every sector of the financial and capital market. Sanctions are published in the HFSA-approved official gazette (*Magyar Tőkepiac*) and the reports of HFSA (which are publicly available on-line). HFSA has a qualified staff of lawyers and economists, who track down cases of non-compliance and follow through the cases from detection to the court phase. In major court cases, HFSA hires lawyers from the market, to ensure that it has the best available capacity.

Voting rights within class/ changes in voting rights

Holders of common shares do not necessarily have the same voting rights. A company’s charter may impose a maximum limit on the voting rights exercisable by a single shareholder.⁵³ Even if voting caps are not employed, Hungary does not follow the general principle of “one-share one-

⁵⁰ CA, Section 185(2)

⁵¹ CA, Section 47. Shareholders voting in favor of a decision cannot bring a case against the company.

⁵² CA, Section 51

⁵³ CA, Section 229(2)

vote”. Preferred shares with multiple voting rights may be issued, with each share having up to ten times the voting rights of ordinary shares.

Changes in voting rights are subject to supermajority shareholder vote. Decisions resulting in changes to the rights attached to existing shares may only be made by the AGM, and only if the affected shareholders agree by at least a $\frac{3}{4}$ supermajority in advance.⁵⁴ This requirement also applies to the issue of new shares, which might result in dilution of the existing shareholders’ rights.

If dividends due on preferred shares with restricted voting rights are not paid for two years, shareholders are entitled to voting rights for as long as the dividend arrears are not paid by the company.

Obtaining information about voting rights

The rights attached to shares must be described in the company’s charter (available at the Court of Registration) and prospectus. The notice of the AGM that will decide on a share issue must also contain detailed information on the capital increase (public or private issue of shares), the subscription minimum, the draft amendment to the charter, and the details of any in-kind contribution.⁵⁵

Voting by nominees

The new CMA regulates in detail the voting of shares held by nominees. The nominee relationship is established via a written contract with the shareholder. The contract should the framework for all communications between the shareholder and the nominee, requesting and issuing instructions and meeting any obligations to provide information. The nominee must request written voting instructions (including the agenda of the upcoming meeting) from the beneficial owner of the shares. The nominee must send the request with sufficient time for voting to take place. The nominee is also obliged to provide the shareholder with any significant information he receives as the nominee. The CMA does not specify the consequences of failure to comply with the duties of the nominee, but under the general rules of civil law, the shareholder may sue the nominee for damages, but would be no possibility to challenge a decision to which the shareholder could not contribute.

The contract between the shareholder and the nominee may stipulate a general authorization to vote on the shareholder’s behalf without explicit instructions if the nominee provides relevant information on the meeting agenda and issues to be decided and an explanation of how the nominee should vote.

Some custodians insert clauses into their client contracts requesting the right to vote the shares they hold on behalf of clients. They use this right to be able to attend “interesting” AGMs and gain useful information, particularly where they hold more than five percent of the shares.

⁵⁴ (Section 238 of the CA)

⁵⁵ CMA, Section 249(1)

Annex F: Ownership Disclosure, Takeover Rules, Insider Trading, and Prevention of Self-Dealing

Ownership Disclosure Requirements

Since July 2001, shareholders have primary responsibility to continuously disclose ownership details to the company and HFSA if their holdings exceed certain limits. Disclosure thresholds are the five percent level and every multiple of five percent up to 50 percent, 75 percent and 90 percent. The acquisition must be publicly disclosed in the daily newspaper designated for disclosure of information by the company's charter, in the electronic or printed HFSA-approved communication system (*Magyar Tőkepiac*) and, if applicable, on the company's website.¹ The acquirer must publish the fact of acquisition within two days, and it must also disclose the fact if its holding decreases by five percent (i.e. from ten percent it decreases below five percent, from 15 percent below ten percent, etc.). Issuers must also disclose their ownership structure in flash and annual reports according to a specific classification.² Acquisitions in other listed companies must be also disclosed, including takeover bids.

Specific regulations related to financial organizations contain even more detailed disclosure obligations regarding their ultimate ownership. Certain financial organizations (i.e. credit institutions, insurance companies, investment service providers, fund managers, stock exchange and clearing houses) must attach an annex to their share register containing the details of any shareholder who controls at least five percent of the voting rights in the company.³ The person acquiring five percent or more of the shares in such entities must immediately disclose this fact to the financial institution and the voting rights in respect of the newly acquired shares may only be exercised upon registration. The rights of shareholders who fail to comply with this obligation will be suspended by HFSA.

Cross-holdings are prohibited.⁴ If two companies acquire control over at least 25 percent of the voting rights (significant holding) in one another, the company which acquired the holding first may keep its shareholding, but the other must dispose of its stake in excess of 25 percent, and until such disposal, it may not exercise the shareholder's rights.

Shareholders' agreements must be disclosed. Shareholders' agreements qualify as information to be provided in the framework of the general reporting obligations and as an extraordinary reporting obligation, if necessary. The CA provides no specific limitations on the content of the agreements, but general rules set limits.⁵

The CMA requires nominees/custodians to disclose ultimate owners. Nominees must identify the shareholders that they represent at the request of the company, HFSA, or a shareholder; if

¹ Capital Market Act, Sections 37(5) and 67.

² Domestic institution/company, foreign institution/company, domestic individual, foreign individual, employees, senior officers, treasury shares, government held owners, international development institutions, other

³ Capital Market Act, Section 235, Banking Act, Section 43(3), Insurance Act, Section 71. The Insurance Act imposes a duty on persons acquiring significant control in an insurance company to notify the PSZÁF within 30 days and the insurance company must inform the PSZÁF on the changes to its ownership structure within 15 days of receipt of information.

⁴ CA, Further, Section 293

⁵ For example, CMA section 206 prohibits unfair manipulation of prices, and the Competition Act prohibits "concerted action".

requested by the company or HFSA, they must certify their holding. Third parties that “justify their interest” may propose to HFSA that the identity of shareholders represented by the nominee be revealed. The new ownership disclosure requirements have improved the ability of regulators and shareholders to identify ultimate ownership. Large international custodians have made the required disclosures at the HFSA’s request. With smaller nominee companies or chains of nominees, HFSA has not yet been able to achieve full compliance. Where share ownership is transferred between two foreign parties, ultimate ownership may change while nominees remain the same, but this is less likely to be disclosed. HFSA is aware of this problem, but stresses that foreign regulators face similar problems, with identical regulations in force.

In the last six months, both HFSA and the BSE have been active in imposing sanctions for non-compliance. However, there have been no major cases of insufficient disclosure.

Takeover Rules

The Hungarian market for corporate control is highly regulated. New takeover rules were enacted to eliminate loopholes in the legislation that were identified in the Borsodchem case.⁶

Should an acquisition result in control over 33 percent of the voting rights in a public rt., the acquisition is only valid if it takes place in accordance with specific takeover rules. The transfer of shares is subject to prior HFSA approval of a public purchase offer.⁷ If the company is widely held (if no shareholder owns more than ten percent of the voting rights either directly or indirectly, except for the acquirer) the threshold of the obligation of public offer is 25 percent. Any acquisition not in line with the takeover rules is “null and void” and the acquirer may not exercise shareholder’s rights in respect of shares acquired illegally. In addition, the acquirer will be obliged to dispose of its shares in excess of 33 percent (or 25 percent) and HFSA has the power to impose monetary fine on the acquirer for such violations.⁸

It is compulsory to commission an investment service provider to manage the public offer (takeover bid). The acquirer and the investment service provider shall be jointly and severally liable for the true and complete nature of information provided in the public offer. The public offer must contain the following information:

- Details of the acquirer and its holding in the company,
- The monetary value offered for the shares and the term of the offer,
- Provisions as to how the offer may be validly accepted,
- Details of the investment service provider managing the takeover,

⁶ The Russian oil company, Sibur (owned by Gazprom) tried to seize majority ownership in Borsodchem. Sibur’s influence was not obtained directly, but through Irish and Austrian companies, with hidden agreements in the background; as well as through a call option on the shares bought by a Hungarian bank assisting Sibur. Under the former regulations, the supervision had insufficient powers for enforcement of disclosure requirements and licensing. PSZÁF did successfully go before the court against the Hungarian bank for non-prudent behavior, and won the case.

⁷ The “Takeover Rules” (Sections 65 to 80 of the Capital Market Act) impose specific limits on transfer of shares of public companies limited by shares. The rules included in the CA have been superseded by the takeover rules in the Capital Market Act.

⁸ Capital Market Act, Section 77

- Information on how to gain access to the business plan regarding the operation of the company after the takeover, and
- A declaration that the acquirer reserves its right to rescind the offer, should it not result in acquisition of shares representing at least 50 percent of the voting rights.

The acquirer and its investment service provider must submit the draft offer to HFSA for approval. The supervisory authority has 15 days to approve it or ask for additional information to be furnished within five days, and an additional five days to approve or reject the amended draft of the public offer. If the offer contains all the necessary elements prescribed by the act, the supervisory authority may not reject the application. At the same time, the acquirer also submits the public offer, together with all annexes and supplements, to the board of directors of the target company. The board may comment on the public offer and share its concerns with shareholders, but it may not block the decision.⁹ In line with current EU legislation, the CMA prohibits management from acting against a public takeover offer.

The takeover rules contain detailed regulations on the offer price. The price (i.e. the monetary value of the consideration to be offered) must form part of the public offer., the offer price may not be less than the higher amount of the following:

- The volume weighted average trading price at the stock exchange in the period of 180 days preceding the publication of the takeover bid or
- The highest price paid by the bidder (acquirer) or persons affiliated to it during the period of 180 days prior to the publication of the takeover bid for the shares (or, in respect of options, the highest exercise price paid during that period). If the securities are not listed on the stock exchange, the volume-weighted price of the shares should be taken into account (and not the trading price at the stock exchange).

The takeover rules aim to protect the rights of minority shareholders. The CMA prohibits any kind of discrimination among the shareholders to whom the public offer is addressed.¹⁰ The public offer must apply to all shares of the target company, it must be addressed to every shareholder, and there should be no discrimination among shareholders regarding the conditions of the declaration to accept the offer.¹¹ Once a public offer has been made, rights to transfer shares of the target company are limited. The acquirer may not acquire or dispose of shares in any way other than in the course of the takeover procedure.¹² The same limitation applies to affiliated companies/persons. Further, once a takeover bid has been published, no voluntary takeover bid may be placed. Up until 15 days before the term of the public offer is over, a counter-offer may be placed, which is subject to the same provisions as the original takeover bid. However, HFSA will only approve the counter-offer if the price stipulated therein exceeds the price of the original public offer by at least five percent.

⁹ CMA, Section 73(3)

¹⁰ CMA, Section 69(3)

¹¹ CMA, Sections 71 and 74(4)

¹² CMA, Section 70(7)

If the takeover is successfully completed, and if the acquirer purchased more than 90 percent of the shares, the remaining shareholders may offer their shares to the acquirer (within 30 days of the closing of the takeover bid) and the acquirer must purchase their shares (a “put option”). The price may not be less than the higher amount of the asset value per share, or the price set out in the successful takeover offer. The acquirer has a similar right to a “call option” on outstanding shares, subject to the same terms that apply to the put option. The BSE only approves delisting if the issuer makes a bid for the outstanding shares.

The Capital Market Act provides a broad definition on acquisition of control, which is fully in line with the applicable EU regulation. Control includes the traditional method of obtaining voting rights to participate in decision-making at the General Meeting of the company, as well as exercising options to purchase, repurchase or purchase in the future shares involving voting rights, or exercising voting rights on the basis of usage rights. Acquisition of control can include: a share purchase agreement or any other agreement whereby the acquirer gains control over the voting rights in the public rt., by pre-emptive rights, options, share buy-backs, derivative agreements relating to the shares, or an agreement to “lease” voting rights or where the acquirer may influence the decisions taken by the General Meeting of the company.

Agreements between two shareholders of the same company are also considered to be an acquisition of control. This includes agreements where the shareholders are entitled to select or recall the majority of the leading company officials, and members of the supervisory board, or when the parties undertake an obligation to act in concert. Thus, acquisition of control also includes any contractual agreement where the acquirer gains power to appoint or recall the majority of the members of the board of directors or the supervisory board, and any agreement to operate the company by concerted action.

Direct and indirect ownership must be taken into account, as well as influence exercised through a nominee. If the shareholder exercises voting rights in its own name but on behalf of another entity, the obligations shall be imposed on the beneficial owner of the shares. Influence is recognized if it occurs because of concerted activities of (independent) persons who do not have any relations with each other.

If an entity exercises shareholder’s rights to shares received as collateral, the acquirer shall be the secured party, unless the parties otherwise agree.

The disclosure and public offer obligation is also imposed on the acquirer in cases where the influence is not created as a result of the direct conduct of the person obtaining influence but originates from other conditions, including inheritance, legal succession, or a resolution of the company modifying the voting rights of shareholders.

HFSA is working to enforce takeover rules, although most efforts appear to be devoted to compliance with ownership disclosure requirements. HFSA recently fined two investment service providers involved in a public bid for Csopak shares. Fines in both cases were HUF 500,000 (USD 2,000). According to HFSA, Ivydale and ING Barings were a day late publishing the bid’s results, which should have been published within two days of conclusion. The bid was part of Csopak’s delisting from the BSE.

Finally, if certain conditions are met, substantial mergers and acquisitions are subject to competition control exercised by the Competition Office. The Competition Office exercises regulatory oversight parallel to the licensing activity of HFSA. The Competition Office was established by the Competition Act of 1990, and is active in two fields: supervision of market practices (including consumer protection) and merger control. With respect to merger control, the Competition Office must approve any large merger or takeover of companies prior to the agreement taking effect.

In certain sectors, the acquisition of significant holdings is also subject to license by the supervisory authority. These specific rules supersede the general takeover requirements. Examples for such sectoral regulations are Sections 106 to 107 of the Capital Market Act on the conditions on acquiring ownership in investment service providers, Section 300 on the conditions of acquiring an influencing interest in the stock exchange and 307 on ownership restrictions, Section 341 relating to clearing houses, and Sections 356 and 357 on grounds on which the HFSA may refuse to issue the license to acquire significant share in an investment service provider or stock exchange. We should also mention Section 230 of the Capital Market Act setting out the conditions to carry out fund management services (although we note that this latter provision is not entirely in line with the structure as it does not impose the obligation on the acquirer to obtain a license). Further examples for specific regulations are Section 12 of the Banking Act providing that none may acquire control over more than 15 percent of the voting rights in a credit institution, except for the state, the Hungarian Post Office, insurance companies, investment service providers and credit institutions or financial holding companies and some other specific exceptions; Sections 37 to 41 of the Banking Act on the conditions of acquiring significant holding, and Section 71 of the Insurance Act on restrictions and conditions on acquisition of ownership.

In line with EU legislation, the CMA prohibits management from acting against a public takeover offer.

Insider Trading

The CMA prohibits any trade in listed securities if the trader uses insider information.¹³ Current regulation complies with applicable EU standards. Insider information, the types of dealing that are prohibited, and “insider” are well-defined. In all cases, the information must not have been published, and its dissemination would significantly influence the market price of the security. In addition to the prohibitions to enter into deals, the act also imposes a reporting obligation on insiders, who must report to HFSA within two days of the trade the details of any trade in the company’s shares.

HFSA exercises supervisory powers, but where criminal liability is established, the attorney public is in charge of the investigation and enforcement is ultimately vested with the courts of the Republic of Hungary. HFSA may impose a penalty on the person who violates insider

¹³ CMA, Sections 199 to 205

dealing laws, unless the person proves that he acted with due care.¹⁴ The limitation of liability is five years, from the date when the supervisory authority receives notice of the violation. The amount of the penalty is equal to the profit generated from the insider deal. If the violation consists of failure to comply with a reporting obligation by the insider the amount of the penalty can reach HUF 2 million (USD 8,000).

Insider dealing is also criminalized under Section 299/A of the Penal Code. There have been no reported convictions to date.¹⁵ The Penal Code sets out two forms of committing the crime: (a) entering into a trade for monetary gain relying on insider information, and (b) commissioning another person to carry out a trade on behalf of the principal that is relying on insider information. The Penal Code contains a slightly different definition of insider information than the CMA, and criminalizes the misuse of information relating to the financial, economic or legal affairs of the issuer, investment service provider or the underwriter of publicly offered securities which might have an impact on the price of the securities and had not been published before. Under Section 299/A of the Penal Code, the penalty for the offense of insider dealing may be up to three years of imprisonment.

In 2001 HFSA reviewed OTP Bank Rt. due to suspected insider transactions. As a result, HFSA penalized the bank, its subsidiary, and the deputy CEO. OTP Bank paid a penalty of HUF 500,000 (USD 2,000), OTP Security Rt. HUF 300,000 (USD 1,200), and the deputy CEO HUF 200,000 (USD 800).¹⁶

Other Abusive Self-Dealing

The AGM must approve sale or purchase agreements when their value exceeds ten percent of the company's registered capital. No quorum or majority requirements apply.¹⁷

The table below summarizes other conflict-of-interest approval rules. Violation of the above rules should result in immediate termination. Executive officers are liable for violation of the above prohibitions and the company may file claims for damages within one year. It is the responsibility of the company to enforce these requirements but the court of registration may take appropriate measures in the framework of legal supervision and ultimately agreements entered into by the company in violation of these rules may also be challenged and held void by an ordinary court.

There is no Hungarian company regulation regarding improper transfer pricing. Tax experts deal with the issue of transfer pricing because this is a widely used concept abroad and Hungarian companies operating as affiliates of international groups must follow foreign regulations.

¹⁴ CMA, Section 405

¹⁵ No judicial decision were found where any person would have been convicted for the offense of insider dealing, although a number of proceedings were initiated. Judicial practice in this area is rather vague and it refers indirectly to decisions by the supervisory authorities (PSZÁF or the BSE) regarding insider dealing. Thus, BH1996.557 upheld the decision of the supervisory authority to impose a fine for insider dealing. One year later, BH1997.394. stated that suspension of trading in a security in order to protect the security and transparency of the market, under circumstances when the supervisory authority initiated investigation of insider dealing, may not serve as basis for damages. This rule was later incorporated in the BSE Listing Rules.

¹⁶ 85/744,745,746/2001 decision of PSZÁF.

¹⁷ Section 224(3) of the CA

The following agreements are prohibited...	...Unless approved by the		
	Charter	Supervisory board	AGM
Concluding sale or purchase agreements where agreement's value exceeds ten percent of the registered capital of the company.			✓
Concluding an agreement with a ten percent shareholder or close relative. ¹⁸		✓	
A member of the management board acting as an executive at another company in the same business	✓		✓
A member of the management board holding shares in another company in the same business, except shares in public companies	✓		✓
Concluding an agreement within the scope of activities of the company with a director or close relatives	✓		
Appointing a management board member or close relative to the supervisory board at the same company	Never		
During takeover bids, director dealing in shares of the company.	Never		

¹⁸ CA, Section 224

Annex G: Disclosure

Hungary has a comprehensive system of information disclosure. Companies must present all relevant information necessary for investors to make informed investment decisions. All public companies must comply with the disclosure requirements of the CMA, including (i) a securities prospectus or offering document; (ii) disclosure of information on a regular basis; and (iii) disclosure of extraordinary (material) information.¹ Listed companies must also follow the Budapest Stock Exchange's more detailed disclosure rules. All companies must submit financial statements, notes on the financial statements, and the auditor's report to the Court of Registration and the Department for Company Registration and Company Information Service at the Ministry of Justice.² Financial and consolidated financial statements filed at the Court of Registration are open to the public. The disclosure requirements are close to full compliance with EU Directives.³

The financial and operating results of the company. Issuers must prepare quarterly or semi-annual "flash reports" and submit them to HFSA and the BSE, and publish them in a national daily newspaper and the exchange gazette or an open public electronic system that is approved by HFSA.⁴ Flash reports are not audited. Issuers must also produce annual reports and consolidated annual reports with audited financial statements, and publish an announcement about the place and time of possible inspection. According to BSE listing rules, Category 'A' issuers must prepare annual reports using IAS or GAAP; Category 'B' issuers may continue to use Hungarian regulation (and 23 out of 26 continue to do so). Issuers are also obliged to publish and send to HFSA extraordinary information within one day of occurrence. Financial statements include the balance sheet, income statement, and the notes on the financial statements.

Company objectives. All regular and extraordinary reporting must include information about the business objectives (and any changes in the objectives) of the company.⁵ Issuers must publish their business objectives in the business report that forms part of their financial statements. The purpose of the business report is to give a fair presentation of the current and expected development of the company.⁶

Major share ownership and voting rights. See Principle ID for a description of the responsibilities of shareholders and companies to disclose ownership.

Voting rights are a compulsory component of regular information disclosure requirements. A detailed description of interim changes in all rights attached to securities in circulation must be included in annual and flash reports.⁷ In addition, the notes to the accounts must contain a breakdown of shares types (further detailed to indicate the number and face value of shares, and

¹ CMA, Section 52-55, Appendices No. 5, 6

² Accounting Act, Section 153

³ According to the Ministry of Finance, disclosure requirements fully comply with Council Directive 80/390/EEC of 17 March 1980, as amended. However, the CMA is not aligned with the most recent amendment to EU capital markets and securities law (Directive 2001/34/EC of 28 May 2001, on the admission of securities to official stock exchange listing and on information to be published on those securities) because the CMA was completed before the Directive was published.

⁴ BSE Listing Rules require Category 'A' companies to file flash reports on a quarterly basis.

⁵ CMA, Appendices No 5, 6

⁶ Accounting Act, Section 95

⁷ CMA, Appendix No. 5 and BSE Listing Rules. Category "B" listed companies must file flash reports semi-annually.

any shares issued in the current year), and the number and face value of convertible bonds.⁸ Any planned changes to shareholder rights are a compulsory extraordinary reporting requirement, and must be filed within one day of occurrence.⁹ When issuing new shares, public companies are obliged to disclose in the information memorandum the type and class of securities previously issued by the issuer and still in circulation.¹⁰

Members of the board and key executives, and their remuneration. The Notes to the financial statements (contained in the annual report) must present:¹¹

- The aggregate remuneration of executive employees and members of boards;
- The aggregate amount of advance payments and loans to executive employees, members of the boards, and the rate of interest, all key conditions, the amounts repaid, and the payment terms;
- The aggregate pension obligations to former executive employees and members of the boards.

There is no common valuation method of calculating the cash equivalent of different types of remuneration and benefits.

Material foreseeable risk factors. In general, companies are not required to disclose their risk management policies. However, financial institutions have to comply with stricter rules and broader regulation.¹² Auditors must also prepare a special annual audit analysis for HFSA when auditing financial institutions, including the financial institution's risk management and internal control system.¹³

Material issues regarding employees and other stakeholders. No specific requirements exist for the disclosure of material stakeholder issues. Statistical information on employees is presented; the notes to the financial statements must include the average number of employees employed and wage costs during in the subject year, as well as other employee benefits, broken down by different staff categories.¹⁴

Governance structures and policies. Annual and flash reports do include the list of executive company officers. Reasons for changes in management during the period must be provided, and new executives must to be introduced in the reports.¹⁵ However, companies need not disclose information on internal governance structures, including decisions and the division of tasks among executive officers. Though the boards may divide tasks among members, members have

⁸ Accounting Act Section 91(b)

⁹ CMA (Section 54 (1))

¹⁰ Act on Capital Market, Schedule No. 3/b/9

¹¹ Accounting Act, Section 89. (4) a-c

¹² Under the 250/2000 Government Degree on Financial Institutions, Section 3 (3), financial institutions must develop policies on risk management, deposit collection policy, investment policy, classification of receivables and off balance sheet items, classification of debtor collateral, and general risk provision calculation policy. All these policies must be sent to PSZÁF, with no requirement for disclosure.

¹³ Minister of Finance's Decree (38/1997, December 18)

¹⁴ (Section 91/a).

¹⁵ CMA, Appendix No. 5.

joint and several liability for damages caused by violation of their duties. As internal structures and policies are not relevant to the liability of executive officers, such structures and policies need not be disclosed.

Compliance with disclosure rules can be considered fair. HFSA and the BSE (along with the tax authority and the Court of Registration) closely monitor public company accounting and auditing systems and policies, and the timely disclosure of all relevant information to shareholders.

HFSA may impose fines for violations of disclosure obligations: up to HUF ten million (USD 40,000) for failure to comply with the requirements of public offering of securities up to HUF 6 million (USD 24,000) for failure to comply with regular reporting obligations, up to HUF 20 million (USD 80,000) for violation of extraordinary reporting obligations, and up to HUF 100 million (USD 400,000) for violation of the takeover regulations.¹⁶ HFSA may also order suspension of trading in the company's securities, suspension of the offering, suspension of shareholder's rights or initiate proceedings at other authorities.¹⁷ HFSA has powers to impose sanctions on the financial institutions that it oversees.

HFSA and the BSE have taken a number of enforcement actions in the area of information disclosure:

- HFSA required Postabank Rt. to update its accounting policy and the chart of accounts according to the effective Hungarian law.¹⁸
- HFSA required CIB Bank Rt. to update its accounting policy and related internal procedures according to the Hungarian law and have them approved by the board of directors.¹⁹
- HFSA ordered Realizing Kft. to comply with ordinary and extraordinary information provision.²⁰
- HFSA imposed a penalty on Integra Informatikai Rt. because the company's annual report was submitted late. The amount of the penalty was HUF 350,000 (USD 1,400).²¹
- HFSA required Raiffeisen Bank Rt. to revise its consolidated annual report according to its updated consolidated accounting policy and effective Hungarian law.
- Synergon Rt. had to pay HUF 2 million (USD 8,000) for late disclosure of an important contract with Vivendi Telecom Hungary Kft.²²
- Inter Europa Bank Rt. was fined HUF 100,000 (USD 400) for not disclosing that the company had changed the face value of its shares.²³

Over the period 1997-2001, the BSE took action 61 times for violations of disclosure rules, including 36 warnings and 25 fines, totaling HUF 6.75 million (USD 27,000).

¹⁶ CMA, Section 406

¹⁷ CMA, Section 400

¹⁸ I 1164/2000, Decision about requirement of Postabank Rt. to change some of its internal procedures.

¹⁹ I-B 1573/2001 decision about the requirements towards the CIB Rt. to change and supplement some of its internal procedures

²⁰ III/10 231-3/2000/B decision about the penalty for Realizing Kft.

²¹ III/81 450/2001/B decision about penalty for Integra Informatikai Rt.

²² 85 684/2001 decision of the PSZAF

²³ III. 81 425/2001/B decision of the supervisory Authority.

Information Channels

Information channels are well established. Issuers must publish interim unaudited (quarterly or biannual) reports in the national daily newspaper and the exchange gazette or HFSA-approved open public electronic system, and send them to the HFSA and the BSE. Listed companies' annual, interim (flash) reports and ongoing (material, or ad hoc) notifications are published on the BSE website at www.bse.hu. Issuers must provide investors access to their annual reports and consolidated annual reports and have to publish an announcement about the place and time of possible inspection in the same locations. In practice, many larger companies post annual and quarterly reports on company web sites. The annual report must be made available for the inspection no later than seven days following the publication of the announcement.

The Court of Registration is the central registry for financial and non-financial corporate information. Companies must file their financial statements along with the auditor's report (if audit is required by law).²⁴ Files lodged with the Court of Registration are open to the public, but a copying charge HUF 5000 (USD 20) applies. The Court of Registration also publishes some company information in the official Companies Gazette, including information about rights, company data, its shareholders, executive officers, and members of the management and supervisory boards.

²⁴ Accounting Act, Section 153

Annex H: The Responsibility of the Board

Board Practices

Hungarian law establishes a two-tier board structure for public companies, consisting of a board of directors (management board) and a supervisory board. However, in practice the true “governing body” is the board of directors. The AGM typically appoints and removes the directors of both boards sets their remuneration, greatly reducing the power of the supervisory board.

In some cases, however, the supervisory board may become involved in operative decisions, turning the governing system of a company into a truly two-tier system.¹ In these cases, the supervisory board appoints and sets the remuneration of the board of directors and the auditor, and exercises a veto power over certain actions/transactions of the company (the list of transactions must be specified in the charter). Should the company charter authorize the supervisory board to exercise these rights, the board nevertheless remains accountable to the shareholders. If the supervisory board does not approve an agreement or other transaction when it has these powers, the management board, or any executive officer may convene a AGM, where a decision to overrule the supervisory board can be made by $\frac{3}{4}$ supermajority vote. The supervisory board must report on its decisions to the AGM. The supervisory board always acts in a derived capacity, as quasi-representative of the shareholders.²

Management board. The management board is responsible for the daily operation of the company. The board makes its decisions collectively sets its own rules, and may decide on any issue outside of the competence of the AGM. The management board must range from three to 11 members. The board must meet at least once a year (although it must report to the AGM on the operation of the company at least annually and three times to the supervisory board, which presupposes more frequent board meetings). Board members are entitled to participate at the AGM with a right of consultation.

Supervisory board. The supervisory board exercises control over management on behalf of shareholders.³ Employees appoint one-third of the members of the supervisory board, which can have as many as 15 members. The supervisory board must examine every report on the operations and finances of the company as well as every proposal to be submitted to the AGM, which may not approve the financial reports of the company without a written report from the supervisory board.

The supervisory board is relatively weak because its main power is to refer issues back to the AGM. If the board finds violations of applicable laws or regulations, the charter of the company, or the resolutions of the AGM, or should it decide that the operation of the management board is contrary to the interests of the shareholders or that of the company, it can convene an extraordinary AGM and “propose an agenda”.⁴ Supervisory board members are entitled to participate at AGMs with a right of consultation.

¹ CA, Section 33

² CA, Section 32(2)

³ CA, Sections 31 to 40.

⁴ CA, Section 32(4)

Shareholders cannot attend supervisory board meetings. supervisory board members may attend management board meetings where they represent shareholder interests and control management. The supervisory board informs shareholders of major developments that occur at the meetings.

Board Equality of Treatment

Both boards are accountable to the AGM. Neither can be “instructed” by shareholders. Therefore, in theory, both boards have a legal duty to all and not to any one shareholder. The Supreme Court has ruled that the appointment of a director must always be “personal” as opposed to defining the position of the director as a person in a certain relationship with the shareholder (e.g. member of the shareholder’s board).⁵ However, in practice, large shareholders generally appoint directors who are connected to them and who defend their specific interests on the board.

Board members are jointly and severally liable for damages caused by violation of their duties under the applicable provisions of law, decisions of the AGM or the charter, unless they can demonstrate that they acted with due care in performing their obligations.⁶ The standard of care expected from executive officers is higher than the general standard. Management board members must perform their obligations with the enhanced care expected from persons fulfilling similar positions, and they must always act in the company’s interest. If the damage is due to a decision of the management board, a member may be exempt from liability if he can prove that he either did not participate in decision-making or voted against the decision and informed the supervisory board on his differing opinion within 15 days of the decision’s date. The company is liable for damages caused to third parties by an executive officer if the damage was caused by his actions in his official capacity.⁷

Supervisory board members also bear joint and several liability for any harm caused to the company by violation of their duties to exercise control.⁸ The standard of care in this case is general; it is not identical to the enhanced standards applicable to board members.

Compliance with Law

Both the supervisory board and the auditor have obligations to ensure compliance with applicable laws. The supervisory board’s role is to detect problems at the management board level and to inform shareholders so that the discrepancies may be cured. The employee seats on the supervisory board are designed to enforce employee access to information and to protect their interests. The interests of all other stakeholder groups are taken into account indirectly (see Principle IIIC). Board members have no obligations to disclose their policies on bribery, corruption, or political donations.

Board Functions

⁵ Decision of the Supreme Court (Cgf. II. 32.394/1991/7)

⁶ CA, Section 29

⁷ CA, Section 29(3)

⁸ CA, Section 38(4)

The board's general duties are laid out in the Company Law.⁹ The supervisory board "...supervises the management of the company for the AGM..." The management board's statutory responsibilities are to:

- Prepare the proposal to the AGM on the company's financial reports and use of after tax income;
- Maintain the books of the company;
- Report on operational issues, the company's financial status and its business, at intervals as required by the charter but at least once a year to the AGM and four times a year to the supervisory board.
- Convene and prepare AGMs and ensure all documentation and announcements are published on time.

Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance and overseeing major capital expenditures, acquisitions and divestitures. The responsibility for strategic planning is relatively diffuse in theory, which appears to concentrate authority at the management board in practice. The management board shares the responsibility to set strategy with the AGM, which may reserve the right to make strategic decisions. Implementation is always the task of the management board. Every public company is required to disclose information on risk factors. The risk policy of companies is regulated only in case of financial institutions. There are no specific legal provisions on the duties of the board regarding annual budgets, corporate performance or business plans.

Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. In theory, the boards play little role in succession planning; the AGM of shareholders typically appoints members of both boards. Formally, "consultation" at the AGM is the only way that the boards play a role in appointing key executives. Since the management board sets the meeting's agenda, it plays the only real role in its own succession planning.

Reviewing key executive and board remunerations, and ensuring a formal and transparent board nomination process. The AGM sets remuneration for members of both boards. However, the AGM is unlikely to be able to establish a transparent nomination process, and the real work will be done by the management board, which will nominate new supervisory board members on the agenda.

Monitoring and managing potential conflicts of interest of management. The supervisory board does monitor conflicts of interest, and must approve all transactions with ten percent shareholders.

Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law. The management board is responsible for maintaining the company's books.¹⁰ The approval of the annual financial

⁹ CA, Section 242

¹⁰ CA, Section 243(2)

reports, balance sheet and auditor's report belongs to the exclusive competence of the AGM.¹¹ However, the AGM may not make a decision unless it reviews the written opinion of the supervisory board; and the supervisory board relies on the input of the board of directors (which must report to the supervisory board at least four times a year on the company's performance).

Monitoring the effectiveness of the governance practices under which it operates and making changes as needed. The weakness of the supervisory board appears to leave the management board in charge of many governance functions, but with little oversight.

Overseeing the process of disclosure and communications. Compliance with disclosure obligations is the management board's responsibility. The management board is responsible for submitting to the court of registration any and all documents that must be submitted under the Companies Register Act, such as amendments to the charter or changes to the registered data of the company.¹² board members are jointly and severally liable for any delay, misleading content, or failure to disclose necessary information.¹³

Liability for non-disclosure of information has not been clearly established. According to one court decision, management is liable for misleading statements or failure to comply with the company's duty to provide investors with reliable information.¹⁴ Under another decision, if a board member (director) deprives a minority shareholder of his right to inspect the company's books and documents and thus violates his duties, the shareholder may sue the company to enforce his rights.¹⁵ While the company might have redress against the board member, there is no judicial practice supporting this argument.

Director Independence

There are no specific regulations or voluntary codes of best practice that regulate the independence of boards. Although judicial practice refers to "internal" and "external" board members¹⁶, no such distinction is made under existing regulation. Some provisions do regulate board member objectivity:

- Nobody (including close relatives) may simultaneously serve on the supervisory board and the management board at the same company;
- Board members may not be employees of the company (except the employee representatives on the supervisory board).¹⁷ According to the Commentaries to the CA, this is the most important independence criterion in the CA.
- Shareholders may not directly instruct the members of the board. Both boards elect their Chairmen from among their members, and have the right to adopt their own rules of procedure (although the rules of the supervisory board must be approved by the AGM). This may provide some operational autonomy, and prevent interference with the internal matters and decision-making mechanisms of these bodies by the shareholders.

¹¹ CA, Section 233

¹² CA, Section 26

¹³ CA, Section 26

¹⁴ According to one court decision (BH1998.296.)

¹⁵ BH1998.598

¹⁶ BH1999.375

¹⁷ CA, Section 38(2)

- Board members must disclose if there is any conflict of interest regarding their appointment and they must either eliminate such conflicts or resign.¹⁸ Executives may not work at or hold shares in another company in the same business activity (except for the acquisition of shares in public companies), or enter into agreements in the company's area of activities.
- The law prohibits the appointment to a management board of a person convicted of a crime, banned from the company's profession, or who has served as an executive in a soon-to-be-liquidated company.¹⁹
- Board members of banks are subject to strict fit and proper tests.

In practice, many companies attempt to appoint some "independent" directors, but not a majority.

A person may only be executive officer (including board Member) in a maximum of three companies, and he must disclose his responsibilities at other companies when he is appointed. An executive officer must inform the other companies of his most recent appointment within 15 days.

There is no requirement to keep board meeting minutes. Since shareholders are prohibited from "giving instructions" to board members, it is not necessary to require that board members should report on their attendance, or account for their involvement in the work of the board. However, since shareholders usually appoint persons who are somehow related to them as directors, in practice, the shareholders do monitor the board member performance.

The CA requires the boards to meet at least once a year to approve the annual report of the company, but does not contain any specific requirements for board meeting frequency.

Director Access to Information

Supervisory board members may ask board members and senior company employees to provide information, and they must be provided access to the company's books (subject to a duty to keep business secrets).²⁰ Board members may also request expert opinion if necessary in matters requiring special expertise.²¹ Judicial practice confirms that either board can "... obtain expert opinion or other forms of professional advice if it deems necessary, especially if the decision to be made depends on the outcome of preliminary proceedings/analysis which requires special expertise".²²

¹⁸ CA, Section 24

¹⁹ CA, Section 23

²⁰ CA, Section 32 (2)

²¹ Companies Law, Section 242(3)

²² Decision of the Supreme Court, no. Cgf. VII. 31.114/1992/3.

Annex I: Response from the Hungarian Authorities

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DEPARTMENT OF INTERNATIONAL RELATIONS

962/£/2003

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The World Bank

*1818 H Street N W. Washington, D.C. 20433
USA*

Budapest, February "7", 2003

Re: Publication of Report on the Observance of Standards and Codes (ROSC) Corporate Governance Assessment for Hungary

Dear Mr. Fremond,

Referring to your letter of January 30, on this subject, we are pleased to inform you that the Ministry of Finance has no objection to the report's publication on the Bank's website. However we wish to make the following general remarks.

In the recommendations of the World Bank connecting to the Principle IIC on page 9 and Principle I VC on page 12 the necessity of carrying out an Accounting and Auditing ROSC is included. In connection with this statement we would emphasise that we do appreciate the initiatives of the World Bank for contributing to the dissemination of the OECD principles of Corporate Governance. We believe that carrying out a ROSC which would review the differences between IAS and Hungarian accounting regulation and the system of auditing quality assurance, may contribute to this purpose. However, taking into account that in accordance with the legal regulation of the European Union, the harmonization of the Hungarian accounting regulation with IAS is in progress, in the framework of which differences between IAS and Hungarian accounting regulations have been studied by different organizations. Our opinion is that it would be more useful to carry out the World Bank review (ROSC) some years later. In this case the review could indicate the remaining differences and failures, but at this moment it could only show such results that have already been known and reflect an interim work phase.

Postponing the review is justified as 'a}ill by the fact that the auditing quality assurance system began to operate only in 2003, so only limited practical experiences are available in connection with that system. Our opinion is that examining its efficiency would be practical only after some years of operation.

Mr. Adam Kirchknopf, Senior Advisor to Executive Director
C.c.: Mr. Alexander Berg, Senior Specialist, Corporate Governance Unit
Mr. John Hegarty, Manager, Financial Management, Europe and Central Asia Region

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