REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

CORPORATE GOVERNANCE COUNTRY ASSESSMENT
GEORGIA

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This Corporate Governance Assessment of Georgia has been completed as part of the joint World Bank-IMF program of Reports on the Observance of Standards and Codes, (ROSC) which are designed to strengthen the international financial architecture. This ROSC is based upon a template structured around the OECD Principles of Corporate Governance completed by the World Bank team and the Georgian National Securities Commission (NSCG), based on a review of relevant legislation and discussions with the National Securities Commission (NSCG), Georgian Stock Exchange (GSE), Parliamentary Committee on Economic Policy, Parliamentary Auditing Council, Supreme Court, Federation of Professional Accountants and Auditors, Central Securities Depository, Securities Industry Association and members of professional service organizations. Detailed comments on the draft assessment were received from the NSCG and the GSE.

The assessment was conducted April through December 2001 by the Europe and Central Asia Regional Department (ECA) of the World Bank by Sue Rutledge and under the supervision of the Corporate Governance Unit of the Private Sector Advisory Services Department (PSACG) of the World Bank.

Georgia
ROSC Corporate Governance Assessment

I. EXECUTIVE SUMMARY

1.1 Georgia's corporate governance is framed by two laws, the 1994 Law on Entrepreneurs (as amended in 1999) and the 1998 Law on Securities Market.

1.2 As of November 2001, 284 companies were admitted for trading on the GSE. However, only 15 securities were traded with some regularity. Two companies – the Bank of Georgia and the United Georgian Bank–represented over 90 percent of total turnover. Total market capitalization of 144 million Georgian Lari (GEL) or US$ 70 million, represented under three percent of 2000 GDP. The liquidity ratio was [ ] percent. As in many post-Soviet countries, the corporate sector is dominated by the presence of business groups.

1.3 Supervision of the securities markets is provided by the National Securities Commission of Georgia (NSCG), established in 1999 under the Law on Securities Market. The same law established the Georgian Stock Exchange (GSE) as the sole organized stock exchange in Georgia and the Georgian Securities Depository as a central depository for the shares of all traded companies in Georgia.

1.4 Since its establishment, the NSCG has been successful in reducing the volume and number of trades taking place outside the stock exchange. It has also taken important steps to increase transparency and disclosure. An April 2001 regulation requires beneficial shareholders owning directly or indirectly five percent or more of a company to disclose their holdings to the NSCG and the GSE.

1.5 However, the assessment highlighted a series of weaknesses in Georgia's corporate governance regime and practices. Combined efforts are needed to strengthen shareholders rights, protect minority shareholders, improve disclosure and transparency, treat stakeholders fairly, and ensure that managing directors and supervisory board members abide by their duties and responsibilities. The necessity of the reform program is perhaps best illustrated by the fact that, as of December 2001, up to one-third of publicly traded companies had failed to hold shareholders' meetings as required by law.

1.6 The reform program should include a component to strengthen the capacity of the NSCG, including its budget, human resources, skills, and powers of intervention. It is recommended that the NSCG establish a website to make information on publicly traded companies easily available. Efforts should also be made to strengthen the enterprise registers which hold important documents such as company charters. Such information should also be centralized and available online.

1.7 It is necessary to strengthen the accounting and auditing profession to ensure the development of reliable audited financial reports.

1.8 It is recommended to initiate a series of measures to increase the ownership of Georgia's corporate governance rules and regulations by issuers. One means of fulfilling this objective is through the preparation of a voluntary national code of best practice in corporate governance. Complementing this approach, an institute of directors should be set up to train corporate directors and disseminate best practice in board procedures.

II. DESCRIPTION OF PRACTICE

A. Capital Market Overview

A1 Capital market structure

As of November2001, there were an estimated 1,500 joint stock companies in Georgia, representing under two percent of all enterprises. Over 80 percent of joint stock companies were created during the mass privatization process of 1993-97. While consolidated records were not available, it was estimated that Georgia had about 100,000 enterprises, most of which were small or medium-sized enterprises taking the legal form of limited liability companies or partnerships.

Prior to the establishment of the Georgian Stock Exchange (GSE) in January 1999, equity shares, privatization vouchers, foreign exchange and commodities were traded on informal exchanges. The creation of the GSE marked an important step forward in establishing an organized and supervised stock exchange, through which pricing of trading in equity shares could be made transparent. As of November 2001, market capitalization of the GSE was 144 million Georgian Lari (GEL) or US$ 70 million[1], representing 2.3 percent of GDP.[2] A total of 284 joint stock companies representing over 40 percent of all joint stock companies were admitted for trading on the GSE.

After nearly a decade of share trading with little or no supervision, a major task for the National Securities Commission (NSCG) has been to reduce the size of the off-market trading, commonly known as the gray market. The 1998 Law on Securities Market requires that all securities trades be recorded on the stock exchange. Through the registrars, the NSCG has been able to identify share trades that occur outside of the GSE and advise the brokers' managing directors of the provisions of the Law on Securities Market. According to the NSCG, as of November 2001 there were 379 "reporting companies", that is, companies whose shares were traded or who had 100 or more shareholders. Working with the share registrars (to identify share trading information) and enterprise court registers (to obtain copies of the foundation documents and the company charters), the NSCG has succeeded in placing over 70 percent of the reporting companies on the GSE.

According to the NSCG, as of May 2000 (one month after the GSE started trading operations), approximately 93 percent of all share trading was conducted outside the organized market. By October of the same year, off-market share trading had fallen to 65 percent of all transactions. The NSCG expects that eventually, all reporting companies will be traded on the Exchange.

However currently turnover remains low with over 90 percent of trading activity related to purchases and sales of shares of two companies–Bank of Georgia and United Georgian Bank—both of whom had originally been privatized through vouchers. Note that of the five companies for whom trading on the Georgian Stock Exchange (GSE) was suspended in 2000, three had failed to maintain the required agreements with independent share

[1] All currency calculations based upon November 2, 2001 exchange rate of one US$ = 2.085 GEL (http://www.bloomberg.com/markets/currency/currcalc.html).
[2] Based upon 2000 GDP figure of US$3,048,164,000 (http://devdata.worldbank.org/data).

registrars.[3] Since the Georgian Stock Exchange was established, there have been only two new offerings of securities and both were conducted outside the exchange.

The GSE is the sole organized stock exchange in Georgia. It is a member of the Federation of Euro-Asian Stock Exchanges. The Rules of the GSE include a professional code of ethics that requires that member-brokers pursue principles of high standards of professional conduct and fairness of mutually profitable principles of trading. The GSE maintains two categories of companies, those that comply with the GSE Listing Rules and those admitted for trading on the GSE. As of December 2001, of the 284 companies traded on the exchange, two met the listing requirements (Bank of Georgia and Industria-Investi), the others falling into the category of companies admitted to trading. There were no Georgian company listed on a stock exchange outside Georgia.

The Law on Securities Market require that independent share registrars be hired by all joint stock companies whose shares are traded on the stock exchange or who have more than 100 shareholders. As of April 30, 2001 there were six share registrars licensed by the NSCG., Records of the shares of all publicly traded companies were centralized through the Georgian Securities Depository.

A2 Legal, regulatory framework and professional/best practice bodies

Georgia's legal framework is based on civil law. The primary legislation for publicly traded companies consists of the Law on Entrepreneurs (as amended in 1999) and the 1998 Law on Securities Market. All companies whose securities are traded must be in the legal form of joint stock companies, which are governed by the Law on Entrepreneurs.[4]

The Law on Entrepreneurs was originally written in 1994, based on the German Stock Corporations Act, while the 1998 Law on Securities Market was inspired by Anglo-American legislation. The Law on Securities Market regulates the trading of all securities, and establishes the primary regulatory agency, the NSCG, as well as the Securities Central Depository.

By law NSCG is not subordinate to any other State agency or institution. It reports directly to Parliament. It is empowered to supervise securities markets participants, including issuers, investors, brokers, share registrars, auditors, the Georgian Stock Exchange and the Central Securities Depository. The NSCG is governed by a Commission composed of Chairman, a Deputy Chairman and three other Commissioners who are appointed and removed by the President of the Republic of Georgia and approved by Parliament, for a term of five years. Members may be reappointed once after their initial term. The Chairman appoints one of the Commissioners as Deputy Chairman. The members of the NSCG can be removed from their posts only: (1) at their own written request, (2) if they have been sentenced by a court for a crime or if they have violated the ethics rules of the NSCG, or (3) if they are unable to perform their duties for more than six months.

[3] The other two companies had filed for bankruptcy.

[4] In addition any enterprise with 50 or more shareholders must take the legal form of a joint stock company

All NSCG members come under strict provisions to avoid possible conflicts of interest. No member of the NSCG may hold any other post, or be employed in any business, with the exception of educational or creative work. A member may not receive remuneration other than the salary from the NSCG and payment for educational or creative activities. The remuneration of the NSCG members is determined by Presidential decree and all expenses of the NSCG are paid from the budget.[5]

No member of the NSCG may participate, directly or indirectly in any securities market operations or transactions subject to regulation by the NSCG. NSCG members must disclose any direct or indirect interests in decisions taken by the NSCG and the disclosure must be recorded in the minutes of the meeting. The member is prohibited from taking part in any decision related to those interests.

The NSCG has 38 employees. In common with the Georgian public sector, its employees are paid less than their private sector peers. In addition, the NSCG lacks reliable funding for its ongoing operations and from time to time lacks telephone or electrical power service in its headquarters offices and even petrol needed to drive to make off-site visits and inspections.

The NSCG can impose sanctions to persons who fail to comply with the Law on Securities Market including fines up to GEL 10,000 (US$4,800). It can refer cases to the Prosecutor-General and carry out investigations valid in criminal courts.[6] The NSCG has the authority to carry out inspections of all parties regulated by the Commission.[7] This includes on-site visits to issuers, brokers and investment funds, and review of all books and records. Decisions of the NSCG are subject to appeal in the Administrative Court. From June through December 2001, the NSCG held 39 administrative enforcement hearings. The cases involved management and large shareholders failing to disclose their share ownership and companies failing to file semi-annual reports. As a result of these hearings 78 persons were fined a total of GEL 9,345 (US$4,672). The fines were imposed against the directors for their individual violations and/or because they are personally liable for the violations of their reporting companies.

The Georgian Stock Exchange (GSE) establishes listing rules, defines the terms and conditions under which securities are admitted for trading on the exchange, and supervises the activities of securities brokers. The Exchange is a joint-stock company with 37 member-owners, which are primarily brokerage companies. Unlike other exchanges in the region, the Government holds no ownership interest in the GSE. The GSE has the authority to warn companies of possible violations of the securities laws, de-list issuers and refer cases for investigation to the NSCG. The GSE maintains a separate department for market surveillance. With only one year of operation, the GSE has not yet referred any cases to the NSCG for further review.

The GSE Rules have been approved by the NSCG. The Rules require that any issuer wishing to have its shares traded on the exchange must file a copy of its legal foundation

[5] Although for the first two years the salaries of the Chairman and one of the Commissioners were funded from a project supported by the U.S. Agency for International Development
[6] Under Article 46 of the Law on Securities Market
[7] Under Article 52 of the Law on Securities Market

documents with the enterprise register before the GSE can admit the company to the trading system of the exchange.[8]

A3 Registration and listing requirements

The Law on Securities Market requires publication of a prospectus for all share offerings except private placements. The Law specifies that the prospectus for a new issue include information regarding the main activity of the issuer, the main risks factors for the company, audited financial statements for the prior two years (as specified by the NSCG) as well as financial projections. The prospectus must also include the names of the members of the supervisory board and the management directors (but not the compensation of either), the name of the securities registrar and any potential conflicts of interest among the three groups. For first time issuers, the prospectus must also include notary-certified copies of the foundation documents as registered with the enterprise registers.[9] All prospectuses must be approved by the NSCG.

The issuer's chief executive officer, chairman and member of the supervisory board, representatives of the brokerage firms assisting the issuers; and the auditor and other experts who assisted in the preparation of the prospectus, are liable for any untrue statement in the prospectus and for failure to disclose a material fact. [10] A material fact or event is defined as a fact or event that a reasonable investor or potential investor would consider important in a decision to buy or sell securities. Any changes in the prospectus must be filed with the NSCG and be published in a newspaper (or other means established by the NSCG).[11] An Issuer must keep offers opened for 30 days. If a change in the prospectus relates to a material item, purchasers have the right to renounce the share purchase and receive repayment of their subscription in full within ten days. It is difficult to assess the level of compliance with the legal requirements on prospectuses since only two new offerings have been made to date.

In addition, publicly traded (or tradable) companies are obliged to prepare annual reports which include: (1) audited annual financial statements; (2) names of the members of the managing body, i.e., managing directors and/or supervisory board (but not their remuneration), and (3) names of the persons who hold or control more than five percent of the votes at the shareholders' general meeting. The information must be filed with the NSCGG within 90 days of the end of the fiscal year, and to the stock exchange if the shares are traded on the exchange. The annual reports filed with both the NSCGG and GSE are available to the public for photocopying.

A shareholder's ownership right is proven by the record in the share register.[12] In addition, all companies that are either admitted for trading on the stock exchange or who have more

[8] When the papers were not available to brokers, the NSCG assisted in collecting the necessary documents from the court registers.
[9] The NSC may waive the requirement for a prospectus for reporting companies if the company has completed all filing requirements for the prior two years, although to date no company has met the filing requirements for two years.
[10] Article 55 of the Law on Securities Market (and under the Administrative Code)
[11] Article 5 of the Law on Securities Market
[12] Section 51 of the Law on Entrepreneurs and, for traded securities, Article 10 of the Law on Securities Market

than 100 shareholders are considered "reporting companies" and must use an independent share registrar.[13] There are fewer than ten independent share registrars and all are closely supervised by the NSCG.

Each of the 60 district (regional and municipal) courts maintains a register for enterprises located within the district. Under the Law on Entrepreneurs, enterprises must file key information with the enterprise registers. This includes the amount of authorized capital, the names of the managing directors and supervisory board members and the amounts of the contributions of the founders, but not changes in ownership after the founding of the company.

In principle, the information in the enterprise registers is publicly available and key legal information about companies is accessible. However the registers face two challenges: (1) the administrative practices of the enterprise registers vary among districts, with some court clerks arguing that the information is confidential and cannot be disclosed to third parties while other clerks allow unknown visitors to borrow the files and make their own photocopies; and (2) the system is neither centralized nor available online, reducing the ability of shareholders or other interested parties to gain easy access to key information on Georgian companies. In addition the enterprise registers suffer from some of the same weaknesses as the court system, including insufficient funding for ongoing operations.

GSE listing rules require: (1) ownership capital of at least GEL 208,500 (GEL equivalent to US$100,000), (2) at least 50,000 shares issued, (3) at least three years of operation, (4) profits in at least two of the prior three years, and (4) financial statements prepared in accordance with international accounting standards.

A4 Ownership structure

Identifying ownership structures in Georgia is difficult. Even the classification of categories of investors (foreign vs. domestic or institutional vs. retail) is difficult. Nevertheless as of December 2001, there were about 500,000 individual (retail) investors in Georgia or about ten percent of the population.[15] Virtually all retail investors acquired their shares for free or a minimal contribution as part of the privatization process. Between five and twenty percent of privatized enterprises were held by individual investors, with most of the balance held by company managing directors. In the absence of restrictions on corporate ownership of commercial banks, virtually all the banks are part of financial-industrial groups, whose holdings include both joint stock companies (whose shares may be traded) and limited liability companies (whose shares cannot be publicly traded). Unlike other transition countries, the privatization investment funds in Georgia played a minor role in the privatization program and acquired only about four percent of the 4.8 million in privatization vouchers issued.

Currently there are no institutional investors. The insurance industry is still under-developed and pensions remain largely the responsibility of the federal budget. Under the Privatization Law, Government holdings of state enterprises was limited to less than 25

[13] Article 10 of the Law on Securities Market

[15] Source: [ ]

percent of the shares and by policy, the Government has retained few shares in privatized enterprises. As of year-end 2000, the Government held shares in about 21 joint stock companies traded on the GSE, or fewer than eight percent of all companies traded.

The Law on Securities Market requires disclosure of ownership of five percent or more, either directly or indirectly, to the ultimate beneficial owner. To implement the Law, at the end of February 2001 the NSCG issued a regulation clarifying the process for disclosing ownership interests. However compliance with the Regulation has not yet started. It is expected that enforcing compliance will be an ongoing challenge in the immediate future.

The market for corporate control in Georgia is limited by the substantial presence of business groups. Such corporate organizations generally consist of several companies, each of which is dominant in its industry, and a commercial bank, which acts as a treasury for the business group and limits its major business to affiliated companies.

B. Shareholder Protections

B1 Basic rights

Clearance and settlement of securities traded on the GSE is conducted by the Central Securities Depository (CSD), established in 1999. All traded shares are in dematerialized form. The CSD provides clearance and settlement of securities and relies on the share registrars to register the transfer of shares. Share registration remains an important issue for shareholders. The NSCG has conducted a series of townhall meetings to advise small shareholders of their legal rights. Of the 982 people who attended the regional townhall meetings of the National Securities Commission during mid-November to mid-December 2000, 72 percent requested verification of their shares in the share registers.

Trades are settled at T+0. Due to the small size of the Georgian securities market and the limited effectiveness of the payment and settlement infrastructure, the Central Depository works on a pre-payment basis, allowing for same-day settlement of trades and following day delivery of payments. The Central Depository plays an important function in efficient and transparent operation of the securities market. However as a new institution, the Depository has yet to review its compliance with international standards, including the principles of the International Securities Services Association (ISSA).

The Law on Entrepreneurs sets out the fundamental rights of shareholders and their treatment by the governing bodies. Two classes of shares may be issued: preferred and common. All common shares have voting rights. Preferred shares are non-voting, except in cases of non-payment of dividends. Preferred shares may be issued with no maximum limit in relation to the company's capital. Full voting rights may be obtained even where only 50 percent of the share price has been paid.[16]

Under the Law on Entrepreneurs, the company charter may limit share transfers by requiring the consent of the company in order for the transfer to be implemented. However the 1999 amendments to the Law reduced the ability of company managers to restrict transfers of shares. Restrictions on share transfers must be specified in the company charter

[16] Article 3 of the Law on Entrepreneurs

and written approval of the restrictions be given by all shareholders.[18] In addition, the consent of the company must be granted unless the transfer would endanger the essential interests of the company.[19] Following implementation of the amendments, the NSCG has received no further complaints regarding restricted share transfers.

B2 Annual general meetings and disclosure of capital structures

Annual shareholders' meetings must be held once a year, within two months after the financial statements have been prepared.[20] Extraordinary general meetings may also be convened by the company at the written request of the holders of five percent of the authorized capital of the company.[21] If the directors do not hold the meeting within twenty days, shareholders may request the regional court to call the meeting. The shareholders' meeting is chaired by the President of the Supervisory Board.

The shareholders' meeting must be announced at least twenty days in advance.[22] The notice must include the agenda, recommendations of the directors and supervisory board regarding proposed decisions, and any possible changes to the company charter. There are no legal provisions stating where the shareholders' meeting should be held, such as in the city of the company's headquarters.

Notification is to be given by registered letter to all shareholders owning one percent or more of the shares and is published in the newspapers or other mass media. However a notoriously unreliable postal system and the presence of some 500,000 small shareholders increase the difficulty in distributing routine notices of shareholders' meetings.

The shareholders' meeting has the sole authority to: (1) amend the company charter, particularly with regard to changing the company's name, amount of authorized capital or authorized activities (the company's business activities) or deciding on the liquidation of the company; (2) take decisions on mergers and transformations; (3) approve the purchase, disposal or exchange of assets in excess of 50 percent of the book value of the company's total assets, unless otherwise provided in the company charter; (4) cancel the preferential rights of existing shareholders when increasing authorized capital or issuing bonds convertible into shares; (5) approve the company's annual report; (6) decide on proposals of the supervisory board on use of the profits; (7) elect and recall the members of the supervisory board; (8) approve the payment of salaries of the members of the supervisory board; (9) elect the auditor and special controller, (10) take court actions against the directors and members of the supervisory board; and (11) take decisions on other issues under the Law on Entrepreneurs.[23] There is no provision to allow the shareholders' meeting to invalidate decisions of the managing directors or the supervisory board, apart from decisions within the authority of the shareholders' meeting.

[18] Article 52.3, Law on Entrepreneurs
[19] Article 52.3, Law on Entrepreneurs
[20] Article 54 of the Law on Entrepreneurs
[21] Article 53.3.3 of the Law on Entrepreneurs
[22] The Law on Entrepreneurs
[23] Article 54.6 of the Law on Entrepreneurs

A shareholders' meeting is authorized to take decisions if at least 50 percent of the authorized capital (i.e. issued capital) is present at the meeting. If the quorum is not met, a second meeting may be held at which 25 percent of the capital must be present. If a quorum is not achieved in the second meeting, a third meeting may be held at which there is no minimum level of shareholders needed. Decisions are made by a simple majority, except as otherwise discussed. (See comments under B4.) Where there is an independent registrar, decisions by the shareholders' meeting are counted by the independent share registrar.[24]

Up to ten days before a shareholders' meeting, shareholders have the right to present written questions to the managing directors and the supervisory board for explanation of any items on the agenda and, if the answers have not been provided, the items should then be discussed as part of the agenda. Refusal to answer the questions must be in writing and can only be justified as being required to protect the essential interests of the company. Participation (representation) via proxies is allowed.

The Georgian Securities Industry Association, which largely represents brokers, estimates that as much as 80 percent of joint stock companies in Georgia fail to hold regular shareholders' meetings. This suggests that up to as one-third of reporting companies fail to meet the basic legal requirement of conducting shareholders' meetings as required by law.

B3 Equitable treatment and statutory remedies

Decisions by the shareholders' meeting, managing directors or supervisory boards may be appealed to the court if the procedures for taking the decision contradicts the law or the company's charter. In case of violation of their own rights, shareholders can initiate derivative lawsuits but there are no provisions that would allow class action lawsuits. The NSCG may also investigate violations of laws and regulations related to companies issuing shares. Decisions by the NSCG may be appealed to the Administrative Court.

Dominant shareholders who knowingly use their position to cause damage to the company's interests must compensate the other shareholders.[25] A dominant shareholder is defined as a shareholder, or group of shareholders acting in concert, who has the ability to control the outcome of voting in a shareholders' meeting.

Upon demand, the company must redeem a shareholder's shares if that shareholder did not vote in favor of: (1) a charter amendment that substantially violates that shareholder's rights; (2) mergers, divisions or transformations; or (3) the purchase, disposal or exchange of real estate at less than 50 percent of its book value, unless otherwise provided for in the company charter.[27] However shareholder redemption rights regarding real estate transactions may be restricted by provisions in the company charter.

Shareholders with five percent or more of the authorized capital may demand a special investigation of the company's economic activity and annual balance sheet, if they consider

[24] Some countries allow decisions at shareholders' meetings to be taken on the basis of a show of hands.
[25] Article 53.4 of the Law on Entrepreneurs
[26] Article 54.8 of the Law on Entrepreneurs
[27] Article 53(1).1 of the Law on Entrepreneurs

that there are violations, for example, of the use of the company's financial assets.[28] In case the shareholders' demands are not satisfied by the general meeting, the decision on the special investigation may be made by the regional court in the territory where the company is located.

Except for complaints submitted to the NSCG, all the above provisions require decisions by the overburdened court system of Georgia and to date, there has been no litigation on the provisions.

B4 Participation in fundamental corporate decisions

Approvals for mergers, acquisitions or transformations and cancellation of preferential share purchase rights (i.e. cancellation of pre-emptive rights) must be given by shareholders representing at least 75 percent of the share capital participating in the meeting. Thus for decisions related to transformations of a company, 50 percent of the share capital must be represented at the meeting and 75 percent of those present must vote in favor of the proposal.

Decisions on the use of company profits or to amend company charter (including changing the company's name, authorized capital or its authorized activities or making decision on the liquidation of the company) must be made by at least two-thirds of the authorized capital participating in the meeting. Other decisions are made by 50 percent of the authorized capital at the meeting. Note that a shareholders' meeting is authorized to take decisions if at least 50 percent of the authorized capital is present at the meeting.

The pre-emptive rights of existing shareholders are clearly maintained, even in conversion of debt to equity. The new shares must first be issued to existing shareholders.[29] Only in the case that shareholders refuse to exercise their pre-emptive rights are creditors permitted to exchange their debt for shares.

All authorizations of new capital must be approved by the shareholders' meeting, although company managing directors may determine the timing of the share issuance.[30] The shareholders' meeting may increase the company's capital in the form of "permitted capital" (or authorized capital) whereby for a period of five years the managing directors are authorized to issue new shares up to the amount approved by the shareholders' meeting.[31] Each issuance must be approved by the supervisory board.

In addition, the shareholders' meeting may vote to increase the company's capital in the form of "conditional capital" (which may include convertible shares) to provide shares to employees or "fulfill the measures of acquiring capital".[32] Conditional capital may also be issued during mergers. The shareholders' meeting must define the period and the conditions under which the conditional capital may be issued so that the decision of the issuance of capital is not subject to a decision of the managing directors or the supervisory

[28] Article 53.3.2 of the Law on Entrepreneurs
[29] Article 59.7 of the Law on Entrepreneurs
[30] Article 59 of the Law on Entrepreneurs
[31] Article 59.2 of the Law on Entrepreneurs
[32] Article 59.4 of the Law on Entrepreneurs

board. However the Law is unclear regarding the maximum amounts of either permitted or conditional capital.

The Law on Entrepreneurs also provides the right for dissenting shareholders who disagrees with the proposed amendment to the company charter to request that the company buy out his/her shares. The legislation also specifies the price and procedure for company buy-out of shares in such cases.

B5 Market for corporate control

The Law on Securities Market regulates tender offers. However, currently there is no takeover law or regulation that would require an investor to offer to buy all the shares of a company after buying a minimum percentage. A person who wishes to solicit proxies may request the current list of shareholders from the company's share registrar.[33] If the tender offer is expected to result in any investor becoming the beneficial owner of more than ten percent of the securities, the investor must first file a report with the NSCG and publish an announcement in the newspaper. The conditions of the tender offer must be the same for all owners of the shares. If the offeror receives more shares than requested in the tender offer, purchases of the shares should be done on a pro rata basis. If the consideration offered to shareholders varies, the offeror must pay the increased consideration to all shareholders, regardless of the timing of acceptance of the terms of the offer. The NSCG has no authority to block a tender offer but it may impose requirements on the preparation and execution of tender offers and the release of the shareholder list to the offering company. To date, no tender offers have been conducted on the Georgian Stock Exchange.

B6 Insider trading and self-dealing

It is prohibited to use insider information to: (1) acquire or dispose of shares, (2) disclose insider information to any third party unless the disclosure is made in the normal course of professional duties, or (3) recommend or procure a third party to acquire or dispose of shares.[34] To date, the NSCG has not issued any specific regulations concerning insider trading or self-dealing. However the NSCG intends to include drafting of a regulation on market manipulation as part of its upcoming work-program.

In addition the GSE's Code of Ethics prohibits member-brokers from using information regarding the ownership of securities to create, increase or decrease purchases, sales, or exchanges of securities except when approved by the beneficial owner of the security.

B7 Related party transactions

While transactions with related parties must be disclosed under International Accounting Standards, IAS is not yet generally followed. In addition there are no mandatory requirements or voluntary codes on disclosure of conflicts of interest. The not infrequent practice of transferring valuable assets to companies in which managers may have a direct or indirect interest suggests the need for requirements on public disclosure.

[33] Article 17 of the Law on Securities Market
[34] Article 45 of the Law on Securities Market

C. The Role of Stakeholders in Corporate Governance

C1 Respect for legal rights

There are no specific legal provisions that require that the company recognize the rights of stakeholders or encourage active co-operation with the stakeholders. However, the Law on Entrepreneurs contains important liability provisions. The labor and environmental legislation was approved in the late 1990s and reflect current international practices.

C2 Redress for violation of rights

The overburdened court system has not yet made any rulings on cases relating to violations of stakeholders rights.

C3 Performance-enhancing mechanisms for stakeholder participation

Employees may be granted by the shareholders' meeting the right to appoint up to one-third of the members of the supervisory board. In addition, employees generally received discounted shares or other preferential rights to company shares at the time of the company's privatization. However due to the undeveloped level of the securities markets in Georgia, share option programs are not used.

C4 Access to relevant information

Stakeholders have the same access to information as the general public.

D. Financial and Non-Financial Disclosure

D1 Disclosure of material information

The NSCG has broad latitude to establish disclosure requirements for reporting companies, i.e. all companies with more than 100 shareholders.[35] Reporting companies must prepare annual reports which include audited annual financial statements, members of the management board, names of the persons who hold or control more than five percent. The information must be filed with the NSCG within 90 days of the end of the fiscal year (and to the stock exchange if the shares are traded on the exchange) and distributed to the registered share-owners. Material events must be disclosed within fifteen days of their occurrence in the form of current reports. Semi-annual financial statements are also required. Under the NSCG's January 2000 Rule on the Preparation and Filing of Current Reports by Reporting Companies, the private or public sale of a significant amount of additional securities is considered to be a material event and must be disclosed to the NSCG within fifteen days.

All reports submitted must be signed by the company's chief executive officer, chief financial officer, and at least a majority of the members of the supervisory board. Note that all signers have liability in the case of failure to accurately disclose information – i.e. for making an untrue statement of material fact or failing to disclose a material fact. In the first

[35] Article 11 of the Law on Securities Market

year of implementation, 31 percent of reporting companies submitted some form of report and 27 percent of reporting companies submitted an annual financial statement.

All private entities (which include all joint stock companies and limited liability companies) must carry out accounting and financial reporting in accordance with international accounting standards (IAS).[36] The requirement to use IAS is applicable to joint stock companies from January 2000 and to limited liability companies from January 2001.

Under the Law on Accounting, Georgia has adopted IAS and is preparing a literal translation into Georgian of the applicable accounting standards. However application of IAS has been slow. Of the 379 reporting companies, only 55 (or fifteen percent) presented their 2000 financial statements in accordance with IAS.

To date, most reporting companies fail to file the required financial reports. In 2000, only 38 percent of all reporting companies filed annual financial reports with the NSCG. However, it should be noted that 2000 was the first year in which such financial reports were required to be filed with the NSCG and it is likely that as the managing directors of the companies become familiar with their reporting requirements a much higher percentage of companies will file their annual reports.

D2 Independent audit

For all joint stock companies, the shareholders' meeting must annually appoint an independent auditor, but the meeting does not approve the amount of the auditing fees, which are subject to approval by company management.[38] The auditor must be legally and financially independent of the company, the managing directors and the shareholders. Auditors must follow the same test of diligence and prudence as applicable to directors and supervisory boards.

While the Law on Accounting follows international standards, the Law on Audit Activity (amended in 1995) is not fully in compliance with international standards. The Law established a Parliamentary Council on Audit Activity, which has responsibility for auditing operations in Georgia, but has limited authority to provide oversight and discipline for auditing companies. The Auditing Council has translated international standards on auditing (ISA) into Georgian, including the provisions of the code of ethics that is part of ISA. However the international standards have not yet been formally adopted into law.

Auditor liability levels follow Russian Federation practice, which limits the maximum liability of an auditing company to the annual auditing fee paid that year by the client company. There exists no additional legal exposure for negligence in preparation of audits. Unqualified reports exist for companies that were on the verge of bankruptcy. The Auditing Council can impose administrative sanctions, which include withdrawing the auditor's license, but cannot impose substantial monetary fines.

[36] Article 9 of the 1999 Law on Regulation of Accounting and Reporting
[37] Under Article 58 of the Law on Entrepreneurs
[38] Article 58 of the Law on Entrepreneurs

The Professional Federation of Accountants and Auditors provides training and professional certification. In 1999 the Federation provided training for over 150 Tbilisi-based inspectors with the Ministry of Revenues.

D3 Major share ownership

Unlike the legislation of most countries in the former Soviet Union, the Georgian securities law requires extensive disclosure of ownership interest and provides a detailed description of beneficial ownership. Disclosure to the NSCG (and if the shares are traded, to the stock exchange) is required if a person or group of persons acquires five percent or more of the voting rights in a reporting company or if the level of beneficial ownership changes by more than five percent.[39] Persons are considered to be acting in concert if they have agreed to pursue a common policy regarding: (1) acquiring, holding or disposing of shares of a company or (2) exercising ownership rights such as voting. The definition of beneficial ownership is someone who: (1) has authorized a nominee to act on his behalf, (2) has the power to direct the voting rights of a security, or (3) receives monetary benefit from ownership of the security. Similarly control is defined as the situation, in which one person, or a group of related persons, holds more than five percent of voting rights in a company. Failure to disclose to the NSCG and the exchange can result in the loss of all voting rights at the following shareholders' meeting. While the ownership disclosure provisions were part of the Law on Securities Market, a specific regulation implementing the requirement was only put in place in April 2001 and it is difficult to determine the expected level of compliance with the regulation.

D4 Disclosures relating to directors, key executives and their remuneration

Members of the managing body of a reporting company must file a report showing their percentage of the beneficial ownership of the company's securities.[40] However there are no other requirements for disclosure of director or management interests in other transactions affecting their companies. In addition there are no provisions mandating disclosure of remuneration (individually or in aggregate) for members of supervisory boards.

D5 Other disclosures

The Law on Securities Market requires that the prospectus for a new issue include a description of the commercial activity of the issuer for the preceding two years and the main risks involved in that activity.

There are no specific requirements for disclosure of issues regarding stakeholders, although the Law on Securities Market requires disclosure of all material issues, defined as a fact or event that a reasonable investor or potential investor would consider important in a decision to buy or sell securities.

There is no legal requirement for disclosure of a company's governance structures and policies.

[39] Article 14 of the Law on Securities Market
[40] Article 12 of the Law on Securities Market

E. The Governing Body

E1 Structure and legal duties

Georgia has a two tier board system. Managing directors and members of supervisory boards are obliged to conduct the company's activities: (1) in good faith, (2) with the care that a person of ordinary prudence would exercise in similar circumstance and (3) in a manner that they believe to be in the best interests of the company.[41] According to law, the members of the supervisory board (and the managing directors) should conduct their activities fairly and diligently and shall compensate the company for damages where they have failed to do so.[42] However to date there has been no litigation on the liability of managing directors or members of supervisory boards.

Apart from the provisions in the Law on Entrepreneurs that define the responsibilities of supervisory boards (described below under E3) and the due diligence provisions, there are no detailed guidelines for the roles, responsibilities, operation, qualifications or structure of supervisory boards. In general, supervisory boards are considered to play a relatively minor role in providing strategic guidance for their corporations.

E2 Nomination

The shareholders' meeting elects the members of the supervisory board. The supervisory board consists of between three and 21 members, the number must be divisible by three.[43] One-third of the supervisory board members may be elected by the company's employees (who need not be shareholders.) However in practice all members of the supervisory board are elected by the shareholders' meeting and workers have no representatives on the supervisory boards.

Members of the supervisory board are elected for four years. Their compensation is approved by the shareholders' meeting both individually and in aggregate. Although permitted by law, cumulative voting is rarely used in Georgia.[44] The largest share registrar noted that in the 400 shareholder meetings attended by the registrar, no supervisory board members had been appointed through cumulative voting. Upon a request from even a single shareholder, managing director or supervisory board member, the regional court may appoint supervisory board members if the position is vacant for more than six months and unless otherwise provided in the company charter.

E3 Key functions

The supervisory board must meet at least once a quarter [45] and has specific responsibilities which cannot be delegated to the managing directors.[46] These include approval of: (1) purchase or sale of more than 50 percent of a company; (2) purchase, disposal, pledging,

[41] Article 9.7 of the Law on Securities Market
[42] Article 56.4 of the Law on Entrepreneurs
[43] Article 55.1 of the Law on Entrepreneurs
[44] Article 54.8 of the Law on Entrepreneurs
[45] Article 55.6 of the Law on Entrepreneurs

leasing or other similar rights involving real estate and leasing of a production unit or cessation of its activities; (3) establishment or closing of branch offices; (4) planning the annual budget, balance sheet, earnings statement, investment plan, and long-term obligations; (5) investments or divestitures exceeding ten percent of the company's book value in the prior year; (6) credit obligations; (7) starting or stopping the company's business (within the limits set by the company charter); (8) determining the company's strategic plan; (8) participation of management in the company's profits and pensions assigned to management; (9) appointment of procurators for legal representation; (10) allowing the company's shares to be traded on a stock exchange if such trading imposes material expenses on the company; and, (11) decisions regarding buy-back of company.

E4 Independent oversight of management

The supervisory board has the responsibility to supervise the company's managing directors, appoint and dismiss the directors, and review the financial accounts and proposal on profit distribution and report to the shareholders' meeting.[47] Approval of the annual report is by the shareholders' meeting itself. Members of the supervisory board are prohibited from acting as the managing director of the company, thus ensuring that the supervisory board consists only of officers that are not part of the company's executive management.

III. POLICY RECOMMENDATIONS

Based on this ROSC assessment and the scores resulting from the OECD principles-assessment matrix, a number of areas warrant attention. The recommendations focus on strengthening four key areas:

?? Basic shareholder rights, including the general shareholders' meeting and the equitable treatment of shareholders;
?? Transparency and disclosure, including corporate disclosure and auditing/accounting fundamentals;
?? Structure and operation of supervisory boards; and
?? Institutional strengthening of both public and private sector organizations and codes of practice.

The policy recommendations are discussed in detail in the next section.

In addition in approximately one year, the NSCG may wish to consider preparing an update of this assessment in the form of an assisted self-assessment, with the support of the World Bank. Such an update would provide the opportunity to demonstrate improvements in the corporate governance framework for Georgia, to monitor the implementation of new laws, and to send signals to domestic and international investors that Georgia is committed to reform.

[47] Article 55.8 of the Law on Entrepreneurs

ANNEX A: OECD PRINCIPLES – DETAILED ASSESSMENT AND POLICY RECOMMENTATIONS

The assessment that follows is based upon the OECD Principles of Corporate Governance (available at: http://www.oecd.org/daf/corporate-affairs/governance/). The OECD Principles are concerned primarily with corporations that are publicly traded on a stock exchange, though many of the issues addressed by the OECD Principles are also of relevance to large non-traded corporations and state-owned companies.

Each statement is given a benchmark, based upon the country's level of observance of the principle (please also refer to Table 2: OECD Principles – Assessment Matrix).

Observed means that all essential criteria are generally met without any significant deficiencies. **Largely observed** means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance within a prescribed period of time. **Materially not observed** means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means that no substantive progress toward observance has been achieved.

Policy recommendations are offered when a principle is deemed less than fully observed, systematically. Comments or policy recommendations may sometimes be offered even if the principle is estimated to be fully observed to point out developments in international best practices.

SECTION I: THE RIGHTS OF SHAREHOLDERS

As highlighted in the main body of the report, up to one-third of all publicly traded companies fail to hold annual shareholders' meetings. Thus decisions that fall under the authority of the shareholders' meetings cannot be exercised in compliance with the law. The scorings below reflect this practice.

Principle A. 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.

(1) Secure methods of ownership registration

Largely observed - Regulation of share registrars falls under the NSCG which was only recently established.

Policy Recommendation: NSCG needs to monitor compliance of share registrars with applicable regulations.

(2) Share transfer

Largely observed – The Law on Entrepreneurs allows company charters to limit share transfers by requiring the consent of the company in order for the transfer to be implemented. The 1999 amendments to the Law reduced the ability of company managers to restrict share transfers by requiring that all shareholders approve in writing such restriction before it can be added to the company charter. In addition, the amendments stipulate that the consent of the company must be granted unless the transfer would endanger the essential interests of the company. To further strengthen the amendments, the Parliamentary Decision determined that share transfer restrictions already in company charters were void unless the written consent of all shareholders had been given. Following implementation of the 1999 amendments, the NSCGG has received no complaints regarding restricted share transfers. While there are still some potential weaknesses in the legislation since "essential interests" are not defined, this does not appear to be of concern to investors.

Policy Recommendation:
The Law on Entrepreneurs should be amended to stipulate that Article 52.3 which allows company managers to restrict share transfers is not applicable to publicly traded (or tradable) companies.

(3) Access to information

Materially not observed – Each district courts maintains a register for enterprises located within the district. Under the Law on Entrepreneurs, enterprises must file key information with the enterprise registers, including copies of the company by-laws, the amount of authorized capital, the names of the managing directors and supervisory board members and the amounts of the contributions of the founders. Changes in ownership after the founding of the company are not required.

The registers suffer from a lack of harmonization of procedures and the information is neither centralized nor available online.

In addition reporting companies (i.e. publicly traded or tradable companies) are obliged to file annual and quarterly financial reports with the NSCG, but to date fewer than one-third of the companies have filed such reports. Also there are few requirements for either publication of financial statements in the newspapers or distribution of financial reports through the postal system.

Policy Recommendations:
(1) Information in the enterprise registers should be easily accessible to the public through the internet.
(2) The NSCG should also develop a website and make the companies' financial reports available through the NSCG website.
(3) The NSCG should require that companies publish their financial statements in one or more specified newspapers or other publications.

(4) Participation and voting at AGM

Materially not observed – While shareholders have the right to participate and vote in shareholders' meetings, shareholders' meetings are frequently not held and there are difficulties in obtaining timely notification of upcoming meetings. See comment below under Principle C.

Policy Recommendations: See recommendations under Principle C.

(5) Election of board

Materially not observed – While shareholders have the right to elect the supervisory board of directors, shareholders' meetings are frequently not held and there are difficulties in obtaining timely notification of upcoming meetings. In addition there is no requirement for the use of cumulative voting for electing. See also comment below under Principle C.

Policy Recommendations: See recommendations under Principle C. Also amend the Law on Entrepreneurs to introduce cumulative voting for the election of supervisory board members.

(6) Share in the profit

Materially not observed – While shareholders have the right to participate in the company's profits, verification of the level of profits may be difficult due to weaknesses in financial reporting as discussed under Section IV.

Policy Recommendations: See recommendations under Principle C.

Principle B. Shareholders should 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.

(1) Amendments to statutes

Materially not observed – While amendments to the company statutes requires approval of a super-majority of capital represented at the shareholders' meetings, shareholders' meetings are frequently not held. See comment below under Principle C.

Policy Recommendations: See recommendations under Principle C.

(2) Authorization of additional shares

Materially not observed – Approval of the shareholders' meeting is required for share capital increases, but the meeting may authorize the managing directors to issue new shares for a period of up to five years and up to the amount of existing capital.

Policy Recommendation:
Amend the Law on Entrepreneurs to restrict the authorization for new capital to one year and clarify the maximum amounts of permitted and conditional capital that may be authorized.

(3) Extraordinary transactions (resulting in sale of the company)

Materially not observed – The Law on Entrepreneurs requires that the shareholders approve any decisions that would result in the liquidation of the company. However shareholders' meetings are frequently not held. See comment below under Principle C.

Policy Recommendations: See recommendations under Principle C. Also the legislative framework should be amended to require mandatory disclosure of sales of assets and conflicts of interest, particularly on related party transactions.

Principle C. 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 shareholder meetings.

(1) Sufficient and timely information about AGM

Materially not observed –Up to one-third of publicly traded (or tradable) companies fail the legal requirement of conducting shareholders' meetings.

Tracking the dates and locations for shareholders' meetings is difficult due to the large number of publications in which the announcement could be made. The Securities Industry Association publishes a weekly supplement to the newspaper *Rezonance*, which describes upcoming shareholder meeting and the proposed agendas. However the information published is less than complete. The Association relies on word-of-mouth to be informed of upcoming meetings. The NSCGG has the right to designate the newspapers where such announcement must be published.

Policy Recommendation: Amend the legislation to facilitate the occurrence of shareholders meetings, build up capacity within the regulatory agencies to oversee enforcement of the legislative framework and impose sanctions on companies that fail to comply with the law.

(2) Opportunity to ask question and place items on agenda

Largely observed – Up to ten days before a shareholders' meeting, shareholders have the right to present written questions to the managing directors and the supervisory board for explanation of any items on the agenda. If the answers have not been provided, the items should then be discussed as part of the agenda. Refusal to answer the questions must be in writing and can only be justified as being required to protect the essential interests of the company.

Policy Recommendation: See recommendation under (1).

(3) Vote in person or in absentia

Materially not observed – Voting procedures are not sufficiently clearly specified by law or regulation. Companies that use independent share registrars generally request the registrar representative to count the votes. Otherwise the company assumes this responsibility. Discussions with market participants suggest that where the company counts the votes, the procedures followed are generally less than fully transparent. Regardless of who conducts the voting, the notary presents a summary of the decision to the court register. Although the notary is obliged to draft the minutes of the meeting, the notary may or may not have been present for all of the meeting. While increasing the administrative costs for the company, the use of an independent share registrar to conduct the voting process appears to instill higher investor confidence than leaving the task to the company.

Participation (representation) via proxies is allowed but neither the Law on Entrepreneurs nor the Law on Securities Market provides detailed guidance on the use of proxies, although the securities law does refer to NSCG (future) regulations on proxy voting. In addition neither the laws nor the existing regulations require that a nominee holding a proxy cast the vote in accordance with instructions from the beneficial owner. There appear to be few cases of abuse of proxy votes but this may be more due to the relatively widespread practice of failing to conduct shareholders' meetings rather than conscientious malpractices of proxy-holders.

Policy Recommendations:

(1) Review the Law on Entrepreneurs and consider modifying the minima amounts of authorized capital present to constitute a valid quorum in second and third shareholders meetings, require full payment for shares in order to obtain voting rights, and make appointment of an independent counting commission mandatory.
(2) NSCGG should issue regulations on voting procedures and proxy voting.
(3) Where the technology is available, investigate alternative methods of voting.

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

Materially not observed – While capital structures and arrangements are disclosed in company bylaws, the lack of disclosure of full ownership and control structures (see comment under Principle A of Section IV) makes it difficult to accurately determine the actual levels of control.

Policy Recommendation: See recommendation under Principle A of Section IV (Disclosure and Transparency).

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

(1) Clearly articulated and disclosed rules and procedures, transparent prices and fair conditions

Materially not observed – The Law on Securities Market includes a section on tender offers. A person who wishes to solicit proxies may request the current list of shareholders from the company's share registrar. The conditions of the tender offer must be the same for all owners of the shares. If the offeror receives more shares than requested in the tender offer, purchases of the shares should be done on a pro rata basis. If the consideration offered to shareholders changes, the offeror must pay the increased consideration to all shareholders, regardless of the timing of acceptance of the terms of the offer. If the tender offer is expected to result in any investor becoming the beneficial owners of more than ten percent of the securities, the investor must first file a report with the NSCGG and publish an announcement in the newspaper. To date, no tender offers have been conducted on the Georgian Stock Exchange. In addition low levels of liquidity on the stock market impede development of an active market for corporate control. Also the market for corporate control in Georgia is limited by the substantial presence of business groups.

Policy Recommendation: See recommendation under Section IV (Disclosure and Transparency).

(2) No use of anti-takeover devices to shield management from accountability

Materially not observed – While the legislation does not prohibit company management from using anti-takeover devices, the absence of hostile takeovers makes it difficult to assess any possible uses of such devices.

Policy Recommendation: Monitor use of anti-takeover devices during tender offers and if necessary, amend the legislation to prohibit the use of such devices.

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

Not observed – Shareholders do not currently evaluate the costs and benefits of exercising their voting rights. There are currently no institutional investors. The insurance industry is still under-developed and pensions remain the responsibility of the federal budget.

Recommendation: Undertake a study to determine whether and how a shareholder culture could be developed in Georgia and what incentives could be put in place to encourage the development of an active institutional investors community.

SECTION II: EQUITABLE TREATMENT OF SHAREHOLDERS

Principle A. 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) Same voting rights for shareholders within each class. Ability to obtain information about voting rights attached to all classes before share acquisition. Changes in voting rights subject to shareholder vote.

Materially not observed – By law, shareholders have the right to obtain information about voting rights and to vote on any changes in voting rights. However where shareholders' meetings are not regularly held, shareholders cannot exercise their rights.

Policy Recommendation: See recommendation under Principle C of Section I (Rights of Shareholders).

(2) Vote by custodians or nominees in agreement with beneficial owner.

Materially not observed – There are no legal requirements that votes by custodians or nominees be made in agreement with the beneficial owners.

Policy Recommendation: See recommendation under Principle C of Section I (Rights of Shareholders) regarding proxy voting.

(3) AGM processes and procedures allow for equitable treatment. Avoidance of undue difficulties and expenses in relation to voting.

Materially not observed – Under the Law on Entrepreneurs, the shareholders' meeting must be announced at least twenty days in advance. The notice must include the agenda, recommendations of the directors and supervisory board regarding proposed decisions, and any possible changes to the company charter.

There are no legal provisions stating where the shareholders' meeting should be held. Notification is to be given by insured letter to all shareholders owning one percent or more of the shares and in addition, is published in the newspaper or other form of mass media. The notice must include a description of the procedure by which a shareholder can, within ten days of the meeting, present written questions to the managing directors and the supervisory board for explanation of any items on the agenda. However a notoriously unreliable postal system and the presence of some 500 thousand small shareholders make it difficult to distribute routine notices of shareholders' meetings. Nevertheless it appears that company procedures do not make it difficult or expensive to cast votes.

Policy Recommendations:
Amend the legislative framework to clarify:
(1) The location of shareholders' meeting and
(2) The list of newspapers for publication of upcoming shareholders' meetings.

Principle B. Insider trading and abusive self-dealing should be prohibited.

Materially not observed – The securities law explicitly prohibits insider trading, and abusive self dealing but such practices are not violations of the Criminal Code. To date, the NSCG has not issued any regulation on these matters.

Policy Recommendation:
Amend the legislative framework to define market manipulation as a violation of the Criminal Code.

Principle C. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

Materially not observed – The Law on Securities Market requires that members of the managing body of a reporting company must file a report showing his/her percentage of the beneficial ownership of the company's securities. Publicly traded (or tradable) companies must file with the NSCGG and if they are traded on a stock exchange, also with the exchange. However there are no other requirements for disclosure of interests in other transactions affecting their companies. There are no provisions under Georgian laws requiring disclosure of conflicts of interest. Frequent reports of the practice of transferring valuable assets to companies in which managers may have a direct or indirect interest suggests the need for requirements on public disclosure.

Policy Recommendations:
(1) The NSCGG should issue a regulation requiring disclosure by the members of the company's management body and supervisory board of any direct or

indirect interests in any transaction covering extension of credits or sales (or pledges) of assets or securities.

(2) Amend the legislative framework to require that members of supervisory boards abstain from decisions where they have a conflict of interest.

SECTION III: ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

Principle A. 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.

Largely observed – While there are no specific legal provisions that require that the company recognize the rights of stakeholders or encourage active cooperation with the stakeholders, the Law on Entrepreneurs contains important liability provisions. Managing directors and members of supervisory boards are obliged to conduct the company's activities: (1) in good faith; (2) with the care that a person of ordinary prudence would exercise in similar circumstance; and (3) in a manner that they believe to be in the best interests of the company. The Law on Securities Market establishes the same liability for managing directors. Furthermore, members of the managing body who voted in favor of a decision which resulted in a breach of any duty are jointly and severally liable for losses caused to the company. However to date there has been no litigation on the liability of managing directors or members of supervisory boards.

Policy Recommendations: See recommendations under Section V (Responsibilities of the Board).

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

Materially not observed – The legislative framework provides opportunity for shareholders and other stakeholders to obtain effective redress in the court system. However enforcement of those rights appears to be difficult given the weaknesses in the court system – i.e., high case loads, lack of familiarity by judges of the issues presented in shareholder rights cases, occasionally improper influences affecting the judicial process— and the low level of stakeholder awareness of their rights.

Policy Recommendations:

(1) Training should be provided to judges on the provisions of the laws as they relate to corporate governance issues and their implementation. Additional hiring may be also be necessary.

(2) The NSCGG should consider ways of introducing class action lawsuits in addition to the existing provisions for derivative lawsuits. Class action suits allow legal redress to be sought on behalf of a whole class of shareholders rather than a series of specific individuals who must be identified ahead of time before the law suit can be filed.

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

Largely observed – Employees may be granted by the shareholders' meeting the right to appoint up to one-third of the members of the supervisory board. In addition employees generally received discounted shares or other preferential rights to company shares at the time of the company's privatization. However the impact is uncertain in encouraging active cooperation between the company and its employees but there are no other mechanisms recognizing the rights of employees as stakeholders in the company.

Policy Recommendations: Commission a study to investigate additional measures to encourage stakeholder participation.

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

Largely Observed – Stakeholders have the same level of access to information as shareholders.

Policy Recommendations: See recommendations on improvements in disclosure and reporting practices described in Section IV (Disclosure and Transparency) for more.

SECTION IV: DISCLOSURE AND TRANSPARENCY

Principle A. 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 the following sections.

(1) Financial and operating results

Materially not observed – The Law on Securities Market requires publication of a prospectus for all share offerings except private placements. Publicly traded (or

tradable) companies are obliged to prepare annual reports which include: (1) audited annual financial statements; (2) names of the members of the managing body, i.e., managing directors and/or supervisory board (but not their remuneration), and (3) names of the persons who hold or control more than five percent of the votes at the shareholders' general meeting. The information must be filed with the NSCGG within 90 days of the end of the fiscal year, and to the stock exchange if the shares are traded on the exchange. The annual reports filed with both the NSCGG and GSE are available to the public for photocopying. The information must also be published and distributed to the registered shareowners.

While the Law on Securities Market requires substantial disclosure by traded companies, it is not yet common practice to follow the requirements. In the first year of implementation, 31 percent of publicly traded (or tradable) companies submitted some form of report and 27 percent of publicly traded (or tradable) companies submitted an annual financial statement.

Policy Recommendations:

(1) Strengthen the enforcement capability of the NSCG.
(2) Review the listing requirements of the GSE and consider introducing several compartments with different disclosure standards.
(3) Provide an incentive system to encourage companies listed on tiers with limited disclosure requirements to graduate to tiers with greater transparency. Incentive systems in other countries include: (a) allowing increased domestic equity investment by state pension funds in tiers with higher disclosure requirements; (b) reducing interest rates for higher disclosure tiers; (c) educating company management on the benefits of graduating

(2) Company objectives

Materially not observed – There are no requirements for companies to disclose their corporate objectives.

Policy Recommendation: Amend the legislative framework to require that companies disclose their corporate objectives.

(3) Major share ownership and voting rights

Materially not observed – While the ownership disclosure provisions are part of the Law on Securities Market, a specific regulation covering the requirement to disclose direct and indirect ownership of five percent or more was only put in place in April 2001. It is difficult to determine the expected level of compliance with the regulation.

Policy Recommendation: Monitor compliance with the regulation requiring disclosure of major share ownership positions.

(4) Board members, key executives and their remuneration

Materially not observed – Publicly traded (or tradable) companies are obliged to prepare annual reports which include names of the members of the managing body, i.e. managing directors and/or supervisory board (but not their remuneration).

Policy Recommendation: Amend the legislative framework to require that companies disclose the amount of remuneration (both individually and in aggregate) for members of supervisory boards and key company executives.

(5) Material foreseeable risk factors

Materially not observed – The Law on Securities Market requires that the prospectus for a new issue include a description of the commercial activity of the issuer for the preceding two years and the main risks involved in that activity. The lack of new share issues makes it difficult to determine the extent of compliance to this obligation. In addition, there is no on-going obligation for issuers to discuss material risk factors in their annual reports.

Policy Recommendation: Monitor compliance with the disclosure requirement on material foreseeable risk factor. Modify listing rules and require companies to discuss material foreseeable risk factors in their annual reports.

(6) Material issues regarding employees and other stakeholders

Materially not observed – There are no specific requirements for disclosure of issues regarding employees or other stakeholders, although the Law on Securities Market requires disclosure of all material issues, defined as a fact or event that a reasonable investor or potential investor would consider important in a decision to buy or sell securities.

Policy Recommendation: Amend the legislative framework to require specific disclosure of material issues regarding employees and other stakeholders.

(7) Governance structures and policies

Not Observed – There is no legal requirement for disclosure of a company's governance structures and policies.

Policy Recommendation: Amend the legislative framework to require disclosure of governance structures and policies.

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

Materially not observed – While the Law on Accounting follows international standards, the Law on Audit Activity (amended in 1995) is not in compliance with international standards. The Law established a Parliamentary Council on Audit

Activity, which has responsibility for auditing operations in Georgia. The Auditing Council has translated international standards on auditing (ISA) into Georgian, including the provisions of the code of ethics that is part of ISA. However the international standards have not yet been formally adopted into law.

A still greater weakness is the low level of liability assumed by auditors. The limit follows Russian Federation practice, which limits the maximum liability of an auditing company to the annual auditing fee paid that year to that client. The result is that Georgian auditors have little effective legal exposure for negligence in preparation of their audits. In addition, the Auditing Council suffers from insufficient authority since the administrative sanctions available to the Council include withdrawing the auditor's license but importantly do not include the imposition of substantial fines.

According to the Law on Securities Market, several parties are responsible for any untrue statement of material fact in the prospectus and for failure to disclose a material fact required to be stated to the make the statements in the prospectus not misleading. The individuals include the chief executive officer of the company, all members of the supervisory board, as well as the issuer, the brokers acting on behalf of the issuer, and the auditors and other experts who participate in the preparation of the prospectus.

Policy Recommendation:

(1) The Law on Audit Activity should be amended to formally adopted international standards of auditing and increase the minimum liability for auditing companies.
(2) Strengthen the ability of the NSCG to impose substantial fines for non-compliance in filing of financial reports.
(3) Extend to supervisory board members the liability for "failed audits" (regarding the quality of independently audited financial statements.)
(4) Request the preparation of a ROSC (Report on Observance of Standards and Codes) on accounting and auditing issues.
(5) Require that the shareholders' meeting approve both the annual auditing fees and the scope of work for the independent auditor.

Principle C. 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.

Largely observed – The Law on Entrepreneurs requires that all joint stock companies have an annual audit with an independent auditor appointed by the shareholders' meeting. Note also comments above under Principle B regarding the quality of audits.

Policy Recommendation: See recommendation under Principle B.

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

Materially not observed – During the first year of implementation of the Law on Securities, 31 percent of publicly traded (or tradable) companies submitted some form of report and 27 percent of publicly traded (or tradable) companies submitted annual financial statements. While this represents a an increase over previous levels of information dissemination, there remains significant room for further improvement. The NSCGG has completed preparation for a website but lacks the funding to set up the site.

Policy Recommendation:

(1) The NSCGG should seek funding for the establishment of a website, as is common practice in both transition and developed markets. The NSCGG could disseminate online the following information:
    (a) the annual, semi-annual and current financial reports for all companies whose shares are traded or who have more than100 shareholders, where such information is prepared in electronic form,
    (b) ownership positions in excess of five percent,
    (c) notifications of upcoming shareholders' meetings, and
    (d) NSCG's proposed draft regulations while they are available for public comment, as well as NSCG's annual and 90-day reports.
(2) Strengthen the enterprise registers as noted under Principle A of Section I (Rights of Shareholders).

SECTION V: RESPONSIBILITIES OF THE BOARD

Principle A. 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.

Largely observed – The supervisory board has specific responsibilities which cannot be delegated to the managing directors. The supervisory board has the responsibility to supervise the company managing directors, appoint and dismiss the directors, and check the financial accounts and proposal on profit distribution and report to the shareholders' meeting. The supervisory board must meet at least once a quarter and conduct their activities fairly and diligently and compensate the company for damages where they have failed to do so. Once damages have been established, the board member or managing director needs to prove that they conducted the company's activities: (1) in good faith; (2) with the care that a person of ordinary prudence would exercise in similar circumstance and (3) in a manner that they believe to be in the best interests of the company. However, there are no

detailed guidelines for the roles, responsibilities, operation, qualifications or structure of supervisory boards. Such guidelines are useful in providing guidance to board members on the recommended ways that the board should conduct its operations. In addition, such guidelines provide a set of industry practices that would assist a judge in determining if board members had conducted their operations in good faith, with prudence and in the best interests of the company.

The concept of "independent" board members—free from conflicts of interest—is not well-understood.

In general, supervisory boards are considered to play a relatively minor role in providing strategic guidance for their corporations.

Policy Recommendation:

(1) Develop a voluntary corporate governance code that would provide detailed guidelines on the roles, responsibilities, operation (including policies for remuneration of supervisory board members and frequency of meetings), structure and qualifications for members of supervisory boards. The code should also make recommendations regarding the creation of special purpose committees attached to supervisory boards, in particular audit and finance, risk policies, remuneration and nomination committees. It should also discuss the criteria for determining independence of board members and procedures for ensuring full disclosure of conflicts of interest. The code could also make recommendations on levels of shareholder approval needed for different types of corporate decisions (including sale of large transactions.) The code could be prepared by a business advisory task force to the GSE or other organization composed of representatives of the public and private sector. In many countries which have followed this route listed companies are generally required to disclose their level of their compliance to the voluntary code.
(2) Provide training for supervisory board members to acquaint them with the guidelines, for example through an institute of directors, which could be created to fulfill this function.

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

Materially not observed – There are no legal requirements that the supervisory board treat all shareholders fairly.

Policy Recommendation: Amend the legislative framework to require that supervisory boards treat all shareholders fairly.

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

Largely Observed – See comments under Principle B of Section III (Role of Stakeholders in Corporate Governance).

Policy Recommendation: See recommendation under Principle B of Section III (Role of Stakeholders in Corporate Governance).

Principle D. The board should fulfill certain key functions, including the following:

(1) Corporate strategy, risk policy, budgets, business plans, performance objectives, implementation and performance surveillance, major capital expenditures, acquisitions, divestitures

Materially not observed – By law, directors are responsible for: (1) purchase or sale of more than 50 percent of other companies; (2) purchase, disposal, pledging, leasing or other similar rights involving real estate and leasing of a production unit or cessation of its activities; (3) establishment or closing of branch offices; (4) planning the annual budget, balance sheet, earnings statement, investment plan, and long-term obligations; (5) investments or divestitures exceeding ten percent of the company's book value in the prior year; (6) new credit obligations higher than the amount fixed by the supervisory board; (7) starting or stopping the company's business (within the limits set by the company charter); (8) determining the company's strategic plan; (9) participation of management in the company's profits and pensions assigned to management; (10) appointment of procurators for legal representation; (11) allowing the company's shares to be traded on a stock exchange if such trading imposes material expenses on the company, and (12) decisions regarding buy-back of company shares within the limits of the Law on Entrepreneurs, unless the provisions are otherwise defined by law. However there are no requirements that directors approve the company's risk policies or performance objectives or that they supervise implementation and performance.

Policy Recommendation: As noted above under Principle A, develop a voluntary corporate governance code. Among other issues, the code should recommend that directors approve the company's risk policies and performance objectives, that they supervise implementation and performance and that adequate procedures be put in place to fulfill these functions.

(2) Selection, monitoring, replacement of key management

Largely observed – By law, the supervisory board has the responsibility to supervise the company managing directors and appoint and dismiss the directors. However the limited effectiveness of supervisory boards suggests minimal monitoring of key management.

Policy Recommendation: See recommendations under Principle A.

(3) Key executive and board remuneration, board nomination

Largely observed – The supervisory board has the responsibility to supervise the company managing directors and appoint and dismiss the company management. However the absence of guidelines on operations of boards hinders their ability to perform their functions.

Policy Recommendation: See recommendations under Principle A.

(4) Monitoring of conflict of interest of management, board members, and shareholders, including misuse of corporate assets and abuse in related party transactions.

Not observed –There are no provisions under Georgian laws requiring monitoring of conflicts of interest.

Policy Recommendation: The NSCGG should issue a regulation requiring mandatory disclosure of conflicts of interest, particularly with regard to sales and transfers of large assets.

(5) Ensuring integrity of accounting and financial reporting systems, including independent audit, systems of control, compliance with law.

Not observed – Under the Law on Entrepreneurs, the supervisory board has the responsibility to check the financial accounts and proposal on profit distribution and report to the shareholders' meeting. However there is no requirement to ensure the integrity of the accounting or financial reporting systems or compliance with the law.

Policy Recommendation: See recommendations under Principle A, and in particular the recommendation for the creation of audit committees as part of supervisory boards. The audit committee should have specific responsibility for ensuring the quality of audit systems, affecting both the internal and external audits.

(6) Monitoring governance practices and making necessary changes

Not observed – There are no specific requirements for supervisory boards to monitor governance practices.

Policy Recommendation: See recommendations under Principle A.

(7) Overseeing disclosure and communication

Not observed – There are no specific requirements for supervisory boards to oversee disclosure or corporate communications.

Policy Recommendation: See recommendations under Principle A.

Principle E. The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.

(1) Assignment of non-executive board members to tasks of potential conflict of interest (e.g. financial reporting, remuneration)

Largely observed – All the members of the supervisory board are non-executive members and are assigned tasks of financial reporting and remuneration. However their work is hindered by the lack of effective internal management information systems that provide reliable financial reports.

Policy Recommendation: See recommendations under Principle A and in particular the recommendation for creation of specialized committees responsible for audit and remuneration issues.

(2) Devote sufficient time to their responsibilities

Materially not observed – Under the Law on Entrepreneurs, the supervisory board must meet at least once a quarter. Currently there are no individual performance measurements for directors and meeting attendance is not a matter of public record.

Policy Recommendation: See recommendation under Principle A. The voluntary corporate governance code could recommend that meeting attendance for each director be disclosed in the annual report that director votes on important issues be made public.

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

(1) Access to accurate, relevant, and timely information

Not observed – There are no specific legal requirements to ensure that members of supervisory boards receive accurate, relevant and timely information. However in order to take decisions on key issues, members of supervisory boards need such information in order to make informed decisions.

*Policy Recommendation***:** Amend the legislative framework to require that company management provide accurate, relevant and timely information to the members of the supervisory board. See also recommendations under Principle B of Section IV (Disclosure and Transparency).

Summary of Recommendations on Institutional Strengthening

Throughout the discussion above, the report suggests several measures aimed at strengthening the institutional capabilities of the institutions that form the corporate governance framework. In summary the recommendations are:

?? Securities Regulator – The NSCG should have sufficient funding and authority to fully implement its role as regulator of the securities markets, including the capacity to review the financial reports of publicly traded companies, the authority to impose substantial fines for non-compliance with reporting and other securities violations, and the establishment of a reliable budget. In addition the NSCG should have the authority to monitor the corporate governance provisions of the Law on Entrepreneurs and to supervise all joint stock companies as well as the private placements of publicly traded companies.

?? Accounting and Auditing Profession – Efforts should also be made to evaluate and strengthen the capability of the accounting and auditing profession, including preparation of an accounting and auditing ROSC.

?? Enterprise Registers – The enterprise registers should be centralized and their information available online. Sufficient funding should be provided to ensure that the registers are able to implement the programs.

?? Corporate Governance Code and Institute of Directors – It is recommended that a voluntary code of corporate governance and an institute of directors be established. These measures would contribute towards increasing the domestic ownership of the corporate governance regime in Georgia

ANNEX B: SUMMARY FACT SHEET

Market and Regulatory Overview	Observed	Remarks
Market Cap (percent of GDP)		GEL 2.3% of GDP (2000)
Turnover Ratio		Not available
Number of Listed Companies		No listed companies, 272 companies admitted for trading
Legal System (Origin)		Civil Law
Autonomy of Capital Markets Regulator		Established by 1998 Law on Securities Market
Powers of the Capital Markets Regulator		De-list issues, halt trading, refer to courts & prosecutor-general, impose fines
Stock Exchange Governance		Owned by member brokers
Corporate Ownership Structure		500,000 retail investors; 5-20% privatized firms held by individual investors, rest by managing directors.
Shareholders' Rights		
Voting Rights	Yes	One share, one vote
Proxy Voting	Yes	Permitted
Cumulative Vote/Proportional Representation	Yes	Permitted but not required for election of supervisory board.
Ownership % required to call Shareholder Meeting	Yes	Can be requested by shareholders with 5% of shares
Redress against Violations/ Minority Oppression Remedies	Yes	Derivative action permitted, but not class action
Take-over Code	No	No takeover code in place
Mandatory Tender Offer in Change of Control	No	None required
Insider Trading & Self-Dealing Prohibition	Yes	Prohibited under 1998 Securities Market Law
Preemptive Rights	Yes	Under Law on Entrepreneurs, must be maintained
Oversight of Management		
Board Structure	Yes	Supervisory board overseeing managing director
Independent Directors	Yes	Company management not permitted to join supervisory board
Committee Practices	No	No guidelines available
Disclosure and Transparency		
External Auditors	Yes	Required for all joint stock companies
Consolidated Statements	Yes	Required under International Accounting Standards (IAS)
Segment Reporting	Yes	Required under IAS
Disclosure of Price Sensitive Information	Yes	Required under 1998 Law on Securities Market
Accounting – Standards and Enforcement	Yes	Follows IAS but audit practices considered weak
Company Officers related Disclosures	Yes	Required under Law on Securities Market
Related Party Transactions	Yes	Not specifically required, except as part of IAS disclosure
Disclosure of Ownership	Yes	Disclosure required for 5% or more ownership stakes, directly or indirect ownership
Risk Management and other Disclosures	Yes	Required under Law on Securities Market