

CORPORATE GOVERNANCE: FIVE YEARS LATER



Center for Liberal-Democratic Studies

Boško Mijatović (editor)

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Foreword

The study is a continuation of corporate governance research in Serbia conducted by the Center for Liberal-Democratic Studies. The previous one, written in 2003, marked a commencement and set the foundations not only for the CLDS, but Serbia in general. The purpose of the new one is to investigate what has happened in the meantime, what are the effects and what else could be done in this important area of economic life.

Analysis of corporate governance relies on two pillars. The first is composed of empirical data collected on the basis of a special survey designed for this study, and data on change of ownership structure through trading on the market. The second pillar comprises analysis of legislation, primarily solutions of the Company Law, Law on Trade in Securities and Takeover Law. Analysis of the actual state of corporate governance and pertinent legislation have led to suggestions for changes in the legislative framework, which was the main purpose of this study.

Boško Mijatović wrote chapters I, II and VII, Boško Živković and Ana Jolović wrote chapter III, Boško Živković and Katarina Đulić chapter IV, Milica Bisić chapter V while Boris Begović is the author of chapter VI.

25 October 2008

Boško Mijatović

Introduction in corporate governance

DEFINITION OF CORPORATE GOVERNANCE

In order to clearly specify the field of research, it would be useful at the beginning to define the main concept of this research – the corporate governance. A well-known definition is the one from Cadbury Report¹ which reads: ‘corporate governance is the system by which companies are directed and controlled’. In this way, corporate governance is defined as a set of mechanisms through which a company operates when the ownership is separate from the governance.

There certainly are many different definitions in the literature but they mostly fall within the two groups. The first is focused on actual behaviour of companies – their performance, growth, efficiency, financial structure, status of shareholders and other stakeholders, etc. Therefore, these definitions cover the issues from the field of corporate governance within the company, such as how the board of directors works, what is role of managers’ remuneration for the company’s performance, in what way the company’s policy towards employees influences its business, what is the role of different actors, and similar.

The second group deals with normative issues of corporate governance, namely the rules according to which the companies operate. These rules stem from different sources, such as the legal system, judiciary, financial markets, and similar. Surely, in this set the observation focuses on the influence of normative environment on the companies’ business. A narrower approach focuses on the rules of capital market on the investment in listed companies’ shares, such as the listing requirements, regulation of insider trading, accounting and information disclosure rules, protection of minority shareholders, and similar. Falling in this category is also the definition that focuses on the question how the outside investors can protect themselves from the insiders’ expropriation. The famous Andrea Shleifer and Robert Vishny definition: ‘Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment’ belongs to this type.² This definition may be extended to include both the finding of solution for the problem of the dispersed proprietors’ common action and the settlement of different stakeholders’ conflict of interest.

¹ *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report), 1992

² A. Shleifer and R. W. Vishny – *A Survey of Corporate Governance*, *Journal of Finance* 52, 1997, pp. 737-83

A broader definition builds on the goal of good governance being the maximisation of the company's contribution to the overall economy and therefore considers that corporate governance includes the relationship between the shareholders, creditors, employees, and corporations, between the financial markets, institutions and corporations, and between the employees and corporations. A broad definition may also include the so-called corporate social responsibility with regard to wider social interests (the environment, labour force, charity, etc).

THE MAIN PROBLEMS OF CORPORATE GOVERNANCE

The most important goal of all interested parties in the field of economy is the efficient functioning of the economy, that is, companies, since it is a precondition for maximisation of incomes, employment, and general wellbeing. For this to be achievable it is necessary that companies are well run, i.e. that corporate business decisions made in them are the best possible in the given circumstances. And the main precondition for taking sound business decisions is a well-structured system of corporate governance. This means that the problem of corporate governance does not only involve the issue of the quality of corporate business decisions, that is, the company's management, but, as mentioned above, the system of corporate direction and control. In other words, it is about the set of the most important rules for the functioning of the company's internal organisational structure (the competences and procedures of the shareholders' meeting, board of directors, management, etc).

The commonly perceived problems of corporate governance, which we will address hereafter, do not arise in all types of companies but only in those with many owners where the ownership is separated from governance. In modern economies, all companies may be divided in two groups. The first group includes the companies run by one or few owners. These are small, usually family businesses. The second group involves large companies with a large number of owners, let us call them corporations, which are not governed by their owners directly but rather by professional managers on their behalf. That is how the main reason for the corporate governance problem arises: separation of ownership from governance. Therefore, it is only in large companies with a large number of owners that corporate governance problems arise, while the companies from the first group boast favourable configuration – the owners run the company and the difficulties of corporate governance, as it is generally defined, are not seen here.

There are two central issues with regard to corporate governance and both their presence and solution depend on the corporate ownership structure. On the one hand, it is difficult for outside shareholders in public companies with dispersed ownership to control the managers' performance since they do not have sufficient power to influence them. On the other hand, in the companies with a small number of owners, the managers are usually controlled by the majority owner(s) so the main issue of good corporate governance is how to ensure that minority owners are able to prevent the controlling owner(s) to avail excessive benefits through the machinations and at the expense of minority owners. Let us see this in more detail.

The first question is the following: how to ensure that professional management in companies with dispersed ownership acts in the interest of the owners and not in their own (principal-agent problem)?³ The reason for this is that the owners are usually not capable (they are not professionals, do not have sufficient information) or do not have sufficient interest (they own only a small number of company's shares) to properly supervise the management. How to ensure in those circumstances –ownership separated from professional governance, dispersion of ownership over modern corporations –that the owner does not only lose the principal amount of his investment but also earn a return? Therefore, this is about the investors' trust in the corporate sector, which proves to be most dynamic in developed countries but also potentially risky for the small investor.

The solution for the above problem is most commonly sought through different mechanisms which can reduce it. These include:

- Relying on the managers' aspirations to acquire and maintain good business reputation of their own,
- Aligning the management's interest with that of the corporation and its owners through incentive schemes for managerial remuneration;
- Delegating the control over the management to the board of directors as the owners' representative that should make strategic decisions and control the management;

³ The above problem usually appears in the economic theory as the so-called agency problem: there are two persons – the principal (owner) and the agent (his employee) – and the question is can the principle ensure that his agent acts for the principal's and not for his own benefit. The problem is of general nature, so it also appears, for instance, in the form of the question; how can the government ensure that a policeman, customs officer, or a minister act in the general interest and not in their own. In the case of corporate governance, the company owners are the principal and the manager (or the entrepreneur) is the agent who directly runs the company. Hence, the question is what are the methods to ensure that managers indeed act for the benefit of the owners and not for their own benefit.

- Clearly defining the manager's fiduciary duty to the corporation, accompanied with filing court actions if the manager violates it;
- Partial concentration of ownership and control in the hands of a single or a couple of major investors, which alleviates the problem arising from the dispersion of ownership;
- Capital market as a signal instrument for poor management performance;
- Takeover by third party when the value of the company falls below its real value because of the poor management performance;
- Fighting for proxy votes at the shareholders' meeting, which produces temporary concentration of ownership or votes when necessary;
- Different forms of minority shareholders protection.

None of the above mechanisms is perfect but their combination usually produces the desired effect, even though not always and not everywhere. The likelihood of the presence of a poor system of corporate governance is higher in the countries with weaker institutions than in the countries with efficient judiciary and other institutions.

The second question is the following: how to ensure in the enterprises with concentrated ownership that the controlling owner does not abuse his control over the company so as to pull out of it more than what is due to him (principal-principal problem)? Namely, what we have here is a conflict between one, perhaps majority owner, who has full control over the company (including the management) and a larger number of small shareholders who are not able and do not have any interest to engage in attempting to contest the action taken by the majority owner or the management appointed by him.

Classic ways of abusing the control over a company at the expense of minority owners include:

- Excessive earnings of the manager/controlling owner,
- The business deals of the controlling owner, parties related to him, or his other firm with the company which are unfavourable for the company,
- Use of insider information for personal gain, and
- Dilution of minority share packages through merger of companies.

This danger is particularly great in the countries such as Serbia, where legal and extralegal (capital market, banks) restrictions for the actions taken by the company's management are modest.

There are different systems and methods for minority shareholder protection:

- Strengthening of the minority owners' status through:
 - a. 'one share one vote' rule, i.e. absence of special voting privileges to be available to individual owners,
 - b. Possibility of convening the shareholders' meeting, which should enable the initiation of action in emergencies,
 - c. The use of the cumulative voting⁴ for the board of directors to facilitate the election of a representative of the minority,
 - d. Pre-emptive right to buy shares of new issue, which should enable the minority owner to maintain his share of ownership, etc;
- Strengthening of internal governance:
 - a. Strengthening the efficiency of the board of directors,⁵
 - b. Stricter regulation of the transaction between related parties;
- Precise regulation of the conflict of interest;
- Precise regulation of the managerial compensation;
- Possibility to file suit against the control owner for abuse in the name of the company before the judiciary capable of rendering a just decision, including the principle of the equality of all shareholders;
- Detailed and timely information of the public and the shareholders about the company's business;
- A developed system of the independent auditing of public companies' books, including the possibility of extraordinary audits;
- A possibility to fight for votes at the shareholders' meeting (the necessary assumption being that the controlling owner is not at the same time the majority owner), and similar.

The problem with many methods of minority owners protection is the following: the greater the minority protection the more affected the majority owners' right of management, which is not always good because it compromises the equality of shareholders' rights, namely the democratic principle: one share one vote.

⁴ In cumulative voting, the number of votes available to each individual shareholder is multiplied with the number of board members; the shareholder has the right to allocate the total number of votes increased in this way to a single candidate or distribute to several candidates.

⁵ In Italy, a radical innovation was introduced with the amendments to the 2005 Company Law: in all public public companies, at least one seat on the board of directors must be reserved for the minority lists, i.e. the lists which are not related to the controlling shareholder.

That is why the main choice the corporations, and particularly the regulators have to make, is the following: how to regulate large active shareholders and, at the same time, attain the best balance between the managerial discretion and the minority shareholders protection, considering that the most direct way for resolving the principal-agent problem is to encourage the creation of large active owners who could control the management in their own and in the interest of other, smaller shareholders. However, this creates the possibility for a couple of large shareholders to make agreement with the management behind the scene and adversely affect the rights and interests of the owners with a small block of shares. That is why the latter need to be protected, which means that the role of large shareholders needs to be restricted, which, in turn, leads to unwanted broadening of managerial discretion. Different countries have resolved this dilemma in different ways. One group of countries places emphasis on the protection of small shareholders by restricting the role of the large ones, and the other favours stricter control of the management by large shareholders.

TRANSITION IN SERBIA

In this section we will outline the developments during the transition in Serbia, i.e. since the end of 2000, when the country's leadership was assumed by the reform coalition, to this date, so as to describe the circumstances in which the corporate governance has been changing and, accordingly, indicate at least part of the reasons for those changes.

Situation before the year 2000

A transition from socialism to a liberal-democratic society is surely a very complex phenomenon and, usually, the goals desired to be attained are numerous and varied. In the economic field, there are two main goals: firstly, to create a competitive market which would much more efficiently resolve the allocation problem of the society, and, secondly, to replace the dominance of state and/or social ownership in (or over) the companies with the dominance of private ownership, and thus facilitate market competition based on sound commercial motives. Attainment of these goals requires both the all-encompassing liberalisation of the economic life and the building of institutions which should protect private ownership and allow normal market operation.

In Serbia, as in a few other socialist countries, the main goal was the latter one, i.e. to change the motivation of corporate operations by replacing the social ownership with private one. Namely, before the beginning of true⁶ transition, i.e. the year 2000, Serbia nominally boasted many common market economy institutions, such as laws on property and its protection, on companies, on foreign investments, anti-monopoly laws, laws on accounting and auditing, etc. Some notable exemptions included the lack of formal foreign exchange and labour markets because trading in foreign exchange was forbidden so as to enable state distribution, and, in the case of labour, to protect the workers.

Before the year 2000⁷ Serbia had in place the institutions which were seemingly and nominally identical to those in standard market economies – self-standing companies, usually free prices, the issuing bank (with inflation), commercial banks, exchanges, customs-free zones, courts, arbitrations, chambers, trade unions, etc. One was mostly free to start a business, but it was complicated. The freedom of possession existed, and so did competition. However, Serbian economic system was by no means a market system in the standard sense of the word. The laws were often bad or were not applied, and the state and socialist party had, in an informal and illegal manner, assumed a role of all-powerful governor who has a decisive influence on all economic developments.

Therefore, Serbia was left with a legacy of many unfavourable economic mechanisms from the earlier period and some new ones were added: dominance of inefficient social and state ownership; discrimination against the private sector; predominance of politics over the economy; conversion of companies into social welfare institutions; reducing of the market to a commodity market while the money, foreign exchange, capital, and labour markets were semi-legal and their prices were usually fixed administratively; non implementation of bankruptcy legislation; low rate of tax payment; administrative distribution of foreign exchange and primary issue loans to the favourites under privileged conditions; dominance of the concept of closed economy (import substitutes); financial relationships ruled by debtors rather than creditors, etc. Nominal market institutions were obviously not functioning. However, both the business community and the general public were used to the market and its

⁶ We mention 'true' transition because earlier, in 1990, a transition started in Serbia, and in the entire Yugoslavia of that time, but in Serbia it was concluded with self-management socialism's being transformed into a degenerated market/administrative system, under the burden of UN sanctions and disintegration of the legal system.

⁷ For more detail see: *Unapredenje korporativnog upravljanja (Improving Corporate Governance)*, CLDS, 2003

complexities. Consequently, in 2000 Serbia was more prepared for transition than many Eastern-European countries had been a decade earlier.

A part of the above weaknesses came as a consequence of the ruling party's socialist-administrative ideology. However, a part came as a response of the inherently weak social ownership and the irrational behaviour of socialistic enterprises which maximised employees' earnings rather than the profit. That is why the main problem was not to establish the market but rather to improve it through institutional reform and, even more, through the fundamental change of the motivational system for main economic operators – enterprises. The reason for this is that the liberation of companies from being administrated by the state/party took place and has been taking place relatively easy in Serbia after the year 2000 but the transformation of property relations was a much harder job.

Therefore, the main goal of transition in Serbia was to improve corporate governance through the transformation of property relations and building of market institutions. It was because the inefficacy of business operation which led to the inefficacy of the overall economic system that socialism failed.

The main features of transition 2000-2008

There is no doubt that political circumstances in which economic transition has been taking place during this decade are unfavourable. Serious difficulties hampered the work of Serbian governments both locally and in the international context. The problem of Serbia's cooperation with the Hague Tribunal, namely unpopular extradition of the indicted to the ICTY, adversely affected the stability of not only the governments and the ruling coalitions in all these years, but also the relations with the so-called international community. Partly connected with this, but partly as a completely internal issue, severe political battles have been waged in Serbia all this time – at first the battle was waged between two leading democratic parties and their respective leaders, and then an opposition party that had grown in the meantime (SRS) got involved. Thirdly, Serbia came out of the war for Yugoslav heritage with two unresolved state problems: the first was the relationship with Montenegro within the new Yugoslav union, and the second was the issue of the future status of Kosovo and Metohija which, after the confrontations in 1998/1999, nominally remained under Serbia's sovereignty but also under provisional protectorate of the United Nations. These three political issues diverted the political energy

from the transition and slowed it down, namely rendered it less effective than what it could have been.

There were two positive factors for the success of transition. First, there existed a considerable experience acquired during the transition process that had already taken place in Eastern European countries which could have been, and in part was, used in developing the concept and carrying out transition. Secondly, some international institutions, especially the World Bank, now wished to show themselves in a better light than before and, therefore, Serbia was afforded much better technical and much larger financial support.

Before coming to power in 2000, the opposition alliance DOS did not have an elaborated transition strategy. Rather, after 2001 it was developed in a somewhat haphazard manner, although not without the basic ideas. That is how the classic dilemma of the transition strategy 'shock therapy or gradualism' was resolved in favour of the latter, but unintentionally. Namely, the Zoran Đinđić Government sought to reform the Serbian economy as quickly as possible but, after the jump-start in 2001/2002, things got severely slowed down, both because of the limited capacity of the public administration and the upsurge of political tensions and shifting the focus on party ratings.

Generally, transition dynamics moved in a zigzag fashion. We mentioned before the excellent start in 2001/2002 which was a result of the reform fervour, and the slow-down in 2002/2003 caused by the political sphere. This was followed by a new acceleration in 2004/2005 as a result of the pressure coming from the IMF and the World Bank,⁸ and, in 2006/2007 the process slowed down again for the pressure from the IMF ceased and the issues of state further complicated the situation.

The other great dilemma 'to take the liberal or the social-democratic road' was resolved by a compromise. The economy was reformed in a prevalingly liberal manner, while the social policy was expressly used as a way to compensate the main transition losers, primarily those who lost their jobs. These generous expenditures were for the most part financed from the privatisation proceeds.

Let us now take a look at the developments in several major fields. The macro-economic policy has also followed a zigzag path, for the phases of expansive and restrictive monetary and fiscal policies interchanged. The dinar exchange rate has been used as a nominal anchor but dinar appreciated in real terms at the times of greater capital inflows from abroad. The balance of

⁸ The IMF's positive opinion was a precondition for the write-off of Serbia's debt with the Paris Club, which was abundantly used by the IMF to exert pressure on the Government towards reforms.

payments and foreign trade has been very negative, to be compensated by the inflow from privatisation, new loans, etc. Prices have been rising all the time, at an annual rate exceeding 10 percent. Interest rates were rather high, which was primarily a consequence of a greater risk (slow judiciary system) than in the European countries.

The economic growth in this period was 4-8%, and this was a consequence of both the low baseline from 1999 (NATO bombing campaign) and the successful restructuring of one part of the economy and the growth of autochthonous private sector. Employment and unemployment have stagnated all this time; therefore, productivity growth rate is high.

In 2001 labour legislation was liberated and essentially rendered complementary with the market economy. It is now possible to dismiss employees, although the procedure is very complex. Collective bargaining is no longer mandatory. Trade unions are weak, although in a number of privatised companies they are strong and negotiate hard. Compensations for the unemployed are decent and are paid out over a long period of time, and active employment policy is practically non-existent, with the exception of a number of training programmes.

The tax system has been radically reformed compared to the old one which had about 230 different charges. The value added tax was introduced in a particularly successful manner. The tax and social contribution burden on salaries has been eased to a great extent so as to encourage employment. Customs duties have also decreased and the basic corporate tax rate is now 10%. Tax administration has greatly improved.

The results have been less good with regard to public expenditure. Its share in GDP is still about 45%, salaries in the public sector have been rapidly rising all the time, public enterprises have neither been restructured nor privatised, the pension system is only partly reformed. Budgeting procedures have improved much and the treasury operation introduced to a large degree.

The financial system has also been restructured and revitalised. The banking system was given a solid base by the liquidation of old state-owned banks and modern legislation, as well as by the entry of foreign banks. Deposits are growing and interest rates are gradually falling. Foreign banks bring in capital from their parent companies.

The securities market in Serbia is primarily a mechanism for redistribution of property rights and to a lesser extent or not at all a mechanism for financing corporate and public sectors. The trade predominantly takes place

with the shares acquired in the privatisation process implemented pursuant to the 1997 law. In this process of ownership transformation, namely of ownership concentration, an important role is played by takeovers. A large number of issues are not well or are not at all regulated in the Law on Takeover (publication of public offer, binding public offer, competitive public offer, supervision, etc).

One of the most important laws in the economic field is the **Company Law**, which was adopted in the Parliament in November 2004. This Law is absolutely modern and appropriate to market economy, as opposed to the previous Law on Enterprises (from 1996) which was semi-socialistic and fraught with poor or imprecise solutions. The main characteristics of this Law include the harmonisation with the EU legislation, comprehensiveness of regulations, flexibility and freedom of choice, improvement of corporate governance, improvement of minority shareholders' rights, transparency of public companies (open public companies), transition status of socially-owned and public enterprises, consistency with other laws, modernity and liberality.

Privatisation

In the beginning of this decade, privatisation in Serbia was considered a critical reform process, which it indeed was. The first reason was that the social and state sectors were using considerable resources although their value was much lesser than what was generally assumed. These resources should have been employed in a productive manner, to the largest extent possible. Secondly, the socially- (and state-) owned sector was an important social welfare factor or, more precisely, problem, the solving of which was unavoidable if creation of a functional market economy in Serbia was wanted. Namely, with a prevailing self-management state of mind and habitual reliance on state subsidies, the rusty socially owned sector was the greatest obstacle to the reforms in the political and social sphere.

The reform government was faced with a choice of the privatisation model: whether to continue with the thus far applied model of workers' shareholding as it satisfied many workers' perception that they have created the national wealth (without incurring any debts?); or to opt for a voucher model, which was very popular in some transition countries in the mid 1990s; or to go for the model of classic sale used in the developed countries

A somewhat modified model of classic sale was chosen. The main reasons for deciding on this model included the previous experience of other Eastern European countries and the circumstances prevailing in Serbia.

The main characteristics of the chosen model were the following:⁹

Sale, rather than free distribution. The distribution of the socially- or state-owned capital to all citizens through vouchers was a popular option in Eastern Europe in the mid 1990s but with time this method proved bad in terms of corporate governance. Serbia's experience with workers' shareholding, which is another method of giving away shares, was also negative.

The method of the sale of socially- and state-owned capital was chosen with the intention to try to find true buyers, i.e. those who will be able to make the most of the privatised companies (economic resources). The starting point was the normal economic reasoning that the one who pays knows why he is paying so much and that the one paying the most is the most likely to be best able to utilise the resources. And that is what brings the efficiency. Certainly, every transition government is in dire need of money for different purposes and the motive of obtaining budget revenues from privatisation is not a negligible one.

However, the sale as a privatisation method has a weak point: it is usually slower than the alternative systems since it requires that each and every company be individually prepared and this, particularly in the circumstances will the limited capacity of government administration, is a very time-consuming process.

Sale to strategic investors. Here the dilemma was: to sell the shares through public subscription or to a strategic, majority investor. In deciding about this dilemma, it was taken into account that, in a transition country with weak institutions, it does matter whether the ownership is dispersed or concentrated, namely that for a long time still Serbia will not have in place those fine mechanisms which ensure good corporate governance in the companies with dispersed ownership. Therefore, the advantage was given to concentrated ownership. Also, when choosing the privatisation model, the government rightfully attached much weight to corporate governance in the post-privatisation period and opted for the sale of the majority package (70%) of socially- state-owned capital to a single investor. This enabled a single majority owner to assume full control over the privatised company and govern the company, in his own interest, without any particular complications. The additional idea was to

⁹ For more details, see: *Četiri godine tranzicije u Srbiji (Four Years of Transition in Serbia)*, CLDS, 2005

facilitate the complex process of corporate restructuring in the post-privatisation period.

The experience of both transition and developed countries has shown that the principal-agent problem is always very unpleasant and that there is not a simple remedy. The problem of preventing the management or owners with only a relative majority to make illegal moves in their interest is particularly complex in transition countries, in which the necessary institutions (judiciary, registers, stock exchange, etc) are not yet perfected. In those countries it is better to rely on the majority owner since that would eliminate at least a part of the principal-agent problem – that which concerns the dispersed ownership.

A small part is given away to employees and citizens. However, here the political motives also caused the inclusion of the gifts for the employees and citizens of Serbia in the form of socially owned capital amounting to 30% of the capital privatised. Then again, this gift did not change the basic idea of the privatisation model – to sell the majority package to a strategic investor so as to ensure good corporate governance.

Competitive sale methods. Namely, the Law on Privatisation envisaged two methods of sale, both of them competitive: the auction, for smaller and weaker enterprises, and the tender, for larger and better ones, which were intended for foreign investors. Also, in both cases it was 70% of the non-privatised capital that is on sale and the remaining is given away to the employees and citizens. A good thing is that the sale methods did not include the direct negotiation between the government and the buyer since this method, although principally suitable and seemingly necessary in the case of bad enterprises for which there is no demand, is, nevertheless, too risky from the perspective of the government for it allows room for, or even encourages, corruptive practices. For bad enterprises, this model envisages a regulated restructuring or bankruptcy.

Privatisation results. In the period 2001-2007, the tender and auction privatisation resulted in selling the capital of 1,632 companies, earning proceeds of EUR 2.1 billion, providing EUR 1.2 billion for investments and EUR 276.7 million for the social program. At the same time, about 1,220 share packages were sold from the Share Fund and the proceeds amounted to EUR 613 million.

The above mentioned shares from the Share Fund portfolio originate from the privatisation pursuant to the 1997 Law which belonged to the workers' shareholding model. Pursuant to this Law, about 500 enterprises were privatised

in the spring of 2001 and some of these enterprises were among the best in Serbia. Therefore, privatisation in Serbia was partially carried out under this model.

These two models of privatisation had different effects on corporate governance and the securities market. Under the 2001 model, the dominant personality was the majority owner with 70% of the capital held. After the privatisation, there was practically no trading in these shares, unless there was a small quantity of shares from earlier privatisations (the laws from 1990 or 1991) after the model of workers' shareholding. Contrary to this, the privatisations under the 1997 model have resulted in the dispersed ownership of the employees and the state pension fund, which gave rise to quite substantial trading. In fact, the shares traded on the Belgrade Stock Exchange are almost exclusively the shares of the companies privatised under the 1997 Law.

Situation in the year 2008

In the past seven or eight years of transition, the Serbian legislation has been completely reformed in the direction that is customary for market economies. All the laws that regulate business operations and the overall economic activity have been adopted. A certain delay in the adoption of some of these laws was caused by the unfavourable political situation in the country as well as by the fact that the economic legislation in the earlier period (in the 1990s) was to some extent reformed and could serve the purpose, at least for a while.

Thus, Serbia today boasts new economic legislation: beginning with the financial regulations, through the laws governing registration of companies and bankruptcy, to the laws governing all other fields (taxes, customs duties, banking, insurance, accounting, auditing, etc), as well as a new constitution which provides a modern framework for main economic relations.

The quality of economic legislation is inconsistent. Some laws are very well written (such as the Company Law), but there are some laws that are not at that level (e.g. some laws in the field of finance). Some of them were produced in haste and have been subsequently improved through amendments.

Regardless of the weaknesses, the laws in the economic field are not the main problem: more important are the flaws in their implementation. The weaknesses in the executive power and the judiciary are particularly conspicuous.¹⁰

¹⁰ For more details, see *Reforme u Srbiji: dostignuća i izazovi (Reforms in Serbia: Achievements and Challenges)*, CLDS, 2008

The executive power does not demonstrate adequate capability to perform this job in a satisfactory manner, primarily with regard to the discharge of its legal authority. Sometimes these weaknesses are manifested in the ineptness of civil servants and entire public institutions to execute the procedures prescribed by the law, and at other times in intentionally erroneous or neglectful implementation of the law. Or, the development of laws is poor, for instance, no attempt is made to calculate their potential effect and all faith is placed in the minister's intuition.

The cause of this is twofold. Firstly, executive authorities are weak in terms of human resources, caused by many reasons: a great deal of good civil servants left after 2000; politicisation of the administration with the creation of unstable coalition governments where no party feels responsible for the state and all try to use their power to pursue their own interest; remuneration of civil servants is poor, which discourages younger generations and direct them towards the private sector. Secondly, the abuse of government has a substantial impact on everyday life. At a higher level, it is the result of the actions taken by interest groups and, at a lower level, plain corruption.

Neither is judiciary at a required level. It should protect the rights of individuals and their companies, not only in private transactions but also from threats coming from the executive power. However, it does not do so to a required extent. The main weakness of the judiciary is its slowness. Cases build up and drag on for years, and persons whose rights are infringed lose hope of a favourable and just outcome. Moreover, the judges' knowledge is not at an adequate level, which is most likely a consequence of fast legislative changes with which some judges cannot keep up. Corruptive practices are present as well, to the extent that cannot be qualified as negligible.

This unfavourable situation in the judiciary is a consequence of both the weakening of the human resource base seen the 1990s when, because of low salaries, many good judges left for the bar, and the threats to judicial independence and politicisation in appointment of new judges.

THE STATE OF CORPORATE GOVERNANCE

The situation with corporate governance in Serbia is not commendable and Serbian economy still lags behind other countries, particularly the developed ones. There are several reasons for this.

Firstly, a considerable number of enterprises are not yet privatised, including large state-owned enterprises and those socially-owned or companies with mixed ownership which are suffering massive losses. Regardless of normative innovations, the old socialistic/self-management mechanisms of governance that are based on social/state ownership and strong political interference are still prevailing in their operation: despite the normative arrangements on the dominance of boards of directors and shareholders' meetings, the CEO is the most important factor and all major decisions depend on him; political factors outside the company are still interfering with strategic decisions or at least with the appointment of the CEO; a soft budget limitation is still in place, leaning on state subsidies, absence of bankruptcy proceedings, etc; the transparency of procedure is poor and the violations of procedures are frequent (often at somebody's expense) and they are usually not sanctioned; just like the times of self-management, disbursement of salaries to the employees is still the main motive for doing business (however, something is always left for the management, the same as it once was) and similar.

Secondly, the privatised/or private companies are not free from the problem of corporate governance either. Namely, major improvements were expected, and rightly so, from the privatisation and the companies' passing from the hands of political party officials to the hands of private owners who are surely much more motivated to perform well and to improve the operations of their company. However, privatisation per se is not a cure-all. It does bring governance improvement, which is clearly demonstrated by the post-privatisation experience in Serbia, but the weaknesses restricting the quality of corporate governance may and do appear even in privately owned companies, and not only in Serbia but also in other countries. Let us mention the principal-agent and principal-principal problems. However, there is also a clear cultural problem, which is mostly a consequence of the tradition, namely the earlier dominance of one method of governance and the people's habits and difficulty of getting rid of such habits.

The obvious problem of privatised companies is the expropriation of minority shareholders by the majority one(s), either through pulling out money from the company or through share dilution.

Thirdly, the economic legislation is not entirely well-reformed, which sometimes puts bad incentives into the legislative framework for corporate operation. The Company Law was adopted towards the end of 2004 and it regulates corporate governance in a modern way. However, despite praises, not all

solutions provided in this Law are the best possible ones and there is room for further improvement. Moreover, it was not possible for its provisions to completely change the corporate governance system in Serbia in such a short time - it takes longer. Also, some other laws are not good enough, such as the Law on Securities Market in some of its provisions, and it is necessary to improve stock-exchange rules (listing requirements) and similar. In other words, further legislative enhancement is required, as well as more time for the current legislation to produce the necessary improvement in corporate governance.

Fourthly, there are weaknesses in the functioning of competent government authorities and the judiciary. The institutions in Serbia, even the most important ones, are not sufficiently strong and efficient to perform their part of the tasks and provide a stimulating, well-regulated environment and, above all, to ensure execution of proper rules of conduct, which will be discussed in further detail below.

However, things are gradually moving forward. The end of privatisation in Serbia is drawing near and, consequently, the inefficient social ownership will soon completely disappear. And the privatisation process has commenced in a few large state-owned enterprises. The general orientation towards selling the socially- and state-owned capital to a strategic owner was a determining factor, and this will be further discussed below, for the type of post-privatisation ownership structure to be, for a long time, in favour of the majority ownership. Arising from this is the main problem of corporate governance in Serbia in the ensuing period: it is not the Anglo-Saxon principal-agent problem, but rather the principal-principal problem, with all pertaining regulatory and functional consequences.

The main regulatory solutions for corporate governance are always provided by laws on business entities (companies, enterprises, etc). Serbian Company Law, passed by the National Assembly in November 2004, brings a material improvement compared to the 1996 Law on Enterprises in force until then. It is more modern, more precise, and offers better solutions. Its particular quality is the flexibility, so many provisions are applied on the default principle, i.e. unless otherwise provided for by the company's instrument of incorporation.

Its main solutions in the field of corporate governance are the following:

- The competences of the shareholders' meeting are much broader than what is customary: in addition to standard ones, such as appointment of the board of directors, amendments to the instrument of incorporation, decisions on share issue, etc, these include the selection of auditors and

adoption of auditor's financial report, adoption of all financial reports, remuneration of the CEO and directors, etc; this approach was intended to strengthen the owner's role at the expense of the role of professional managers, although it is uncertain to what extent it will actually succeed,

- The board of directors, as a body representing the owners, is intended as the main authority in the company – it strategically governs the company and appoints and dismisses the management, which should allow it to control the management; the dilemma between two-tier boards (management and supervisory) or one-tier board (board of directors) was resolved in favour of the latter solution, which is the advanced, Anglo-Saxon principle;
- In order to strengthen the board of director's independence from the management and large shareholders, the Law stipulates the mandatory election of a majority of non-executive members¹¹ and at least two independent members¹² in the managing board of listed public companies
- The supervision over (financial) operations of the management, and even the board, is conceived as a duty shared by an external auditor and the shareholders' meeting, considering that external audits are mandatory; auditor's reports are to be approved or not approved at the annual general shareholders' meeting,
- Setting the managers' remuneration is deregulated, i.e. the company can, as it is a common practice globally, bind the managers' remuneration to the company's performance (share price growth, profit, etc) and, accordingly, encourage the managers to act in the company's best interest,
- The management is bound by the provisions on fiduciary duty to act loyally towards the company, i.e. to act diligently in the company's interest, which, in the case of non-compliance may result in unpleasant lawsuits and disputes before courts,
- Minority shareholders protection is also developed. This is very important in Serbia where privatised enterprises feature an accentuated and, for small shareholders, risky dominance of a single owner; namely:
 - A possibility of cumulative voting for the members of the board of directors, which increases the chances of minority shareholders to have their own representative on the board,

¹¹ Those who are not members of the executive board, i.e. the management.

¹² This criterion has been diluted by the provision on minimum requirement, which provides that an independent member is deemed to be a person who holds, together with affiliated persons, less than the high 10% of the company's shares.

- Imposing the ‘one share one vote’ principle at the shareholders’ meeting, which precludes some shareholders’ special benefits manifested in super-proportional voting rights,
- The right of minority shareholders (at least 10% of shares) to convene the shareholders’ meeting,
- A special decision-making procedure with regard to large transactions, to be decided by the shareholders’ meeting,
- Special procedure with regard to the conflict of interest of responsible persons (their business with the company), through exclusion of such persons from the decision-making process,
- The shareholder’s right to sell their shares at the market value to the company, when such shareholder has formally expressed his dissent with any major decisions; with this right, minority shareholders who are owners of poorly liquid shares (preference or not listed) are given the opportunity to leave the company.

A very important method for restricting the managers’ arbitrariness in public companies with dispersed ownership, which is available only in a small number of Serbian companies, is pooling of shares. The reason for this is that concentrated ownership creates a possibility of resolving the principal-agent problem through direct control of the management. Concentration may be permanent or temporary, full or partial, and it may be achieved in several ways:

- By purchasing shares on the stock-exchange; however, public takeover bid is mandatory when the threshold of 25% of the total number of the company’s shares is exceeded,¹³
- By pooling proxy votes at the shareholders’ meetings, i.e. the right to entrust one’s own votes to somebody else and the resulting possibility to acquire a larger or a large pool of votes by adding up the votes of small shareholders,,
- By taking over the controlling interest in the company through fast purchase of shares, using the public takeover bid; this is a convenient way to remove poor management when neither the board of directors nor the shareholders’ meeting perform well.¹⁴

¹³ Under the Law on Takeover of Public Companies

¹⁴ Takeover of companies is regulated by the Law on Takeover of Public Companies.

Empirical data: results of survey on corporate governance

In order to enable evaluation of the state of corporate governance, investigate operation of its key mechanisms and identify changes from the previous period, some empirical data are needed that can be provided only by a survey of companies in Serbia. Therefore, to meet the needs of the project, a survey of corporate governance was conducted in Serbia.

Let us review the main features of the survey. The sample comprised 214 public companies. Only public companies were selected since they primarily encounter corporate governance problems, based on separation of ownership from the management, and also since they account for the predominant part of Serbian economy not only in turnover, but in absolute number, as well. The latter results from the fact that all privatized companies in Serbia have been transformed from socially owned companies to public companies.

Among 214 surveyed companies 91 belong to the industry sector, 68 to trade, 33 to construction and 22 to finances. Among them, 62 have up to 25 employees, 56 between 26 and 100 employees, 43 between 101 and 250 employees, while 53 employ over 250 staff. Territory-wise, 60 public companies are seated in Vojvodina, 77 in Belgrade, and 77 in Central Serbia.

It is a quota sample, constructed on the basis of three important features of companies: size, line of business and location of the seat by the Serbian regions.

Responses were collected by direct interviews of surveyors with a member of the management of participating public companies. The survey was conducted in April 2008 by SMMRI agency.

ABOUT COMPANIES

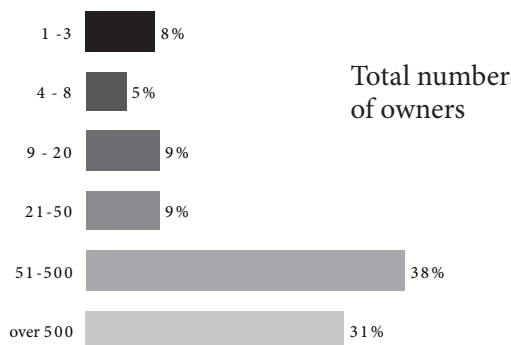
Let us see how our public companies have been established in the first place. Most of surveyed companies have become public companies through the privatization process (68%), 17% were re-organized from another legal form, and only 15% were set up as public companies from the very beginning. This illustrates that this status form is intentionally selected for only about a third of public companies while for a vast majority (over two thirds) privatization was the decisive factor. Over the years in which privatization has taken place, and this will continue in the future, as well, contrary to the process of develop-

ment of new public companies through privatization, another, reverse process goes on in parallel: closing of public companies, i.e. change of status of public companies into the private ones or into limited liability companies. The process is only natural, since a large number of public companies is small in terms of turnover, capital and staff, so that they do not need to preserve this status form, but opt for a simpler one. Namely, as it is well known, the form of an open/public company is associated with substantial cost, in the light of complexity of organization and operational procedures. It is, therefore, convenient for large companies and ambitious owners, while smaller enterprises and companies find limited liability company or even partnerships or shops more convenient. Therefore, the process of small and medium enterprises turning private may only be approved, as useful for many companies that have become public companies by the force of law, instead of economic rationale. As a consequence of their turning private, the sample covered three quarters (75%) of public companies and one quarter of private ones.

Who are the owners of public companies, domestic or foreign investors? How concentrated is the ownership?

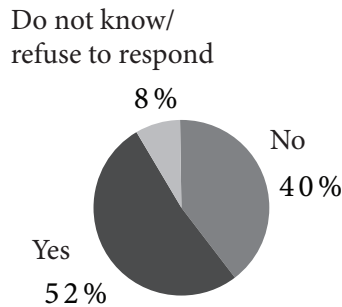
On the level of Serbia, the ratio of private and social/state capital is 84:15, suggesting a large predominance of private ownership. The predominance results from privatization and development of autochthonous private sector in the previous years. The social/state capital holds majority capital in 10% of public companies, meaning that these are companies not yet in the privatization process or not having completed it, or these are public companies that will not be privatized at all. The 62% of public companies have private capital only.

Concentration of ownership of public companies in Serbia is an interesting issue, since it is an important determinant of both problems and methods pertinent to corporate governance.



As we can see, 13% of companies have up to 8 owners, and additional 18% have up to 50 owners. Most public companies belong to the category with multiple owners, 51 to 500 (28%) and over 500 (31%), i.e. 69% in all. This suggests fairly dispersed ownership.

Nevertheless, an alternatively formulated question throws a proper light. When asked whether they have owners of ordinary shares with over 66.7% of the shares they gave the following answer:



Accordingly, at least 52% have owners with over two thirds of shares, i.e. ownership. Naturally, this is a consequence of the privatization mode resorted to in 2001, where one investor purchased 70% of socially owned capital in a competitive manner. When asked if they have any owners with between 50 and 66.7% of ordinary shares, 11% of companies confirmed, meaning that 63% of public companies in Serbia have a majority owner.¹⁵ Besides, 19% of companies have owners with 25 to 50% of shares, and 29% companies have owners with 10 to 25% of shares.

This concentration of ownership may be described as high even in comparison with conventionally understood European shareholding model. Certain dispersion, particularly in larger companies, also resulted from privatization, but the previously applied model, based on distribution of shares among employees. These shares slowly pass from employees to investors, but the process has not yet been completed.

For corporate governance it is important whether the managers own shares or not. If they do, they are probably interested in the company fate. If the stake is substantial, however, the management may expropriate the minority shareholders for its own benefit. In Serbia, managers of 28% companies

¹⁵ Do not overlook the remaining 8% of the answers formulated as 'do not know' or 'refuse to answer'.

in our sample do not own any ordinary shares, and even if they do, the total number of shares usually does not exceed one quarter of the total (in 15% of companies, the management owns up to 25% shares). Only in 14% of public companies, the management owns majority shares, meaning that the majority owners have taken over operational management of the company. Interestingly enough, in as much as 42% of the cases the responders did not know or did not want to talk about the percentage of ordinary shares owned by the management.

Employees and retired staff lose their ownership status, although they used to be predominant owners. Thus, they own majority of shares in only 10% of public companies, minority in 45%, none whatsoever in 9%, while in 36% we did not get any answer. Foreign persons are majority owners in only 5% of public companies, minority in 15%; they have no shares in 30%, and in 50% we could not obtain an answer.

Let us review the types of securities issued by Serbian public companies. In addition to ordinary shares, as standard ownership securities, priority shares have been issued by 8% of surveyed companies. They were issued in Serbia following the same rationale as elsewhere worldwide – aspiration of a person controlling the company to provide a more favorable position for himself. Thus, in Serbia several companies have issued priority shares before privatization and distributed them among the staff, pursuant to the previous laws, providing them privileged position in comparison with ordinary shares. Company shares were issued by 3% of the companies only, substantiating high restraint resulting from lack of practice in raising capital on the financial market through either shares or bonds.

RIGHTS OF SHAREHOLDERS

In order to make shareholders able to exercise their ownership right, it has to be transparent and undisputable. In Serbia, pursuant to the Law on the Market of Securities, this is a task of the Central Depository. Former Books of Shareholders, kept by the public companies themselves, are no longer proofs of ownership, neither can they secure the rights relating to the securities in question. Accordingly, for a share to be a proper share, it is necessary to be registered in the Central Depository.

Results of the survey show that shares of 85% public companies are entered into the Central Depository, and that the procedure is in progress for

12%. Shares of only 2% of companies have not been entered, which may result in serious problems and loss to their owners, as was the case in the notorious case of share manipulations by the *C market* management.

Freedom of owners to dispose of the shares, i.e. free trade in shares, is an important feature of ownership right, but the feature contributes to increase of the share price in comparison with the situation in which the trade is not quite free. In Serbia, 69% of the surveyed companies have completely free trade in their shares, while in 17% it is not, due to provisions of the Articles of Association stipulating preference of the current shares; in 12% the trade is not free since they are either not listed on the stock exchange (31%) or they are closed/private public company (23%), etc. Belgrade leads in the percentage of companies whose shares may be freely traded (83%); the percentage is lower in Vojvodina (50%). On the other hand, the current shareholders have the pre-emptive right for purchase of shares in 55% companies covered by our sample.

Shares of 65% of the companies in the survey have their shares listed at the Belgrade Stock Exchange; only 3% have their shares listed on an international stock market; shares of almost a quarter of the companies are not listed on any market, while in 6% of companies the shares are not listed, but are free to trade. The issue of listing on the Belgrade Stock Exchange highlights an old problem: The A-Listing, which is the place of trading, includes shares of only two public companies, while the remaining ones are on the so-called B-listing, i.e. over-the-counter trade on the stock exchange. Therefore, the status of many shares remains unclear, particularly since they are not traded continuously, but only occasionally.

It is interesting to see how members of the managerial structure of Serbian public companies evaluate the prices of own shares. Thus, representatives of companies whose shares are listed on the Belgrade Stock Exchange very rarely believe that the achieved price exceeds the fair one (6%); 45% find the price fair, and 44% find their shares underpriced. This widely spread belief that the value of shares is underpriced does not match opinion of market analysts who suggest that the value of shares on the Belgrade Stock Exchange is still overpriced, in spite of the fall registered in 2007-2008. They interpret the maintenance of the current prices by speculative reasons, while the fundamental one (i.e. absence of pertinent profit) suggests that the prices should be lower. The current shareholders are usually the main buyers at the Exchange. (27%); they are followed by other investors (22%) and managers (8%). The 43% respondents

do not know or do not want to reveal the main buyers of shares at the Stock Exchange in recent months.

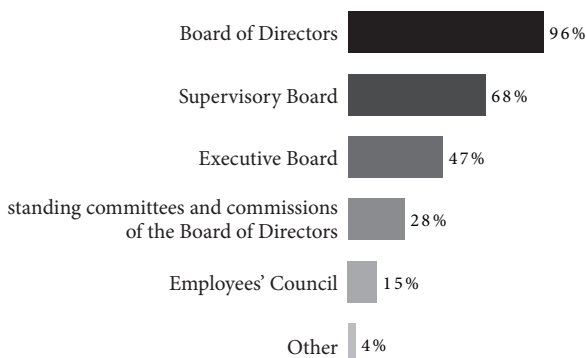
Protection of minority shareholders' rights is a subject of concern of legislators worldwide, including the Company Law in Serbia. The Law suggests mechanisms for protection thereof using the imperative (rarely) and dispositive (frequently) provisions. Minority shareholders do not enjoy special protection in 36% of the cases, and do enjoy it in almost 60%, by being given the right to convene the company Meeting (40% of the whole sample) or by resorting to the cumulative vote for election of the Board of Directors members (16% of the sample).

A dissatisfied shareholder is entitled to file an action against the company for violation of his rights. In Serbia, the practice is not widespread, so that in the last two years only in 13% of companies cases of lawsuits against the company management or company itself have been reported.

It goes without saying that the interests of shareholders are or should be prioritized through respect for the company interests in order to increase its value. In addition to the company interests, important business decisions are usually governed by the interests of employees (60%), clients (35%), banks (22%), state (20%), creditors (18%) and suppliers (16%).

COMPANY MANAGEMENT

Let us review the institutional structure of Serbian public companies. Following provisions of the Company Law, they all have Shareholders' Meeting, Board of Directors and Director General. The other associated bodies include



Board of Directors is almost a universal body, but it is not present in all public companies, since pursuant to the Company Law closed/private public companies may have its role played by the Director.

Supervisory Board is present in two thirds of companies, although the Company Law stipulates it as a mandatory body, except in special situations. Obviously, the habit to set up boards, developed pursuant to previous enterprise laws, has remained and the idea of having such body has been accepted in Serbia. Executive Board of Directors is present in a half of these companies, where its presence is usually dependent on the company size: less common in small companies (24% in companies with up to 25 employees) than in big ones (74% in companies with over 250 employees). Interestingly enough, one in seven companies has an Employees' Council although we do not know whether it is prescribed by the Memorandum of Association or institutionalized, or practically informal.

Competences of company bodies

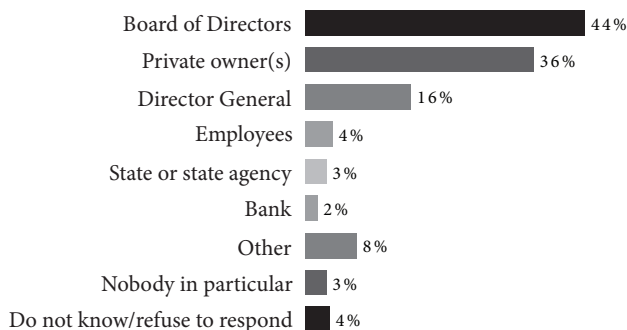
	Meeting	Board of Directors	Management	Do not know/ refuse to respond
Adoption of rulebooks and similar general documents	36	68	18	4
Formulation of business policy	29	63	28	4
Decisions on major transactions	45	53	20	5
Investment decisions	32	65	22	5
Decisions on company development strategy	33	58	25	8
Issue of new shares	60	28	7	16
Issue of other securities	46	27	9	26
Selection of auditor	40	38	23	11
Contract with auditor and remuneration setting	22	39	41	13
Approval of annual report and financial statements	58	44	16	8
Initiation of extraordinary audit	31	42	16	27
Decisions on dividend	57	31	8	18
Establishment and maintenance of internal control system	22	45	31	17

As we can see, adoption of rulebooks and similar general instruments such as formulation of business policy, investment decisions, decisions on development strategy are all within the field of competence of the Board of Directors (about two thirds of our sample); decisions on large transactions are entrusted to the Board of Directors (53%) or company Meeting (45%); issue of new shares is usually entrusted to the company Meeting (60%), and so is the issue of any other securities (46%). Responsibility for selection of auditors and contracts with them is equally distributed by the Meeting and Board of Directors (approximately 40% each). Approval of the annual report is usually accomplished by the Meeting (58%) and Board of Directors (44%); extraordinary audit is initiated by the Board of Directors (42%) and Meeting (31%), while decisions on dividends are usually made by the Meeting (57%), and establishment and maintenance of internal control system is entrusted to the Board of Directors (45%).

Distribution of competences among the bodies of public companies in Serbia generally follows not only the legislation in place, but the one common in countries with mature shareholding systems: predominance of the Board of Directors over the management is quite salient. Nevertheless, such distribution of competences does not illustrate sufficiently the true, i.e. informal impact of one body on another, such as, e.g. frequently strong or decisive influence of the General Manager on the Board of Directors. The purpose of these surveys is to establish the true influence, even the one exerted behind the scene, if needed. In order to precisely define such influence the following question was asked:

‘Who of the parties listed below effectively controls the company, where such control implies actual decision making relating to most important company matters?’

The responses were distributed as follows:¹⁶



¹⁶ The sum exceeds 100% since multiple responses were acceptable.

As we can see, in 44% companies covered by the survey effective control of the company is in the hands of the Board of Directors, in 36% of the private owners, and in 16% of the Director General. Such distribution of responses may, generally, fail to identify “the boss” in the companies, since in countries with dispersed ownership structure it is not quite sure who controls the Board of Directors: shareholders or the management. Nevertheless, in Serbia these dilemmas are not present since, obviously, at least to the extent to which we rely on the survey, owners have no major problems with the management. They dominate the public companies either directly or through the Board of Directors, and make key decisions in their own interest. Board of Directors, at least in companies privatized pursuant to the 2001 Law (majority) were elected by at the only majority owner and he, undoubtedly operates promoting the interests of the majority owner.

Only in 4% of companies the employees have the true control of the company, suggesting that the era of self-management has definitely been left behind, in the history. It is present only in the companies privatized pursuant to previous laws where shares were distributed to employees, i.e. where employees are the main owners, and accordingly company managers.

Let us now focus on how the main company bodies operate.

Meeting, composed of shareholders and supposed to enact main decisions, the most important one, apparently being the Board of Directors election. Regular Meeting is convened once a year to discuss operational results in the previous year and possibly elect Board of Directors and issue guidelines for the following operational period. Extraordinary Meeting may also be convened to discuss pertinent issues.

The initial question is whether shareholders may directly participate in the Meeting proceedings. It appears that in 72% of the companies all shareholders may directly participate in the Meeting proceedings, while in 20% of the surveyed companies this is not possible. They require no less than 1% of the shares (31% of the companies), 6-10% (19%) or over 10% (26%). No doubt is it quite convenient to have a single person Meeting, since it simplifies deliberations substantially, but it is still unfair to have Memorandum of Association requiring as much as 5 or even 10% of the total number of shares. The idea suggests an intention to prevent participation of minority shareholders in the Meeting proceedings, and their eventual expropriation.

Quality of corporate governance is affected by the organization of the shareholders' Meeting, since each of them could exercise their ownership

rights. Influence of shareholders usually ends with the Meeting, i.e. decision on election of the Board of Directors and, possibly, some formal decisions that are important, but not for the operational management. Let us start with the summons. Members of the Meeting are usually summoned by a written invitation sent to each individual Meeting member (63%), newspaper announcement (47%), internal notification in the company premises (21%) and e-mail (8%). The terms are also important for shareholders to be able to plan their commitments and get prepared for the Meeting. In 53% of the companies the Meeting members are notified no less than 30 days in advance, in 35% companies 10-30 days in advance, while 9% companies require less than 10 days. It is also important to know what the summons contain: most commonly the proposed agenda is attached (74%), description of each item on the agenda (35%), substantiating documentation for each item on the agenda (35%), annual report (31%) and financial statements (27%). In distribution of the material, a balance is required between completeness of information and cost of sending large packages to a large number of addressees. Manipulations are also possible by scheduling the Meeting far from the company seat, assuming that many shareholders will not attend. However, in Serbia, shareholders' Meetings are by far most commonly (92%) held in the town in which the seat is, then elsewhere (4%).

The quorum for the Meeting is usually defined as representation of over 50% of shares with voting right (90% of sampled companies). The quorum for the operation of repeated Meeting to deliberate a specific issue is usually set at one third of the shares with voting right for that particular issue (65% of sampled companies). Interestingly, in a certain number of public companies the quorum for both the first and second attempt to hold the Meeting is set at over 50% of shares, substantiating the wish to have a large number of shareholders participating at deliberations of the Meeting.

Let us now review the voting techniques. At the Meeting, most common is a public vote, by raising of hand or a card (59%); in 29% of the sampled companies the voting method depends on the issue at stake. In 22% one may not vote *in absentia*, but if this is an option, in most companies a proxy is required (61% of the sample) or voting in writing (23%). Most commonly other shareholders act as proxies for the absent ones (44%).

In 60% of the cases the principle that the number of votes a shareholder has at the Meeting is proportional to the number of shares is strictly applied. In companies with exceptions to this principle, the most common reason is setting the upper limit of the number of votes that a shareholder may have (25%

of the whole sample), or degression, i.e. slower rise of the number of votes with increasing number of shares (8% of the whole sample).

In most companies, a qualified majority is needed to execute decisions such as status changes, change of form and company dissolution (70%), increase or decrease of registered capital (60%), distribution of annual profit and coverage of loss (59%), election for some managerial positions (30%).

In 52% of the sampled companies election of the Board of Directors members is accomplished by non-cumulative vote, as opposed to 43% companies that resort to cumulative vote. The non-cumulative principle is somewhat more common in Belgrade than elsewhere (70%).

Minority shareholders may convene a Meeting in 56% of the sampled companies; in 35% they may not (9% of the surveyed do not know or do not want to answer). In most of the companies where minority shareholders may convene the Meeting, 10% of shareholders are sufficient to make a decision to convene the Meeting (53%).

Presence of shareholders at the Meeting is usually high, which is customary for companies with fewer shareholders. The last regular Meetings of 31% of the sampled companies were attended by over 85% of the shareholders, the attendance of 29% companies was 66-80% while in 19% the attendance was 51-65%. Accordingly, at four fifths of the Meetings over a half of the shareholders were present, again substantiating high concentration of ownership. Meetings of public companies with dispersion of ownership are characterized with attendance of owners of very low percentage of shares.

In most companies the latest Meeting was uneventful and all proposals were adopted almost unanimously (74%). In others, opposing fractions (3%) and open discussion expressing dissatisfaction (18%) were present.

In 46% of the sampled companies, Extraordinary Meetings were held in the last two years. Most common reasons for convening them were the change of Articles of Association (38%), replacement/election of the Board of Directors or management (31%), issue of new shares (16%), approval of special contract (10%). Most commonly the Board of Directors initiated convening of an extraordinary Meeting (63% of companies who had an extraordinary Meeting in the last two years); they were followed by majority owners (16%) and management (14%). Obviously, the extraordinary Meetings were not convened for corporate governance issues, but reasons relating to normal operations.

Board of Directors. This is a body of any public company that should manage the company affairs. It is elected by shareholders at the Meeting to

manage the company in their stead. The body decides on strategic affairs of the company when the Meeting does not do that. The body also elects and oversees the management that should take care of operational business affairs, i.e. implement the Board of Directors decisions.

Let us now review the data on the Board of Directors composition. In about two thirds of public companies (62%) the Boards of Directors are composed of five or less members, while in one third (30%) they have more than five members. The number of Board of Directors members rises with the size of a public company.

On the average, members of the Boards of Directors are 41-50 years old (55% of the companies), which is a relatively young age for people who are not operational staff, but manage the company strategically. They are followed by the 20 to 40 age group (22%) and +50 (11%).

Boards of Directors have fewer women than men: 22% of companies with Board of Directors have no female members; 31% have one and 26% have 2 or more. On the average two women take seats on the Boards of Directors, where the average number of seats is 5.7. It means that female members account for 35% of the main managing bodies, which is not bad and is only an unattainable goal for many other professions.

In recent years a trend has been identified in the corporate world, and increasingly in the regulatory one, to include people not even employed at the company, not its shareholders, in the Boards of Directors assuming that they will be impartial and conduct business effectively, particularly in comparison with the employed staff (i.e. management). In Serbia, this idea has only been partially implemented: 15% of the sampled companies have no independent members, 36% have one, and 26% have more than 2. As to the Board of Directors members employed at the company, 11% companies have no employees on the MB, 35% have one, and 38% have two and more

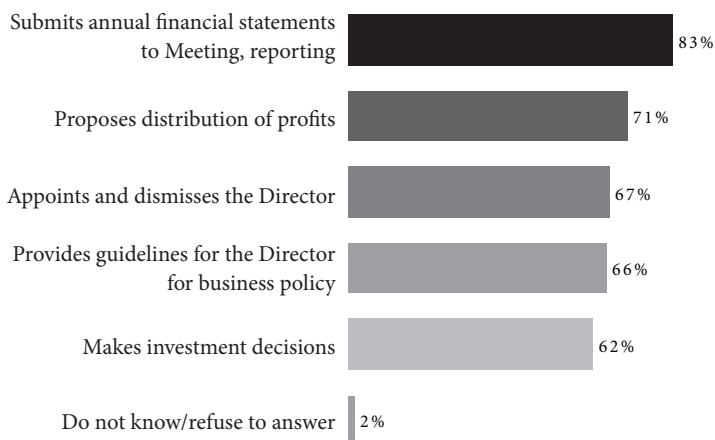
In 22% of the sampled companies the Board of Directors meetings take under 30 minutes, in 44% 30-90 minutes and in 24% over 90 minutes. Last year in 37% of companies there were up to 5 Board of Directors meetings, in 29% 6-10, in 22% over 10. In 22% of the sampled companies the Board of Directors meetings were attended by up to 3 members on the average, in 39% 4-6, and in 27% 6 and more members.

Average values for BD composition and its meetings

	Total	Core business				Company size/ no. of employees				Region		
		INDUSTRY	TRADE	CONSTRUCTION	FINANCE	Up to 25	26 - 100	101 - 250	Over 251	Vojvodina	Belgrade	Central Serbia
N	188	82	62	29	15	51	49	37	51	40	74	74
No. of members	5.7	5.9	5.8	5.0	5.3	4.6	6.2	5.8	6.1	6.8	5.2	5.5
Their average age	45.7	45.8	44.6	47.2	46.4	46.0	44.3	46.2	46.3	46.3	47.0	44.0
Female members	2.0	2.2	2.1	1.1	1.4	1.1	2.2	3.6	1.2	3.1	1.1	2.2
Independent BD members	2.1	2.2	2.2	1.5	2.5	1.7	2.4	2.2	2.3	2.3	2.0	2.3
Board of Directors members employed at the company	2.9	3.6	2.3	2.6	1.2	2.0	2.6	4.0	3.0	3.7	2.2	3.0
Average duration of BD meeting (in minutes)	66.9	70.7	61.7	64.8	72.3	64.4	76.6	61.9	63.9	90.3	54.1	66.8
Meetings held last year	9.3	8.9	10.9	6.5	10.9	8.9	8.4	8.0	11.7	8.3	9.8	9.4
Average attendance	6.0	6.1	6.8	4.7	5.0	4.4	5.5	8.0	6.9	8.6	5.9	4.8

Highlighting the averages by all above features, we see that there are 5.7 members of Board of Directors, their average age is 45.7 years, with 2 female members, and 2.1 independent members, and 2.9 persons employed at the company and members of the BD at the same time. The meetings take 67 minutes on the average, and last year 9.3 were convened.

Functions of the Boards of Directors are presented below:



It means that 83% of the Boards of Directors of public companies in the sample submit the financial statements and report to the Meeting; 71% propose distribution of profits, 67% appoint and dismiss directors, 66% provided business policy guidelines to the director; 62% make investment decisions. These are all usual functions of Boards of Directors.

How is a Board of Directors elected? Who nominates the candidates, since the nominator may reasonably expect loyalty of Board of Directors members. In 63% of the sampled public companies with a Board of Directors of their own, the body was elected upon recommendation of majority shareholders, in 12% the employees nominated them, in 9% the director, and in 4% the appointment followed recommendation of other persons and organizations. Obviously, in Serbia the majority shareholder controls the situation. He proposes members of the Board of Directors to the Meeting, following his own interests, and the Meeting complies since the majority shareholder controls the Meeting.

In most public companies (57%) special majority of votes is required to appoint the Board of Directors Chairperson, i.e. majority of the Board of Directors members, while in fewer cases (39%) majority of the attending members will suffice.

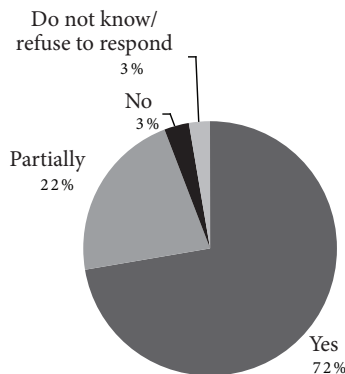
Information is power, as they say, and a prerequisite of successful management and business. Company managers need all relevant information. Let us see what goes on in Serbia, i.e. what are the responses to the question whether

Board of Directors members have access to all company information and documentation. In 90% of the surveyed companies, Board of Directors members these companies they still do not understand who manages the company, i.e. the director successfully marginalizes the Board of Directors. We believe that it is partially a remnant of the past, self-management era, where the director is the only true power, and the others are just puppets on a string, and partially a realistic balance of power in a company in which the director prevails.¹⁷

Collaboration between the Board of Directors and Director General is usually very good. Thus, Boards of Directors adopt proposals of the Director General practically always in 38% of the sampled companies; they do that frequently in 45%, rarely in 4%, and in 11% of the companies the Board of Directors usually elaborates proposals of their own members. Obviously the harmony is not prevailing in just a tiny segment of the companies.

Most commonly it is the director who reports to the Board of Directors on the business operations. Only in 7% of covered companies the Director General does not report to the Board of Directors, and in as many as 48% he reports in writing (once a month in 32%, quarterly in 22%); in 58% he reports in orally (once a month in 36%, quarterly in 18%). Thus, the Boards of Directors always have an opportunity to discuss company operations and at each of the meetings decide on support to the Director by adopting or refusing to adopt the report.

We have also directly asked who controls the company effectively, bearing in mind that direct questions usually do not lead to direct answers.



¹⁷ The author is a member of the Board of Directors of a national public enterprise. He makes great efforts to make colleagues understand that the Board of Directors is in charge of company affairs, but nevertheless they appear not to be convinced. Most members chose to believe that the Board of Directors is an advisory body to the director, which they find agreeable since it is an easier job to do, and some even lack the required managerial abilities.

Therefore, the following results were obtained: only in 3% of the companies the Board of Directors does not retain full effective control of the company; in 22% it retains a partial control, and in 72% it has full effective control of the company implying oversight of the management and providing for full control on basic material affairs. The high percentages nevertheless suggest that Boards of Directors in Serbia do not have excessive problems with the management.

Let us now review the remuneration systems for members of the Board of Directors and Director General. In most of the cases earnings of the Board of Directors are fixed (45%), in 21% they depend on their attendance of the Board of Directors meetings, in 19% on total company revenue, and in 8% on the profits. Obviously, remuneration based on company performance (income and profit) is not common, substantiating that the owners do not find it needed to stimulate Board of Directors members to work productively. They apparently believe that firm control of the majority shareholder is sufficient.

In conclusion, Boards of Directors in Serbia apparently hold the reigns of the company firmly in their hands. The classical problem of corporate governance – the one called the principal-agent problem in economic theory – does not exist in a vast majority of Serbian companies.

In the last three years, some public companies (6% of the sample) have bidden to take over another company. In 92% of the cases the Board of Directors of another company has taken no steps to oppose the takeover bid; in all cases the takeover bid was eventually accepted, substantiating a certain immaturity of corporate governance in Serbia.

Director General. Previous chapters revealed that the Director General usually takes a proper place – in charge of operational affairs, within the scope of competences. The previous practice where he was the dominating factor, with Workers' Councils and Boards of Directors marginalized, has been discontinued. The survey shows that Director General manages the operational affairs independently in 48% of the sampled companies, partially independently in 50% (in 49% since the Board of Directors participates, as well, and in 9% since his staff has substantial independence).

As to the fate of the previous Director General, he was dismissed in 27% of the sampled companies, in 23% he left on his own, in 15% he passed away, and in 15% his mandate expired.

In almost two thirds of companies the current Director General worked in the company even before the current assignment, and in one third he did

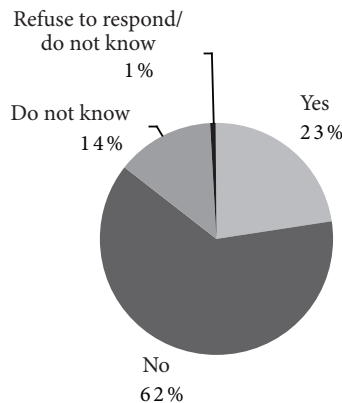
not. It appears that the (new) owners believe that familiarity with the company affairs is an important eligibility criterion for the top manager.

Salary of the Director General is usually fixed (52%), or it depends on the profit (19%) or the overall company income (19%). Like with the Board of Directors, fixed salaries predominate. It probably means that in most companies they believe that directors are not sufficiently independent in decision making or accountable for financial results of the business, so that their earnings should not be linked to the business performance of the public company.

Other. Let us now have an insight into the tradeunionship in public companies, conflict of interest, political influences and the like.

In almost one quarter of the sampled public companies not a single trade union is active. In 30% there is at least one trade union, which is poorly active, and in 44% there is at least one which is very active. Accordingly, in over a half of the companies the management has no problems with trade unions, but in a substantial number of companies trade unions are present and active.

It appears that the conflict of interest is a fairly common phenomenon in Serbian public companies. Look at the graph.



Namely, the results show that in 23% of the companies at least one member of the management (Director, Board of Directors member, Executive Board member, etc.) is employed at a company, or owns a company dealing with similar core business, while this is not the case in 62%. The 23% partly account for the connections controlled by the majority owner (membership in Board of Directors of a daughter company or sister company), but probably

there are some links that should not be there, i.e. those that jeopardize loyalty of a management member to the public company subjecting it to the interests of another company. These links are most common in industry (29%), and least in finances (9%).

Similarly, in 62% of public companies not a single management member has any business relations with the company (loan, trade, service, deposit, guarantee, etc.), 9% have with approval of the Board of Directors, and 7% have but without such approval. The latter 7 are a cause of concern, since they may illustrate deals that damage the interests of the company for personal gain. Most importantly, these are usually related to the finance sector (housing and other loans?), while in other sectors, they are negligible.

We have also investigated the influence of politics (influential individuals, ruling parties, governmental bodies, etc.) on some deals of public companies. It has been shown that the influence is much lower than it used to be in the past, which is only to be expected after privatization. The greatest influence is exerted through privatization (11.7%), investments (11.2%) and current business decisions (11.2%), and lesser through organizational form (7.5%) and least with management election (4.7%). The predominant cause for political influence lies in the fact that Serbian public companies still have the social and state capital, thus the right of the state to participate in decision making.

TRANSPARENCY

Transparency, i.e. high level of information publication relating to company operations, it is one of the cornerstones of successful corporate governance. Here is why:

High level of information is required by shareholders to be able to make informed decisions within their scope of competence, particularly the strategic ones,

High level of information conveyed to the public is good for a public company since it enables potential investors to make a reliable decision in investment, i.e. purchase of securities.

Transparency should, by no means, be expensive for a public company, or lead to disclosure of confidential data or deterioration of its competitive position.

The following responses were obtained to the question ‘Which of the following documents are publicly disclosed’:

Publicly disclosed documents

	%
Annual report	87.4
Balance Statement	83.6
Income Statement	79.9
Auditor’s report	64.0
Changes in the registered capital	62.1
Cash Flow Statement	53.7
Auditor’s opinion	50.5
Report on materially important events	41.1
Verbal description of financial statements	39.7
Articles of Association and company rulebooks	34.1
Company organizational structure	29.4
Quarterly report	28.0
List of shareholders (their identities)	27.1
List of shareholders controlling over 50% of shares	21.5
List of related persons	19.6
CVs of Board of Directors members	15.4
Total amount of earnings of the Board of Directors members	15.0
Individual earnings of the Board of Directors members	14.5
Information on sale and purchase of shares by the management	14.0
Policies and principles of corporate governance	12.6
Identity of the final user blocking the shareholders	12.1
CVs of the managers	11.7
Total amount of earnings of the managers	11.2
Individual earnings of the managers	10.3
Nothing of the above	6.5
Do not know/refuse to respond	0.5

Thus, the annual report is the most commonly publicly accessible document – 87% of the sampled companies; it is followed by the Balance Statement

(84% of the companies), Income Statement (80%), Auditor's report (64%), changes in the registered capital (62%), Cash Flow Statement (54%), Auditor's report (51%), etc. The reasons for not disclosing some of the aforementioned documents include: lack of legal obligation to do so (51%), lack of request for such information (45%), lack of economic reasons to do so (21%).

	%
Report of the Board of Directors Chairperson	70.6
Analysis and discussion of financial performance and business risks	66.4
Report of External Auditor	53.3
Major liabilities and receivables	51.4
Report of auditing committee or company commission	39.7
Company aims and strategies	38.8
Market share and distribution of sales by the leading clients	36.4
Ownership structure, dividend policy and dividend history	35.5
Major court disputes	34.6
Audited financial statements with pertinent notes	29.4
Principles and policies of corporate governance	26.6
Shareholders' names and amount of shares they own	22.9
Number of shares owned by Board of Directors members and managers	20.1
CVs of Board of Directors members and managers	13.1
Earnings of Board of Directors members and managers	11.7
Do not know/refuse to respond	3.3

The latest annual report included the Report of the Board of Directors Chairperson in 71% of sampled companies, analysis and discussion of financial performance and business risks conducted by the management (66%), reports of external auditor (53%), major liabilities and receivables (51%). All other documents are represented in less than 40% of reports of the samples public companies.

The responders suggest that a potential investor may obtain information on the management, business operations and financial performance by review of the annual report (53% of the sampled companies), obtain it from the company upon request (46%), at the company website (46%), and/or public quarterly report (14%).

Major material transactions were less frequently disclosed to the public. Thus, 33% of public companies covered by the survey would publicly disclose a transaction before related parties and transaction exceeding 10% of the company's book value, 12% would disclose only a transaction before related parties, 9% only transaction exceeding 10% of the company's book value, while 32% of the companies would not disclose either.

The question: "Specify the reports that the company submits to the Securities Commission and Belgrade Stock Exchange" yielded the following answers: To the Securities Commission: the annual report (67% of the sampled companies), change of ownership including over 10% of ordinary shares (34%) semi-annual reports (29%) and quarterly reports (13%); to the Belgrade Stock Exchange: the annual report (65% of the sampled companies), change of ownership including over 10% of ordinary shares (32%) semi-annual reports (31%) and quarterly reports (16%).

Nevertheless, the Belgrade Stock Exchange is not in a situation to insist on more extensive publication of business information, since it is faced with serious problems in its own activities: First, the A-Listing (the proper one) has only two public companies, while shares of a vast majority are traded on the so called OTC market; secondly, the number is decreasing, since the process of transformation of open/public public companies into closed/private or limited liability companies is in progress.

Reliability of information, particularly the financial ones is increased upon certification by auditing companies. The business community then appreciates its credibility. Since audit is not only useful for impartiality of information, but in Serbia it is also a statutory duty, let us see who our public companies entrust the task to: a local auditing company (54% of the sampled companies), international auditing company (22%), and individual auditor (16%). Notably, companies in the financial sector are prone to relying on services of international auditing companies (55%).

Shareholders and members of the Meeting get information on the company operations at the Meeting (55% of the surveyed companies), personally at the company seat (31%), from written materials that each owner receives by mail or at the company seat (25%), at the bulleting board (22%), in the press, advertisement (22%), while only 1% of the sampled companies do not communicate this information to the shareholders.

Internet in an increasingly important means of communication and information for business purposes. Serbia lags behind in this respect since as

much as 28% of surveyed companies do not have their website, 53% have a modest one, while only 19% of the surveyed companies have a proper, comprehensive website.

As many as 59% of the companies do not publish their financial results and business reports (except for the balance statement that is submitted to the National Bank), 41% of the companies do so submitting the reports to the media, 58% post the reports on their website, 17% submit the reports to economic and financial analysts, and 13% do that in other ways.

About 26% of companies tend to communicate information of all relevant company and related events to the media, 36% do that rarely, while 37% of the surveyed companies never do that.

Quality of accounting statements is an important aspect of transparency. International Accounting Standards (IAS) are applied by 79% of the surveyed public companies, while 11% of the companies do not abide by them. Financial reports based on the International Financial Reporting Standards (IFRS) are generated by over three quarters of the sampled companies, while only 9% do not comply with these standards. Praiseworthy, we must say.

It appears that accounting is quite meticulous in Serbia. The latest auditing reports did not contain any objections to the bookkeeping methodology in 78% of the surveyed companies. Objections were made in 9%.

ATTITUDES ON CORPORATE GOVERNANCE

The international corporate governance standard is the one proposed by OECD. In Serbia, a half of the respondents were familiar with OECD corporate governance principles, while 47% were not.

We also investigated the opinion of respondents on the state of corporate governance in their company, in Serbia as a whole and legislation pertinent to corporate governance. They graded them as follows:

State of corporate governance in the company	3.2
State of corporate governance in Serbian companies	2.8
State of legislation pertinent to corporate governance	2.8

Grades 1 (poor) to 5 (excellent)

The difference between the evaluated quality of corporate governance in own company and other public companies is quite interesting. With perfect knowledge, the difference should not be present. Nevertheless, if we assume that the respondents are more familiar with the situations in their own companies than in the other, which may reasonably be assumed, we may conclude that the state of corporate governance in Serbia is better than it is generally assumed.

The following main obstacles have been recognized in promotion of corporate governance: lack of knowledge and information (36% of respondents), ineffective corporate legislation (16%), corporate governance information as business secrets (13%), etc.

CONCLUSIONS

The key conclusions of the CLDS survey on corporate governance suggest the following main processes in the corporate sector and main features of corporate governance in Serbia:

- In Serbia, the corporate structure is mostly, for the time being, defined by the Privatization Law, by the type of companies and ownership structure,
- Predominant form of the company is an open/public public company, produced by the obligation to transform former socially owned companies through privatization into open/public public companies.
- By the ownership structure – predominantly conventional and in other countries outdated form of public company where majority ownership is in the hands of another legal or natural person.
- The main problem of corporate governance thus, is not the principal-agent relationship with dispersed ownership, as it is in Anglo-Saxon world, and elsewhere, since in Serbian public companies there is an undisputable majority shareholder who appoints and controls the management easily.
- In Serbia, the main corporate governance body is the Board of Directors, instead of the management.
- The relationship between the majority and minority owner may be perceived as a bigger problem, since the former has motives and opportunities to expropriate the latter, due to immaturity of both shareholdership and the judiciary.

- Conflict of interest in managers of public companies is fairly widespread, with both knowledge and approval of the company bodies and without.
- Public companies do not make an effort to inform the public and potential investors on own performance; this is most probably caused by very low level of interest to raise new capital by the issue of new shares.
- Managers in Serbia are aware of weaknesses of corporate governance, less in their own than in other companies.

Concentration of ownership and the problem of investor protection

INTRODUCTION

All to date publicly available research identifies the presence of the ownership concentration process in public (open) public companies in Serbia. The same findings can be drawn from the CLDS survey and the activation and acceleration of the concentration process was announced already in the first issue of the CLDS monograph on corporate governance from 2003.¹⁸ Before the latest CLDS survey, the process was registered in the World Bank, namely IFC¹⁹ survey conducted between 4 – 31 May 2006 and covered 130 public companies of different size and from different economic sectors and regions of Serbia. Other relevant findings came from the data of the Serbian Central Securities Depository (CSD). The results obtained that suggest the existence of the ownership concentration trend were to be expected.

The text below will first offer the available evidence of the presence of the ownership concentration phenomenon. Then it will address different causes of this process. In this context, particular attention will be paid to the interconnection between the concentration process and one of major problems of corporate governance – the level of protection enjoyed by the external (minority) shareholder. Finally, it will present the main consequences of the problem, both on the characteristics of corporations in Serbia and on the operation of the stock market in general.

IDENTIFICATION OF THE PRESENCE OF CONCENTRATION PROCESS²⁰

Ownership concentration, primarily registered as a reduction in the number of securities accounts, was measured on three random company samples over a period of 2 years. This research covers the period before the market expansion in 2007, followed by the entry of a large number of individual investors.

¹⁸ See: Unapređenje korporativnog upravljanja (*Improving Corporate Governance*), CLDS, 2003.

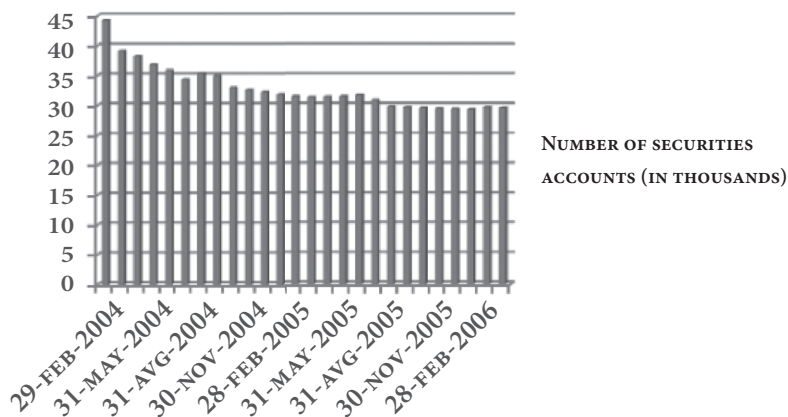
¹⁹ According to: K. Veljović, *Korporativno upravljanje i koncentracija vlasništva u Srbiji (Corporate Governance and Ownership Concentration)*, doctoral dissertation, Faculty of Economics, Belgrade, 2007.

²⁰ More details in: K. Veljović, op.cit, pp. 144-290

For this reason, in this case the reduction of the number of securities accounts can be considered a reliable indicator of the presence of this process. Although the time of monitoring this phenomenon was relatively short, considering that the survey was conditional upon the period of CSD existence to the time when the monitoring commenced, its detection allows for the conclusion that the presence of this process was proved.

The first, main sample was formed from a set of public companies registered and entered in the CSD database in the period after 12 January 2004 and remaining in that database until 28 February 2004. In the period above, 47 public companies were registered, so concentration of the equity was monitored for a longer period of time on the sample created. Following the sample of the original survey, K. Veljović included only the public companies that were subject to the takeover procedure in accordance with the then applicable Law on Securities. The sample was created from the public companies registered and entered in the CSD database in the period between 12 January 2004 and 30 May 2004. This sample included 44 public companies.

Graph 1. Reduction of the number of securities accounts



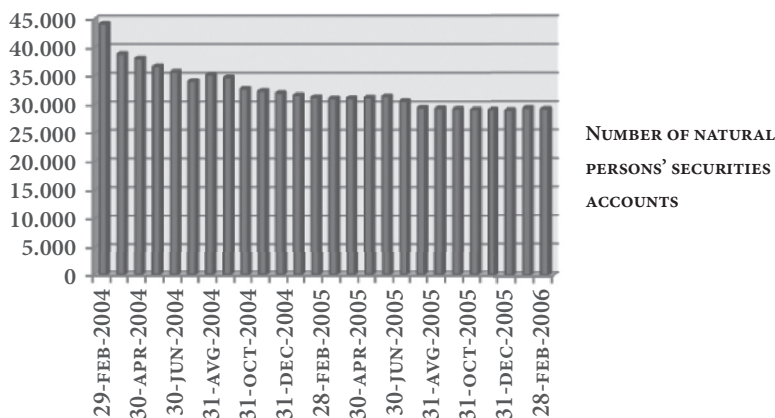
Source: K. Veljović – *Korporativno upravljanje i koncentracija vlasništva u Srbiji* (Corporate Governance and Ownership Concentration in Serbia), doctoral dissertation, Faculty of Economics, Belgrade, 2007.

In the observed period of only 25 months, the number of securities accounts was reduced by about a third, which is one of the proofs of the presence

of the ownership concentration trend (see Graph 1). The control variable (volume of capital) increased, at the same time, by slightly more than one third (by 34.4% or approx. RSD 9.2 billion). The rise in the equity shows that the equity increase processes did not lead to the dispersion of ownership structure and higher number of investors but mostly to the purchase of the additional issue by the dominant shareholder. It would be realistic to assume that these occurrences were followed by massive capital dilution.

The concentration process in the public companies created by insider privatisation developed through a divergence within the insider group. Under the rules of the procedure, a dominant insider (majority shareholder) could not be created within this group. It was created through the concentration process, either from the existing set of shareholders (mostly from the ranks of managers and associated persons) or externally.²¹ This process advanced relatively quickly, which is confirmed by the indicators shown in Graphs 2 and 3. It is obvious that the shareholders created through insider privatisation were most prone to concentration, namely most inclined to sell their shares. The data shown in Graphs 2 and 3 suggest that the observed period also saw a decrease of the number of their securities accounts and the absolute value and percentage of their ownership in the equity of the companies included in the sample.

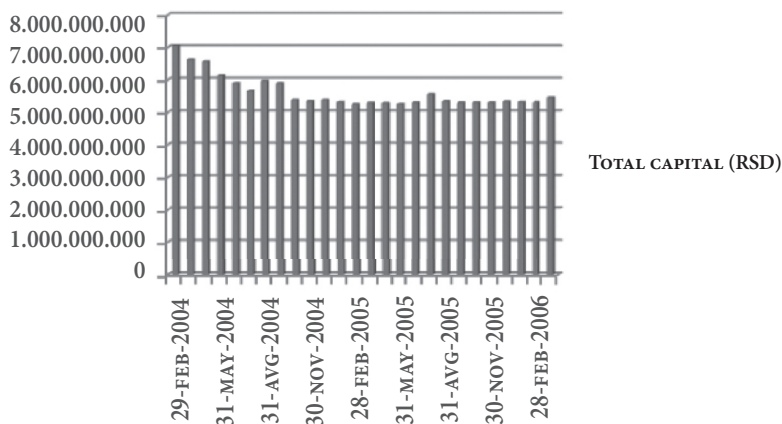
Graph 2. Number of securities accounts held by natural persons



Source: K. Veljović, *ibid.*

²¹ The first solution was allowed by the rules for trading in the shares from the Share Fund where the so-called employee consortia appeared as buyers.

Graph 3. Total capital (RSD) held by natural persons



Source: K. Veljović, *ibid.*

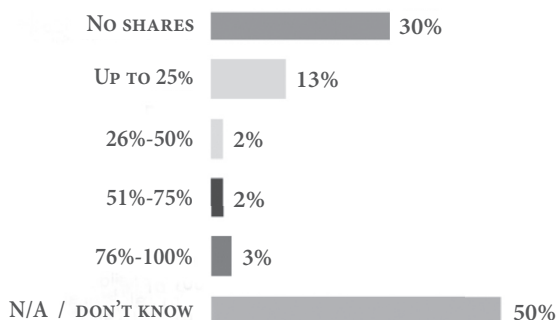
The findings confirm the expectations from the CLDS 2003 study.²² Individual shareholders from the insider set, who acquired their shares mainly through insider privatisation and who did not have any preferential treatment whatsoever, were most affected by the weak protection by formal rules. In the observed period, the number of securities accounts decreased by 34%, and the insiders' capital decreased by 22.6%. If these findings are interpreted in the context of the findings shown in Graph 1, it follows that the process of segregation of the insider set advanced very quickly. In the beginning the process monitoring, natural persons in the observed sample owned 99.44% of securities accounts and 26.4% of capital. In the end of the observation period, they held 98.54% of securities accounts but only 15.2% of the capital of observed companies. It seems that this process was expected even by the general public.

The relevant question is surely who are the main actors in the concentration process. Formally, they are the so-called foreign shareholders who, in the observed period, have both increase in number and percentage of equity they owe. This assessment must be relativised considering that local definition of this set includes all legal persons registered abroad, regardless of who their beneficial owners actually are. A realistic assumption is that these are dominantly domestic investors organised in the so-called pyramidal ownership schemes, where the top of the pyramid is registered in the tax haven countries. The CLDS 2008 survey shows that, according to the information known to the

²² See: Unapređenje korporativnog upravljanja (*Improving Corporate Governance*), CLDS, 2003.

respondents, foreign natural persons do not hold shares in 30% of the cases. A more significant result is the finding that half of respondents do not know, or do not want to answer the question asked.

Graph 4. How many ordinary shares are held by the respective groups?



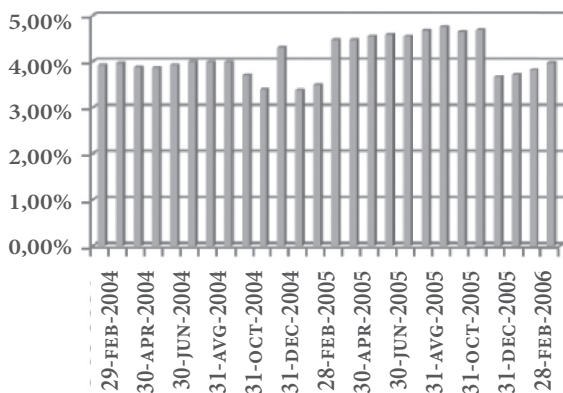
Source: CLDS 2008 survey

There is no doubt that a significant volume of equity of public companies in the given sample is concentrated in the hands of the above mentioned set of owners and that they tend to increase the ownership concentration. It is a relevant finding that the speed of concentration is highest in this set of owners, namely that relative increase of the number of these investors is less than the increase of their share. In the beginning of the observed period, 247 foreign investors or 0.5% of the total number of shareholders in the sample held 57.1% of the sample's capital. At the end of the period, 375 foreign owners or 1.27% of the total number of shareholders in the sample held 67.6% of total capital in the sample or by 34.4% more than in the beginning of the period.

Different conduct is seen in institutional investors (Graphs 5 and 6). Their number increased much faster than the percentage of their equity which shows variability in both directions. The number of institutional investors' securities accounts was very small both at the beginning and at the end of the period. The value of capital held by institutional investors mainly stagnated at the level of about 4% of the share in the total capital of the sample. The explanation for their conduct is simple – institutional investors are minority shareholders *per definitionem*. In the circumstances of low factual investor protection, they are indeed exposed to a high risk of expropriation. This assumption was

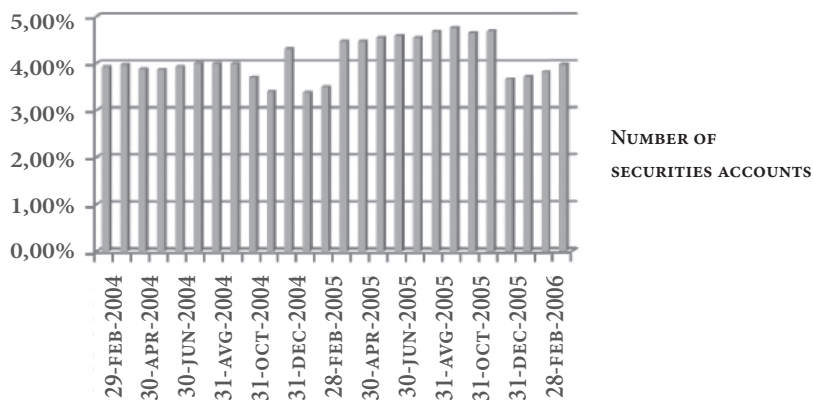
confirmed by Katarina Veljović' findings: out of three companies from the sample in which foreign investors dominate, institutional investors appear only in one with a share exceeding 1% of the equity. At the same time, the findings confirmed the assumption that minority shareholders, including institutional investors in this set, do not play any major role in corporate governance of Serbian companies.

Graph 5. Share of institutional investors' equity in total equity



Source: K. Veljović – *Korporativno upravljanje...*

Graph 6. Number of institutional investors' securities accounts

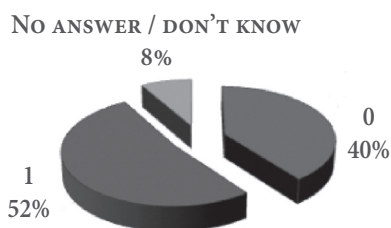


Source: K. Veljović – *Korporativno upravljanje...*

The third sample of the research conducted by K. Veljović included the companies taken over pursuant to the then applicable legislation. As it was to be expected, in this group of companies the concentration was fastest. Blockholder in acquired companies continued with the purchase of shares from minority shareholder, despite already being controlling shareholder. Other relevant finding is that the capital increase process was accompanied not by the increase but rather by the decrease in the number of owners. If the status quo remains, there will be no IPOs to raise additional capital. In this way, high values of the controlling package (far above 50% plus 1 share) will be maintained, but the growth of the capital of open (public) public companies (corporations) in Serbia will remain limited by the wealth of their owners, which leads to a loss of one of the main advantages and, ultimately, the reason for the existence of corporations.

This finding was indirectly confirmed by the CLDS 2008 survey. In the survey sample, in as much as 52% of the companies, there is one shareholder who holds more than 66.7% of the shares. Such ownership concentration considerably exceeds the ownership concentration that is common in the developed economies but is comparable with the concentration level in the transition countries with a low level of investors' protection²³.

Graph 7. Distribution of answers to questions: how many shareholders of common shares belong to which group – over 66.7%
- the number of shareholders

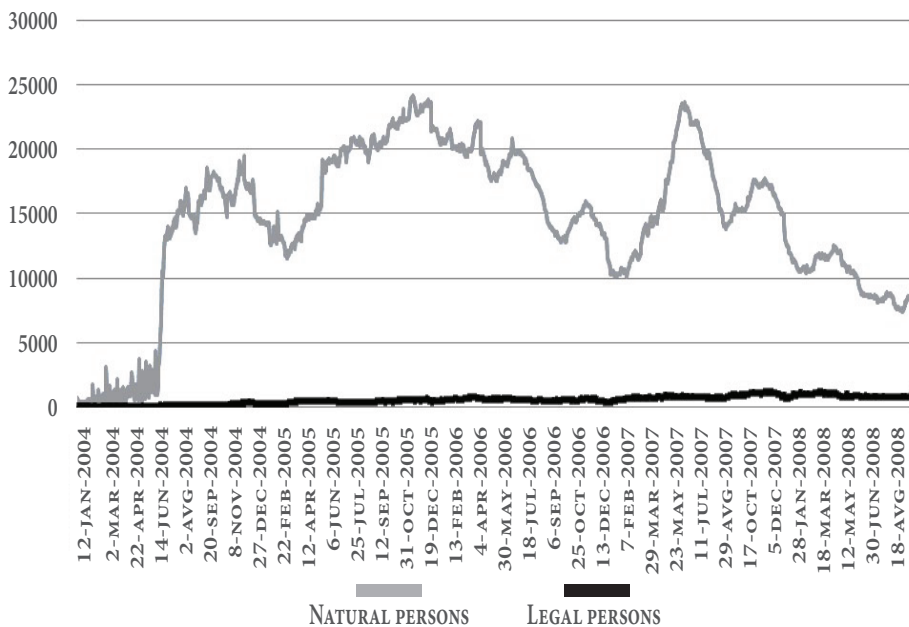


Source: CLDS 2008 survey

²³ For more detail about the ownership concentration level in transition countries, see: Živković, B., *Investor Protection, Corporate Governance Quality and Takeover Market Amidst Transition*, Scientific Review 31-32, 42-52

The ownership concentration in Serbia may be proven by monitoring the orders on the Belgrade Stock Exchange. To prove our claim, we have analysed the number of new buy and sell orders between January 2004 and September 2008. The research shows that the number of new selling orders issued by natural persons by far exceeds the number of legal persons' orders (Graph 8) in the entire period under observation. This finding does not change even during significant bull or bear market, i.e. individual investors leave the market to a much greater extent.

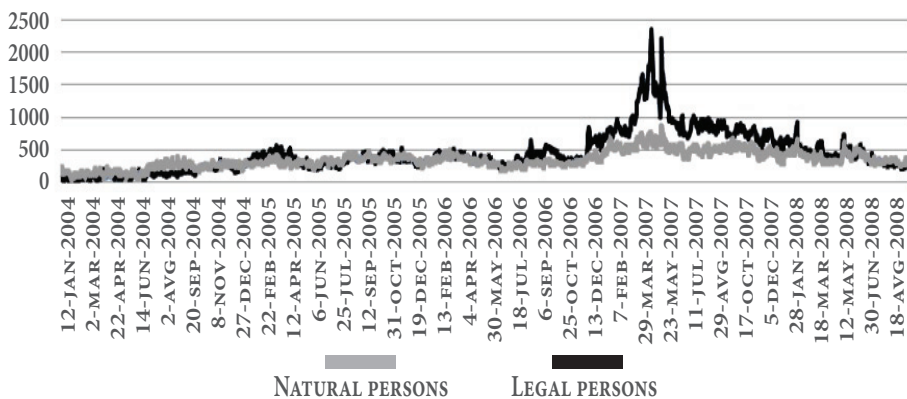
Graph 8. Sell orders of natural and legal persons between 2004 and 2008



Source: Belex

In the case of buy orders, the analysis shows that their number is similar, except in the periods of marked market growth (Graph 9).

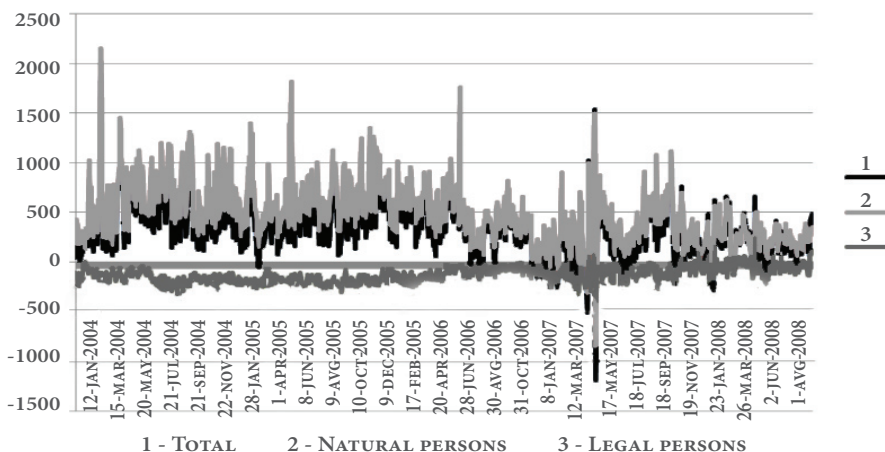
Graph 9. Buy orders of natural and legal persons between 2004 and 2008



Source: Belex

The summary of results obtained and monitoring the net order trends²⁴ confirms the assumption of market draining. It is dominant in the case of natural persons, as well as when we observe all shareholders regardless of their natural or legal person status (Figure 10).

Graph 10. Net orders of natural, legal persons and total net orders between 2004 and 2008

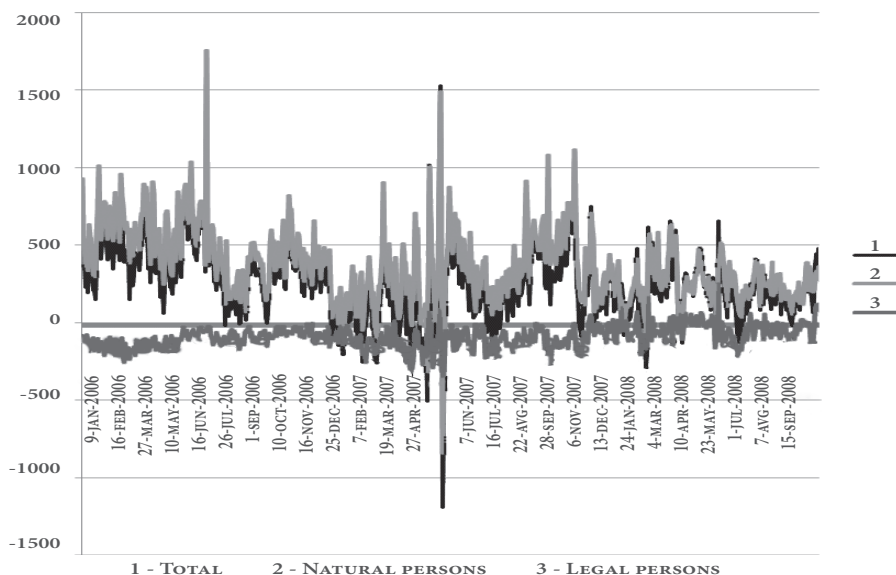


Source: Belex

²⁴ Order trend represents the difference between sell and buy orders.

The drainage, with few exceptions, is noticeable even at the time of market growth, as shown in Graph 11.

Graph 11. Net orders of natural, legal persons and total net orders between 2006 and 2008



Source: Belex

All the above evidence is in favour of the thesis that the Serbian equity market is draining, that is, that the number of accounts is decreasing, and that the market is moving towards concentration and public companies going private.

MAIN REASON FOR CONCENTRATION: THEORETICAL FRAMEWORK

Concentration of ownership over the shares of public companies in Serbia has several complexly interrelated causes²⁵. It is to be expected, for it follows as a consequence of the mass privatisation model within the framework of which there are no conditions for sustaining a corpus of owners created in this way. Therefore, in the general phenomenological sense, the model of mass privatisation is the main cause of the fast concentration process. Privatisation in Serbia, in almost all its modalities, was followed by the incorporation of socially-owned enterprises, and then by the obligation of forced listing of public companies created in this way as stipulated in the law. Such an outcome of the “ownership democracy” was seen in almost all countries which applied the mass privatisation model. However, it should be noted that concentration dynamics varies and, in some cases such as the Republic of Slovenia, is slow. In the second group of countries, concentration was fast and accompanied by massive undervaluation of shares, which led to creation of ownership oligarchy, where Russian Federation is indicated as a typical case.

The phenomenon of (de)concentration also exists in the so-called normal circumstances, that is, without phenomenology which is generally called transition or mass privatisation. Theoretical explanations for ownership concentration in general, regardless of any special institutional circumstances and the level of development of the economy and financial market, may be roughly divided in three groups.

The problem of ownership (de)concentration in corporations is one of the main problems of both the traditional and modern financial economy. Traditional Berle & Means Principal-Agent Theory has identified the moral hazard problem in this relation, but it did not explain the phenomenon of (de)concentration. In the 1990s, these ideas were further developed in the papers of a group of authors which were under a large influence of R. Coase, a Nobel-prize winner. New papers have essentially changed the traditional financial corporation theory and, because of this radical turn, they are often called the Coasian Revolution.²⁶ The main relation in which the problem of moral hazard develops is no longer the Berle-Means’s principal – agent relation but rather the principal – principal relation.²⁷

²⁵ For more detail, see: B. Živković - *Koncentracija vlasništva i problem zaštite investitora* (Ownership Concentration and the Investor Protection Problem), zbornik radova sa X Miločerskog savetovanja, Finansijska tržišta, Savez Ekonomista Srbije, 2004, pp 42-54

²⁶ R. Coase - *Durability and Monopoly*, Journal of Law and Economics, 15, 1972, 143-149.

²⁷ A. Shleifer and R. Vishny – *A Survey of Corporate Governance*, The Journal of Finance 52, 1997, 737-783.

The former, prevailing and currently a very dynamic group of ideas finds the main cause for ownership concentration in the level of protection of minority shareholders (investors). The main causal relation is as follows: if the level of minority shareholder protection is low, namely if there is a great likelihood of yield appropriation, there is a clear and marked ownership concentration. In the systems which do not have or do not apply the standards of minority shareholder protection, witness a high concentration of corporate ownership. This pattern does not change regardless of the stage of the company's life cycle and the level to which the economy is developed. The findings of the research conducted by La Porta and co-authors²⁸, Zingales²⁹, Dyck, and Zingales³⁰, and many other authors, confirm this pattern.

The second group of ideas finds the explanation for the concentration phenomenon in the long-term cyclicity. The findings of the research published by Frenks, Meyer, and Rossi³¹ identify the cycle phenomenon in the case of Great Britain which had dispersed ownership in the first half of the 20th century, even though it did not have any formal protection of minority shareholders, that is, investors. The protection of minority shareholders, as a decisive factor which determines the concentration/dispersion is relativised. The explanation of the concentration phenomenon should, in keeping with these ideas, rely on the assumption that the evolution of ownership in the direction of (de)concentration is led by the demand for shares. Therefore, the companies will place new shares on the market when and only when there is a high demand for them³². The markets on which the demand is below the supply unavoidably lead to ownership concentration. Bhide³³ argued that this cause led to a widely dispersed ownership in the US. At the same time, high liquidity of shares results in the company's exposure to a great likelihood of takeover. If the controlling owner and his management do not manage the concentration effectively, there will appear the interest of a new controlling owner for the takeover at an appropriate premium. The cyclical functioning

²⁸ R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R.W. Vishny – *Corporate ownership around the world*, Journal of Finance 54, 1999, pp. 471-517.

²⁹ L. Zingales – *The value of the voting right: a study of the Milan Stock Exchange experience*, Review of Financial Studies 7, 1994, 125-148.

³⁰ L. Zingales, A. Dyck - *Private Benefits of Control: An International Comparison*, Journal of Finance 59, 2004, pp 537-600.

³¹ J. Franks, C. Mayer, and S. Rossi – *Ownership: Evolution and Regulation*, ECGI - Finance Working Paper, No. 09/2003, 2006

³² For more detail, see: C. Fritz Foley and R. Greenwood – *Giving Up Control to Pursue Growth: The Evolution of Corporate Ownership After IPO*, Working Paper Series, SSRN, 2008.

³³ A. Bhide – *The hidden costs of stock market liquidity*, Journal of Financial Economics 34, 1993, pp. 31-51.

of the takeover market indirectly confirms that this idea is realistic. Namely, it was noted a long time ago that mass takeovers in developed economies behave cyclically. It is obvious that the synergy of secondary market for shares and takeover market effectively protect the minority owner, even when their formal protection is not present in the formal law. In the circumstances where both markets function effectively, the need for concentrated ownership as the control mechanism is reduced.

The third group of ideas sees the cause of ownership concentration/dispersion in the efforts of the corporate management to harmonize the time of share issue with the situation on the capital market. In case of the bull market, as found by Graham and Harvey³⁴, approximately two thirds of corporations are trying to issue stocks. At such time the shares are overvalued. When the market conditions are opposite, the company may repurchase stocks because they are undervalued. Consequently, ownership concentration decreases when the value of the P/B ratio, that is, the ratio of market and accounting value of shares is low and when its growth is expected because that situation was preceded by a period of high yield.³⁵

Relationship between the investors and the controlling owner (insider)

Minority shareholders (investors) and the dominant shareholder have different preferences. The main investor preference is the optimisation of the ratio between the risk and yield of their investment. Because of this, the investor minimises own costs of the use of management rights for as long as the marginal utility of the use of such rights is lesser than the marginal costs of the use of such right. The marginal value of the investor's voting right depends on its marginal efficiency. If the costs of consummation of ownership rights exceeds the marginal yield from their use, there appears the problem of abstinence, namely minority shareholders do not use the voting mechanism (*control by voting*). The dominant owner or insider as per legal definition, namely the holder of the controlling share package, tends to maximise residual yields³⁶ which are under his control and constitute his private benefits. The insider's costs are direct and indirect costs of corporate governance. Risk aversion is

³⁴ J. R. Graham and C. R. Harvey – *The long-run equity risk premium*, Finance Research Letters, Volume 2, Issue 4, 2005, pp. 185-194.

³⁵ For more detail, see: J. Helwege, C. Pirinsky, and R. Stulz, *Why Do Firms Become Widely Held? An Analysis of the Dynamics of Corporate Ownership*, NBER Working Paper No. W11505, 2005.

³⁶ Residual yield is the yield of the corporation that is not taken by the minority owners.

characteristic of the majority owner as well; thus, he will also try to maximise the yield (residual flows, that is, private benefits) and minimise the risk to their own budget. Therefore, his third goal is to reduce the risk by Markowitz diversification of the capital budget. The resulting strategy of these three preferences and his main optimisation strategy is to appropriate the highest possible private benefit per investment unit with the smallest possible contribution (in terms of the exposure to costs and in terms of the share in his total capital budget), that is, with the least relative value of the controlling package. This is true under the standard assumption that controlling shareholder cannot influence the price of corporate shares. If the market is extremely imperfect and if he cannot influence the price of shares, the other strategy, the one that will be outlined in more detail below, will be activated.

Marginal values of shares of one and the same corporation are different for the insider and for the investors³⁷. The insider's marginal value of share is higher than the investor's if the private benefits of control exceed the marginal costs of managing the company. The value of investor's shares is revealed on the secondary capital market. The value of the insider's share is not known in the time continuum. These two values become aligned at the time when the insider's share is the subject of transaction, namely when a given corporation is exposed to a takeover. The difference between these two values is the so-called *takeover premium*. This difference is revealed by the corporate market or the *takeover market*. Therefore, the very existence of this difference and the existence of the takeover market make sense if and only if the value of the insider's share exceeds that of the outsider's. The main determinant of this difference is the size of the residual yield that is appropriated by the insider and is not the outsider. That is why the basic Coasian argument is that the level of optimal concentration of corporate ownership (optimal in terms of the insider's preferences) is inversely related to the level of investor protection. If the protection level is low, there is a great likelihood that high residual yield will be appropriated by the dominant owner. Hence, the relative value of the controlling package held by the insider is high because the additional yield appropriated by him is an adequately high compensation for the risk of concentration that he assumes.

This solution successfully explains the statics of a modern corporation. The financial systems with high standards of investor protection have relatively

³⁷ For a mathematical proof for this argument, see: B. Urošević – *Dinamička optimizacija vlasničke strukture korporacije* (Dynamic Optimisation of Corporate Ownership Structure), Faculty of Economics, Belgrade, 2007

low share in the controlling package in the corporation.³⁸ High standards of investor protection lower the value of the difference between the insider's and the outsider's share. The insider tends to diversify and increase the capability of the corporation to absorb the capital from the environment. Until recently, the problem of the ownership structure dynamics was open. Namely, it is well known that the insider decides on opening up, namely issuing shares through initial public offer (IPO)³⁹, by which his ownership interest is reduced. In a borderline case, the so-called capital dilution may occur, defined as a reduction of the insider's asset value. But this is a borderline case, and in normal circumstances the process of issuing new shares is followed by a concurrent reduction of existing owners' interest and increase in value of their total assets.

A recently published original⁴⁰ solution for the problem of ownership structure dynamics comes down to the following: namely, the decreasing of the ownership concentration level may reduce the level of the insider's private benefits and, accordingly, the same applies to the incentive to increase the corporate governance efficiency. The consequence of this is a negative impact on the price of its shares. Consequently, the ownership structure dynamics affects the wellbeing of all owners, both large and small. So – how does the controlling package and the equilibrium price of corporate shares evolve optimally, and which factors determine the insider's equilibrium ownership interest in the long-term equilibrium state?

It is assumed that the dominant shareholder's interest in the company affects the mean value and risk of the company's cash flows, and thus the value of its shares. The efficiency of his governance and, consequently, the yield on shares are a consequence of the size of his share in the corporation. In a situation where the investor protection level is high and the insider's residual yield is relatively low, the insider's dominant strategy is conditional upon his aversion to risk. The premium on his investment risk grows as a function of the relative size of his ownership share. By reducing the relative value of the controlling package, the insider achieves a higher level of diversification of his portfolio, namely reduces the risk to his own total investment in the Markowitz sense.

³⁸ These systems dominantly rely on the Anglo-Saxon legal tradition.

³⁹ In the case of Great Britain, the ownership interests of insiders, in particular the management, are considerably reduced in the process of the Initial Public Offering (IPO). See: W. Mikkelson, M. Partch, and K. Shah – *Ownership and operating performance of companies that go public*, Journal of Financial Economics 44, 1997, 281-307.

⁴⁰ See: P.M. DeMarzo, B. Urošević – *Ownership Dynamics and Asset Pricing with a Large Shareholder*, Journal of Political Economy, 2006, pp 774-816. This paper develops a complex method of dynamic programming which enables to determine, at the equilibrium, both the equilibrium price of company shares and the optimal dynamics of the control package level, at the same time.

This choice involves a very important problem of time consistency of the optimum ownership structure. Namely, once the insider reduces his ownership interest, he has reasons to do it again, since as the owner of a smaller interest in the company he is no longer affected by the reduction of his investment as he was in the beginning, when his ownership interest was larger. Consequently, unless legal mechanisms are in place to prevent it, the ownership interest of a large shareholder and his overall efforts for the benefit of the company will become lesser with time.

That is why in normal circumstances, i.e. in the circumstances of high investor protection, the relative value of the insider's controlling package is, in general case, reduced with time. This pattern can be checked by analysing the evolution of the modern corporation which usually starts as a proprietorship and gradually grows into a widely-dispersed ownership structure. The pace of (de)concentration can be defined by an equation which is, to put it simply, reduced to the difference between the marginal values of the insider's and the outsider's share⁴¹. In the case of a high level of investor (outsiders) protection, the speed of change of the insider's ownership interest is in proportion to the level of cash flow risk and in reverse proportion to the level of moral hazard facing the insider. When the difference between marginal values is small, namely, when private benefits from controlling the corporation are small, the owner of a relatively high-value controlling package (measured by the shareholding in the corporation) has a high-risk portfolio. Due to the exposure to high risk, his shares consistently have a smaller marginal value of the share than the outsider investor's, so the difference between marginal values is negative. Generally, in the process of balancing out, the insider tends to reduce the relative value of his controlling package.

A similar thing happens in the situation when the growing trend on the share market, which is determined by the factors external to the corporation, results in a faster growth of share prices. In such a case, the insider's yield may be lesser than the investors because the insider cannot, without risking a loss of control, sell the shares to make a capital gain. Unlike him, the investor can do that since the length of the holding period is in his case determined by the criterion of his portfolio optimisation and not by the criterion of retaining control. Thus, the insider's residual yield may be inferior to the investor's capital gain created by the rising trend on the market. That is how the Graham-Harvey's idea, according to which the offer of shares by the insider is

⁴¹ See: B. Urošević, *op. cit.*

dominantly dependant on the market conditions, factually appears as a special case of the Coasian idea.

This solution successfully explains corporate behaviour in the circumstances of high investor protection. The controlling shareholder aims for de-concentration with simultaneous maintenance of control. A corporation gets the opportunity to maintain the optimum ownership structure, theoretically without limitation. In the final outcome, this removes the limitation on the corporate growth which was imposed either by the level of the shareholder's wealth (in pre-corporate forms) or the need to maintain ownership control within the corporation.

If the level of investor protection is low⁴² and private benefits from corporate control are high, the difference between marginal values of the shares held by the insider and the investor may become positive. The consequence: in the circumstances of low investor protection, the dominant shareholder increases the relative value of his ownership in the corporation. This consequence of the main solution explains the behaviour of European corporations and, in particular, of the corporate forms in which companies organise in the conditions of transition. In Western Europe, which has a long tradition of corporate organisation but a relatively low level of investor protection, the level of ownership concentration in the insider's hands still remains high.⁴³ This effect is even more accentuated in Eastern Europe, where the level of shareholder protection is lower than in Western Europe. The macroeconomic consequence: shares in this configuration are not a significant source of corporate financing and financial systems are configured with a strong dominance of commercial banks.

In the final outcome: in the circumstances of extremely low level of investor protection, the corporation ceases to exist and returns to the previous evolutive corporate form – proprietorship or limited liability company. This kind of “final outcome“ is exactly what is happening in a large number of public companies in Serbia. Low level of investor protection leads to the increase of the relative value of controlling share package in the corporations with a high positive difference between the marginal values of the controlling shareholder's and minority shareholders' shares, and a high level of this difference

⁴² A detailed analysis of the behaviour of price and relative value of the insider's controlling package in the conditions of low level of investor protection may be found in: B. Urošević, B. Živković – *Optimal Ownership Dynamics of a Controlling Shareholder's Stake under Conditions of High and Low Investor Protection*, International Conference Contemporary Challenges of Theory and Practice in Economics, Quantitative Economic and Finance, pp 230-238, Faculty of Economics, Beograd, 2007.

⁴³ The evidence for this statement can be found in: B. Živković – *Investor Protection, Corporate Governance Quality and Takeover Market Amidst Transition*, Scientific Review 31-32, 42-52

is a consequence of the high values of residual flows controlled by the insider controlling shareholder.

The third, important consequence of this solution, which is at the same time essential for understanding of the phenomenon of ownership concentration in Serbia, concerns the problem of (in)stability of the ownership structure. Namely, it follows from this solution that the corporate ownership structure stabilises when marginal values of the insider's and the minority shareholders' shares almost even out. This equivalence defined the situation of long-term equilibrium as the situation in which the difference between marginal values of these two actors equals zero. Hence, in the case of high level investor protection, the situation of long-term equilibrium corresponds to the level of full Markowitz diversification. In the event of weak protection, i.e. in the situation when the benefits from control are large, the long-term equilibrium is established considerably below the level of full Markowitz diversification. The level of ownership concentration in this case will be considerably higher.⁴⁴ A relevant consequence of this solution is the definition of the capacity of such type of corporation to absorb additional capital from the market. Namely, the controlling block residual (defined as the difference between the share of the controlling package and the total ownership) may be deemed to be an approximate measure of the corporation's capability to absorb additional capital from the environment.

Minority shareholders in Serbia

If the concentration process continues to speed up and remains under present institutional conditions, it may be expected, in the ad absurdum logics, that minority shareholders in Serbia disappear. However, this will not happen. The number of present minority shareholders will probably decrease until the appearance of initial public offers motivated by the need to raise additional capital. In these circumstances, which will at the same time mean the establishment of the main functions of capital market, the number of minority shareholders will stabilise. The level of their share in the ownership of open (public) public companies is impossible to foresee at this moment since the number and relative importance of minority shareholders in the corporate ownership structure is conditional upon the legal tradition, quality institutions, privatisation model, etc.

⁴⁴Typical cases of this kind are average relative values of the controlling share package in Russia and Serbia.

Generally, the main reasons for the existence of minority owners, include:

- the individual investors' need to invest their savings without assuming the entrepreneurial risk, where their investment is small compared with the total value of the company;
- the individual and the institutional investors' need to reduce the investment risk through diversification;
- the need to maintain asset liquidity (large share blocks are far less liquid than individual shares and, consequently, their price can be lower);
- modern legislation which increasingly more intensely protects minority shareholders.

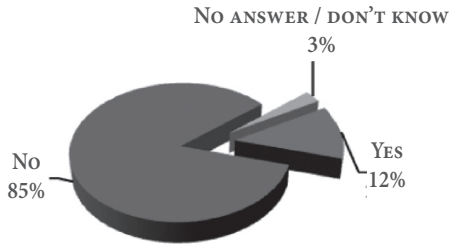
Minority shareholders, in accordance with their ownership interest, have less rights in corporate governance but at the same time they are in such position that their rights may further be reduced or completely eliminated by the (arbitrary) will of majority shareholders or managers. A common misconception is that only natural persons are minority shareholders. A large and the most important part of minority shareholders in the world are legal persons, special institutional investors.

There are two main ways in which minority shareholders can influence the company, regardless of the group of minority shareholders concerned, and protection of their governance rights: shareholders' activism and lawsuits.

In recent years much has been written about **shareholders activism** and it is insisted upon as a way of monitoring and minority shareholders protecting, but also as a way in which they can assume an active role in corporate governance. This notion as such does not have a strict formal definition. Shareholders' activism is deemed to be any expression of shareholders' opinion intended to influence the manner of corporate governance and the decisions taken by the management. This term would be deemed to include any type of action, such as writing of a public letter to directors or other shareholders, voting, or proposing new items of the agenda at the shareholders' meeting. Judging by the findings of the CLDS survey, shareholders' activism is not widely spread in Serbia.

In addition to activism, minority shareholders can resort to the judiciary to exercise their rights and influence the corporate governance decisions. The CLDS 2008 survey suggests that in the previous year, about 13% of shareholders filed lawsuits because of the infringement of shareholders' rights and that most lawsuits concerned the companies from the financial sector.

Graph 12. Distribution of answers to the question: has any shareholder, in the past two years, filed a lawsuit against the company or company management because his rights were violated



Source: CLDS 2008 survey

Table 1. Distribution of answers to the question: has any shareholder, in the past two years, filed a lawsuit against a company or company management for violation of his rights

	Total	Core activity				Size as per the number of employees				Region		
		Industry	Trade	Construction	Finance	Up to 25	26 - 100	101 - 250	More than 251	Vojvodina	Belgrade	Central Serbia
Yes	12.6	9	18	6	23	13	11	19	9	18	6	14
No	84.6	88	82	88	73	84	86	81	87	77	92	83
No answer / Don't know	2.8	3		6	5	3	4		4	5	1	3
Total	100%											

Source: CLDS 2008 survey

It is obvious that judicial protection of rights is not yet deeply rooted in Serbia, either as a way of actual protection of own ownership rights when they are threatened or as a way of fighting with the company management.

Minority shareholders are often excluded from the decision-making process. The survey showed that in 22% they do not have any representatives in boards of directors while in 29% this fact is not known.

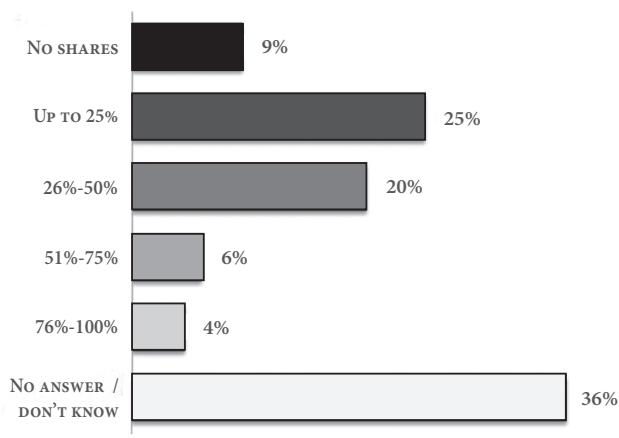
Graph 13. Distribution of answers to the question: indicate the number of BoD members who represent minority shareholders



Source: CLDS 2008 survey

In the Serbian corporate ownership structure one may find corporate employees as minority shareholders. Employee shareholders have a dual role at odds with itself – on the one hand, they are company employees, whose main motive is to be paid as much as possible and, on the other hand, they are investors who have invested their capital and expect that the company has the highest possible profit with the lowest possible costs. This “schizophrenic role” is simplified in the cases when the employees acquired the shares through privatisation and did not invest their own funds nor had a personal motive to become shareholders. In such a case their role is only seemingly muddled – they are primarily company employees whose main motive is to be well-paid and confirming this is the fact that most employees in transition countries who have acquired free shares have sold them as soon as they had the opportunity.

Graph 14. Share of employees and pensioners in total shareholders



Source: CLDS 2008 survey

This situation – with minority shareholders who are in actual fact the employees who acquired some shares in the course of privatisation – has a decisive influence on the character of minority shareholding in Serbia, corporate governance technology, and problems in the relationship between relevant actors. This matter will be further addressed below.

Other causes of concentration in Serbia

Ownership concentration in Serbia, besides the above mentioned, is caused by other factors, such as the very manner in which the corporations and shareholders were created through the privatisation model which was changed several times, low GDP per capita, inconsistency of different laws, institutional framework development level and coordination, etc.

Financial markets all over the world were generally created as the response to the human need to allocate the accumulated savings with a yield exceeding the deposit interest rate and with the possibility of risk diversification. They are a result of the evolutive changes that followed the borrowing of funds, in which both parties, the investor and the entrepreneur, harmonised their mutual relationship, discovered the ways to obtain additional security, and influenced the creation of different intermediary institutions with the aim of ensuring

efficiency and reducing transaction costs. Contrary to this kind of evolution, the financial markets of transition countries were not created evolutively, as an expression of the issuers' and investors' needs, but rather by the will of the legislator. They were introduced by the strength of this will as a supplement to the mass privatisation model. The development of the financial system and its institutions is seen as the *conditio sine qua non* for further unhindered development of the transition towards the developed economy.

This (re)evolution may be viewed as the "inverse evolution". Instead of investors and entrepreneurs who strive for further progress initiating the creation and continuous improvement of the financial market, the state creates the *ad hoc* institutions and then directs both of the above parties to become a part of that system. External introduction of shareholdership and its accompanying elements, which was not initiated by an internal need, caught many people unprepared who, by the force of circumstance, found themselves in the situation where, without any personal motive or at least basic knowledge, they became the shareholders. What most citizens and holders of the shares from privatisation are facing is an incomprehensible and, for them, absolutely alien financial market from which they cannot get answers to their doubts, such as the one about the value of shares they have received.⁴⁵ For that reason, it is no wonder that many of minority shareholders, usually the employees who have acquired their shares through free distribution, tend to convert them to cash as soon as possible, which leads to ownership concentration. This process is only natural considering that (1) the employees are not 'true' shareholders nor do they intend to become true shareholders, and (2) their income is often low and any proceeds from the sale of shares comes in handy.

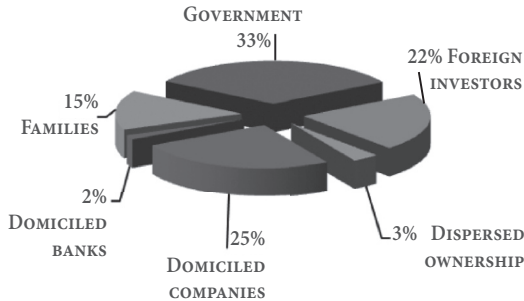
The above fact is accompanied by numerous problems, among which insufficient liquidity is the most obvious one. The stock exchange created in this ways is not in a position to offer the adequate supply of capital as required by the economy at a given level of development.⁴⁶ The marked low liquidity and the fact that shareholders did not invest any money in the shares⁴⁷ contribute to their fast exit from the market. Data suggest that, in transition countries in 2005, only about 3% of ownership was dispersed among minority shareholders.

⁴⁵ Taking into account some individual negative experiences of minority shareholders in Serbia, this situation provokes absolute aversion on the part of potential minority investors, current and future shareholders.

⁴⁶ In the theoretical considerations of this problem, a question may be asked whether the economy, at its current state, would be able to effectively use the capital, even if there were enough of it.

⁴⁷ Taking into account the original model of privatisation in Serbia and the inflation rate, it cannot be said that the shareholders have invested their own funds to any significant extent and that they are the shareholders in the true sense of the word.

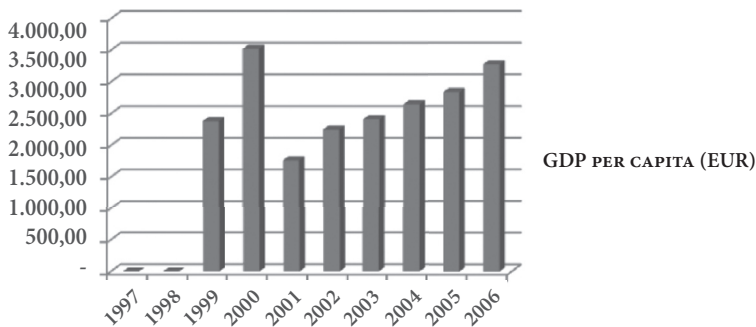
Graph 15. Share of ownership in transition countries, as per groups of investors in 2005



Source: -WB Database on Financial Development and Structure

The additional motive for disinvesting in Serbia is the low level of income, namely the disproportion between the flows and stocks of funds available to the shareholders in the first instance. Graph 12 shows the movement of gross domestic product per capita. Bearing in mind that the savings of the population were to a large extent exhausted during the 1990s, and that for a certain period of time people were not able to invest even in the most basic household items, it is only understandable that, with a GDP per capita⁴⁸ below EUR 3,500, they are inclined to convert the shares to cash, i.e. to consumption or, to a great extent, to repaying their debts.

Graph 16. Movement of gross domestic product per capita 1997-2006

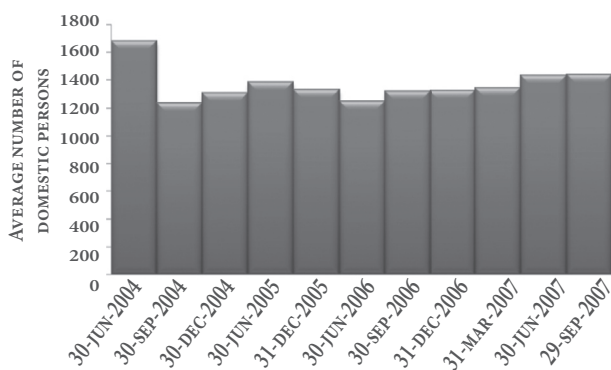


Source: The Republic Statistical Office

⁴⁸This is the average GDP and for most of the population the GDP is far below the one shown in the graph.

The evidence in favour of the statement that the above mentioned causes of ownership concentration in Serbia, such as creation of the financial market through the privatisation process, shareholders protection level, low level of GDP per capita, etc, influence the development of the financial market, is the behaviour of domestic shareholders in the period of the accentuated growth of share prices (Graph 13). Even though it is to be expected that the price growth would influence the behaviour of potential investors, in terms of considerably raising their average presence in the ownership of companies included in the BelexLine, we note that this did not happen.

Graph 17. Average share of domestic persons in the companies included in the BelexLine



Source: Belex

LEVEL OF INVESTOR PROTECTION IN SERBIA

Corporate Governance Index (CG index) for Serbia⁴⁹

La Porta et al.⁵⁰ were among the first to measure the quality of corporate governance. After the names of authors, their index is also called the LLSV

⁴⁹ For more detail, see: A. Jolović – *Merenje kvaliteta korporativnog upravljanja – primer Srbije, (Corporate Governance Quality Measurement – the Serbian Case)* Trenutna ekonomska politika i strukturne promene u Srbiji, Belgrade, 2008.

⁵⁰ R. La Porta, F. Lopez-de-Silanes, A. Shleifer – *Law and finance*, Journal of Political Economy 106, 1998, 1113-1155; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny – *Corporate ownership around the world*, Journal of Finance 54, 1999, pp. 471-517.

index or index of anti-directory rights. Today, there is a large number of papers addressing the subject-matter of measuring the quality of corporate governance and all of them were built on the LLSV index. Since the time La Porta and his co-authors constructed this index with the idea to measure the corporate governance quality there has been further research with the aim to improve the existing index by extending the list of factors affecting corporate governance, introducing other fields of impact in addition to the legislative framework, and changing the countries in which the research was conducted. Some of this research was conducted in the transition markets, such as the research conducted by Slavova⁵¹ and Pistor et al.⁵². The same objection can be raised to all this research – the choice of factors, their number, existence/non-existence of factor weighting in the formation of indices, etc. Corporate governance indices, regardless of their flaws, offer an overview of the corporate governance quality in the absence of any better measures for its determination.

The past research of corporate governance in Serbia does not involve any serious attempts to construct a corporate governance index which would measure the level of shareholders protection. The main reason is the lack of a database which would be used in the analysis. The authors were forced to use interviews and surveys. That is the reason why the research has been criticised from the very beginning – the answers obtained in the surveys come exclusively from the companies who are willing to take part in them on a voluntary basis. The realistic picture is further distorted through the prism of managers' and shareholders' answers to specific questions when there is no reliable way to verify the answers obtained. The other part of the problem concerns the lack of a professional database, such as *Moody's International*, *WorldScope*, *IRRC (Investor Responsibility Research Center)*, which prevented the authors, in addition to having access to reliable data, to follow-up the time series. This made it almost impossible to track how legal provisions affect the quality and development of corporate governance Serbia⁵³.

The text below lists the factors of the basic LLSV index for Serbia. The obtained index value is 2, which is somewhat below the average in the countries with French or German legislation but far below the average in the countries

⁵¹ S. Slavova – *Law and Finance in Transition Economies*, World Bank Working Papers, 1999.

⁵² K. Pistor, M. Raiser, S. Gelfer – *Law and Finance in Transition Economies*, Economics of Transition 8, 2000.

⁵³ Authors can always decide to build databases of their own, which takes a long time, is very inefficient, and most of the time does not include all the required data.

with Common law.⁵⁴ The Company Law⁵⁵ was used for the assessment of the index and the factors were, after the original research model, allocated either one point or zero points.

The factors included in the index or supplementing it are as follows:

1. **“One share – one vote” principle** is clearly defined in Article 208, paragraph 3 of the Law.⁵⁶ On these grounds Serbia was given one point for having the “one share – one vote” principle which, the same as in the case of LLSV, is not included in the index but rather constitutes its supplement in the analysis of the obtained results.
2. **Proxy by mail** is not allowed in Serbia. Shareholders need to vote in person or by proxy (Article 287), where the proxy must personally attend the shareholders’ meeting. This means that this factor contributed zero points to the index.
3. **Blocking of shares before or after the shareholders’ meeting** to identify the shareholders with voting rights is not envisaged by the Law (Article 286); accordingly, Serbia was allocated one point for this factor.
4. **Cumulative voting** is defined by Article 309, paragraphs 4 and 5.⁵⁷ If account is taken of the fact that Article 186, paragraph 5 at the same time grants the right to the board of directors to change the statute (unless such right was explicitly vested with the shareholders’ meeting by the instrument of incorporation) and that the chairman of the board of directors is at the same time the managing director (CEO) unless it is otherwise provided by the statute or instrument of incorporation (Article 312, paragraph 4), it is clear that cumulative voting may be avoided in the cases of the accentuated principal-agent problem. That is why this factor is given zero points.
5. **Protection of minority shareholders** in the manner defined in the LLSV model is lacking; accordingly, Serbia was given zero points⁵⁸.

⁵⁴ Comparison with individual countries should be taken with some reserve considering that the original research was conducted in 1997 and each and every one of these countries could have changed its legislation several times in the meantime.

⁵⁵ Zakon o privrednim društvima (Company Law) (2004)

⁵⁶ “The right to vote at the general meeting (shareholders’ assembly) based on the principle that one share gives the right to one vote.”

⁵⁷ (4) In the open (public) public company, members of the board of directors are elected by cumulative voting unless the company’s instrument of incorporation or the statute provide otherwise. (5) Cumulative voting in the context of paragraph 4 of this Article implies that voting, in which every shareholder or proxy has a voting right, the number of available votes is multiplied by the number of members of the board of directors which are elected and those votes may all be given to a single candidate or distribute without limitation to all the candidates.

⁵⁸ Articles 302, 303 and 304 provide for the possibility to challenge the resolutions of the shareholders’ meeting, appointment of the managing director (CEO), members of the board of directors,

6. **Right of priority subscription or pre-emptive right** defined in Article 213, paragraphs one and two⁵⁹. The already mentioned Article 186, paragraph 5, grants the board of directors the right to change the statute (unless the instrument of incorporation explicitly assigns this right to the shareholders' meeting); it is, therefore, clear that Serbia does not comply with the requirement which La Porta and his co-authors considered deserving of one point in the index. The authors explicitly cite that it is a pre-emptive right which can be waived only by the shareholders by means of voting, which is rather an option than a rule in Serbia.
7. In order to **convene an extraordinary shareholders' meeting** in Serbia, shareholders need to submit a written request and hold at least 10% of the shares conferring the right to vote on the issue proposed for such shareholders' meetings (Article 277); therefore, this factor brings one point.
8. The law does not provide for the company's **mandatory dividends** to the holders of common shares on an annual basis, as it is the case in most other countries.

Based on the points assigned to specific factors, the anti-directory rights index was constructed; how it compares to other countries' indices and averages for specific factors and legislations are shown in the table below.

Table 2. Value of the LLSV index for Serbia and its comparison to other countries' indices

Country	One share – one vote	Allowed voting by mail	No blocking of shares before shareholders' meeting	Cumulative voting	Protection of minority shareholders	Pre-emptive right	% capital required to convene new shareholders' meeting	Index of anti-directory rights	Mandatory dividends
Serbia	1	0	1	0	0	0	0.1	2	0
Australia	0	1	1	0	1	0	0.05 d	4	0

and challenge the resolution of the approval of financial reports; however, they do not provide for the possibility of shareholders, in their own name or on behalf of the company, challenging the decisions made by managers or directors, or the possibility to automatically sell their shares to the company if they oppose any major decisions (such as merger or takeover) made by the managers or even those made by the shareholders' meeting.

⁵⁹“(1) Shareholder shall have the priority right to subscribe the shares from the public company's new issue commensurate with the nominal value of the shares held at the time of issue, or commensurate with the accounting value of the NPV shares. (2) Shareholders referred to in paragraph 1 of this Article shall exercise their priority right to subscribe in accordance with the company's instrument of incorporation, statute, or decision of the company's board of directors.”

Country	One share – one vote	Allowed voting by mail	No blocking of shares before shareholders' meeting	Cumulative voting	Protection of minority shareholders	Pre-emptive right	% capital required to convene new shareholders' meeting	Index of anti-directory rights	Mandatory dividends
Canada	0	1	1	1	1	0	0.05	5	0
Hong Kong	0	1	1	0	1	1	0.1	5	0
India	0	0	1	1	1	1	0.1	5	0
Ireland	0	0	1	0	1	1	0.1	4	0
Israel	0	0	1	0	1	0	0.1	3	0
Great Britain	0	1	1	0	1	1	0.1	5	0
USA	0	1	1	1	1	0	0.1	5	0
Argentina	0	0	0	1	1	1	0.05	4	0
Belgium	0	0	0	0	0	0	0.2	0	0
Brazil	1	0	1	0	1	0	0.05	3	0.5
France	0	1	0	0	0	1	0.1	3	0
Greece	1	0	0	0	0	1	0.05	2	0.35
Italy	0	0	0	0	0	1	0.2	1	0
Mexico	0	0	0	0	0	1	0.33	1	0
The Netherlands	0	0	0	0	0	1	0.1	2	0
Portugal	0	0	1	0	0	1	0.05	3	0
Spain	0	0	0	1	1	1	0.05	4	0
Turkey	0	0	1	0	0	0	0.1	2	0
Austria	0	0	0	0	0	1	0.05	2	0
Germany	0	0	0	0	0	0	0.05	1	0
Japan	1	0	1	1	1	0	0.03	4	0
South Korea	1	0	0	0	1	0	0.05	2	0
Switzerland	0	0	0	0	0	1	0.1	2	0
Denmark	0	0	1	0	0	0	0.1	2	0
Finland	0	0	1	0	0	1	0.1	3	0
Norway	0	1	1	0	0	1	0.1	4	0
Switzerland	0	0	1	0	0	1	0.10 e	3	0

Country	One share – one vote	Allowed voting by mail	No blocking of shares before shareholders' meeting	Cumulative voting	Protection of minority shareholders	Pre-emptive right	% capital required to convene new shareholders' meeting	Index of anti-directory rights	Mandatory dividends
Countries of Anglo-Saxon law, on average	0.17	0.39	1	0.28	0.94	0.44	0.09	4	0
Countries of German law, on average	0.33	0	0.17	0.33	0.5	0.33	0.05	2.33	0
Countries of French law, on average	0.29	0.05	0.57	0.29	0.29	0.62	0.15	2.33	0.11
Countries of Scandinavian law, on average	0	0.25	1	0	0	0.75	0.1	3	0
Average of the sample	0.22	0.18	0.71	0.27	0.53	0.53	0.11	3	0.05

Source: La Porta et al⁶⁰ and the Company Law⁶¹

The Serbian index is equal to the index of Ireland or Japan,⁶² but a part of the rights related to the shareholder protection, although provided for by the Law, may be eschewed by the agent if he does not find them to be to his benefit. Comparing Serbia with other countries shows that investor protection is at the same level as that in Denmark, Switzerland, Greece, Netherlands, Austria, etc. and it is better than in Germany or Italy. At the same time, better than Serbia are Peru, Columbia and Nigeria.

The assessed value may be further checked by the comparative analysis using the indices which the transition countries had in the beginning of 1990s.

⁶⁰R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny – Legal determinants of external finance, *Journal of Finance* 52, 1997, pp. 1131-1150.

⁶¹Zakon o privrednim društvima (Company Law), Official Gazette 125/04

⁶²If one takes into consideration that the Law provides the possibility of cumulative voting and pre-emptive rights to shares.

Table 3. Value of LLSV index in transition countries

Country	Anti-directory rights index in transition countries (1998) and in Serbia (2007)
Armenia	5,5
Georgia	3
Kazakhstan	5,25
Kirgizstan	2
Moldova	3,5
Russia	5,5
Ukraine	3,5
Uzbekistan	3,85
Czech Republic	3
Latvia	2,5
Estonia	3,75
Romania	3
Hungary	3
Poland	3
Slovenia	2,5
Serbia	2
Average of all transition countries	3,13

Source: K. Pistor, M. Raiser, S. Gelfer – Law and Finance in Transition Economies, Economics of Transition 8, 2000.

Therefore, according to the criterion of the value of investor protection index, namely corporate governance quality, Serbia is at the level of Kirgizstan some ten years ago. At the same time, Serbia is somewhat above Slovenia and Latvia in the same period. Taking into account a very different development level of the mentioned countries and their financial markets at the moment, it is more than clear that some other factors had contributed to this.

Quality of institutions and the problem of implementation of investor protection norms

The construction of the corporate governance index for Serbia and its comparison with other countries' indices suggested that there is a clear divergence in Serbia between the legislative norms and the implementation thereof, namely between the legal and the factual situation.⁶³ The main problem with the low level of corporate governance quality is not in legal norms but rather in the weakness of institutions. Research conducted by Veljović i Ječmenica⁶⁴ confirmed these statements. The conclusion of this research is identical to ours – the main problem with the low level of corporate governance is not in legal norms but rather in the weakness of institutions. Following the methodology developed by La Porta et al, the research covered four fields:

1. Assessment of the securities and equity market legislation;
2. Assessment of sanctions as the main instrument of implementation;
3. Assessment of private enforcement (courts);
4. Assessment of public enforcement (Securities and Exchange Commission).

The methodology used was developed in cooperation with the Stockholm Institute for Transition Economies. Legal analysis was made with regard to the assessment of investor protection through the regulation of entry to an organized capital market and continuous information, and protection of market integrity against trading on the basis of privileged information (insider trading) and market manipulation.

With regard to the entry to market, Serbia was assessed the lowest because, regardless of the legislator's good intentions, due to inadequate solution in the securities legislation, legislative inconsistency, and mass violation of regulations by market participants, as well as the regulator's inability to sanction this behaviour, the situation was created where the companies can enter the organized market even without a prospectus. On the other test (which assessed mandatory prospectus contents) Serbia scored well because the legislation adequately specified mandatory contents of the prospectus. With regard to the

⁶³ If the index were to be taken as a comprehensive measure of minority shareholder protection, minority shareholders would be equally protected in Serbia, the Netherlands, Austria. At the same time, shareholders in Serbia would be better protected than shareholders in Germany. Considering that in practice we see major differences between the levels of minority shareholder protection in the above countries and in Serbia, the next step to be taken is to analyse the implementation of current legal provisions protecting minority shareholders.

⁶⁴ K. Veljović, T. Ječmenica – *Kvalitet finansijske regulative (Quality of Financial Legislation)*, Kvartalni monitor no. 9, 2007.

continuous information, the legislation as such is not problematic but non-transparent business operation constitutes one of the greatest problems for the investors and corporate governance in Serbia. Rules of continuous information are regulated by current legal provisions in a satisfactory manner; all essential elements with regard to the required reports are covered and there is manifest tendency towards ensuring that they are regularly updated. However, in this case it is possible for the issuer not to be sanctioned for not fulfilling this legal obligation. Namely, a company which had initially entered the market with a prospectus but later on did not fulfil the obligation to continuously inform the investor will be sanctioned only by subsequently getting the BP (“bez prospekta” - no prospectus) status. In the beginning of 2007, 42% of companies on Serbian market had the BP designation (2% have entered without a prospectus and others did not fulfil the continuous information obligation).

Enforcement of rights has two arms: the Securities Commission and the courts. The analysis has shown that both arms of the enforcement of legal rules protecting investors are underdeveloped, powerless, and ineffective.

The quality of private enforcement was assessed by interviewing the Supreme Court and Commercial Court judges. With regard to the courts and case law, in the part related to the securities issue in the broadest sense, including any disputes arising in connection with the securities market, it is the general assessment that the case law is underdeveloped. A similar conclusion applies to a somewhat more abundant but still quite modest case law related to company law.

The assessment of public enforcement was obtained in close cooperation with the Securities Commission. The assessment of public enforcement covers five fields. The main characteristics of the regulator and its institutional independence are first assessed. The second field of assessment is regulatory independence of the Commission, where the attempt is made to determine whether the authority of the Commission to regulate the capital market is the Commission's original authority or the authority delegated by the Ministry of Finance. The third field assesses the effective power which the regulator has in the investigation. If the Commission has power to order the issuer, distributor and/or accountant/auditor to provide relevant documentation, namely if it can order that relevant person give testimony, the Commission has the effective power in the investigation to identify the reasons for inaccuracy or obsolescence of the information provided to investors. The fourth aspect is the effective power of the regulator to impose (non-criminal) sanctions.

This power is critical in assessing whether the regulator (public enforcement) can counteract the weaknesses of private enforcement. These sanctions most commonly involve an order to the issuer's responsible persons to do something or to cease an activity, e.g. to remedy the problem and ensure compliance with the legislative requirements concerning the publication and transparency, to introduce the changes recommended by the supervisory authorities, to cease an illegal activity, to compensate the damage incurred to the investors, etc. These orders may also be directed to the issuer and the distributor and the accountant/auditor; therefore, in the assessment of the regulator's effective power, the order to "do" and the "cease-and-desist" order for all categories of potentially responsible persons are also taken into account. Finally, the fifth aspect of the assessment of public enforcement concerns the criminal sanctions for violation of the securities related legislation and the role of regulator in criminal proceedings.

The final assessment of the first aspect of public enforcement – the characteristics of the regulator (institutional independence) – is unsatisfactory. The process of appointing the Commission members is not adequately protected against interference by the executive power and politics. The term of office aspect was also unfavourably assessed because of the insufficiently clear legal definition of reasons for dismissal of the members before expiry of their term of office. Finally, although the focus variable (that the regulator regulates and supervises only the securities market and not the banks) receives the highest scores according to the adopted methodology. The question is how good this solution is in practice, considering the conflict of competences between the two regulators (the Commission and the NBS) and the Commission's lack of effective supervision over some of the strongest players on the securities market.

As regards the effective power of the regulator in the investigation, even though the regulations have, on the face of it, furnished the Commission with the tools necessary to obtain desired information when performing its supervision, in the course of the project the Commission declared itself incapable of implementing effective supervision and stated that its effective powers in supervision are quite modest in relation to those of regulators in the comparative legal systems. The main problem, according to the statements made by the Commission, is the inadequate power of the regulator in its supervisory function, the fact that its employees do not enjoy the immunity in performing their supervisory function, and inadequate measures (sanctions) for the violations committed. Before the adoption of the New Law, the Commission tried to fill the above mentioned legal "gaps" by subordinate legislation (taking

recourse in the regulatory power leverage). The New Law worsened the situation since it limited its regulatory power and sterilised the efforts which the Commission made to “close the loopholes” by adopting subordinate legislation and responding in a timely manner to the new situation on the market which is constantly in the process of creation and changing. Moreover, the Commission does not have the authority of documentation search and seizure, which is important for the discovery of insider trading and manipulation. In addition, the Commission does not have the investigative powers to impose injunctions, in particular those “freezing” the situation encountered in the course of supervision until the completion thereof, which would be of utmost importance for a successful investigation.

With regard to the regulator’s effective power in the sphere of sanctioning, during the survey the Commission stated that it believes that it does not have appropriate powers to impose the necessary measures in the case it encounters unlawful and irregular act/practice in the course of supervision. Thus, for example, the Commission has neither the authority to impose on the spot fines, nor the authority to conduct first-instance misdemeanor proceedings⁶⁵. The Securities Law stipulates that only by the “second decision” by which it pronounces a new measure if it finds that the unlawful or irregular practice has not been remedied pursuant to the “first decision” it issued when it discovered the presence of unlawful or irregular practice, the Commission may impose a fine on the supervised entities. The Commission’s decisions are final and may be appealed by initiating administrative disputes. The role of the Commission in the criminal proceedings is reduced to the filing of the criminal complaint, i.e. possibly initiating criminal proceedings. The Commission has never managed to secure criminal prosecution of a perpetrator, which indicated the inefficiency and ineffectiveness of this sanction, even though in reality there is anecdotal evidence of extensive insider trading, poorly informed investors, and market manipulation, for which criminal liability is envisaged.

So, the research has shown that the legal status of the Commission is relatively well defined (with the exception of the sphere of regulatory independence). At the same time, the actual status of the Commission in Serbia is such that it may be concluded that the Commission has clearly defined competences, but not clearly defined goals. The current Law on Securities was a radical step backwards compared to the previous one, particularly concerning the Commission’s institutional and regulatory independence. The Commission cannot

⁶⁵ Some representatives of the Commission believe that the Commission does not need to have this authority.

effectively carry out its supervision, and the main characteristic of its activities thus far was a relatively small regulatory, supervisory, and institutional capacity of this body. It should be (and is not) operationally and financially independent, it should have enough expert staff who have the knowledge necessary for exercising the regulatory functions and enough authority and political support (and does not have either) to perform effective supervision. At the same time, the Commission should operate in a transparent and accountable manner. The influence and open pressure exerted on the Commission by the executive power have been observed ever since it was set up.

SOME CONSEQUENCES OF CONCENTRATION

Concentration as a solution for the corporate governance problem

The problem of corporate governance, particularly the problem of investor protection, is solved, or, more precisely, eliminated for a short term, through faster concentration. The main method of solving the problem is the factual abandonment of the corporate form of the company. For a large number of companies which were forced to list, this is a rational solution. The problem is in the fact that the concentration develops fastest in the group of the best and largest companies which, according to their characteristics, can be open (public) public companies. The companies which, according to their performance, cannot be public corporations, remain open (public) and their shares are traded on the discontinuous market segment.

Maintenance of such configuration over the medium and long term may lead to an absurd situation where high-risk and low-quality companies remain on the market and large and valuable companies withdraw from the market. This manner of concentration sacrifices in a way the “civilisation” mission of the corporation as the only kind of company that can absorb and efficiently use the capital from the environment in the best possible way.

Concentration and characteristics of the Serbian financial market

In the short and medium term, the concentration of ownership over shares deforms the basic functions of the financial market. This deformation stems from the change of the financial market’s basic functions. In this case,

it is not used as a mechanism for direct financial intermediation but rather as a mechanism for transfer of ownership. Most Serbian public companies which are listed on the capital market do not *de facto* raise additional capital in the market. According to the findings from the above quoted World Bank research, 89% of companies in the sample did not receive any external investments in the past five years, and 90% of interviewed companies do not intend to issue new shares or to raise additional capital through the capital market in the following three years⁶⁶.

In these circumstances, the capital market will stay shallow and illiquid over a long term. Things observed on the market for shares are a typical consequence of the low level of investor protection. On the supply side, there dominate the shareholders who have been given their shares in the privatisation process. The dominant buyers on this market are in actual fact the acquirers of these companies and not the buyers of shares (investors). Their aim is to acquire the company's share package which will ensure the actual control of the company. The owner who assumes control over a company is not interested in capital increase through a public offer since it can threaten the ownership structure and the control acquired. In such circumstances other buyers (standard investors interested in the yield) are not interested in such company in these circumstances since, due to the ownership and, consequently, the control structure they cannot have any significant influence on the company's business. The shares of such company are not interesting for the investor's portfolio either, since they are not liquid. The consequence: the company actually goes private (becomes a closed one), i.e. it is transformed, and the market as such is being progressively emptied up because of the withdrawal of shares and declining demand from the investor segment, including both individual and institutional investors.

The capital market, with the exception of its continuous segment⁶⁷ is not in actual fact an equity market but rather a company market. It is used for the redistribution of wealth and control and not for the information- and price-efficient

⁶⁶ K. Veljović, Op. cit.

⁶⁷ In the continuous trading market segment, during the rise of the market in the second half of 2005 the other source of offer was activated from the corpus of portfolio investors who had bought shares earlier and were now selling them to obtain capital gain or restructure their investment portfolios. A consequence of this is increased liquidity of the continuous trading market. The growth of trading volumes and prices in the continuous trading segment in 2005 resulted in a temporary break in the process of market drainage. The introduction of the banks' shares to continuous trading contributed to this and these shares were the shares of banks in which there was no apparent takeover strategy. Even at the time of its most intense rise, the market still remained exceptionally narrow: if the trading in 3 or 4 most traded equities is excluded, the remaining shares on the market are just "stage props".

allocation of capital. This mechanism explains the large difference between the market capitalisation level and the trading volume in Serbia.

If the level of Serbian capital market development is measured only by the standard market capitalisation indicator which recorded high dynamic growth between 2000 and 2008, a conclusion can be drawn that Serbian financial market underwent strong expansion. The above indicator, however, is inadequate and does not describe the real situation, considering that a large part of the total capitalisation is illiquid⁶⁸. That is why the trading volume and the liquidity ratio are used as more reliable measures of activity on the capital market since they reveal the pattern of behaviour of the Serbian capital market.

The data confirm the thesis that, despite a notable growth in trading volumes, particularly in shares, Serbian capital market is illiquid. A small number of companies whose shares are actively traded and small trading volumes of those shares constitute the main problems for further development of this market. The liquidity ratio, as the ratio of total turnover to total market capitalisation, is low. The turnover to capitalisation ratio was 6.65% in December 2003, 2.26% in December 2004, approx. 1.3% in December 2005, and about 2.5% in the first quarter of 2007. That is why the liquidity ratio should be taken with reserve considering that the right measure of market liquidity would be obtained only after the truly liquid shares were identified and then their share in the total turnover and in capitalisation measured.

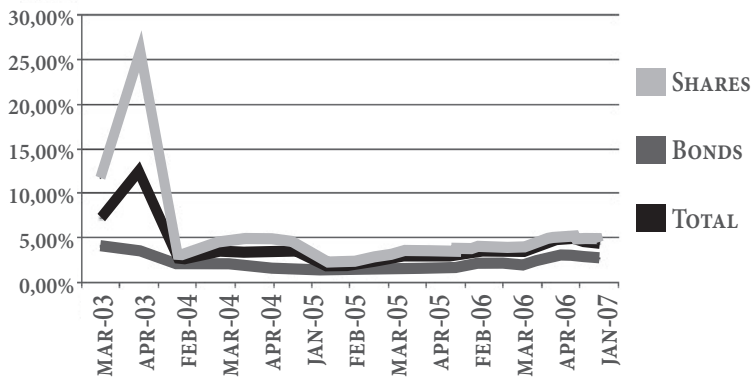
The actual situation in the Serbian share market suggests that there are two markets: the continuous trading and the periodical auction trading. These two markets differ significantly. The periodical auction market is a one-way market. The experience shows that main sellers of shares in this market come from the retail sector, namely that these are shareholders who have acquired their shares for free within the process of mass insider privatisation (primarily in the second wave of privatisation in 1997). In other words, on the supply side it is the employee-shareholders that are dominant. The dominant buyers on this market are actually the acquirers of these companies, rather than buyers of shares. The aim of these buyers is to acquire a company share package which will ensure them actual control over the company concerned

The above ownership concentration mechanism and the consequential drainage of the periodical auction market operate as follows: on the eve of concentration and in the course of that very process, the turnover of the "attacked" company's shares gathers speed, the number of transactions increases and this

⁶⁸ Source: B. Živković, B. Urošević, D. Cvijanović i M. Drenovak – *Finansijsko tržište Srbije: 2000-2005* (The Financial Market of Serbia: 2000-2005), *Kvartalni monitor* br. 1, januar-jul 2005 (pp. 59-66).

goes on until formation of a significant majority package, i.e. the share package which ensures factual control over the company concerned. Thereafter, the turnover of that share declines, the demand decreases and, consequently, the price of the share falls.

Graph 18. Liquidity ratio



Source: www.belex.co.yu

The main cause of this phenomenon lies in the fact that, when a single person or a group of affiliated persons concentrate the ownership over the company's shares in their hands, they do not want to sell their stock. The goal of the share purchase is to gain control over the company and the control is ensured through acquiring of the majority package. This fact confirms the theoretical proposition that a high value of the private benefits from control implies a low level of protection of investors' ownership rights⁶⁹. Namely, since insider privatisation has left behind a rather dispersed ownership structure, control over a company could be gained even with a significant share package which need not necessarily be a majority package. In the Serbian share market, however, it has been noted that the owners are, as a rule, interested only in the majority packages which guarantee factual control over the company and thus they render superfluous the reliance on legal protection.

⁶⁹ See: La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny – *Law and Finance*, 1998, *Journal of Political Economy*, Vol. 106, No. 6, 1113-1155); La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny – *Legal Determinants of External Finance*, 1997, *Journal of Finance*, Vol. 52, No. 3, 1131-1150). ; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny – *Investor Protection and Corporate Valuation*, 2002, *Journal of Finance*, Vol. 57, No. 3, 1147-1170).

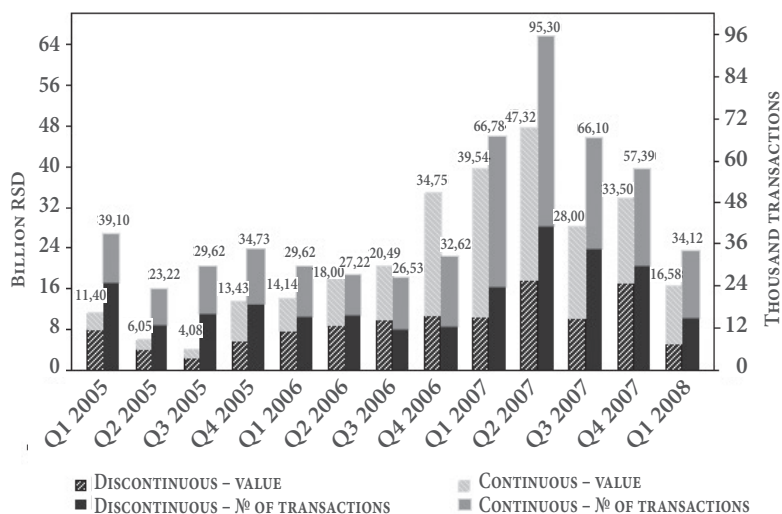
On the other hand, there is not much interest in the significant (although minority) packages offered by the Share Fund. Of all the companies offered on the capital market, primarily those offered by the Share Fund, only 55% of companies were sold in 2002, 57% in 2003, and 54% of offered companies in 2004. The absence of investors' interest in minority packages and their insistence upon factual control over the company suggest that there is a lack of investors' trust in legal protection and the high value of private benefits from the control, which are typical for the low level of investor protection.

The owner who assumes control over a company is not interested in the capital increase by means of the public offer considering that public offer may compromise the ownership structure and the acquired control. At the same time, other buyers are not interested in such a company either, because, due to the ownership and, consequently, the control structure, they cannot have any major influence on the decision making in the company, or its operations. A share of such a company is not an efficient allocation alternative for the portfolio investors either, since it is not liquid. Consequently, such a company actually (although not always in legal terms) becomes a closed one (goes private). At the market level, the consequence is gradual "drainage". Moreover, only low-quality companies remain and thus, aggregately, the price-to-book ratio was constantly falling until the beginning of 2006. At that time this ratio changed in a certain number of shares which attracted the interest of individual investors and investment funds from abroad. Considering that discontinuous trading market still retained low values of these ratios, it is not really the share market but a company market. Also, this operating mechanism explains a great difference between the level of market capitalisation and the value of turnover in this market segment.

It follows from this finding that periodical auction market (which is still dominant in Serbia, although its share is constantly decreasing both due to its drainage and the development of the continuous market, i.e. the continuous trading market) is used for the purposes other than standard ones: instead of being used for the companies' *going public*, it is used for the companies' *going private*. This process is taking place in the circumstances of low information- and price efficacy. Namely, it is assumed that, in these circumstances, the market undervalues the shares and this further accelerates the process of drainage. The evidence for this statement lies in the following facts: the sellers on the periodical auction are dominantly from the retail sector and they have generally acquired their shares for free, in the process of mass privatisation. It follows that these shareholders cannot be thought of as investors who

have chosen to invest their funds in the equities of a specific company but rather as the employees who consider these shares a kind of compensation. Besides, since they are at the same time employed in the company concerned, there is always a possibility that their agent (manager) may terminate their employment and deprive them of income (salary) which exceeds the yield from shares. Bearing in mind that they chose between these two rights and the yield, they actually do not have the opportunity to control the managers. Since the agents (managers) have often acted against these principals (shareholders) and in concert with the acquirer, it was very hard to distinguish between the amicable and hostile takeovers. This expropriation often included the cancellation of the right of disposal of own assets. The low quality of corporate governance and inability of employees-shareholders to use this mechanism to protect their ownership rights (although, enjoying them under the regulations) have additionally speeded up the conversion of discontinuous market into the corporate control market.

Graph 19. Volume and structure of share trading, 2005–2008



Source: Quarterly Monitor No 1. 2008

Specific limitations for institutional investors

In addition to the high yield and high systemic risk, the Serbian financial market at the present state of development and in the foreseeable future imposes some specific limitations on the institutional investors and mutual investment schemes. In addition to the yield and market risk, the activity of institutional investor is also subject to the level of specific risk to which he is exposed as a minority owner *per definitionem*. This risk is the risk of the expropriation of yield and assets that develops in the circumstances of low investor protection. The analysis that has been conducted so far indicates that low legal protection does not have its roots in the inadequate legal rules (regulations) governing the field of company law and in their implementation. The problem in the first place stems from 1) mass violation of these rules and inability of shareholders to ensure any enforcement of these rules, and (2) the shareholders' difficulties to vote by leaving the company, i.e. to "punish" the management by selling their shares on the illiquid capital market. The first set of problems could be resolved by reviewing corporate legislation and increasing the efficiency of institutional superstructure (regulatory bodies and courts). The second problem originates from the inefficient and inadequate regulation of the takeover market; therefore, a radical revision of current takeover law is needed.

This group of investors' main risk on the share market is the process of market drainage due to ownership concentration. This will continue until the IPO market develops. The concentration process further narrows the investment base and limits the efficiency of institutional investors. This characteristic of the market is essential in the estimation of the effects of the public enterprises' becoming open public companies, namely their listing. Taking into account the present situation on the share market, it is to be expected that their shares too will be captured in the concentration process, unless the basic market-related legislation is previously revised.

The assumption on the continuation of the share market drainage process is based on the estimation that low level of investor protection will be kept in the long term. The arguments in favour of this forecast come from the experience of similar countries. Besides the reform of market and corporate legislation, the increase of the institutional superstructure quality is the main precondition for changing the investor protection quality and level. The low level of investor protection and low liquidity of the market on one the hand, and dispersion of ownership on the other hand, make an incompatible combination.

Studies have shown that the concentration of ownership is much higher in the countries with low level of protection, and that ownership most commonly concentrates in the hands of insiders⁷⁰ who are in a strategic coalition with the management. At the same time, a feedback mechanism exists, since ownership concentration itself results in an underdeveloped and illiquid capital market. Namely, if concentrated ownership prevails, financial instruments are then in the hands of a small number of investors, which inevitably results in reduced liquidity. This illiquid market conserves the existing ownership concentration as well as the low protection level of the shareholders who do not have any exit strategy and cannot influence the management by threatening to leave (sell their shares). The previous chapter demonstrated the underdevelopment and illiquidity of Serbian share market which makes the alternative “voting by leaving” the company a feeble alternative for the Serbian shareholder.

In short and medium term, the limitations acute for institutional investors are those related to the opportunities to diversify the portfolio. Namely, the demand by both individual and institutional investors concentrates on a relatively limited market segment. The prices of the shares on this market grow and fall quickly and in large amplitudes. The other big limitation is the absence of the low or relatively low risk instrument. This is especially the case with debt instruments. Besides the foreign-currency savings bonds, the market of which is relatively shallow, there are no classic low-risk instruments from the municipal or corporate sectors. The result is a relatively shallow portfolio diversification, high share of cash, and a relatively low yield.

An important consequence of the above findings concerns the current limitations in resolving the problem of institutional investors' portfolio optimisation. Although the market correlation coefficient is probably low, any wider diversification is limited by the low liquidity of shares. This brings different groups of institutional investors into different situations. The investment funds which can assume high risk (particularly the so-called private funds) and non-life insurance companies can, conceptually, assume a higher risk than the pension (voluntary and mandatory) funds. For this reason, the capacity of the first group of institutional investors to optimise their portfolio is higher than the capacity of the other group. This was seen in the behaviour of investment and voluntary pension funds to date. The problem was radicalised in 2007 when the demand accrual, with the limited offer level and structure, resulted in a faster growth of prices and concentration of trade on a small number of shares.

⁷⁰ See: A. Shleifer and R. Vishny – *A Survey of Corporate Governance*, Journal of Finance 52, 1997, pp 737-783.

If high risks of the companies' going public are not removed, the desynchronisation of the demand and supply accrual dynamics may cause distortion of the market. In the present circumstances, trading has obviously concentrated on several shares and one treasury bond. If no new issues of securities and debt and equity instruments take place in medium term, the problem will arise regarding the market survival and growth of systemic risks. A consequence of any accelerated growth of demand will be the additional reduction of capacity and efficiency of diversification. This characteristic of the market will most probably be maintained over the mid-term and this will, consistently, threaten the efficiency of institutional investors, particularly the investors whose capacity of risk assumption is limited by the standard regulatory norms.

The limited liquidity and reduced depth of the market will in the medium term continue to restrict the conservative institutional investors' ability to adapt to the price shocks coming from the market. That is how the customary regulation of open investment and pension funds will come to crises. Standard limitations of the fund's maximum exposure become ineffective if the status of securities changes fast in terms liquid/illiquid. This was, in our previous experience, seen in the behaviour of voluntary pension funds on the share market. Their ability to protect themselves from the price changes and to maintain the investment unit value growth trend in the circumstances imposed by the legislation and fall of the exchange index, proved in 2007 to be limited. The shallow market places this group of investors before a specific problem: by withdrawing from a security (disinvesting), they considerably increase its supply and, therefore, lower its price. This was not observed in the investment funds, which are given more freedom to choose to invest in the less liquid securities on the discontinuous market segment by the rules of portfolio structuring.

A critical point of the future evolution of Serbian financial market will be the (il)liquidity of the periodical auction market. Depending on this market segment will be the (non-)formation of a critical investor mass on the side of demand. This especially applies to future strategies of all the institutional investors who are not specifically present in this market segment. It is not realistic to expect any significant shift in demand towards this segment over a short term, considering that even a much deeper continuous market is highly sensitive both to small accruals and the change in demand structure. The key risk of this market segment is low investor protection; that is why this market is still being drained. If the causes of drainage are not eliminated, (primarily poor protection of investors' ownership rights), the decline in demand will inevitably lead to the decline in prices. This segment of the capital market will

in this case operate as long as there exist the resources for distribution, namely the offer of shares derived from the privatisation process. It shall not perform any of its main functions. The necessary precondition for this is a fundamental change of this market's regulation, strengthening of oversight in financial markets (institutional building), and effective protection of ownership rights.

The problem of the narrow investment base, namely the lacking and unfavourable structure of the securities supply, could radicalise in short term, if the demand considerably rises at the present level and structure of the supply. Fast increase of the demand would cause the creation of small or larger price balloons on the share market.

Financial markets regulation: Main flaws and possible improvements

EVOLUTION OF THE REGULATORY FRAMEWORK OR A STEP FORWARD, TWO STEPS BACK

The Law on Market of Securities and other Financial Instruments that was enacted in November 2002⁷¹ was, according to the general opinion, not good. Under this Law, the level and quality of protection of the investors in securities was low. This Law has only provisionally regulated the takeover market. The activity of investment funds was not regulated at all, despite the fact that their activity on the national market was intensive. In a nutshell: the entire complex of securities issuance and public trading was either unregulated or under-regulated, and the regulator (supervisor) did not manage to effectively ensure the application of rules.

The Serbian securities market was a reflection (and a consequence) of such regulatory status. While this Law was in force, market capitalisation (relative to GDP) was large, but more than 90% of this capitalisation was illiquid.⁷² There were no IPOs on the market. Main reasons for revision of this Law (for the sake of simplification, hereinafter: the Old Law) included the following:

The first problem was the introducing of securities to the so-called organised market, the Old Law has declaratively “opened” all public companies (made them public) by the provision which treats all shares issued before the beginning of its application as the shares issued through public offer. With this provision the law has ignored the economic reality and logic. A paradoxical situation was created in which the companies which, due to their economic nature, cannot be corporations (single-member public companies, small and medium-sized enterprises) had to enter the organised market – stock exchange.⁷³

⁷¹ Official Journal of FRY, No. 65/2002 and Official Gazette RS, Nos. 57/2003, 55/2004, 45/2005, 101/2005.

⁷² B. Živković, B. Urošević, D. Cvijanović and M. Drenovak – *Finansijsko tržište Srbije: 2000-2005, (Serbian financial Market)* Kvartalni monitor No. 1., January-July 2005 (pp. 59-66).

⁷³ The subsequently adopted Company Law (CL) tried to reconcile the legal and the economic world and thus it introduced two categories of public companies – closed (public) ones and open (public) ones and brought the public companies which are by their very nature the closed public companies (which can have a maximum of 100 shareholders) closer to the form of a limited liability company,

The legislator tried to create a market by imposing the creation of an organised securities market and this with the requirements which makes it possible for all securities holders to place their (already issued) securities on such market. The goal of the legislator was, however, that the companies being traded on the organised market (i.e. whose securities are publicly traded) respect the obligations that the Old Law envisaged for public companies⁷⁴ and that those companies are supervised by the Securities Commission (the Commission) and that is why it directed them to the “organised market”.⁷⁵ However, this intention of the legislator was eschewed by registering all “shares from privatisation” on the so-called free exchange market rather than on the formal Belgrade Stock Exchange listing. The market capitalisation of shares covers the market capitalisation of all the issuers who were included on the free exchange market, while both official listings (A and B), to which the Stock Exchange attached complex requirements which the Old Law had placed before public companies, are almost completely empty. These requirements, however, do not concern the free market although it is, in actual fact “organised” by the Belgrade Stock Exchange. The requirements which must be met to enter the free exchange market are much less strict than the official listing requirements: only the registration of securities and their holders with the Central Depository and applying with the Belgrade Stock Exchange for inclusion on the free exchange market, and signing the contract with the Belgrade Stock Exchange accompanied with the prospectus. This raises a question whether the Commission has any authority with regard to the companies on the free exchange market (almost all Serbian companies traded in an organised manner) or whether its supervision is limited to the formal Stock Exchange listing, namely to the, until recently, an empty set.

with a possibility of imposing restrictions to the transfer of shares by internal company instruments. This left the possibility for the exclusion of free transferability and trading on the organised market and created a legal possibility to trade outside of the stock exchange, but also created a conflict with the Old Law. Open public companies (with over 100 shareholders and those with fewer shareholders which are open of their own choice), are treated by the CL as “public companies” in the sense of the Old Law. Therefore, the body of open public companies under the CL is more narrowly defined than the body of public companies defined by the Old Law.

⁷⁴The Old Law in Art. 5 para. 1 sub-para. 12 defines a public company as a legal person that has issued securities through a public offer on the organised market, whose securities related operations are supervised by the Securities Commission, and which is obligated to inform the public about its operations in accordance with the law.

⁷⁵The Old Law in Art. 5 para. 1 sub-para 5 states that an organised market is a market on which the trading in securities and other financial instruments issued in accordance with this Law is carried out in the manner and under the conditions laid down by such Law, the Commission's instruments and the rules of operation of the authorised participants on the organised market supervised by the Commission.

The second problem of the market and, at the same time, the reason for changing the Old Law was the lack of transparency in terms of issuer information. On the face of it, the regulation of the market entry and continuous information as provided by the Old Law was defined in a satisfactory manner and included all key elements related to the prospectus, required reports, with a manifested aspiration to lead towards the achievement of its increasingly better updatedness. However, it was shown in practice that it is possible that the issuer is not sanctioned for non-compliance with this legal obligation. Namely, as it was said above, the shares which, according to the Old Law, should be traded on the Stock Exchange, were introduced to a special segment of the stock-exchange market, the so-called free exchange market where the trade can take place even without a prospectus, with a special designation BP (*bez prospekta* – without prospectus). Considering that, according to the rules of the Belgrade Stock Exchange, the acceptance to this market segment does not require a prospectus nor compliance with specific legal criteria for public companies, the trading is regulated only by the rules of the Stock Exchange and the investors knowingly assume the risk to invest in the absence of obligation to provide inform of the listed companies. Further, a company which has initially entered the market with a prospectus and later on failed to comply with the requirement to continuously inform investors, will be sanctioned only by subsequently acquiring the BP (without prospectus) status.

The third problem concerned the inefficiency of supervision and inefficient application of law. Despite the good intentions of the legislator, due to inadequate solution in the Old Law, frequent changes of the regulations, inconsistency between different laws, etc, the market participants violated regulations en masse and the regulators and courts were unable to effectively and efficiently sanction such behaviour. Private enforcement (application of law by the courts) was inefficient due to inadequate activity of shareholders themselves and due to the inefficiency of courts. As regards public enforcement (application of law by the public regulatory body, namely the Securities Commission), it is also at a very low level. Firstly, it should be noted that a consolidated supervision over Serbian financial sector is absent and that there are two competing regulators – the National Bank of Serbia (NBS) and the Commission – between which the conflict of competences may be both positive and negative.⁷⁶ In the circumstance where private enforcement of law is inefficient,

⁷⁶This primarily refers to the activities of banks, insurance companies and pension funds (falling within the scope of competence of the NBS) on the securities market. With regard to granting banks authorizations to engage in a business activity with securities and a business activity of custody bank, a conflict of authority cannot *de iure* occur between the Commission and the NBS. Namely,

the public regulatory body, that is, the Securities Commission, is the first and often (actually) the last line of defence of investor rights. It is a very important determinant of the investment climate and it is critical for the credibility of the entire financial market. However, as it was already mentioned above, the question was raised whether the Commission has any authority whatsoever in respect of the companies on the free exchange market (all Serbian companies which are traded in a regulated manner) or its supervision is restricted to the formal Stock Exchange listing. Also, the factual situation is such that a conclusion may be drawn that the Commission has clearly defined competences but not clearly defined objectives. Furthermore, it is not in a position to effectively carry out its supervision and the main characteristic of its operation thus far was relatively small regulatory, supervisory and institutional capacity. The Commission should be (and it is not) operationally and financially independent, it should have sufficient knowledge to perform the regulatory function, and sufficient authority and political support (and it has neither) to effectively exercise supervision. It should operate in a transparent and responsible manner. The influence and open pressure made by the executive power on the Commission has been noted ever since it was established.

In June 2006 three laws were adopted: the Law on the Market of Securities and other Financial Instruments (for the sake of simplification, hereinafter: the New Law),⁷⁷ the Law on Takeover of Public Companies,⁷⁸ and the

it is envisaged that a bank may engage in a business activity of a broker-dealer company, or a business activity of a custody bank, provided it acquires previous consent of the NBS and the license of the Commission to carry out such business activities (see Art. 137 and 141 of the Old Law, and Art. 176 and 180 of the New Law. Therefore, the NBS grants a prior consent and the Commission issues the license. The New Law no longer requires the prior consent of the NBS. A danger of the conflict of authority may possibly occur in the sphere of supervision over the operations of the authorised bank. Namely, the Law (Art. 139 of the Old Law, and Art. 178 of the New Law) envisaged that if the Commission finds any unlawful practices or irregularities in business operations of the authorised bank in the course of the supervision procedure, it shall submit the decision on the measures taken to the NBS. However, the supervision function in relation to banks, and the authorisation for issuing sanctions in the event of violation of regulations and practices by the bank, has been established in favour of the NBS by the Law on the NBS (Art.63). Thus, the Commission does not have the effective power (even though the law allocates the competences and the responsibility) to exercise the supervision over the banks' activities on the securities market where the banks are *de facto* the largest players. A similar conclusion is drawn with regard to custody banks. The same Article of the Law on the NBS (Art. 63) stipulates that the NBS shall issue regulations governing the standards of prudential banking operations (regulatory power of the NBS). On the other hand, within the scope of its competence, the Commission issues instruments for the implementation of the law on securities. It is therefore easy to imagine a situation where a conflict of authority between the NBS and the Commission could arise in this sphere of regulatory authorisations too.

⁷⁷ Official Gazette of RS No. 46/2006.

⁷⁸ *Ibid.*

Law on Investment Funds.⁷⁹ The Law of Investment Funds was doubtlessly a huge step forward. The Law on Securities and the Law on Takeover were a step backwards.

THE FIRST STEP BACKWARDS OR BASIC CONCEPTUAL ELEMENTS OF THE CURRENT LAW

The expectations that the New Law would change the relations on the financial market were not met. The New Law, briefly put, is a slightly modified version of the previous one, and it enabled a faster pace for the drainage of the market.⁸⁰ The main novelties in the New Law, compared with the old one, concern the following areas:

1. Market morphology: a division of the organised market to the stock-exchange and over-the-counter market⁸¹ and a concept of the market regulator are now introduced.⁸² The explanation of this solution is twofold. Firstly, the legislator believes that it enables the SMEs to enter the market. Secondly, this solution is supposed to ensure the competition to the Belgrade Stock Exchange so as to ensure that the competition between the market organisers, namely between the organised markets, remedy the above described weaknesses of the Belgrade Stock Exchange. This solution, in compliance with the experience in other comparable situation, should increase the number of companies on the free over-the-counter market and thus speed up the process of the share ownership concentration.
2. The relationship between the issuer and the market: the required company transparency is clearly increased, which should result in a reduced information asymmetry on the market; however, it is still unclear how far these changes can reach, given that they apply to a small body of listed companies.
3. Supervision and regulation: the New Law considerably derogates already insufficient competences of the Securities Commission.

⁷⁹ *Ibid.*

⁸⁰ To be fair, a good side of the New Law is that, in some aspects, it has removed the inconsistencies between the national legislation and the IOSCO and EU regulations. At this time it cannot be ascertained if the Transparency Directive and the Market Manipulation Directive were taken into consideration. A big step forward was made in this field and it will contribute to the protection of financial market integrity and prevention of the abuse of insider information. It remains unclear whether these provisions will be effective.

⁸¹ Art. 10 of the New Law.

⁸² Art. 2 paragraph 1 sub-paragraph 11 of the New Law.

Stock-exchange and over-the-counter market

According to the solutions of the New Law, the stock-exchange and the over-the-counter markets have identical operating rules, require the same level of transparency, and provide the same possibilities of access. The difference in the definition of these two markets is in the structure and characteristics of the instruments traded on one or the other market. On the stock-exchange market, only those securities which comply with relatively strict criteria laid down by the Commission may be listed. On the over-the-counter market, the securities issued through public offers and without any additional stipulated requirements may be listed.

The New Law provides a precise definition of the concept of market organiser. The largest controversy among the experts in the field arose with regard to the extension of the group of persons who can be the founders, namely, shareholders of the market organiser. These may include any local or foreign, natural or legal, persons. The only requirement is that any acquisition of a qualified share in the structure of ownership over such entity must be previously approved by the Commission. There, however, the competence of the Commission ends. This solution may result in the creation of more than one stock exchange and more than one over-the-counter market. Surely, this is not the necessary or the only outcome. However, this outcome is more likely than the one offered in a formal explanation of the legislator that the creation of the over-the-counter market will result in the companies' easier access to financial resources other than through banking intermediation. The logic of the over-the-counter market itself goes in favour of this assumption, since it does not function efficiently in the circumstances of high risk. Namely, this type of the market does not have centralised auction as the main procedure for price disclosure. Over-the-counter markets identify the price at several points of their structure (so-called market makers) within the range of buying and selling rate. This range expands with the increase of risk. Markets of this kind tend to form prices at a considerably lower level than the auction markets (stock exchanges). The same was seen, in quite dramatic forms, in the Czech Republic (RMS) and Romania. Even the most efficient and the best organised of these markets, the NASDAQ of the US, abandoned this concept and adopted the system of price identification in auction, through AMEX. The reason for this was the widening of the difference between the securities buying and selling price in the circumstances of high risk. In the circumstances prevailing in the US, the investors responded by leaving the NASDAQ. In the circumstances

when the investor protection level is low, in all the likelihood the outcome would be mass redistribution at the expense of small shareholders.

Information openness of the issuer

All shares traded on the Stock Exchange are included in the free exchange market on which the trade may take place without the prospectus (with a special mark BP), where the investors knowingly assume the investment risk in the absence of the obligation of inform on the part of the quoted companies. Investor protection is primarily ensured through timely, accurate and comprehensive information which the issuer provides upon entering the market, and through continuous information provided to the investment public. This information enables the identification of the fair price and valuation of investment alternatives. Otherwise, high information asymmetry would create high transaction costs. In the event of stronger regional cooperation and EU accession, quality securities will migrate to other markets.

The concept of the prospectus for securities issuance that is incorporated in the New Law is, basically, in compliance with the EU Prospectus Directive.⁸³ The New Law finally laid down the obligation of the issuer of securities issued through public offer to always publish a short prospectus in at least one daily newspaper. The main objection to this solution was that the responsibility for the contents is not focused, even though joint and several liability of the accountant and the issuing agent increases the chance for compensation of damage to the investor in the event of any problems with the prospectus. The solution would be to make the management clearly and unequivocally liable for the accuracy of information.

Public companies' reporting was, in general, made transparent. Under the New Law, the issuer is obligated to publish (in at least one daily newspapers) a report on outcome of public offer, a report on material events, an extract from annual accounts, as well as other reports relevant for the operation of those companies. Moreover, the New Law defines the procedure for transparent monitoring of changes in ownership structure. The concept of insider information is harmonised with the EU Market Manipulation Directive. Unauthorised use of insider information was defined as grounds for abuse and manipulation on financial markets.⁸⁴ A more precisely defined concept of related parties enables

⁸³ Prospectus Directive, i.e. European Parliament and the Council Directive 2003/71.

⁸⁴ There are some advocates of insider trade who support their thesis arguing that it actually leads towards better price information, which automatically improves the allocation of funds. L. Ausubel

the regulator to monitor and identify other important categories of manipulative practices related to securities prices.

In addition to the information asymmetry, also arising on the primary share market is a strong conflict of interest: the issuer wishes to sell shares at the highest price possible and thus conceals any negative information about the company. The investor is interested in getting accurate and comprehensive information about the issuer and, at the same time, wishes to buy the shares as cheaply as possible. Good regulation makes the issuers responsible for disclosure of all relevant information because such allocation of responsibility is most efficient economically (the issuer is a participant on the market for whom it is the least costly to obtain and publish such information).⁸⁵ This practice is in the interest of the issuer as well. Namely, in the event of information asymmetry, the investors assume the worst possible scenario and include the premium on that risk into the purchase price of shares. Therefore, the price of securities burdened with information asymmetry consistently decreases below the equilibrium value and it is the good companies that are relatively more affected by this. In other words, bad and inefficient regulation of the problem of information closeness/openness is harmful for good companies and beneficial for bad companies (negative selection).

Here the Law was well on the way to solving the main problem with information asymmetry. In our country this problem appears in a dramatic form, in the relation between the investor and the issuer. In order to eliminate or at least alleviate this problem, regulation may tend to lower the costs of obtaining the information and raise the quantity and quality of the information accessible to the public. This allows the investor to make a rational choice. There are two main aspects to the regulation of corporations' information openness. The first is to lay down the procedures for applying for the listing and quotation on the Stock Exchange (entry into the market), and the other is to define the standards for continuous publication of market information by the issuer. Information affects the market price and, at the same time, enables efficient operation of the market, namely the situation where the price precisely reflects the value. In other words, the main purpose of the regulation of financial markets is to provide information and, accordingly, price efficiency of the market.⁸⁶

– *Insider Trading in a Rational Expectations Economy*, American Economic Review 80, 1990, 759-776; M. Fishman, and K. Hagerty – *Insider Trading and the Efficiency of Stock Prices*, Rand Journal of Economics 23, 1992, str. 106-122; D. Bernhardt, B. Hollifield and E. Hughson – *Investment and Insider Trading*, Review of Financial Studies 8, 1995, 501-543.

⁸⁵ S. Grossman and O. Hart – *Disclosure Laws and Takeover Bids*, Journal of Finance 35, 1980, 323-334.

⁸⁶ F. Allen, R. Herring – *Banking regulation versus Securities Market Regulation*, Wharton School University of Pennsylvania, 2001.

The New Law has identified this problem but has not solved it. The vague regulation of the information disclosure obligation (listed companies or all companies whose shares are publicly traded?), protects bad issuers at the expense of good companies and good investors.

The achievements of the New Law

The equities market today comprises the free exchange market and the Belgrade Stock Exchange official listing (A and B).⁸⁷ The Stock Exchange has associated with the listed companies the complex requirements which the regulations on securities impose on public companies. Until recently, this group was completely empty. The number of listed shares is still quite low. So, a question arises whether the law and the public regulatory body in charge of its application have any authority whatsoever towards the issuers whose shares are traded on the formal (listed) stock-exchange market or the Commission's supervision is limited to the officially listed shares. In other words, whether the New Law, the same as the Old Law, actually regulate an (almost) vacant group?

Regrettably, the answer to this question is affirmative. Officially listed companies (over which the Commission would, both in legal and practical terms, have clear authority related to public companies) are and will be few. Namely, a corporation becomes a real "issuer" in economic and factual terms only if it decides on a public offer of securities or if it appears on the formal listing of the Stock Exchange with which strict listing rules are associated. Thus far, Serbia has seen no case of IPO which would naturally result in the quotation and formal listing and the legal status "public company". There are only four formally listed companies. The legal definition of a "public company" was extended to include the companies which have never passed through the formal legal procedures envisaged for the IPO. Many of them would have never obtained a positive opinion of the Commission had they really undergone

⁸⁷Two formal listings of the Belgrade Stock Exchange (A and B) have been vacant for years. At the moment, this market hosts four shares. All other shares that are traded on the Stock Exchange are registered on a so-called free exchange market (approx. 1,650 companies). Only the shares of a hundred or so companies are traded, and the shares of about 1,200 listed companies have not been traded at all in the past seven years. Free exchange market is regulated by the Stock Exchange internal rules and, from the strictly legal aspect, the companies on this market are not public companies. The liquidity ratio, as the ratio between total turnover and total market capitalisation, is very low. The ratio between the turnover value and the capitalisation is decreasing – in December 2003 its value was 6.6% and in the beginning of 2007 it fluctuated around 2.5%.

these procedures. Certainly, given free choice, many of these companies would have never taken this decision.

To sum up, neither the New nor the Old Law, faced with the heritage of insider privatisation, with the lack of rules and lack of the Commission's authority towards the corporation on the free exchange market and poor institutional capacity of the Commission as such, provide adequate protection to investors in these securities. The Commission does not have the authority to order the company whose shares are placed on the free exchange market (the actual issuer, considering that securities of that company are publicly traded) to discontinue any detrimental actions or to issue another appropriate order concerning either future business operations of the issuer or sale/purchase of the issuer's securities.⁸⁸

Poor institutional capacity of the Commission and imprecise and incomplete IPO regulations suspend all good provisions on information openness of the issuer. This means that deep information asymmetry on our market will subsist, that share prices will be inherently low, and that present accelerated ownership concentration will continue.

The solution could involve two steps. The first would be to clean up the market from low quality securities, and the other would be to clearly define supervision. Market segmentation would occur if the consistency the New Law, the Company Law and the Privatisation Law were harmonised and if every company were allowed to, decide for itself whether it wants to be a public company or not, whether it wants to be an open (public) or a closed (private) public company, or whether it wants to be listed/quoted by fully complying with the procedures laid down by the Company Law. The attempt to impose the listing on companies has resulted in mass violation of regulations, which is impossible to prevent, and to "dumping" poor quality instruments on the market. The proposed change would enable the differentiation of the structure of public companies and respect of the rules of minority shareholders protection. When the economic and legal reality draw closer, then the level of regulatory risk will decrease (the need for frequent regulatory changes or a high level of the regulatory body's discretion), which will create an environment conducive to public issues and filter the market instruments on the Stock Exchange "keeping" only quality securities. A clearer specification of supervision will be discussed in the next chapter.

⁸⁸ A case was recorded (when the Old Law was in force) when the Commission issued an act ordering the issuer on the free exchange market to discontinue some specific actions with regard to the securities operations, and the issuer did not comply with such act because it was familiar with the fact that the Commission did not have any legal authority to issue such an act nor to take any action in the case of non-compliance therewith.

Erosion of the regulatory body's capacity

It was empirically shown that the Old Law made the Securities Commission an institution without a clearly defined goal, with inadequate authority and poor regulatory, supervisory and institutional capacity. Nevertheless, at least formally, the Commission was institutionally, operationally and financially independent from the executive branch of power. In actual fact, it was operating without sufficient authority and institutional support required for effective supervision over the market. The New Law was supposed to provide for the institutional reform of the Commission and remedy the flaws that prevented it from effectively regulating and supervising the market.⁸⁹

This did not happen. Firstly, consolidated supervision of the financial market was not provided. An important change that new legislation did bring was the introduction of a new regulator on the financial market. The “competing” regulator is the NBS which, in addition to banks, also supervises insurance companies and pension funds. The likelihood of the conflict of authority between the NBS and the Commission is high, particularly in the field of regulation and supervision of the operations of the authorised and custody bank. Moreover, the Serbian financial market is bank-centric (approximately 90% of financial assets are controlled by banks).⁹⁰ Banks are gradually becoming the main players on the securities market as well (universal banking). Non-banking supervision is inefficient and lags behind the supervision over the banking sector. The NBS is a constitutional category and the Commission is not, not even after the passing of the new Constitution.

The solution for this problem is in the concept of integrated supervision. Integrated supervision could be located in the central bank. Alternatively, an institution outside the NBS can be the new regulator, defined by a special law and established by transferring the regulation of banks, insurance companies and pension funds from the NBS, and the regulation of the securities market from the present Commission. The key problem with this choice is how to efficiently and quickly establish a new institution.⁹¹ The experience with the

⁸⁹ See a more detailed analysis of different aspects of the independence of institutions in M. Quintyn and M. W. Taylor – *Regulatory and Supervisory Independence and Financial Stability*, IMF Working Paper, WP/02/46, March 2002.

⁹⁰ See: *Serbia and Montenegro: Serbia – Financial System Stability Assessment (FSSA), including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Payment System*, International Monetary Fund, Washington D.C., March 2006.

⁹¹ There is no doubt that, at this time, the necessary preconditions for the establishment of a strong and fully independent regulator are not met. The main problems are the conflicts inside the institutional structure and the competition in the political superstructure which actually enables political par-

newly-formed independent regulatory bodies in Serbia makes this alternative seem inferior.

In respect of the institutional independence of the Commission, the New Law is a huge step backwards. The Commission was declaratively defined as an independent and autonomous organisation of the Republic of Serbia, which is accountable to the National Assembly of the Republic of Serbia, but such declarative autonomy was radically relativized: the powers of the Commission are not original but delegated. Delegated responsibilities (in accordance with the Law on Public Administration) are discharged by different agencies, administrative authorities, etc. These are, simply put, the responsibilities that were originally within the scope of competence of a specific ministry and are delegated to those institutions. If a securities commission exists in the institutional structure of a country, then its competences are not the competences of any ministry but rather its original competences. If the competences are delegated, then there is no need for a commission. In such a case, a more efficient solution would be that the Ministry of Finance both regulates and supervises. As it is, we now have a strange, hybrid solution which will result in further reduction of already low level of the Commission's independence.

With regard to the institutional design of the Commission, the New Law gets very low marks. Namely, according to the position taken by the International Organisation of Securities Commissions⁹², the regulatory body should in the first place ensure the achievement of the following objectives: investor protection, a fair, efficient and transparent financial market, and reduction of systemic risk. These objectives imply that, firstly, the law should clearly define the goals of the Commission as the protection of investors and market integrity. Secondly, the regulator needs to be given greater authority and effective power in its supervisory function. Thirdly, the Commission needs to have the original and not the delegated competences to regulate and supervise the financial market. Fourthly, clear rules on career advancement would close the door for bribery and corruption and, in addition, enable the institution to attract quality personnel to perform those very important and complex governmental functions. Then, reasonable systems need to be in place that allow the audit and ensure accountability of the regulator, but, at the same time, they must not call into question the integrity of the supervisory function and must not be detrimental to the clients. To eliminate any interfering of laypersons, another thing to consider is the existence of special courts or at least special depart-

ties to exercise control over the formally independent institutions. A risk of this kind may strongly compromise the new institution of a single regulator.

⁹²These objectives of the legislation were in 1998 defined in the IOSCO document: Objectives and Principles of Securities Regulation, and they are binding for all members.

ments within the courts. Furthermore, institutional independence is founded on three constitutive elements: appointment and dismissal of the regulator's management, governance structure in the regulator itself, and openness and transparency of the decision-making process.

With regard to regulatory independence, it is particularly important to take account of the fact that, up to now, the Commission has tried to overcome the legal vagueness in inadequate authorisations by using its own Statute and other bylaws. The New Law worsened the situation because, firstly, it did not solve the problems with inadequate competences, and the fact that the Commission discharges all responsibilities as delegated by the Government restricts its regulatory power and sterilises the Commission's previous efforts to respond to the market evolution by adopting bylaws. The Commission is obliged to submit all the rulebooks and other bylaws that are placed within its scope of competence to the Ministry of Finance for opinion since it discharges its responsibilities as delegated (by the Government). After the New Law was adopted, the existing effective powers of the Commission were conserved and a natural evolution of the regulator was prevented, since any changes of competences and authorisations require amendments to the law in the parliament (or approval of the Ministry of Finance in the case of bylaws).

The Commission or its successor (integrated supervisory institution) must have original authorisations and its regulatory power must not be limited by any a priori or a posteriori approval by another authority. The degree of autonomy which the Commission enjoys in defining prudential rules is of critical importance.⁹³ The next big problem that turns the national regulatory body into the legendary "toothless lion" is the absolute absence of operational autonomy. (in comparison: the National Bank of Serbia may operatively act in an absolutely autonomous manner while the Commission does not have that possibility.)

⁹³In order to identify the adequate degree of regulatory autonomy, it would be useful to classify financial sector regulations in three groups: economic (control of prices, profits, market entries and exits), prudential (concerns the control over product types and the supervised companies' production processes) and information (concerns the information which the supervised companies need to provide to the supervisory authority and the general public). Past experience has shown that economic and information regulations usually do not change materially with time and, therefore, can be left to the legislator in the classic sense (the parliament) with possible mandatory previous consultations with supervisory authorities. However, the situation is very different with regard to prudential regulations. These rules are the fundamentals underpinning the entire supervision process and determining the stability and "soundness" of the entire financial system. The conclusion is that the degree of autonomy in the definition of prudential rules is of critical importance for regulatory independence and that it is a necessary precondition for the financial sector of a country to respect the best international standards and practices.

The Commission should be equipped with all instruments for effective supervision over the financial market.⁹⁴ In addition, the relevant legislation should be quite specific with regard to the limitation of the decision-making level, the process and the time period in which appeal may be filed against the supervisory authorities' decisions. The Commission should be allowed to impose regulatory fines. It was necessary to ensure by the New Law greater powers for the regulator in its supervisory function, and immunity of the Commission's employees in performing such supervisory function, as well as the appropriate measures for violations with a minimum of discretionary powers in order to avoid pressures on the Commission. (Analogous solutions were incorporated in the new Law on Banks). According to the current law, the Commission is not authorised for search and seizure of documentation, which is of importance for the discovery of insider trading practices and manipulative behaviour. The Commission has no investigative authorisations to impose injunctions and in particular those in which the situation discovered in the course of supervision is "frozen" until the supervision is completed and which would be of utmost importance for effective inspection. In this area, the New Law has made a huge step backwards.

Finally, personal and financial independence of the Commission⁹⁵ has never been at a high level. This solution derogates apparently soundly defined independence aspect. The Commission had great problems due to the non-approval of its budget by the Assembly on several occasions (the budget and the Commission's final accounts for the years 2003, 2004, 2005, and 2006 were not approved). Such obstruction by the Parliament is unacceptable if the intention is to build an independent regulator that will protect the investors and the capital market integrity.

It would be desirable to prevent any political influence on the appointment of the Commission members. In this regard it is important to set up two different structures within the Commission – the governance and the supervisory one. The decision-making and governance should be exercised

⁹⁴ Effective power of the regulator reflects in: the powers to assess the competence of the management and owners of supervised entities (fit and proper test); the application of suitable and versatile sanctions against the infringing entities; the ability to directly intervene in the supervised institution if necessary; the power to revoke licence for engaging in a specific business activity within the financial sector; and, finally, the protection of regulator's employees (in their discharge of the supervisory function) by providing them immunity against the lawsuits which the supervised companies may initiate against them personally.

⁹⁵ Institutional independence was, declaratively, ranked very high, both by the old and the new law. The main problem is that past experience has shown that the law does not actually protect the Commission against arbitrary dismissal before the expiry of its term primarily for political reasons.

by a collegial authority, but the decision-making (two-tier validation before deciding on most important issues), and ruling (acting on appeal against the first-instance decision), needs to be two-tier. This would imply the existence of the executive and the non-executive segment of the Commission's governance structure embodied in two mutually independent bodies, the governing one and the executive one. The governing body (management board), as the second instance, should consist of at least five members whose terms of office would last five years, except for the first term, which should be different so that these terms of office end with a two-year difference, which would prevent electing more than two members of the Commission by the same Assembly. The executive body, which takes decisions and manages, must also be elected by the National Assembly and it could be a single person body since the decision quality control is ensured by the existence of the collective governing body. The appointment of members to these bodies could include public interviews with the nominees in front of the competent parliamentary committee. The legitimate wish of the authorities to exercise supervision could be fulfilled through a supervisory body which could reflect the parliament mandate structure, and the guarantee for this could be a resolution adopted in the National Assembly which would politically and morally bind the deputies to consistently represent the current composition of the parliament. The most important instrument of the supervisory authority could be the internal audit which must be completely independent from the governance structure and must operate in accordance with the internal audit best practice. The above method could divide the supervisory power as well as the political accountability for the operations of the Commission. Accordingly, this would enable its operations to move outside the field of daily political argumentation. Continual insight into the operations of the Commission would enable all political participants to become a part of the "fourth branch of government" system and ensure that changes of the ruling majority in the National Assembly does not have a devastating effect on the Commission's personnel continuity and, consequently, its expertise, professional conduct, and independence. The supervisory body would have a second-instance authority to decide in the matters of Commission management, as well as to propose, in lieu of the Government, on the basis of consensus, the dismissal of members to the management board and the executive body. It is necessary to precisely define the role of the executive and the legislative power in determination of the size and use of the regulator's budget, and prevent any obstruction.

LAW ON TAKEOVER OF PUBLIC COMPANIES OR THE SECOND STEP BACKWARDS

After it had been repeatedly announced and drafted in several versions and concepts, the Law on Takeover of Public Companies came at the time when the main wave of takeovers had already passed without any serious rules of the game. So, the first and main problem with regard to this Law is that it came so very late. A large number of efficient and potentially efficient companies have been taken over. Widely dispersed ownership is still massively present in small and relatively inefficient companies, and a relatively small number of efficient companies still operate according to the open (public) corporation regime with public trading of shares.

So far, the takeovers have mostly concerned the good companies, which were privatised after a model provided by the 1997 Privatisation Law. Some takeovers have led to the forming of monopoly market structure. In the past two years, the process of taking over the companies in Serbia has displayed all the characteristics of early, unregulated transition that were seen in other countries too (Russia is a typical example). The main features of this process include accelerated pace of ownership concentration, a low level of corporate governance quality in the public companies which were privatised under the 1997 Law, and low level of minority shareholder protection. The outcome of this situation was that, in the past three years, takeover was a dominant method for ownership concentration in Serbia. In 2004, the volume of transactions on the takeover market exceeded that on the Stock Exchange. The main reason for the expansion of takeover market was the absence of rules, namely the absence of this law which has just been enacted.

The takeovers took place in the circumstances of low price efficiency of the market and this resulted in the low value of the price-to-book ratio. The price efficiency level was particularly affected by the actual absence of the obligation of the acquirers to purchase all shares from the small shareholders at the takeover price, and a small number of competitive bids. There was an additional risk in the fact that the agents (managers) often acted contrary to the interest of the principal (shareholders) in collusion with the potential acquirer. It was often impossible to distinguish between a friendly and hostile takeover. All these distortions of the market and absence of standard regulations allow that the manner the corporate control market functioned to date can be described as discriminatory in favour of the acquirer.

Protection of minority owners was, in almost all takeover cases, poor and inefficient. In the circumstances of poor protection of small shareholders, the offer of shares in the takeover procedure was large, in almost all cases seen so far. Observed in most cases was the presence of so-called selling avalanche, i.e. the avalanche of shares offered to the acquirer. In such circumstances it was the acquirer that decided on the price and thus the expropriation of small shareholders, in a large number of cases, could be proven by the share price-to-book ratio. Because of this, the shareholders of this kind, in most cases, tended to sell their shares in the takeover procedure, because they had reason to expect that the price and the liquidity of their shares would fall after the takeover, when the company gets a controlling shareholder and when, due to the low level of minority shareholder protection, external investors lose interest in such a company.

The only mechanism for the protection of small shareholders was generated by the market itself. This refers to the competing bid phenomenon which, as a rule, resulted in the increase of share prices. Unfortunately, the absence of the rules of the game and frequent collusion between the management and one of the bidders has discouraged competition on the demand side. Therefore, during 2005, only 21.62% of the total completed takeover bids featured competitive bids, and 68.75% of them resulted in the increase of prices⁹⁶.

Because of its above properties, the Law on Takeover should be either fundamentally revised or replaced with a new one.

Main flaws of the takeover law

The main purpose of the EU takeover market regulation, to which this Law refers, is the creation of the institutional environment for the activation of efficient corporate control market. Both the relevant directive and the Report of the so-called Winter Group start from the viewpoint that the efficient market is the best investor protection. The efficient market is activated, on the one hand, by restricting the right of the current management of the public company to prevent efficient takeover, and, on the other hand, by the institution of the competitive takeover bid. Our law has successfully resolved the first problem but not the second.

⁹⁶Report on the Operations of the Republic of Serbia Securities Commission and fluctuations on the securities market for 2005 and the period January – June 2006.

The main weakness of the law is its vagueness in the definition of requirements for announcement of a public and competing bid. The law defines the competitive takeover bid in a more or less standard manner and in compliance with the sources to which it refers. However, the very operationalization of the competitive bid in the text of the Law contains a possibility to avoid or to sabotage it. According to the text of the Law, the bidder is obligated to publish the takeover bid within one day after the day of incurring such obligation. This obligation is in place regardless of the definition of the threshold at which this obligation is activated (EU standard is 25% of interest). If the precise definition of the moment when this offer must be activated is missing, the acquirer may, both in theory and in practice, in one day acquire 50%, 70%, or at least 25.1%, and only then publish the takeover bid.⁹⁷ The likelihood of this happening in Serbia is not small considering that the basic market is inefficient and that there is a hard institutional conflict among the shareholders. Namely, the Serbian corporation features a definition of the principal-agent problem that is unique in the world. The agent (director) may dismiss the principal (shareholder). In the circumstances when there is a coalition between the management and the acquirer, the employed small shareholders are forced to choose between their wages and the dividend. Considering that both the former and the latter variable are controlled by the management, it is relatively easy for the management to prepare a setting for a takeover at low prices. The arguments for such a claim can be obtained by analysing the takeovers that have taken place. In all those cases, small shareholders hurried to sell their shares. Therefore, the phenomenon that can be described by a well-known term: “selling avalanche” can be observed on the national market. In the final outcome: if there is a strong likelihood that a bidder may acquire control over the company before the expiry of a public bid, then the likelihood that a competitive bid will appear behaves as its residual. To put it more simply: every well prepared takeover may, in Serbia, exclude a competitive bid.

The possibility of actual acquisition of over 25% share before the publication of the takeover bid may result in manipulations with the target company's prices. The likelihood that this happens is relatively strong in the case of companies whose shares are (mostly by will of the management) not traded on the Stock Exchange. Namely, there exists the obligation to publish the bid, according to the solutions provided by the Law, only if the target company's shares have been traded for at least three months. Let's assume that it is not the

⁹⁷ See more details in D. Malinić – *Implikacije nove regulative na razvoj tržišta hartija od vrednosti u Srbiji (New Regulation Implications on the Development of the Securities Market in Serbia)*, SES, Miločer Economic Forum, pp. 229-255

case here. (This assumption can be easily proved by comparing the number of public companies and the number of shares traded on the Stock Exchange.). If an acquirer attacks such a company, it has three months to obstruct the defence and any competitive bids. The main obstruction mechanism in this case is price manipulation. The likelihood that price manipulation will take place proved to be quite strong. The market is shallow, share liquidity is low, and the Law allows that the price is considered disclosed even if it was only one transaction with only share that took place. In the final outcome, the acquirer may “park” the price at the target value, and only then publish his takeover bid.⁹⁸

In order to have its main function, the law must prevent any coalition between the management and the bidder at the expense of the company’s shareholders, and it must define the operationalization of the competitive bid more precisely.

Any imprecision with regard to the obligation of the acquirer to publish the public bid may result in the destruction of decision-making process and the target company’s business. Namely, any further acquisition of shares (above 25%) in the situation which the Law defines as the situation where the requirements are met for publication of the bid, the acquirer may “obstruct corporate governance in the target company⁹⁹”. The acquirer in this case loses the right of vote attached to the additionally acquired shares (any shareholding over 25%). Consequence 1: the total number of shares is reduced. Consequence 2: the management rights attached to the shares acquired by the acquirer above the 25% threshold, which makes it possible to have control with a smaller number of voting shares. Consequence 3: the acquirer may control the company even with 25% of shares and, if the period of decision-making on the company’s investing, disinvesting, or borrowing is long enough, the characteristics of the company subject to attack can change. In the ad absurdum logic, in the period of three months, the acquirer may even dispose of the shares he holds. Therefore, in the end of the period, he will no longer hold more than 25%, which means that, according to what the law says, he need not publish the takeover bid. Such a regulatory situation allows the development of a coalition between the fictitious and the real acquirer. A typical strategy in this case would be that the fictitious acquirer first devalues the target company and then, in the end of a 3-month period, to sell the shares to the real acquirer.

⁹⁸ See further evidence in: D. Malinić, *op.cit.* p. 255

⁹⁹ D. Malinić, *op. cit.*, p. 248

Moreover, with still inadequately selective codification of the mandatory character of the takeover bid publication, the Law closes another source of competition on the corporate control market. This is a large and potentially powerful source of demand from the group of professional investors. They are not exempt from the obligation to publish the takeover bid. Any acquisition of more than 25% (including the shares which the professional investor is already holding) imposes the obligation on the professional investors to publish the bid to acquire all shares of the target company. The interest of professional investors is not the control but rather the return on their investment in the company and, therefore, their acquisition is not motivated by takeover. The Law is actually converting them to the takeoverers. The risk of this kind will exclude this group from the minority packages market and open a wider space for the real predators. A suitable solution of this problem would be to exempt some professional investors (private funds, in the first place) from the obligation to publish the takeover bid.

CONCLUDING REMARKS

Ever since it was set up to this date, the financial market has dominantly been a mechanism for ownership rights redistribution and only to a lesser or almost insignificant extent a mechanism for corporate and public sector financing. The main (strategic) goal of financial market development is to build its capacity to perform its basic function. This could be done through a fundamental reform of the regulatory framework which would enable the issuing of corporate and public sector securities. This reform needs to include a) the revision of basic securities laws, b) their harmonisation with company legislation, and c) the improvement of implementing legislation, and d) the efficiency of regulatory bodies.

In addition to the New Law, which is partly harmonized with EU directives, it is also necessary to fundamentally reconstruct the Takeover Law which, since the existing solution actually suspends the competition on the takeover market. The main direction of legal revision is the harmonization with the EU standards. There are important issues that constitute an integral part of the regulatory framework for this area in the EU that are either not covered or not adequately regulated by this Law. Some solutions are ambiguous so their implementation is almost impossible. (Public Offer Directive 89/298/EEC and

subsequent directives) A part of this solution is incorporated in the currently proposed amendments.

In parallel to lowering the risk, which would be achieved by revising the basic laws, it is possible, in a short term, to lower the costs associated with the issuing of new instruments. These fiscal and regulatory costs (fees of the Securities Commission, Central Depository and other related institutions) increase the costs of issuing securities both from the corporate and the public sector. These measures should encourage, in conjunction with new regulation, the issuing of new securities and this would contribute to the broadening and deepening of the market. The activation of new sources of demand in the financial market from the sectors of investment and pension funds could otherwise lead to accelerated growth and equally fast fall of index values, as it was seen in 2007. In addition to the revision of basic laws, it is also necessary to have a separate law on mortgage securities, i.e. on securitisation. This law would enable the issuing of mortgage based low-risk securities.

The strengthening of regulatory and supervisory functions on financial markets can also be considered a goal of strategic importance. It is necessary to redefine the regulatory body competences and increase its real capacity for regulation and supervision by defining its status as a regulatory body unambiguously and actually independent both from the Government and the market participants. These goals may be achieved either by the strengthening of the existing institution (the Securities Commission) or by the setting up of a new institution for supervision over all financial activities (banking, insurance, funds, financial market) – the concept of integrated supervision. Bearing in mind the experience of other countries, it would be with considering a possibility of setting up a new institution for integrated supervision over all financial activities, which would be de facto and institutionally independent both from the executive segment of power and from the participants on the market. (See specifically the chapter on institutions.) Also important is the goal of strengthening self-regulatory bodies and professional associations which facilitate the strengthening of market discipline and improvement of ethical standards of the professions, increased the level of expert knowledge and skills, and creation of investment community's and general public's trust in institutions.

Legal regulations of corporate governance: overview, analysis and suggested changes

BACKGROUND

Essentially, economic purpose of statutory regulations of companies is to clearly assign and establish the mode of implementation and protection of ownership rights in relationships that the company establishes with external environment and relationships established inside, i.e. within the company. In either case, economic purpose of such establishment is to reduce the transaction costs incurred in exchange, exercising and protection of ownership rights, as follows:

- In legal transactions among both natural and legal persons, and
- In advocacy of interests of different groups, primarily the owners, within the company.

Statutory regulations of the first set of issues are mostly boiled down to prescription of modes of incorporation, i.e. foundation of a company, registration of a company and its main data in public registers, as well as duties and responsibilities in legal transactions with third parties.

Statutory regulations of the second set of issues are primarily aimed at resolution of the problems between principal and agent, as well as related problems of information asymmetry and class action. A set of regulations aimed at the resolution of the principal-agent issues and related problems establishes a legal framework for distribution of roles, responsibilities and rights within a company, or, in other words, legal framework of corporate governance.

The source of problems between principals and agents originates from the separation of management and control from the company ownership. The company owner, i.e. principal – delegates the right and duty of management to professional managers, i.e. agents, relying on their knowledge and professional competence in an effort to increase the rate of return to his investment. At the same time, he is forced to find a way to prevent the professional management to appropriate or spend the company assets in the manner not conducive to the optimum profit/return for the owner.

In addition to problems occurring in the company owner(s) vs. management relationship, the rules of corporate governance strive to resolve the

problems ensuing in relationships among the owners themselves, particularly when one of them has a predominant stake. Like in any other circumstances in which the rights of a minority should be protected from selfish or malevolent behavior of a majority, with concomitant preservation of basic principles of democratic governance (i.e. one person = one vote, and majority decision making), and a set of rules aimed at protection of minority shareholders, the following question needs to be answered: How to protect a minority without jeopardizing the majority rights? The answer to this question is particularly important in corporate governance since these are not general human rights, but very specific property rights.

In other words, under circumstances in which a relative influence on decision making is directly linked to the relative amount of assets invested in the company, and parallel proportionally higher risks for the decisions, it is very important to carefully balance and identify the areas in which the shareholders are given decision-making impact which is disproportionately higher than their ownership stake in the company. The issue of the relationship between minority and majority shareholders is very important in Serbia, since most of the current public companies resulted from privatization, which will be elaborated below.

This part of the study will review and analyze the parts of the Company Law¹⁰⁰ (CL), as well as accessible examples of the Case Law relating to the regulations of the corporate governance issues. Since these issues appear to be most acute in cases of public companies, primarily the open ones, the legislator tried to regulate them in detailed statutory provisions. We shall, therefore, focus on them.

In respect to public companies, it is also important to keep in mind the following two tools that the owners have at their disposal to discipline the company management.

In addition to his effort to exercise and protect his rights within a company, any owner – shareholder, should, by default, be given an opportunity and right to simply and without any limitations whatsoever, leave the company by the sale of his shares. Decision on the sale of shares and implementation thereof (except only to a certain degree when it is primarily led by the need to improve solvency) is a powerful tool that the owner has at his disposal to control the management. By resorting to this tool the owner clearly communicates to the management, and sometimes to the general population as well,

¹⁰⁰ Official Gazette of the Republic of Serbia, vol. 125/2004.

that he is not satisfied with the operational results. This puts at stake the position of management, monetary and other forms of compensation they receive in the current, and prospectively, in other companies, as well. In other words, it questions their position on the pertinent labor market and, in the long run, may undermine their plans for future revenue. Clearly enough, this tool is an indirect one and the easiness of its use and associated cost mostly depend on solvency of the capital market and pertinent governing rules.

Another way of establishment of effective control of management by the owner is to concentrate his ownership in the company. By the increase of his stake in the company equity, the owner increases and occasionally monopolizes the control of the company management which he may change, as the last resort. Thus, he provides a direct tool for himself: if he is dissatisfied with the operations of the professional management, the management shall leave the company, not he. The possibilities and modes to resort to this tool also depend on the mode in which the capital market is regulated and special rules that may limit the amount of stake in the equity.

Since the statutory rules that regulate the capital market and, especially, the procedure for takeover of public companies, will be analyzed in the second part of our study, we shall not elaborate them here. This means that out of five responses to the principal-agent and related problems, recognized by both theory and practice:

1. ownership concentration
2. hostile takeover
3. assignation of competences and control
4. managerial reimbursement policy
5. fiduciary duties of the manager and class actions.¹⁰¹

This part of the study will focus the overview and analysis of rules that the CL stipulates in respect to the last three groups of answers.

The overview and analysis will be presented as follows. We shall start with the main features of the legislative framework of corporate governance in Serbia. This part will include the basics of the forms and main features of companies with detailed elaboration of the managing and controlling bodies, particularly the solutions relating to public companies. Besides, a review of available case law is also provided, identifying the common causes of dispute.

¹⁰¹ M. Becht, P. Bolton, A. Röell – *Corporate Governance and Control*, Finance Working Paper No 02/2002, updated August 2005, www.ecgi.org/wp

A list of open questions will follow, together with possible solutions including the issues open not only due to CL, but due to other borderline pieces of legislation or the ones that directly affect the issues of corporate governance.

Finally, in the concluding part, a review of the social context in which corporate governance operates in Serbia, as well as its impact on effectiveness and applicability of legislative solutions will be presented.

LEGAL FRAMEWORK OF CORPORATE GOVERNANCE

The basis of the legal framework for corporate governance in Serbia is provided by the Company Law and a set of regulations governing the capital market, the most important being the Law on Market of Securities and Other Financial Instruments¹⁰² and Takeover Law.¹⁰³ Since the latter two pieces of legislation primarily regulate the issues focused in the second part of the study, they will not be elaborated here.

Two more groups of regulations directly influence the mode and outcome of implementation of the corporate governance in Serbia. These are regulations on privatization, the most important being the Privatization Law¹⁰⁴ (PL) and Law on Entitlement to Free Shares and Monetary Compensation in the Privatization Process¹⁰⁵ (LEFS), and regulations on accounting and financial statements, led by the Accounting and Audit Law¹⁰⁶ (AAL).

By the stipulations that privatization of socially-owned capital is an open tender for shares, PL basically established public companies in today's Serbia. By appropriation of free shares to employees in the privatization process and establishment of special protection measures for minority shareholders generated in this manner, the law greatly determined the structure and motivation of shareholders in vast majority of public companies. Therefore, one may suggest that the law, although essentially transitory and made for a single occasion, actually has a decisive impact on the issues recognized as the primary ones in the area of corporate governance in Serbia today.

By provisions stipulating the terms, deadlines and mode of compiling, auditing and publishing of financial statements, rules of internal audit and

¹⁰² Official Gazette, vol. 47/2006

¹⁰³ Official Gazette, vol. 46/2006

¹⁰⁴ Official Gazette, vols. 38/2001, 018/2003 and 45/2005

¹⁰⁵ Official Gazette, vol. 123/2007

¹⁰⁶ Official Gazette, vol. 46/2006

persons obliged to comply with these, AAL establishes the scope of corporate governance in the area, so that CL itself stipulates quite a number of norms that refer to AAL, as the source for such provisions.

It should also be mentioned that Chamber of Commerce of Serbia in line with modern trends¹⁰⁷ adopted two codes representing a sort of self-regulation in the area of corporate governance. These are the Code of Corporate Governance¹⁰⁸ and the Code of Business Ethics.¹⁰⁹ Relying on CL provisions, these documents aim at completing them or elaborate them by recommendations, focusing the rules on loyalty, transparency and ethics in corporate governance and operations of a company in general. This form of self-regulation is a novelty in both business and legal practices of companies and courts in Serbia. It is, therefore, difficult to expect that at this point of time they may have any major impact on the corporate governance practice in Serbia, so they will not be discussed further.

A series of other pieces of legislation, laws and accompanying by-laws, such as Competition Protection Law, Law on Registration of Businesses, Labor Law, Law on Entrepreneurs, taxation-related and other laws cover the areas that border or overlap with issues of corporate governance regulated by CL. Pertinent provisions of these regulations will be presented to the extent in which their influence on corporate governance or its outcomes is relevant.

In addition to regulations, the case law, i.e. court rulings in cases raised in relation to corporate governance issues, also plays an important role in the establishment of a legal framework for corporate governance.

Forms, main features and bodies of companies

In an effort to comprise all legal forms of business, in addition to companies, CL regulates the foundation, responsibilities and dissolution of entrepreneurs. This form of business has no legal entity apart from the founder; instead, it has the status of a natural person. In the light of the fact that this

¹⁰⁷ In the last decade of the precious century, enactment of the corporate governance code, i.e. a specific self-regulation of companies in the area has become very popular. So far, almost all EU countries and EU itself, other supranational organizations (among which the most important are the OECD principles), quite a number of Asian countries, Canada, USA, some African countries have enacted their respective documents of this kind. Exhaustive review of these documents, including the texts may be found at the website of the European Corporate Governance Institute: www.ecgi.org

¹⁰⁸ Official Gazette, vol. 1/2006

¹⁰⁹ Official Gazette, vol. 1/2006

form of business is also regulated under the Law on Private Entrepreneurs,¹¹⁰ one may suggest that CL was only partially successful in this attempt, while it remains debatable whether it should have covered it in the first place. Although it goes far beyond the topic of this study, it must, nevertheless, be stated that this form of business, which is basically self-employment, requires more systematic legislative efforts. The current situation is best illustrated by the fact that the law in force was enacted as early as 1989 and has been amended 13 times so far. Actually, facilitation and simplification of the rules for businesses of entrepreneurs (which is a good quality of CL solutions) should be focused.

Contrary to the previous Law on Enterprises, CL has no special provisions of socially owned enterprises. Only in the final and transitional provisions (Art. 454) it is prohibited to have socially owned companies or companies with majority socially owned capital as founders of a partnership or limited partnership. They are not even mentioned elsewhere in CL. Until the privatization process is completed, these enterprises shall be governed by provisions of the Law on Enterprises (Art. 456 CL), which is a good solution.

The problem that the direction of change of organization of companies founded by the state (Republic or local self-government), the so called public enterprises was insufficiently clear at the time of enactment of CL (and has remained so) was resolved in the current CL by exempting them from implementation of CL provisions until new pertinent regulations are enacted (Art. 453). Therefore, in principle, public enterprises should be organized in one of the forms of companies specified in the CL (where the pertinent provisions shall apply). When and how, however, depends on special regulations pursuant to which the public enterprises have been set up and/or organized, i.e. pertinent amendments of these regulations. It appears that this was a good, solution, pragmatic above all.

In respect to companies, CL like the previous Law on Enterprises stipulates four forms. These are two companies of persons: partnership (o.d.) and limited partnership (k.d.) and two companies of capital: limited liability company (d.o.o.) and public company (a.d.).

The main problem that the corporate governance rules aspire to resolve, the relationship between principal and agent, is not particularly marked in either companies of persons or limited liability companies. Therefore, companies of persons will not be analyzed further, and provisions relating to limited

¹¹⁰ Official Gazette, vol. 54/89 and 9/90 and Official Gazette, vol. 19/91, 46/91, 31/93 – Decision USRS, 39/93, 53/93, 67/93, 48/94, 53/95, 35/2002, 101/2005, 55/2004, 61/2005.

liability companies will be referred to only for comparison with solutions for public companies.

In terms of public companies, CL differentiates between the open/public and closed/private ones (Art. 193). The key difference between the two types of public companies lies in marketability of their shares. Namely, there is no public secondary market for shares of closed public companies, while shares of public companies must be traded on the open market only.¹¹¹

Therefore, Memorandum of Association and Articles of Association of a closed public company may specify various limitations in terms of trade in shares (pre-emptive right or acquisition of company shares or shares of other shareholders, approval of trade in shares with third parties, etc.) while CL explicitly prohibits introduction of such restrictions for public companies (Art. 196, para. 4). It is, therefore, prohibited for a closed public company to subscribe share by public tender (Art. 194, para. 4), while an public company may subscribe shares through a closed tender only exceptionally, under the conditions stipulated under the law.¹¹²

In its features, a closed/private public company is quite similar to a limited liability company, and the difference is essentially boiled down the mode of expressing the ownership participation in the company capital: shares or stakes.

Table 1 illustrates the most important features and bodies of a limited liability company and, closed and public companies. Similarity of an Ltd company and a closed public company is quite obvious. The differences are primarily formal in nature: required minimum amount of the pecuniary capital to set up and the maximum number of founders. The only apparently more significant difference is in mandatory independent audit. CL stipulates the mandatory duty for closed public companies to have an independent audit, while in case of limited liability companies, CL delegates the answer to that question to AAL (Art. 333). However, in the light of the fact that AAL exempts only

¹¹¹ Art. 51, Art. 52. and Art. 62. of the Law on the Market of Securities and Other Financial Instruments stipulates that shares of an public companies may be traded beyond the organized market (i.e. without public secondary market) only in cases of takeover (when provisions of pertinent legislation shall apply), enforced sale/purchase pursuant to CL, execution of rights of dissenting shareholders, in company reorganization procedure, or upon ruling of the court as a closure of a court case, as well as in a series of various cases in which the state is the final owner of such shares.

¹¹² The Law on the Market of Securities and Other Financial Instruments and related regulations cover the area of the market of capital.

entrepreneurs and small legal persons¹¹³ from mandatory audit of financial statements, it appears that this difference between an Ltd. company and public companies has no practical relevance.¹¹⁴ In terms of mandatory bodies there is practically no difference between provisions relating to Ltd. companies and public companies

Table 1. Companies of capital: capital and bodies

	Ltd	Closed jsc	Open jsc
Minimum monetary capital	€ 500	€ 10.000	€ 25.000
The stake entitles to	One stake	Certain number of shares	Certain number of shares
Minimum number of investors	1	1	2
Maximum number of investors	50	100	No limits
Issue of shares	-	Closed subscription	Rule: public invitation, closed subscription allowed by law and limited
Company bodies			
(General) Meeting	Yes	Yes	Yes
Board of Directors (BD) BD members	BD or Director	BD or Director	Mandatory <ul style="list-style-type: none"> • no less than 3 and no more than 15 • Most non-executive • No less than 2 independent
Director General (DG)	BD or Director	BD chairperson or other person	BD chairperson or other person
Executive Board (EB) Chairperson	-	Optional DG	Mandatory DG

¹¹³ Article 7, AAL stipulates that small legal persons are those that meet at least two out the following three requirements: less than 50 employees, annual income below EUR 2.5 million, and average annual value of operational assets below EUR 1 million, while Art. 37, AAL stipulates mandatory audit of financial statements for all medium and large legal persons

¹¹⁴ The questions as to why the external audit of financial statements is mandatory for ltds, and why the financial statements and the pertinent auditor's report have to be submitted to NBS should be addressed to AAL. We, nevertheless, have to underline that these solutions only substantiate essential lack of understanding of the role of audit of financial statements, and that it, albeit indirectly, affects the problems encountered in corporate governance that will be discussed below.

Supervisory Board (SB) Internal auditor (IA) Board of Auditors (BA)	- Optional	Optional	Mandatory
BD committees	-	Optional	2 mandatory ones: • Appointments Committee • Remuneration Committee
Company Secretary	-	-	Mandatory
Independent Auditor (IA)	If required under AAL	Mandatory, pursuant to AAL	Mandatory, pursuant to AAL

Therefore, a following question needs an answer: Should a closed public company be recognized in Serbia as a special legal form of company organization, although it is not present in many countries? Prof. Vasiljević believes that it is more pertinent for Serbia, as a country in transition, to allow this option for public companies, as well.¹¹⁵ Proper response to this question will be obtained by the practice itself, i.e. the economic life in which this form of organization of a business company will find its place or not, as was the case with limited partnerships.

Generally, CL is dominated by dispositional solutions, except in cases of an public company. Thus, the law leaves it to the founders to regulate many very important issues in their Memorandum of Association, including the managing bodies they decide on. In case of public company, however, the law prescribes establishment and structure of strictly defined managerial bodies. In a more general context, somewhat more precise regulation of public companies in comparison with closed ones and limited liability companies result from the intention of the legislator to protect the interests of a wide range on non-professional shareholders that usually account for most of the shareholders. Namely, it is believed that limited liability companies and closed public company are usually owned by business people that understand operations of institutions pertinent to the economic life, so that regulation of their mutual relationships within the company may be left entirely to their discretion. It is, however, justifiably believed that most owners of public companies are simply not familiar with these rules, and that it is needed, in order to protect them from manipulations and fraud, to regulate some forms and procedures under the law.

¹¹⁵ M. Vasiljević - *Komentar Zakona o privrednim društvima* (Comments to the Company Law), Official Gazette, Belgrade, 2006, pp. 367

When opting for the form of a company, CL stipulates that the company capital must be expressed in shares if the number of founders exceeds 50, i.e. then the company has to be organized as a public company; if the number of founders exceeds 100, the company has to be an public company.

In principle, one may ask whether it is necessary that the law requires mandatory expression of the capital in shares only because the number of owners exceeds a certain arbitrary number. If we take the position that it is not a duty of the state to protect individuals from consequences/results of their own choices, setting any maximum number of founders of any legal form of a company makes no sense. Conversely, however, setting a number is always arbitrary, so that advocating another number is associated with the same shortcoming.

From the point of view of corporate governance, however, the only relevant issue is whether the statutory managing bodies are up to the entrusted tasks, here in Serbia, and whether they are able to help in the resolution of the principal-agent problems, and other related problems of information asymmetry and class action? In other words, is the statutorily imposed regulation of the internal relationships in the company sufficiently beneficial for those that it is intended to protect (share owners) to balance out the administrative costs imposed to the company.

Public companies: distribution of competences and control

Mandatory bodies of an public company, as stipulated in CP, as the body in charge for the election thereof, and accordingly the body to whom, hierarchy-wise, these bodies report on their operations, are illustrated in Figure 1. These are:

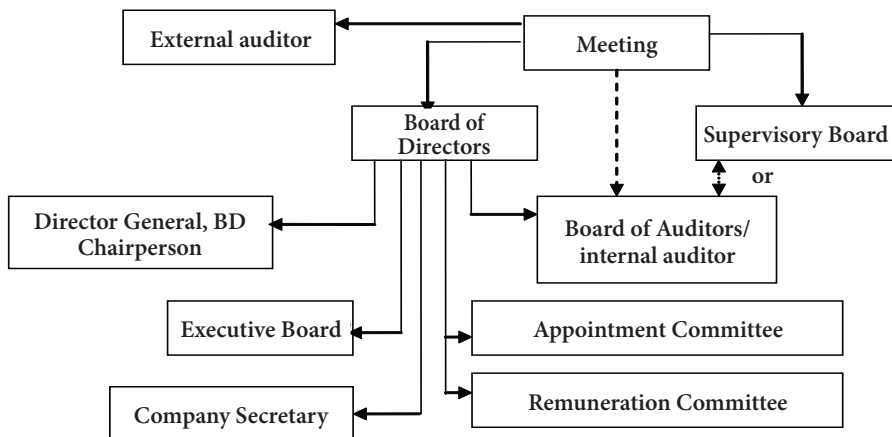
- Shareholders' Meeting (Art. 275, para. 1),
- Board of Directors (Art. 307, para. 2),
- Executive Board (Art. 322, para. 1),
- Supervisory Body (Supervisory Board, Board of Auditors or internal auditor, Art. 329. para. 1)
- Director General (Art. 323),
- Company Secretary (Art. 337)
- Board of Directors Committees (Appointment Committee, Remuneration Committee) (Art. 317)
- External (independent) auditor (Art. 333)

Shareholders' Meeting

The *Company Meeting* is composed of shareholders that, pursuant to the Company Articles of Association, are entitled, directly or through they proxy, to participate in decision making at the Meeting (Art. 275. para. 2). The Articles of Association may not deny this right. Instead, special mode of exercising it may be specified. The procedure, reasons and terms of convening the Meeting of open or closed public company and, for comparative purposes, limited liability companies, as well, are summarized in Table 2.

CL differentiates between regular (annual) and extraordinary Meeting of shareholders. The Meeting may be repeated with the same agenda for lack of quorum, but only once and within 15 days after a failed Meeting convention (Art. 292). CL stipulates the reasons to convene a Meeting upon a court order (Art. 278), mandatory shortest and longest terms for serving the summons, and the documents that should be furnished with the summons to each of the shareholders (Art. 281). CL leaves the selection of the Meeting venue to the company, but in dispositive provisions stipulates that the regular annual Meeting be held at the company seat (Art. 276, para. 3).¹¹⁶

Figure 1. Bodies of public company and their election



¹¹⁶ Companies with up to 10 members may hold the meeting using ICT equipment, Art. 296.

CL opens the possibility of establishing the date to set up a list of shareholders, i.e. composition of the Meeting, by the company Memorandum of Association or Decisions of the Board of Directors, if any. If there is neither, CL stipulates that it is the date at which the notification on regular Meeting is given, i.e. day on which the first request to convene an extraordinary Meeting is signed and dated (Art. 286).

Table 2. Procedures, reasons and terms to convene an Meeting of a company of capital

	ltd	Closed jsc	Open jsc
Regular/ annual			
• Held	• Once a year, not later than 30 June of the current for the previous year	• Once a year, 3 months after the financial statements are submitted to BD at the latest, but always before 30 June of the current for the previous year	• Once a year, 3 months after the financial statements are submitted to BD at the latest, but always before 30 June of the current for the previous year
• Venue	• Company seat or other	• Company seat or other, specified in the Memorandum of Association	• Company seat or other, specified in the Memorandum of Association
• Convening	• DG, BD or other, specified in the Memorandum of Association	• Specified in Memorandum of Association or convened by BD	• Specified in Memorandum of Association or convened by BD
• Invitation	• Personally, in writing, 15-7 days before the meeting date, or in other manner, if everybody agree	• Personally, in writing, 60-30 days before the Meeting date	• Personally, in writing, 60-30 days before the Meeting date, or at the website and daily newspaper (cumulatively) if specified so in Memorandum of Association

	ltd	Closed jsc	Open jsc
• Invitation contents	• Time and venue of the Meeting, proposed agenda, proposed decisions, substantiating materials	• Time and venue of the Meeting, proposed agenda, proposed decisions, substantiating materials	• Time and venue of the Meeting, proposed agenda, proposed decisions, substantiating materials
Extraordinary • Held	• As needed, always upon request of no less than 10% of membership or less as per Incorp. Doc.	• Upon request of BD or min. 10 of shareholders, and always in case of operational loss	• Upon request of BD or min. 10 of shareholders, and always in case of operational loss
• Venue	• The same as for regular Meeting	• The same as for annual Meeting	• The same as for annual Meeting
• Convening	• The same as for regular meeting, and members themselves may do so (min. 10%)	• The same as for annual Meeting	• The same as for annual Meeting
• Invitation	• The same as for regular Meeting	• Personally, in writing, 60-30 days before the Meeting date, and otherwise if all members agree	• Personally, in writing, 60-30 days before the Meeting date
• Invitation contents	• The same as for regular Meeting	• The same as for annual Meeting, specifying the reason for convening the Meeting	• The same as for annual Meeting, specifying the reason for convening the Meeting
Repeated	• Within seven days after the failed convening	• Only once, not later than 15 days after the failed convening	• Only once, not later than 15 days after the failed convening
Upon court order (non-contentious proceedings, to be resolved within 48 hrs after the application is filed)	• Extraordinary: Upon request min.10% of the membership if an extraordinary Meeting has not been convened upon their request	• Annual: upon request of shareholders with voting rights or DG/BD if it is not held • Extraordinary: Upon request of shareholder who asked for it, if it is not held within a 30 day term.	• Annual: upon request of shareholders with voting rights or DG/BD if it is not held • Extraordinary: Upon request of shareholder who asked for it, if it is not held within a 30 day term.

The Meeting may decide only pursuant to the pre-set Agenda proposed by the Board of Directors, but the shareholders with no less than 10% shares with voting rights may require up to two more issues to be included in the Agenda of the Meeting in the manner stipulated under the law (Art. 284).

The Meeting quorum is defined as the simple majority of shareholders with voting rights on the subject matter, but CL makes provisions that the Company Memorandum or Articles of Association may require a greater majority, as well (Art. 292).

The Meeting is chaired by the Chairperson who is elected at the outset of the meeting (if that is specified in the agenda) or the mode of his/her election is specified in the company Articles of Association (Art. 285). The Chairperson appoints a minute taker and members of the voting committee (Art. 288)

A share-holder may participate at the Meeting deliberations in person, or may empower a proxy. The power of attorney shall be in writing, and its content and mode of issuance are prescribed. It is valid for one Meeting, but may be extended to apply to the repeated Meeting, as well. It may be revoked at any time before the company Meeting or by personal attendance of the member exercising his/her voting right. The Director, members of the Board of Directors, members of the Executive Board and controlling shareholders may not be proxies for shareholders employed by the company, or related persons, but may be so for other shareholders (Art. 287).¹¹⁷

Referring to contracts that shareholders may conclude voting-wise, Article 295 of CL specifies only those that shall be treated null and void. These are contracts binding a shareholder to vote pursuant to instructions of the company or member of the Board of Directors, Executive Board or binding the shareholder to use his/her voting right in a certain manner or abstain from voting in exchange for benefits granted by the company or member of the Board of Directors, Executive Board or Director. This provision of the law may allow for a conclusion that all other contract may be legally valid.¹¹⁸ On the other hand, since CL does not specifically regulate these contracts, they should be governed by provisions of the law on obligations, so that the implementation or violation remains within the relationships of the contracting parties. Case law on these grounds would be a novelty and at this point of time it cannot be predicted with any certainty what would be the positions of courts in evaluation of liabilities of the parties and possible incurred damages. It can therefore

¹¹⁷ This concept is partially in collision with the concept of proxy's statement specified in Article 75 of the Law on Market of Securities and Other Financial Instruments.

¹¹⁸ This position is supported by Prof. Vasiljević in (*Comments to the Company Law*), JP "Official Gazette", Belgrade, 2006, pp. 572.

hardly be expected that these contracts may become a more important means for exercising or abuse of rights in the area of corporate governance.¹¹⁹

At the Meeting, simple majority of shareholders,¹²⁰ attending personally or through proxy, is usually sufficient for decision making, except if the Memorandum of Association specifies a higher number of votes and in cases where CL stipulates decision making by qualified majority (Art. 293, para. 1). CL specifies the qualified majority as no less than 2/3 of votes of shareholders with voting right on the issue that is at stake (Art. 293, para. 2).

Issues that require qualified majority in decision making are stipulated under CL as follows: changes in the Memorandum of Association (Art. 339), except for those that may be enacted by the Board of Directors (Art. 338), and company dissolution (Art. 345). Having in mind, however, the mandatory content of the Memorandum of Association (Art. 185) two third majority is needed in cases of the following changes: business name and seat, core activity, whether it is closed or open (except in cases in which this change is mandatory under law), amount of founding capital, number, nominal value, type and class of shares, powers and composition of the Board of Directors as well as any other provision that was entered into the Memorandum of Association pursuant to CL, and they want to change it subsequently (e.g. mode of voting of the Board of Directors members). In the light of these, it is obvious that ownership of no less than two thirds of shares is required for effective control of the company.¹²¹

The law stipulates secret ballot for election and dismissal of director, Board of Directors members, auditors and bankruptcy administrator, as well as voting on adoption of financial statements and remuneration of managerial staff and members of the Board of Directors, while the public vote is stipulated in all other instances (Art. 297).

Previous rules relate to shareholders with voting rights, i.e. owners of ordinary shares; they also relate to owners of preferential shares in cases in which CL prescribes the right and duty for them to speak up. These are situations in which a decision made affects the scope of rights associated with shares of a certain class (Art. 341). Moreover, the impact is exerted not only by decisions

¹¹⁹ In countries with developed market of capital, there are two types of these shareholder voting agreements – (1) pooling agreement and (2) voting trusts. The difference is that in case of pooling agreement the shareholders remain the title holders of the shares, while in agreement of voting trusts, the right to shares is transferred to the trustee, who is the registered title holder to such shares in the Company Register of Shareholders.

¹²⁰ Each ordinary share is associated with one vote (Art. 208)

¹²¹ In the sample of 204 public companies covered by this survey, 52% had a majority shareholder with two thirds stake in the company capital.

changing the features of these share, but also buy amendment of any right or privilege associated with the shares of that class. In these cases, CL prescribes a duty to convene a special Meeting of holders of that class of shares.

All detailed regulations of preparation and holding a shareholder's Meeting are directed to the protection of their right to truly participate in company management that may be jeopardized by the managerial staff or majority shareholders.

*Board or Directors, Board of Directors Committees
and Company Secretary*

The number of members of the Board of Directors of an public company¹²² shall be specified in the Memorandum of Association, ranging from 3 (min) to 15 (max) members (Art. 308). Members of the Board of Directors shall be elected at each annual company Meeting or at any other extraordinary Meeting convened for such election (Art. 309, para. 1). Thus, the term of office of the Board of Directors members is limited to one year, which is explicitly specified in Art. 311. The underlying idea of such solution is that in the course of transition and maturation of shareholding in Serbia easier replacement of the management should be provided. Members of the current Board of Directors, shareholders and Appointment Committee may nominate candidates for Board of Directors members.

Although CL establishes, in principle, that in an public company members of the Board of Directors shall be elected by cumulative vote, it is nevertheless provided that the company may regulate the voting method in its Memorandum of Association differently (Art. 309, para. 4).¹²³ The cumulative vote is defined in the usual manner: number of votes available to each individual shareholder is multiplied by the number of members of the Board of Directors, and the shareholder is entitled to award the total number of votes obtained in this manner to one candidate or distribute them among more or all candidates. Legislator's advocacy of the cumulative vote results from his intention to protect the minority shareholders accordingly, since the cumulative vote increases the chances of a candidate of minority shareholder to be elected into the Board of Directors.

¹²² Closed public company may opt to have either a Director or a Board of Directors. If they opt for a Director, provisions for public company relating to the Board of Directors shall apply to the Director of the closed public company, accordingly. (Art. 307)

¹²³ With closed public company the situation is converse: Such public company may specify cumulative vote in its Memorandum of Association.

The law also provides for a possibility to fill in a vacancy in the Board of Directors (between two Assemblies) by co-opting, except in cases when this method of filling in the vacancy is forbidden by the Memorandum of Association (Art. 311, para. 2). Although in cases in which the number of members of the Board of Directors is reduced below the half, CL stipulates that Meeting should be convened to elect new members (Art. 311, para. 2), it nevertheless does not limit the number of Board of Directors members who may be appointed by co-opting. Namely, if members of the Board of Directors leaving it are timely substituted by co-opting, it would be possible to have the membership completely replaced between two annual Assemblies. Only in an exceptional case in which over a half of the Board of Directors would leave at the same time, the company is obliged to convene an extraordinary Meeting to elect new members.

A member of the Board of Directors may be dismissed only by a decision of the shareholders' Meeting at the session convened in the prescribed manner where the dismissal is on the agenda. The dismissal may, but need not be substantiated. The shareholders right to replace a member of the Board of Directors is undoubtedly derived from their ownership right. Sufficient number of votes for dismissal depend on the mode of voting for the initial election, i.e. a simple or qualified majority of shareholders with voting right present at the company meeting. If members of the Board of Directors are elected by a cumulative vote, and not all of them are dismissed at the same time, sufficient number of votes for dismissal of one member is the number that would be sufficient to elect him, had all members of the Board of Directors been elected (Art. 327).

Listed public company must have in their Board of Directors a majority of non-executive staff, with at least 2 independent ones (Art. 310 CL).¹²⁴ Provisions regulating the membership of Executive Board suggest that not only the listed, public companies, but all public companies must have a majority of non-executive members (Art. 322, para. 5).

CL defines a non-executive member as a person who is not a member of the Executive Board. An independent person is the one that personally or

¹²⁴ Whether a company is treated as listed or not depends on the regulations covering the market of capital. The Law on Market of Securities and Other Financial Instruments does not clearly specify which public companies are affected by this provision of CL. It is only logical to assume that listed public company is a company present at the stock market (Art. 101. Law on Securities). Accordingly, this provision in Serbia will be binding for three companies only: Energoprojekt holding a.d., Soja protein a.d. and Tigar a.d. All other public companies are on the so called over-the-counter (OTC) market.

with family members has not been employed by the company in the last two years or has paid to or received from the company an amount exceeding EUR 10,000, does not own more than 10% shares or stakes in the person that paid to or received from the company the amount specified above, has not been a manager or member of the Board of Directors of the company, except in an independent capacity, and has not been an external auditor of the company. At the time of election and during the term of office, independent members may not be employed by the company, while the non-executive members may be so (Art. 325, para. 1 and 3).

Inclusion of the concept of (non)executive and (in)dependent members of the Board of Directors, the CL went along the global streamline, i.e. prescription of the Board of Directors composition. It has, however, remained controversial in reference literature. Namely, it violates the right of company owners to elect the managing body as they choose, while on the other hand there are no empirical proofs that such regulation contributes to promotion of the Board of Directors operations and corporate governance in general.

Convening and chairing the Board of Directors sessions is the duty of the Chairperson, who is elected by the Board of Directors itself and may dismiss him/her at any time, without any limitations whatsoever (Art. 312). However, the Memorandum of Association or Articles of Association may specify alternative election. The Board of Directors Chairperson is also the company Director General, unless the Memorandum of Association or Articles of Association stipulate otherwise. Also, the Memorandum of Association or Articles of Association may vest the powers of the company president with the Board of Directors Chairperson.

Thus, it is possible that a company has a Board of Directors Chairperson and Director General, and it is also possible that the Board of Directors Chairperson be the Director General and Company President at the same time. The law, however, does not prescribe a special role for the Company President, beyond the one vested with his role of the Board of Directors Chairperson, so that one may conclude that the position is more of the status nature, than of any practical significance.

In the period between two regular annual sessions of the Meeting, the board has to convene at least four times (regular sessions). The last regular session has to be held not later than two months before the annual shareholders' Meeting which is determined and harmonized with the terms for convening the annual shareholder' assemblies. The number of extraordinary sessions of

the Board of Directors is not limited. The Chairperson may convene them at his discretion or upon written request of no less than one third of the membership, who may also convene the Meeting if the Chairperson fails to do so. The invitation for the session has to be in writing, and served no less than 8 days before the session is due. The term may be shorter if the reason to convene it is urgent, as specified in the Memorandum of Association or Articles of Association. Irregular invitation of a member of the Board of Directors is disregarded if he is present at the Meeting, except if he attends to protest the regularity of convening the Meeting (Art. 315). The sessions may be held with the use of communication equipment, except in cases when such possibility is ruled out by the Memorandum of Association or Articles of Association (Art. 316, para. 1)

If the Memorandum of Association or Articles of Association do not require otherwise, majority of the total number of members make the quorum for deliberations and decision making at the Board of Directors sessions; majority of present members are sufficient for decision making, and in case there is a tie, the Chairperson's vote shall decide (Art. 319). Decisions come into force as of the enactment date, and are entered in the Decision Ledger without delay.

CL allows that a decision is treated as enacted even without the session held, if such decision is not contested in writing by any of the Board of Directors members (Art. 316, para. 2). The law, however, fails to specify how the Board of Directors members that did not participate at its enactment are to be notified thereof.

Board of Directors of a public company has to set up two *committees: Appointment Committee and Remuneration Committee*. The former proposes candidates for members of the Board of Directors and Executive Board, and the other remuneration policy for managerial staff and auditor. In terms of membership, eligibility requirement for membership, election and dismissal procedures and other issues relevant for operations of these committees, CL requires only that the committees must have at least three members each. Everything else is left to the discretion of the Board of Directors or the company Articles of Association. (Art. 317).

CL requires that a public company has a company Secretary, who is elected by the Board of Directors, while the term of office is specified in the Articles of Association, while the earnings and other rights are regulated under a contract concluded with the Board of Directors, upon advice of the Chairperson (Art. 337). The main duty of such Secretary is to organize and monitor

preparation of the sessions, take the minutes, keep the Decision Ledger of the Meeting, Board of Directors and Executive Board, as well as keep all documents specified in the law or Memorandum of Association, except for the financial documents (these are explicitly listed in Art. 342).

Mandatory establishment of a secretary function in an public company is one of CL innovations in comparison with the Law on Enterprises, in concert with the legislative intention to increase transparency and introduce modern rules of operation into the public companies in Serbia that are in practice only in their infancy. If nothing else, the company Secretary is a known address at which shareholders, auditors and other entitled persons may seek information.

Executive Board and Director General

Any public company has to set up the Executive Board composed of executive managers. The Executive Board members, i.e. executive managers are elected by the Board of Directors, which may dismiss them at any time, without any limitations whatsoever. The Memorandum of Association or company Articles of Association may specify powers and duties of the Executive Board members (Art. 322). Executive Board members are elected from the ranks of the Board of Directors, but may also involve other company employees (Art. 322, para. 5). The executive managers have to be company employees (Art.325, para. 2).

Director General of the company, elected by the Board of Directors chairs the Executive Board (Art. 323). Thus, the Executive Board Chairperson is also the company Director General, but the Director General may also be the Company President and Board of Directors Chairperson, as well.

The Law does not set any limitations as to the number of Executive Board members. Assuming that the legislator intended to set up a collective body, the Executive Board may not be composed of fewer than 3 members. If a company wishes that all Executive Board members are also the Board of Directors members, which may have up to 15 members, where over a half have to be non-executive staff, an Executive Board may have 7 members at most.

Internal supervision and control

CL stipulates that a listed public company¹²⁵ establishes a function of internal control and supervision, but also gives the freedom to choose whether this will be accomplished by a Supervisory Board, Board of Auditors or an internal auditor (Art. 329, para. 1). Thus, CL introduces an option of the so-called single-chamber model for management of public companies in Serbia, contrary to the previous Law on Enterprises requiring a two-chamber system, i.e. mandatory establishment of a supervisory board.¹²⁶ Mandatory Supervisory Board may, however, be required for certain businesses, pursuant to the law (Art. 329, para. 2). Closed public companies however, are bound to a single-chamber system, since this type of company may decide to introduce a Board of Auditors or an internal auditor in their Memorandum of Association or Articles of Association.

If they decide to set up a Supervisory Board, the first Chairperson and members shall be appointed by the Memorandum of Association, and all other shall be elected and dismissed by the shareholders' Meeting. The Chairperson and members of the Supervisory Board are elected by a cumulative vote, unless the Memorandum of Association or Articles of Association stipulate otherwise. The mode of voting for dismissal depends on the mode of election and shall follow the same procedure that is used for dismissal of the Board of Directors members. Members of the Supervisory Board may not be members of the Board of Directors, and all members shall meet the requirements for an independent member of the body (Art. 330). Supervisory Board shall be composed of no less than three members.

CL does not limit the term of office of the Supervisory Board members which, contrary to the Board of Directors members, need not be dismissed and elected at each annual company Meeting. Also, CL does not specifically regulate the method of convening, operations and decision making procedures

¹²⁵ If we assume that in Serbia listed public companies are those that are on the stock market, only three previously mentioned companies would be obliged to do so.

¹²⁶ Three systems may be differentiated according to the manner in which a supervisory body is established. In the so-called single-chamber system, supervisory board is not a mandatory body, but the auditors (external or internal) perform the controlling function. In the so-called two-chamber system, two boards are mandatory: managing and supervisory, where members of both are elected by the company Meeting. In this system, the controlling function is performed by the auditors, in addition to the supervisory board. In the third system, the Meeting elects the supervisory board, which in turn elects the Board of Directors, although it is possible to have the Meeting elect the Board of Directors, as well, see M. Vasiljević – *Komentar Zakona o privrednim društvima* (Comments to the Company Law), Official Gazette, Belgrade, 2006, pp. 518-521

for the Supervisory Board. Instead, the law refers to pertinent implementation of provisions relating to the Board of Directors (Art. 332, para. 6).

If the company opts to introduce a function of an internal auditor or Board of Auditors, the first internal auditor or members of the Board of Auditors shall be specified in the Memorandum of Association, while all subsequent ones shall be elected from the ranks of independent members of the Board of Directors. The Board of Directors does not have sufficient number of independent members, the company meeting shall elect the rest. Internal auditor or members of the Board of Auditors shall be dismissed following the same procedure as for their election.

CL clearly stipulates the mandate of one year for the internal auditor or members of the Board of Auditors who are also members of the Board of Directors, i.e. they are elected at each annual Meeting together with other Board of Directors members. The law, however, fails to specify the duration of term of office of these persons when they are elected directly by the Meeting, so that one may assume that these issues have to be regulated in the Memorandum of Association or Articles of Association.

In addition to requirements specified for an independent member of the Board of Directors, these persons have to fulfill special eligibility requirements stipulated under the law. The Accounting and Auditing Law stipulates the following criteria: university degree, minimum three years of auditing experience, i.e. five years of accounting experience, certification (passed exam for chartered auditor), and clean criminal record, i.e. no convictions for crimes that would make him/her unworthy of these duties (AAL, Art. 4, para. 5).¹²⁷

Auditor and Expert Fiduciary

Introducing a duty for any public company (open and closed, alike) to have an auditor, and duty to notify the auditor on any company Meeting at the

¹²⁷ Article 4, AAL. The new AAL with this provisions was enacted in 2006, i.e. in the year in which the deadline for companies to comply with CL expired. From the enactment of CL in late 2004 until that time, it was not clear what these special requirements are for an internal auditor or members of the Board of Auditors. The problems have not been resolved with enactment of the new AAL, either. Introducing a special professional title of a certified internal auditor, AAL stipulates that the Chamber of Chartered Auditors issues a special certificate substantiating the title, which is preceded by an exam also set up by the Chamber. Another year was needed to set up the Chamber and commence operations. Accordingly, only in mid 2007 there were no persons in Serbia meeting the requirements for the post of an internal auditor or members of the Board of Auditors. Even now, their number is quite small and limited by the capacity of the Chamber to organize and conduct exams and issue pertinent certificates. Refraining for more thorough elaboration of this issue, we have to say that provisions of AAL infer that persons with international certificates and corresponding exam passed abroad are not considered qualified in Serbia to pursue the job of internal or external audit.

same time and in the same manner as any other shareholders, CL refers to the law covering accounting and auditing, i.e. AAL (Art. 333) for regulations on the auditor's position and powers.

CL also regulates that the company Meeting elects the auditor (Art. 290, para. 1, item 8), which is a means to protect the shareholders, but fails to specify whether he is to be elected at each annual Meeting. However, AAL prescribes that audit of financial statements may be conducted by a single auditing company for five consecutive years at most, i.e. up to five more years if the audit is conducted by other chartered auditors of the same company, the so-called rotation of auditors (AAL, Art. 38, para. 8 and 9). Practically, this makes it possible for the same auditing company to conduct audit of financial statements for up to ten years, which is aimed at prevention of excessive bonding of the company and its auditor, which may incur adverse consequences.

AAL specifies that a (chartered) auditor is an independent professional performing the audit and is responsible for proper conducting of the audit, composing audit reports and expressing auditor's opinion pursuant to the International Auditing Standards and AAL (AAL, Art. 4, para. 2). The same requirements apply for this title and for the title of certified internal auditor (AAL, Art. 4, para. 3). For a chartered auditor to audit financial statements, it is necessary to have a pertinent license (AAL, Art. 38), which is issued, renewed and cancelled by the Chamber of Chartered Auditors,¹²⁸ and with endorsement of the Minister of Finance prescribes the pertinent requirements and procedures (AAL, Art. 39).

AAL also specifies the circumstances under which an auditing company, i.e. an auditor as a natural person, may not conduct audit of a legal entity, i.e. conflict of interest in this area (AAL, Art. 45). AAL recognizes the conflict of interest in cases of ownership relation between the auditing company and/or auditor and audited company, as well as in case of kinship (blood relative, in-laws or legal kinship) between the auditor and founder and/or company management (blood relative in the straight line, of any degree; in the side line up to the fourth degree; spouse or in-laws up to the second degree, regardless of

¹²⁸ ALL stipulates the following reasons to set up the Chamber: promotion and development of accounting and auditing profession, implementation of international accounting and auditing regulations and harmonization with such regulation, protection of individual and general interests in the area, organization and service providing in this area, organization and conducting the exams for professional titles, issuance and cancellation of licenses for auditing of financial statements. All chartered auditors employed by auditing companies and certified internal auditors, as well as auditing companies themselves are members of the Chamber, which is a legal entity. (AAL, Art. 50)

possible marriage breakup; adopted children or adopted parents of founders or directors of audited company, as well as guardian or foster parent of founder of audited company).

Since the Remuneration Committee also proposes the remuneration policy for auditors (Art. 317, para. 3, item 2), and since the company Meeting adopts the remuneration policies for Board of Directors members only (Art. 290, para. 1, item 5), CL provisions actually stipulate that the Board of Directors negotiates the amount of remuneration for auditing services.

In addition to auditors, validity of financial statements may also be evaluated by an expert fiduciary who, in terms of expertise and title, has to comply with requirements for auditors. An expert fiduciary is appointed by the Meeting upon request of owners of no less than 20% of the company equity (Art. 334).

CL does not specify special reasons that may entitle the shareholders to appoint an expert fiduciary. It appears, accordingly, that the right is derived from the very fact that representatives of a sufficient share of equity require additional check of validity of company books and financial reports.

The “sufficient” amount is double the 10% that is required to convene an extraordinary Meeting, whereby the legislator decided to link this option with a more substantial majority of minority shareholders. At the same time, the percentage is still sufficiently low to be accessible to the minority shareholders even in companies where the majority shareholder owns over two thirds of equity and statutorily can control all the issues that require qualified majority for decision making.

CL stipulates that, in principle, the term of office, rights and duties of an expert fiduciary may be specified in the Articles of Association or decision of fiduciary’s appointment (Art. 334, para. 7), but it is explicitly established that he is authorized to review the books and financial statements, take statements from the management, and that all persons that he approaches asking for information are obliged to provide such information (Art. 335). The company management is obliged to put the fiduciary’s report on the agenda of the first following meeting, and if the report shows any major violations of statutory or company regulations, the management must convene an extraordinary Meeting without delay.

If the fiduciary’s report, instead, substantiates proper accounting and/or financial statements, the request to conduct a special audit shall be deemed unjustified. Shareholders requesting it, had they done it *male fide* or by gross negligence, shall be jointly liable to the company for the damage incurred by it (Art. 336).

Distribution of competences in public company

CL dedicates a whole article to the scope of work, i.e. competences of the company Meeting, Board of Directors and Supervisory Board (Meeting, Art. 290, Board of Directors, Art. 313, Supervisory Board, Board of Auditors or Internal Auditor, Art. 332). Statutory distribution of competences of these and all other bodies of an public company may be discussed only in the context of other legal provisions. Table 3 presents a review of competences of the Meeting, Board of Directors, Executive Board, Director General, and Supervisory Board of an open joint stock company.

Table 3. Competences of bodies of public company

Meeting	Board of Directors (MB)	Executive Board (EB)	Director General (DG)	Supervisory Board (SB)/Internal Auditor (IA) and Board of Auditors (BA)
<ul style="list-style-type: none"> • Changes of Memorandum of Association (MA): particularly equity changes • Status changes • High value property • Distribution of profits/coverage of losses • Adoption of financial statements and reports of Supervisory Body • Remuneration policy for BD members • Election and dismissal of BD members • Election and dismissal of auditor • Questions upon proposal of BD • Other from MA 	<ul style="list-style-type: none"> • Control of truthfulness of financial statements, supervision of EB • Development management, business planning • procura • Convening the meeting: <ul style="list-style-type: none"> - proposal of agenda and decisions, - shareholders' day with right to attend the Meeting • Distribution of profits/coverage of losses (MA) • Issuance of securities within the limitations of MA and CL • Establishment of value of shares and other assets pursuant to CL • Election, dismissal and remuneration of EB members • Day, amount, terms and mode of dividend payment (MA) • Other from MA 	<ul style="list-style-type: none"> • Implementation of BD decisions • Running current business • Reporting to BD • Matters delegated by MA or BD decision that are not within the scope of competence of the Meeting or BD 	<ul style="list-style-type: none"> • Convening and chairing the EB meeting • Representation of the company • Responsibility for books and internal supervision 	<ul style="list-style-type: none"> • Reporting to the Meeting on: <ul style="list-style-type: none"> - accounting practice - compliance of operations with regulations - eligibility of independent auditor - contract of the company BD members and/or related persons • Together with BD deliberations on: <ul style="list-style-type: none"> - remuneration for the independent auditor - financial statements - reporting to shareholders - compliance with code of ethics - pertinence and statutory compliance of business policies - responses to objections

It should not be overlooked that CL leaves a fairly broad leeway for companies to regulate one of these issues in their Memorandum of Association or Articles of Association (MA). The only exception is statutory definition of the scope of work of the Supervisory Body, where such leeway is not given.

Thus, in addition to competences of the Meeting presented in table 3, the company Memorandum of Association may specify others as well, and some may be delegated by a Board of Directors decision. Also, unless otherwise specified in the Articles of Association, the list of issues that the law specifies as the field of competence of a Board of Directors (presented in Table 3) under normal circumstances, i.e. in absence of any judicial dispute, may not be taken by the Meeting unless the Board of Directors itself requires so. On the other hand, although it is allowed that the Memorandum of Association or decision of BD establish special issues to be the scope of authority of the Executive Board, CL clearly stipulates that these issues may not be the ones that are otherwise within the scope of competence of the Meeting or Board of Directors.

Generally, review of the position of bodies of an public company substantiates that CL practically vested the competence in the Meeting to control the key, one may say decisive, issues for the company. These are amendments to the Memorandum of Association, status changes and disposal of high value assets.¹²⁹ Although within the powers of the Meeting, adoption of financial statements and distribution of profits, i.e. coverage of losses (Memorandum of Association may also delegate the latter to the Board of Directors) are essentially under the control of the Board of Directors that prepares such reports and is much more familiar with the details of the reports than the shareholders, so that it may present in to the Meeting accordingly. Thus, the second key leverage of control that CL assigns to the Meeting is the election and dismissal of the Board of Directors members, and election and dismissal of the company external auditor.

Assuming that expertise and time they dedicate to the issues of company managing are the Board of Directors strengths, the legislator decides to give the broadest freedom to the body in the manner in which the competence will be used. By allowing that members of the Executive Board may also be members of the Board of Directors, CL aims at optimization of the cost of coordination and transfer of information in the company management.

On the other hand, by requiring that the Board of Directors has a majority of non-executive members, i.e. those that are not concomitant members of

¹²⁹ CL defines high value assets as property the market value of which at the moment of decision on acquisition/disposal is made accounts for no less than 30% of the company market value as presented in the last annual balance statement (Art. 442).

the Board of Directors, CL tried to place the company management beyond the direct control of the executive power in the company, which is given the primary role of enforcement of decisions and implementation of Board of Directors policies.

If a company has no supervisory board, and since the internal auditor and members of the Board of Auditors may also be members of the Board of Directors, the Board of Directors is directly in charge not only of the supervision, but also of internal control of the company operations.

In addition to the right of representation and accountability for books and internal supervision, the Director General who is also the Chairperson of the Executive Board, derives his competences from the functions he performs in the company. In cases when he combines the chairing functions in both Board of Directors and Executive Board, the Director General plays a key role in the actual control of company business. In such cases, the Director General functions concentrate competences of both boards, and he gets a powerful tool for managing and administering company operations, which may hardly be expected to be restricted by the remaining members of both boards.

In distribution of competences CL tried to offer the possibility to the company meeting to play an active role in enforcement and protection of the principal's rights, but avoided to call the Meeting the supreme company body.¹³⁰ It is therefore obvious that the piece of legislation adopted the principle of conditional hierarchy whereby each body is independent within its scope of work. The principle of the scope of work is, thus, the foundation for distribution of roles among the company bodies and has been consequently implemented through the pertinent legal provisions, where the Meeting is given an additional leverage – election of the Board of Directors and, indirectly, all other company bodies.

Duty to inform, fiduciary duties and remuneration policy

According to the above, CL entrusts the Board of Directors with the crucial role in control over an public company. It means that realization and protection of interests of shareholders and company itself depend substantially on professionalism, commitment, activity and honesty of Board of Directors

¹³⁰ Prof Vasiljević in M. Vasiljević - *Komentar Zakona o privrednim društvima* (Comments to the Company Law) Official Gazette, Beograd, 2006, pp. 534 substantiates the position that the lack of such definition and any direct definition of the company meeting, except that it is composed of company shareholders, is quite intentional.

members. In order however, to exert legal pressure on the management to honor and protect these interests, CL introduces a series of provisions to secure the right of shareholders to request and obtain information on company operations, establish duties of the management and provide for transparency of remuneration policy for the management,

Duties of the company management to provide information to the shareholders

Already in its first part, in the basic provisions CL established the duty of a company to notify the founders and shareholders on its operations and enable insight into the information or documents that the CL and, accordingly company articles require to be accessible. Should they fail to do so, the competent body or authorized person of the company shall be considered liable for damages incurred to company founders or shareholders, who may also resort to court, i.e. non-contentious procedure to exercise their right to information and access to company documentation (Art. 43).

Importantly, the right that CL grants to owners of all companies, including the shareholders, is not determined by the size of their stake in the company equity. In other words, ownership of a negligible tiny percentage of the company equity entitles one to access to all business information and business records.

Interestingly enough, CL does not apply the same principle to the duty to keep business secret (Art. 38). Namely, CL specifies liability for damages incurred to the company by disclosure of business secrets for controlling shareholders only, i.e. those who own over 50% of ordinary shares (ref. Art. 31, 38 and 367). Since the right to information and insight into the business records is not limited by the size of stake in the capital, we suggest that liability of shareholders for damages incurred by disclosure of business secret should also be independent on the size of their stake.

In addition to this general right, CL stipulates a special right of shareholders to be informed (Art. 289). This CL provision explicitly requires the Board of Directors to submit a timely and complete report to the annual Meeting on the company operations, focusing the financial statements, and in case the company bought back own shares presents the pertinent data to the shareholders. In case a shareholder is denied this right, regardless of the number and relative importance of his shares, he may resort to court to exercise this right.

In an effort to relieve any possible misunderstanding as to which documents should be accessible to shareholders, CL specifies a list of documents

that have to be kept, for how long, and place of storage so that they are accessible to the shareholders (Art. 342). In addition to the Memorandum of Association, Articles of Association and all pertinent amendments thereof, financial statements and accounting records, they also include, *inter alia*, minutes and decisions of the Meeting, Board of Directors and Executive Board, Supervisory Body, list of all transfers of shares from shareholders, including all liens and other transfers of shares where the acquirer does not become a shareholder.

Such a long list of documents that a company has to keep for no less than five years (except for the Memorandum of Association that is kept indefinitely) at the location known and accessible to shareholders suggests that CL complies with the First EU Directive on Transparency of operation of companies of capital.¹³¹ Some of these documents, however, are governed by regulations of securities market and should be regularly furnished to the organized market of capital. At this market, potential investors, in addition to the shareholders may get information and have access to these documents, which is equally important in respect to public companies.

Any company is obliged to place these documents at disposal and enable copying to the shareholders and previous shareholders for the period in which they were shareholders (Art. 343). The only requirement the shareholders have to meet is to have valid evidence of their status that the company is entitled to require before allowing the insight into the documentation.

If the company management does not provide access to the required documents five days after the pertinent application, or rejects the application, any shareholder or a previous shareholder may resort to court and claim their rights in a non-contentious procedure. The court shall decide on such claim within a three-day term, while a person obtaining the right through court is prohibited from publishing or disclosing them and inflict damage to the company, accordingly. CL, however, does not specify the mode of establishing liability and damages in case it nevertheless happens (Art. 344)

Duties of management to the company

CL establishes four main duties of members of the Board of Directors, Executive and Supervisory Boards, as well as members of the Board of Auditors and internal auditor to the company. These are:

- Duty to operate in the company interest (Art. 31),
- Duty of care and business judgment rule (Art. 32)

¹³¹ First Directive EU, Art. 2 and 3.

- Duty of loyalty (Art. 33), and
- Duty of confidentiality (keeping business secrets) (Art. 38).

Duty to operate in the company interest is also established for controlling shareholders, meaning that the management has to represent interests of the company as a special entity, and only in this manner, i.e. indirectly, the interests of its owners – shareholders. In other words, representation of individual interests, even if they are interests of shareholders would collide with this legal provisions. Thus, an issue arises as to whether there is a company interest that is independent of the interests of its owners? If the company is treated as a network of agreements and interests of different groups, shareholders and creditors, employees and the company management itself are the stakeholders. Also, the community in which the company operates may also have some respective interests, and it usually has. Does, therefore, this legal provision basically requires the management to balance these interests and combine them into a new, special interest of the company itself? Regardless of the answer to the question, it is difficult to expect any management to behave like that in practice. The provision may, accordingly, be treated as one of (idealistic) principles with little direct impact on behavior of the management. Provisions that specify behaviors in the interest of the company are much more important, together with those that recognize and sanction the opposite ones.

Provisions on duty of care and business judgment rule, duty of loyalty and duty of confidentiality (keeping the business secrets) are such stipulations. The first one relieves from responsibility any person that operates in the best interest of the company, basing the judgment on the information and opinion obtained from experts in the area. In other words, the management may be relieved of liability for their business decisions if they may prove to have made them carefully and conscientiously taking into account all relevant facts. Duty of loyalty clearly defines obligation of the management not to use the company assets for their own needs, and not to use (i.e. abuse) insider information and position for their personal gain. The third provision establishes liability of persons for damage incurred to the company by disclosure of a business secret that is, in turn, defined as information specified in a company document that may inflict substantial harm to the company if disclosed to third persons.

By prescribing these four duties, the legislator wanted to stimulate the management to operate in the best interest of the company, i.e. the shareholders, since conversely, one may file against the violators and claim for compensation damages. Such threat is not particularly effective in the most developed

countries either, since courts usually tend to refrain from evaluation of complex issues of pertinence of business and similar decision, so that we, in Serbia cannot expect much, either, except in cases of obvious and gross offences.

In an effort to stimulate sound business judgment CL opens a possibility for the Board of Directors to adopt a written code of conduct (corporate governance guidelines) or adopt any other code that establishes the standards of qualifications, independence, responsibility, good judgment, conflict of interest, remuneration policy and related issues, and that report on any annual meeting on compliance of operations with the adopted code (Art. 318).

By a definition of personal interest, i.e. situations of conflict of interest (Art. 34), CL establishes the manner in which a legal transaction involving a conflict of interest may be authorized, including its nullity if not properly authorized (Art. 35). In provisions on public companies CL additionally focuses situations in which the voting right is denied due to conflict of interest of shareholders (Art. 300), or a member of the Board of Directors (Art. 320). A shareholder is not entitled to vote in cases of decisions on decrease or relief of his duties to the company, initiation or dismissal of a case against him, and authorization of transactions in which he has conflict of interest with the company. A member of the Board of Directors shall be denied the voting right in case of issues generating conflict of interest, applying *mutatis mutandis* provisions relating to a company shareholder.

The law also establishes prohibition of competition (Art. 36) specifying the capacity in which members of the management may not operate in a competing business. Finally, CL regulates legal consequences of the violation of the prohibition of competition rule prescribing that the deals and pertinent income and claims shall be recognized as transactions on behalf of the company. CL grants this right to any shareholder with no less than 5% of the company basic capital if he claims it through court 60 days after the discovery of the violation or three years after the violation date, at the latest.

In an effort to sanction behavior inconsistent with the stipulated principles of duty, CL explicitly prohibits that persons with history of conviction for crimes in economy or business and those violating CL provisions on limited payments be elected, *inter alia*, for members of company managerial bodies (Art. 45).

CL establishes cases of special material liability of members of the managing and executive boards (Art. 328). They will be jointly and severally liable for compensation of damages incurred to the public company by violation of their

duties stipulated under the law. These are, *inter alia*, duties listed at the beginning of this section. Thus, CL additionally specifies liability of the company management for inloyal and unfair conduct.

Thus, the rules introduced by CL establish clear limitations and/or stimulations for certain behaviors of the company management. However, motivation of an individual, and in particular management of a company is tightly linked to direct material stimulation, i.e. pertinent remuneration policy. The theory elaborating the principal-agent problem, i.e. opportunistic behavior of the agent, focuses the manner in which the agent's, i.e. management's remuneration is set as a means to overcome the problem, which is the best way to match the interests of the management with the interests of the principal (shareholder).

CL has not elaborated the area in great detail maybe because the law primarily established duties to the company, instead to its owners. In addition to binding Board of Directors of public companies to establish remuneration committees, CL only stipulates that the scope of duties of the shareholders' Meeting includes adoption of the remuneration policy for the Board of Directors members (Art. 290, para. 1, item 5); also, approval of the contract with members of the Board of Directors (who are not employed by the company) and members of the Executive Board must be approved by the Meeting (Art. 325, para. 5 and 6). Consistently with the commitment to full transparency of the information on operation of public companies, CL opens the possibility that these contracts, as well as the amounts of remuneration of the management be included in the report submitted to the annual meeting and published pursuant to regulation on securities market (Art. 325, para. 6).

The role of courts and case law

Types of claims and role of court

In its basic provisions, CL specifies persons who may file and grounds on which they may file an individual (Art. 40) and derivative action (Art. 41), or both (Art. 42).

The right to file *an individual action (lawsuit)* on his own behalf against any persons that CL specifies to have duties to the company (controlling owner, members of the management and supervisory body – Art. 31) is granted to a member or shareholder of a company for compensation of damages that such

person has caused by violation of the legally specified duties. The lawsuit may be filed by several persons jointly.

Derivative action for compensation of damages to the company, i.e. action on one's behalf but on the account of the company may be filed by a member or shareholder of a company against any persons that CL specifies to have duties to the company. It is assumed that a company suffered damage due to the fact that these persons operated contrary to their statutory duties. In this case, it is required that a member or a shareholder fulfills two more requirements before filing the lawsuit. One is to have individually or together with other persons joining the action no less than 5% of the company registered capital. The second is that before filing the action, the plaintiff has addressed the commercial court in writing asking to file a lawsuit, where this request was either dismissed or has not been complied with 30 days after the filing date. Proceedings pursuant to derivative action may not be settled out of court. Compensation of damages in the derivative cases is ruled to the company, and the person filing the action is entitled to reimbursement of the incurred costs.

CL allows simultaneous filing of individual and derivative actions, where limitations pertinent to the derivative action do not apply to the individual one.

CL does not explicitly recognize a *class action*, i.e. action that although filed by one person, protects interests not only of the filing person, but also by all other persons in the same position. However, on two occasions, the law recognizes the possibility of such action. First, in Article 306, para. 11 stipulating that a ruling annulling a decision of the shareholders' meeting is effective on behalf and against any shareholder and binding for relationships between shareholders and company on the one hand and company and management on the other. Secondly, in Article 444, para. 11 which stipulates that a ruling relating to the rights of shareholders in dispute is binding not only to the filing party, but also to all other shareholders holding the same position.

When derivative actions are concerned, CL established grounds to file them in case of violation of the rule of conflict of interest and prohibition of competition (Art. 37), business secret (Art. 38), statutory duties of the management (Art. 328), and in case of request for special audit in bad faith or with gross negligence (Art. 336)

CL prescribes court protection in the following situations, as well:

- Violation of shareholders' right to information, when the court, upon request, orders the right to be enforced (Art. 43);

- In case an annual or extraordinary shareholders Meeting is not convened, the court may, upon request of entitled persons (in case of annual Meeting, any shareholder who is entitled to attend or any member of the management and in case of an extraordinary Meeting, shareholder who filed a pertinent request to that effect) appoint a temporary representative with powers to convene and chair the Meeting and set the time and date of the Meeting, as well as the pertinent agenda, where a decision to that effect is made 48 hours after the receipt of the request at the latest (Art. 278);
- In case two items, properly requested by entitled shareholders, are not introduced in the Meeting agenda, the court shall rule to introduce them 48 hours after receipt of the request at the latest (Art. 284);
- In case of violation of right of shareholders to special information, the court shall order that the information be provided to the shareholder who submitted the request 15 days after the date of the shareholders' Meeting at the latest (Art. 289);
- In case the Meeting fails to appoint a fiduciary expert upon request of an entitled person (shareholders with no less than 20% stake in the capital), the court may appoint one upon request of an entitled person filed within 15 days of the Meeting date, having previously provided opinion of the company management (Art. 334);
- In case insight into books and documents stipulated under the law and/or company documents is prevented, the court shall order the right to be exercised (Art. 344).

CL entitles shareholders to file to court for annulment of decisions of the shareholders' meeting, establishing the grounds for such annulment. The grounds for annulment may be general or special. The general include decision made at the Meeting that was not convened pursuant to the law, Memorandum of Association or Articles of Association, mode of enactment of such decision or collision of the decision with these documents (Art. 302, para.1). A lawsuit may be filed on these grounds by any shareholder who voted against such decision, as well as by those who were not properly invited or were not attending the Meeting at which the decision was made due to a justified reason; it may also be filed by any member of the Board of Directors and Executive Board. Special grounds for annulment include annulment of election of the director or member of the Board of Directors (Art. 303) and annulment of decision on adoption of financial statements (Art. 304).

CL (Art. 306) established that proceedings pursuant to such lawsuit are urgent, that court may enforce a temporary measure of suspension of enforcement of the shareholders' Meeting decision that is contested, if the court finds that the enforcement of such decision may incur "substantial damage" to the company and shareholders, and that the ruling annulling the contested decision is in favor of and against all shareholders and is binding for mutual relations of shareholders, company and company bodies.

CL stipulates special protection of rights of dissenting shareholders (Art. 444) if they were entitled to vote, voted against or abstained in the voting on: amendments to the Memorandum of Association changing their rights, status changes of the company or change of the company legal form, decision on disposal of high value property, and any other matter where the Memorandum of Association prescribes the right to dissent and compensation in case of dissent. In these cases, a shareholder is entitled to request the company to buy out his shares at the market value, and the company is obliged to comply 30 days after the request at the latest. In case the company fails to comply with such request or buy the shares at a price that the dissenting shareholder believes to be below the market value, the dissenting shareholder is entitled to file an action to the court. If the court rules that the market value is higher than the one paid by the company, the same ruling shall apply to all dissenting shareholders, and not only to those filing the action. This court ruling is published in the manner in which the summons to the shareholders' Meeting are published, notifying all shareholders, accordingly.

Claims from the company or company debtors and company claims against members, debtors and third parties shall expire 180 days after the date of becoming aware of the reasons for such claims, and three years after the payment due date at the latest unless law stipulates otherwise for special claims (Art. 47). It means that CL stipulates the subjective statutes of limitations of three months and objective of three years, leaving the option that other laws applicable to special kinds of claims may be invoked and other pertinent statutes of limitations applied.

Case law

CL stipulates that commercial court with the jurisdiction at the seat of the company shall be competent for resolution of disputes resulting from this piece of legislation. Generally, the court rules in non-contentious proceedings. The

case is treated as urgent, and the court in the first instance is required to decide within 60 days of the receipt of the request, or even sooner pursuant to CL. An appeal may be submitted within eight days. A court in the second instance is obliged to rule upon the appeal within 30 days after receipt of the appeal, while appeal against this decision does not suspend its enforcement (Art. 46)

There are 17 commercial courts in charge of proceedings relating to CL, and one higher commercial court that rules on appeals. In addition to cases referring to CL, they are also competent for other disputes in the area of economy. Large number of diverse cases and absence of systematically pooled and classified documentation makes it almost impossible to have complete insight into any type of disputes, including those resorting to CL. Therefore, in continuation, the case law based on the issues stipulated in CL will be illustrated through decisions of the Higher Commercial Court, in the period 2005 to 2008. Although it may mean that a substantial number of issues presented to the court is not covered, since the Higher Commercial Court deals with appeals only, it might not necessarily hold in this particular instance since in Serbia it is customary that a party losing the case in the first degree regularly appeals to the higher instance.

All issues relating to corporate governance ruled at the Higher Commercial Court (HCC) in the period 2005 to 2008 relate to the position and rights of company shareholders.

It may also be concluded that the most common problem faced by the shareholders is convening the Meeting itself. In the reviewed cases, the issue of convening an extraordinary Meeting was the cause of dispute, when the company management refused or failed to convene. The most common disputable issue, i.e. rationale for refusal or failure to convene the Meeting is the issue whether the shareholders requesting the Meeting are entitled to do so pursuant to CL.

HCC confirmed the ruling of the first-instance courts in the following situations: refusal of request to convene extraordinary Meeting because of incapacity of the applicant (associations of shareholders that do not have the status of a shareholder), appointment of temporary representative in case an extraordinary Meeting was not held (plaintiff claimed that the court has the right only in case of annual Meeting), extraordinary Meeting to appoint an expert fiduciary (the plaintiff claimed that appointment of expert fiduciary is not within the scope of competence of the Meeting).

HCC annulled the decision on the court in the first instance that refused the request of shareholders to order an extraordinary Meeting because of lack

of capacity (the company in question was 95.96% socially owned while only 4.04% was the shareholders' equity). The ruling in the first instance was annulled, and the case returned for reevaluation because of breach of procedure, since the court in the first instance did not rule on the ownership structure, and accordingly capacity of the applicants on the basis of the data in the Central Depository of Securities, as the source of valid data.

The following position of HCC is highlighted as the key for the future case law and corporate practice in Serbia:

“In a situation when a company Board of Directors refuses to convene an extraordinary shareholders' Meeting on the basis of validly proposed request, pursuant to Art. 277, it is obvious that this is the situation when provision of para. 2, Art. 278. CL should be applied and temporary representative appointed who will conduct all actions relating to convening of extraordinary Meeting, since the order of the court itself to convene an extraordinary Meeting when legitimate rights of minority shareholders are obstructed by the Board of Directors, without simultaneous appointment of a person that will conduct all actions relating to convening and holding such extraordinary shareholders' Meeting, will not result in actual protection of minority shareholders, granted by this provision of CL.”¹³²

The next most common cause of dispute was exercising of the shareholders' right to information. In these rulings, HCC consistently upheld the following position:

“If minority shareholders have no information on shares, agents and Articles of Association, and the public company management refuses to make it accessible, any shareholder, regardless of the number of shares, is entitled to court protection.”¹³³

The only decisive aspect of these cases was the evidence on whether a person is a shareholder of the company in question. Thus, for example, HCC took the position that shareholders of a parent company are not entitled to insight into documents of a daughter company, pursuant to CL, since they are not shareholders of the company in question, but shareholders of the founding company.

In case of appeal to the ruling of the first instance court refusing to annul decisions of the meeting, HCC however took the position that since he

¹³² HCC Ruling , Pž. 21/2006 of 24. 1. 2006, *Sudska praksa privrednih sudova (Case Law of Commercial Courts, Bulletin)*, Bilten vol. 1/2006,

¹³³ HCC Ruling , Pž. 5158/2004 of 9. 12. 2004

participated in deliberations of the Meeting, the plaintiff could not contest its decisions on the basis of irregular convening, as stipulated in CL.

In the studied period, HCC did not rule on cases in which a shareholder addressed the court to protect the company interests (derivative action), or claims for compensation of damages suffered by individual or company resulting from unlawful operations of the management.

In one case, however, HCC upheld the ruling of the first-instance court on annulment of a legal transaction involving a conflict of interest. In this particular case, Chairperson of the company Board of Directors empowered himself, without the pertinent Meeting, to sign a contract on transfer of claims to another company that he personally owned. In addition to the fact that the grounds for such transfer were not stated in the contract, the court also highlighted that this legal transaction was also annulled because it was not authorized in the manner stipulated in CL for situations involving the conflict of interest, when a person with the conflict of interest is deprived of the voting right.¹³⁴

Although the above may appear to suggest, at least at first sight, that shareholder in Serbia encountered greatest problems with the management that does not want to convene extraordinary Meeting, more detailed analysis of the cases reveals underlying conflict between majority and minority shareholders. In some cases the majority shareholder is the one that prevents convening of the Meeting and appointment of new management. These are usually post-privatization situations where the employees, now in the capacity of minority shareholder, support the old management that opposed the “hostile” takeover. The concluding remarks will elaborate this post-privatization situation in Serbia.

OPEN ISSUES AND POSSIBLE SOLUTIONS

Shareholders' rights

The set of legislative norms that regulate the rights of shareholders pursuant to the OECD principles of corporate governance¹³⁵ should provide for the following:

¹³⁴ HCC Ruling, Pž. 2664/2007 of 2. 4. 2008, *Sudska praksa privrednih sudova (Case Law of Commercial Courts, Bulletin)*, Bilten vol. 2/2008

¹³⁵ For detailed illustration of these principles, and comprehensive analysis of corporate governance issues in the Serbian theory and practice, see K. Veljović - *Korporativno upravljanje i koncentracija vlasništva u Srbiji*, (Corporate governance and concentration of ownership in Serbia) doctoral dissertation, School of Economics, Belgrade, 2008.

- Reliable methods of ownership registration,
- Assignment/transfer of shares to others,
- Timely and regular information on any matter pertinent to the company,
- Participation and voting at the shareholders' meeting,
- Election of the board members (Board of Directors and supervisory board, if any), and
- Participation in the company profits.

CL provisions cover, establish and regulate the mode of exercising of all these shareholders' rights. Entry in the Central Depository of Securities is the valid proof of ownership. Public companies are prohibited from any limitations in free transfer of shares. A series of provisions establish the shareholders' rights to information and access to company documents, and the list of most important documents is explicitly specified. The rules of participation and decision-making are also stipulated where all owners of the same class of shares have equal rights. Cumulative vote is also an option for members of the managing and supervisory boards, and the right to participation in company profits is limited to shareholders *pro rata* their ownership stake and pursuant to rules specified in decisions on emission of the shares they own.

CL particularly insisted on protection of minority rights. Thus, the right to request and obtain information and access to company documents is granted to any shareholder regardless of the size of his stake in the company capital. In order to resort to court protection in case of violation of the right to conflict of interest, it is sufficient that the shareholder's stake account for 5% of the company capital. To be entitled to require an extraordinary Meeting 10% stake is sufficient, while 20% ownership is required to ask for a special audit of company operations.

In an effort to provide for documentation basis to enable shareholders to obtain information, CL binds companies to keep register of shareholders, list of transfer of shares, while all company bodies, including the Executive Board, are required to keep the register of minutes of their meetings and pertinent decisions. One should also bear in mind that public companies are also required, pursuant to regulations on the market of securities, to submit regular information, financial statements and other reports to the Stock Market and Securities Commission.

It appears, therefore, that in an effort to provide full information on company operations to shareholders, the legislator adopted the principle

that potential benefits for the shareholder is prioritized over the related administrative cost the company has to bear. In addition to being expensive, increased number of documents and reports make them less user-friendly and they may be completely useless to an ordinary shareholder. Therefore, the list should be revised. It appears that the register of shareholders and transfer of shares are completely unnecessary when CL itself specified that the Central Depository of Securities is the only valid source of pertinent information.

Also, cumulative voting for members of Board of Directors may be avoided fairly easily by establishment of an alternative mode of elections in the Memorandum or Articles of Association. Since it is not binding, the concept of cumulative voting as the mode of direct impact of minority shareholders to election of the management makes no particular sense.

Inconsistencies between CL and Law on Securities (LS) in the manner in which a shareholder may authorize another person to represent him at the Meeting, i.e. clarification of the role of representative and agent referred to in CL and LS, respectively, requires amendments to at least one of these. CL entitles a shareholder to empower a representative pursuant to a specified procedure, and establishes their mutual rights and responsibilities. LS however, binds a public company to notify shareholders with voting rights, together with the summons for a shareholders Meeting, that they are entitled to appoint an agent for that Meeting, and a form of pertinent statement of appointment prescribed by the Commission for Securities. In order to be able to represent a shareholder, the agent must be acknowledged by the shareholders Meeting, upon proposal of the management of shareholder (LS, Art. 75).¹³⁶

In the light of the fact that this domain of public companies is governed by Commission for Securities, they have to comply with LS provisions, particularly in situations in which the decisions enacted by the Meeting are subject to approval or control of this Commission, such as say, issue of new shares. In case of other decisions of the Meeting e.g. distribution of profits, shareholders may resort to a fiduciary, pursuant to CL. The situation, however, is associated with legal uncertainty, since one may not rule out that any entitled person (management or shareholders) contest any decisions because they resorted to one or the other concept. We shall refrain from preferring one over another, since both have strengths and weaknesses. We also do not advocate a solution whereby cases in which one or the other concept is pertinent are clearly defined. Most importantly, any current ambiguity should be resolved since it is worse than any of the options available.

¹³⁶ This duty does not include public companies with fewer than 15 shareholders and those public companies whose Memorandum or Articles of Association exclude such statement.

It should however, be underscored, that the above issues, except partially the inconsistency of CL and LS may not be treated as important obstacles in execution of rights and interests of shareholders in corporate governance.

Company management

In regulations of company managing-supervisory bodies, as it has already been said, the legislator has basically opted for compliance with the principle of scope of competence, avoiding the rigid vertical hierarchy, and for a single-chamber management model (entitling an public company to elect a two-chamber model, at its discretion). Thus, CL entrusts the company Board of Directors with the most important role. However, whether it will play this role, or will be superseded by the company Executive Board, depends primarily on the influence, motivation, and mode of behavior of its independent, but also on non-executive members.

Although CL explicitly specifies competences of the Board of Directors and the fact that the Executive Board may not deal with issues that are within the scope of the Board of Directors, the composition of a Board of Directors, method of defining independent and non-executive members, and stipulated one-year term of office of the Board of Directors members combined make it possible for the Executive Board to take control over fairly easily.

First, although CL stipulates that executive members of a Board of Directors should be a minority, since non-executive members may be employed by the company, the difference between executive and non-executive members may easily be only formal. Thus, any company manager will meet the requirements for a non-executive Board of Directors member the only requirement being that he is not a member of the Executive Board, as well. The difference between a Board of Directors member who is a company manager and an Executive Board member who is also a Board of Directors member, from the position of separation the roles of the two bodies is only negligible.

CL stipulates that a quorum for Board of Directors decisions is made up of majority of its members, while valid decisions may be enacted by majority of the present members. Thus, without the presence of independent members, members of the Executive Board may pass a decision of the Board of Directors. Besides, CL also allows that a decision is considered passed even if the Meeting has not been held at all, if the decision is not contested in writing by any of the

Board of Directors members (Art. 316, para. 2). Without specifying the mode or the terms within which the members not participating in a decision making have to be notified thereof, CL gives a great opportunity to the Executive Board members to enact decisions on their own and subsequently substantiate them (orally). At the same time, other Board of Directors members are required to contest the decision in writing, which requires serious elaboration of a decision which may, say, have been enacted several months before and apparently had no major impact on the company business.

Further, CL stipulates one year mandate for the Executive Board members, while, in principle, membership in the Executive Board is not limited in time. Additionally, without limiting the number of places on the Board of Directors that may be filled by cooptation, CL practically enables replacement of all members between two annual Assemblies. Under circumstances in which the Executive Board has taken over control of the Board of Directors one may easily imagine that the replaced members are its non-executive, i.e. independent members who, for example, do not want to oppose any longer, have no willpower or motivation to wage public war and simply resign from the membership excusing themselves by various personal reasons.

The practical separation of competences thus relies on independent members of the Board of Directors, i.e. their willingness to judge and vote really independently. Independence is a personality trait that need not (and should not) depend on one's position and (direct material) interests of an individual. Since this, however, cannot be stipulated under the law, it only remains that law prohibits situations in which an individual may be more prone to fall victim of temptation to betray his independence in judgment.

Thus, CL also establishes situations in which an individual may not be considered an independent Board of Directors member. Focusing the direct relationships between individuals and company, CL also prevented some indirect ones, i.e. hiding behind another person, natural or legal. When natural persons are concerned, (broadly defined) kinship is pertinent, while for legal persons the property relations matter (direct or indirect ownership of over 10% of the capital). Employment of persons in legal persons related to the company by capital, however, is not prohibited. It is, therefore, quite possible that a person employed by or in contractual (but not ownership) relation with the legal entity which is ownership-wise related to the company in question or even fully controls the company in question is still considered an independent Board of Directors member.

In other words, CL provisions do not pose a serious obstacle to the Executive Board to take over full control of the Board of Directors whose role becomes only symbolical, which, apparently was not intended by the legislator.

Resolution of the issue, however, depends on the answer to the following question: Is it possible or needed at all to prevent the Executive Board, i.e. direct executive power of the company, to play a leading role in the managerial and strategic, instead of only executive and tactical affairs?

The answer to that question substantially depends on the belief of the respondent on human nature and behavior, as well as on the role that a state should play in an effort to guide and limit them.

Assuming, as the author does, that an effort to codify interests or human character traits is doomed to failure, in this particular case it would be better to refrain from imposing any structure of managerial bodies to companies. Instead, it would be sufficient to clearly establish the rights and duties of the owner (principal) and management (agent), ways of implementing them, and judicial protection and sanctions in case of breach thereof. It does not, however, imply that in case of listed public companies the state should refrain from stipulating duties of these companies to regularly publish important facts on their business operations. With such requirements for these companies the state fulfills one of its duties and advocates the interests of third persons in an effort to provide them valid information to make an informed choice.

This is substantiated by the current ownership situation in public companies in Serbia. As it has already been shown, the companies are most commonly owned by unequivocal majority shareholders, since in the privatization process 70% of the socially owned capital was sold at once. When one owner controls 70% of shares, he may easily control both the managing and executive boards, so that a discussion on the relationship between two boards is more scholastic than truly relevant, at least in a large majority of public companies in Serbia and at least for now.

If, however, one finds the above position too liberal, and it appears that modern trends in corporate governance regulations confirm that this may be a prevailing impression, it would be needed to implement the desired concept in a consistent normative manner and rectify any shortcomings in stipulations relating to the composition, position, procedure and relationships with the management of an public company.

Bearing in mind the current situation in Serbia, the manner in which most public companies have been set up, as well as situation in other pieces of

legislation that at least partially affect the corporate governance issues, which will be elaborated in continuation of this study, it nevertheless appears that such changes would not affect practical life significantly and that they are not, accordingly, necessitated as a matter of urgency.

Position and purpose of external audit

In respect to CL provisions on external audit, one editorial comment and one principal question are due.

Maybe in an effort to limit the number of words used, CL used the term auditor to describe an internal auditor, a member of the board of auditors and an external auditor, alike. Regardless of the AAL stipulations that these persons have to meet the same requirements to do the jobs, i.e. to be elected to the pertinent position, the roles of external and internal audits in a company differ a great deal. Therefore, different terms for the two would be preferred, so that, say, the term auditor could be used to designate only internal auditors, while external auditors should be always specified as such, or vice versa.

One objection, as a matter of principle, relates to the mode of setting remuneration for an external auditor. CL stipulates that a Board of Directors Committee for remunerations proposes the remuneration policy for auditors, as well (Art. 317, para. 3, item 2), while the Meeting adopts the remuneration policy for the Board of Directors members only (Art. 290, para. 1, item 5). Accordingly, CL stipulates that the Board of Directors sets the amount of remuneration for auditing services. In the light of the situation described above (quite probable in real life) where the Executive Board has taken over the control of the Board of Directors, the remuneration is actually set by the Executive Board.

An external auditor supervises and verifies financial statements prepared by the company management, and does so on behalf of the shareholders. It would be only logical that the shareholders' Meeting, which appoints the auditor in the first place, also sets the amount of remuneration for the services, instead of the Board of Directors, as it is now. Assuming unblemished honesty of auditorship, this would, nevertheless, reduce temptation of both the management and auditors to set the amount sufficiently high to turn a blind eye on the possible different perceptions of the mode of bookkeeping.

Positions, tasks and objectives of financial statements audit as well as coverage of companies that are obliged to have their statements audited externally

are covered by AAL, so that other objections refer to pertinent provisions of this law.

AAL explains that the introduction of professional titles of certified auditor and certified internal auditor is aimed at the protection of “public interest related to financial reporting” (AAL, Art. 4, para 1). In the light of the fact that this law establishes the duty of auditing on the basis of a company size, instead of its legal form, clearly enough AAL implies that neither shareholders of public companies nor potential investors to these companies are in the focus of the public interest.

It appears that the “protection of public interest” in AAL is an echo of the former role of the Social Accounting Service (SAS)¹³⁷ and primarily implies a special perception of the interest of the state institutions and state itself. Moreover, legal persons and entrepreneurs are obliged to submit “approved” financial statements to the National Bank of Serbia (NBS) by February of the following years for the previous year (AAL, Art. 31, para. 1). Since CL specified 30 June of the following year as the deadline for adoption of annual financial reports (Art. 276, para. 1), it remains unclear who can “approve” these statements, and whether the word “approval” has any meaning in terms of CL.

Apparently, such “approval” does not imply the Meeting, since AAL stipulates that this time, subjects of audit should submit the “adopted” financial statements for the reporting year that the auditor revised in comparison to the “approved” financial statements with auditor’s opinion, to the NBS by 30 September of the following year, at the latest. If the “adopted” financial statements are not different from the “approved” ones, only the auditor’s opinion should be submitted to NBS (AAL Art. 31, para. 2 and 3).

What does NBS do with the submitted financial statements?

The Bank processes them and published data supplied in the reports to review operational results and financial standing of legal persons and entrepreneurs, keeps them for 20 years, while the data contained in these reports are public and accessible to all legal and natural persons (AAL Art. 33). NBS also prescribes remuneration for these jobs, from collection and processing to publishing and providing of the data (AAL Art. 34).

An AAL provision making it possible for an “adopted” financial report to differ from the “approved” one only in case the auditor writes a qualified opinion, which is the true meaning of the phrase “if the audit resulted in

¹³⁷ In the system of social ownership of companies, this service played a role of a special public auditor that protected the interest of principal (whole companies) and controlled the agents (employees – self-managing bodies of socially owned companies).

correction” in AAL. This would actually mean that the “approved” financial statements did not represent the financial results truthfully, which would require dismissal of the management, to say the least. Having in mind, however, that the deadline for submission of the “approved” statements is the end of February of the current for the previous year (as used to be the case for annual balance statements), which is not sufficient for this task, it frequently happens that the management itself, independently of the auditor, identifies some errors subsequently. Moreover, it is neither unusual nor unacceptable that the management has a different opinion on the amount of a certain provision or any other item in the balance statement, and subsequently complies with the auditor’s position, in order to obtain a non-qualified opinion. That is actually the true purpose of auditor’s report – to check truthfulness of financial statements that are furnished to shareholders and their compliance with business and accounting policies adopted by the company. Truthfulness of the financial result, in the above sense, need not and as a rule is not the same as the exactly assessed taxable base.

In Serbia, financial statements and auditor’s report are additionally differentiated from the roles they have in the countries with developed market of capital by the regulations on income taxation. Namely, the Tax Administration accepts only financial statements stamped with the NBS seal, where the analysis of the taxable base is grounded on the income stated in the financial statement, where the statement itself is not reviewed. Accordingly, NBS has practically retained the role of tax review (played by the former SAS) since it “guarantees” the accuracy of the financial results presented in the income statement. Validity of this guarantee is highly questionable, since neither the NBS processing procedure, nor its professional capacities are up to such requirement.

Although these issues do not appear relevant for corporate governance, at least at first sight, they are nevertheless important for proper understanding of the overall context in which it operates in Serbia. Presented provisions of several laws (and there are more of them) substantiate that Serbian legislators still associate the purpose of financial statements with the meaning of former annual balance sheets, while the auditor’s report is associated with fiscal functions.

As the shareholders are interested in the amount of profit they may immediately distribute as dividend without jeopardizing the future rate of return, the state is interested in the amount of the taxable base that can be assessed immediately, regardless of whether a future expense is maybe even correctly

accounted as a cost of the current period, following the IAS rules. It would be logical, accordingly, to separate the audit of financial statements conducted by external auditors, which is aimed at providing for truthfulness of information conveyed to the owners on the management operations and company results, from tax control which is primarily aimed at assessment of the taxable base, which is, as it has already been said, not the same as the profit calculated pursuant to IAS.

It means that the duty to submit financial and audit reports to NBS should be discontinued, and in general duty to audit companies should be abolished for all companies, except for the listed ones, which does not rule out auditing of others if they specify so in their internal documents. It is not clear why, for example, an owner of a limited liability company would try to represent his financial statements untruthfully and have the state protect him by obliging him to hire (fairly expensive) auditors.

As to the necessary transparency of financial and auditing reports of public company, it has already been provided for by the regulations on securities that require their submission to the stock market and publishing in mass media.

Fiscal interests of the state should, only naturally, be protected by the Tax Administration, and fiscal regulations may and should require all tax payers to submit pertinent reports for the purpose of taxation.

Thus, the need for unnecessary and meaningless differentiation between the “approved” and “adopted” financial reports would no longer exist. Open/public companies would be given enough time to produce their own financial reports pursuant to CL, and all companies would have their administrative (and cash) expenses related to unnecessary reports to other state institutions reduced.

Three more issues open in other laws

Who is entitled to a dividend? CL correctly and logically limits the right to distribution of profits, i.e. dividend, to owners, i.e. shareholders, only (Art. 218). IAS, which do not allow accounting of payment to any other persons as a distribution of profit, also apply the same principle. The Labor Law, however, allows the so called participation of employees in the profit (Labor Law, Art.14). The Law on Personal Income Tax (LPIT) goes another step forward

and treats remuneration of employees and members of a company management related to the participation in the profits as income from capital (LPIT, Art. 61, para. 1, item 3). In the light of the fact that employment may provide grounds for distribution of profits in socially owned companies only, it would be advisable to delete these provisions with completion of privatization.

What are own shares? The concept, acquisition requirements, time-wise and amount-wise limitations relating to own shares are regulated in CL carefully and in great detail (Art. 221-224), in order to introduce rules that make companies acquire own shares only exceptionally and temporarily. The Privatization Law, however, establishes a company duty to acquire own shares. These are the shares that the company buyer, i.e. new shareholder, acquires by capital increase at the time of effectuation of obligations contained in the privatization contract. However, although acquired by the buyer, PL treats them as company own shares that the company will assign to the shareholder if he fulfills all duties stipulated in the privatization contract. Should he fail to do so, and the contract is terminated, the “own” shares are transferred to the Share Fund, which will, on the occasion of repeated sale of such company, pay a part of the generated income to the previous buyer with whom the contract has been terminated (PL, Art. 41). It is easily understandable why these provisions have been introduced with the latest PL amendments (to prevent dilution of other shareholders before final contract execution), although it is not quite clear what they achieve (preservation of influence of minority shareholders – employees or closer ties of the buyer with his investment, or reduction of the number of interested buyers in the privatization process?), it could, nevertheless, have been avoided if these objectives (whatever they are) were achieved by borrowing the names of concepts specified in CL that has a completely different meaning.

How is it possible to become an public company with five million shareholders that possess under 15% of company shares in six months only? Large public companies, commonly various mutual funds, frequently have a very large number of shareholders that individually hold a tiny part of the equity. In order to set up such a company, it is necessary that it is the intention of the founder, to design and successfully implement pertinent strategies and, not least importantly, it is necessary that such company is proven to be a safe investment opportunity for a broad circle of investors. In Serbia, however, a company may get 5 million shareholders overnight, without any intention of its own! It suffices that the company, its current shareholders or other potential investors, do not believe that it is profitable to buy its shares entered in

the privatization register at the price at which the socially owned capital was bought at the time of privatization. In such a case, pursuant to Art. 17 of the Law on Entitlement to Free Shares and Monetary Compensation in the Privatization Process (LEFS),¹³⁸ enacted in 2007 the company is obliged to distribute the shares currently held in the privatization register to all holders of such right. All citizens of Serbia, having turned 18 before 31 Dec 2007 have this right under the condition that they have not received anything in the privatization process before. Thus, 5 million people responded to the call for registration of their entitlement. Clearly enough, an individual citizen may or may not have any benefits from such exercise, but the companies in question will bear huge initial and permanent administration costs. It remains to hope that since implementation of this LEFS provision collides with numerous provisions of CL, the very fact will be sufficient to have this law amended timely.

Previously discussed issues brought about by provisions of other laws illustrate political and economic environment in which CL and corporate governance are implemented in Serbia. The final review will, instead of a conclusion, complete the puzzle.

INSTEAD OF A CONCLUSION

In order to analyze the influence, justifiability and implementability of CL provisions in the concrete Serbian milieu, it is necessary to understand the nature and motivation of the most important category of corporate governance participants – the category whose protection is aimed at by the pertinent rule – the owners themselves. These are domestic¹³⁹ owners and most of them may be easily distributed into two large groups: one is composed of company founders, i.e. persons, limited liability companies and large/majority shareholders (hereinafter: owners), and the other is composed of minority shareholders.

The difference between two groups is substantial and relevant for understanding of the social context in which the statutory rules of corporate governance are applied.

The owners are a part of the entrepreneurial layer, very tiny in Serbia, that decided in the course of the eighties and nineties of the previous and the first decade of the current century to generate own income independently conducting own business. Some differences are present within this layer, as well. They

¹³⁸ Official Gazette, vol. 123/2007

¹³⁹ Foreign investors usually have all the features usually associated with the corporate governance theory.

are primarily caused by different personality traits of persons who wanted and could plunge into own business in different political and economic conditions present in Serbia over these three decades. The eighties were characterized by marked economic and political crisis of the former SFRY, with eventual consequences that most people were unable to perceive. SFRY disintegrated in the nineties, and the times were scarred by war, economic and political sanctions and isolation of Serbia. After 2000, the previous socialist regime was deposed and efforts, at least declaratory ones, were introduced to build market economy based on private property and rule of law, i.e. transition.

In spite of apparently clearly different political and economic conditions in Serbia over these three decades, there is an important common feature, as well. It is decisive to enable pooling of all owners in Serbia, at least from the corporate governance point of view, in a single category. During the whole period, now three decades long, Serbia has been burdened with a high level of uncertainty in respect to basic and usually unquestionable issues. These relate to the exact borders of the country, manner in which the current property and contractual rights may be enforced (e.g. collect uncontested claim or obtain a building permit on a plot where urban planning and property issues are resolved, or when an economic dispute will be resolved). Discretionary judgments, inconsistency and bias of public institution are more of rules than exceptions. Corruption, although receding with time, and reliance on “connections” are usually the only modes of protection and enforcement of ownership rights.

Under these conditions, lack of reliance on the legal system and pertinent rational behavior make the owners combat the principal-agent problem by not even creating it in the first place. In other words, they assign their managerial power in management, administration and representation to professional managers to a minor degree, if any. If they, nevertheless, decide not to be in the front row, they appoint completely dependent managers and make sure to increase their dependency over time.

Although the above features are more or less common for all founders of companies of persons and limited liability companies, they are particularly salient in Serbian owners because of their utter lack of trust into honesty and effectiveness of public administration and judiciary system. Therefore, they are not interested in understanding and/or implementation of legal provisions, particularly the principled, systemic solutions such as those spelled out in the Company Law. They address compliance of this and other similar pieces of

legislation almost exclusively to abide by the legal form, fearing the sanctions, if they are sufficiently probable. The findings of this year's survey should be interpreted in that light. Namely, a year and a half after the expiry of the statutory deadline (30 November 2008), 97% of public companies have either already harmonized their Memorandum of Association and other documents with the Company Law, or are in the process of harmonizing them.

Owners believe that their success primarily depends on their ability to have direct control over all internal company operations and external stakeholders, primarily the state, that may have an important impact on their reaching the set goal.

On the other hand, most of small shareholders in Serbia have acquired the status through privatization of socially owned companies, by free acquisition or purchase at exceptionally privileged terms. This is substantiated by the fact that only in 9% of public companies the current and former employees are not company shareholders. Moreover, most of public companies also occurred as a result of privatization, due to the statutory requirement that issue of shares in the privatization process is treated as an open one. Thus, as expected, over two thirds (68%) of public companies in the surveyed sample resulted from privatization.

This aspect determines motivation and behavior of a typical Serbian minority shareholder and how he understands his own role.

First of all, he is not, and he is rarely prone to be an investor. In other words, he does not perceive the return on his share – dividend – as his ownership right, or the amount (if any) of such return has any relevant impact on his decision to retain/sell the shares. Most commonly he is also employed at the company and perceives acquisition of the shares as his right derived from his labor relations.

Secondly, he frequently perceives acquisition of shares in the privatization process as a poor and/or unfair compensation for the loss of right that used to be associated with labor relations in the course of socialism. *Inter alia*, this is the right for direct management (self-management) and decision on distribution of profits that is perceived as a natural part of his earnings in the labor relations. Therefore, practically all privatizations implemented through sale of companies to strategic investors were perceived as hostile takeovers by most employees, now minority shareholders.

Third, like the categories of owners, minority shareholders also lack trust in the legal system, state and its representatives, and they are utterly

disinterested to learn more of their legal rights as shareholders, as well as their implementation by legal means. Therefore, in Serbia, in addition to problems encountered with any class action, lack of interest of minority shareholders results also from their belief that resorting to legal means to execute their right is futile.

When a domestic dominant shareholder/owner and minority shareholders – employees are together present in a company, the statutory rules of corporate governance, even if all documents and written procedures are present and are fully compliant with the law, are only hurdles or means that should be removed or used, as the case may be, to reach the final objective.

In terms of corporate governance, the most common final objective of any dominant shareholder in Serbia (this time not only the domestic one), is to close the company, i.e. transform it into a limited liability company. Except for three isolated examples, all other public companies have shown neither the wish nor intention to obtain resources for its financing at the market of capital. Moreover, in Serbia trends of cost of share at the market are not perceived as reliable or relevant information on the company success. Thus, reasoning leading companies to remain open/public in Serbia is not related to either finances, or reputation. Most of them remain at the market because of the set of legislative norms stipulated in the Privatization Law, Company Law, Takeover Law and Law on Securities and Other Financial Instruments.

As to a domestic minority shareholder, his pertinent objective is most commonly boiled down to selling his shares at the highest possible price, primarily because he needs cash, and to preserve his post if he is also employed at the company.

In principle, selection of a company form is not an expression of free will of the founders, except in a limited number of cases. Therefore, before all open/public companies, whose majority shareholders want to do that, have become closed/private and transformed into limited liability companies, and before a critical number of minority shareholder have become investors in the true meaning of the word, the rules of corporate governance in Serbia will, essentially, be more of the rules of the game between two currently existing groups of shareholders – majority external owner and minority – employees – to achieve their final objectives, than serve its main purpose.

This should be born in mind when the effects of the Company Law on the Serbian corporate scene are evaluated. In most of the provisions, which will be elaborated below, the Law is a good example of continuation of development

of the Serbian legislative framework on the foundations of the existing legal and practical rules, integrating solutions derived from solutions to problems at the markets that are similar or more mature in the respective aspects. In other words, the law, contrary to many “transitional” laws governing Serbian economy that frequently and unfortunately are only sets of poorly translated recommendations of foreign consultants or laws of the countries of origin, is a fruit of knowledge, systematic exercise and effort to find best solutions.

Nevertheless, the impact of its solutions on the corporate governance practice in Serbia will, mostly, be evaluable only when the most important participants in the corporate governance, the owners themselves, approach the usual theoretical definition of a principal, in terms of their motivation and behavior. Development of the milieu in which they conduct business is not less important; it is expected that after the turbulent pre-war, war, and eventual transitional changes the more peaceful “evolutional” times will follow.

Rationale for some unusual solutions in the Company Law, in particular the provisions on the methodology for determination of market value of shares (Article 445) is related to these features of business environment, characteristic of Serbia. This provision stipulates the method for determination of a value that, by definition, is an expression of the balance between supply and demand, whereby its determination pursuant to the law is paradoxical.

This provision is an effort to protect minority shareholders from disproportionate reduction of their stake in the company capital, i.e. the provision stipulates that the issue price of a share has to equal its market value, compounded by the methodology to calculate it. This is the best proof that the legislator was aware of the utmost objective of majority shareholders in public companies generated by privatization: dilution of minority shareholders and minimization of their influence on the company management and increasing the chances to close. In substantiation of the above, when would any management or majority shareholder who really find their interest in keeping the company public company, want to issue new shares of their company at the price which is below their market value and thus, decrease inflow of financial resources for own operations and, accordingly, reputation of the company?

The fact that such provision is included into the Company Law suggests that in regulation of these issues, in the conflict between the majority shareholder – owner and minority shareholder – employee, the legislator decided take the side of the latter. The same applies to other laws in the area (e.g. Take-over Law). Regardless of whether the reasoning may be defended from the

ideological, demagogical or professional points of view, the only true consequence of these provisions is to impede closing (turning private) of companies whose owners are not interested in keeping them open, i.e. listed on the stock market. This, however, does not imply that the mode of closure (turning private) will really stop them (it still remains questionable whether they should be prevented and whether this was the underlying intention of the legislator). The closure will, most probably, eventually be accomplished, but the cost incurred by majority shareholders and received by the minority one will be higher than the one which will be achieved without such hindrances.

Some may suggest that it is fairer this way. Even in terms of fairness, there is only an attempt of the state to subsequently rectify some “injustices” from the past. They have, however, been generated by the very manner in which the state has implemented the laws (and unfortunately, still does). Therefore, it is a natural result of transition, one may say its very purpose, transfer of ownership of “social” capital from all citizens (in theory) to the hands of fewer owners, associated with the need of political elite to justify itself before the (voting) majority. It appears, therefore, that demagogy here prevails over justice, i.e. political elite is not ready to publicly acknowledge the unpopular, but only natural consequences of transition.

From the purely economic standpoint, redistribution itself, regardless of who the loser and who the winner is, leads to loss of efficiency that, eventually, is suffered by all, most of all ordinary citizens. In other words, the longer the attempts to codify interests of players in the field of economy, the later the clear-cut ownership rights and effective market economy will be established, with increased associated cost and with usual set of issues that are subject of regulation of the rules of corporate governance.

SUGGESTED CHANGES

The Company Law, as it has already been said, regulates all issues that modern understanding of corporate governance finds relevant for resolution of issues that may occur in the relationship between owners and management, and those relating to protection of minority shareholders. This law is also one of the few good examples of development of Serbian legislative framework harmonized with the changes and economic milieu in Serbia, as well as with development of pertinent regulations in more mature markets. It follows modern solutions and introduces new legal concepts but also takes care that their

transformation into legal norm is conducted, whenever it is possible, by the use of the existing concepts, familiar and understandable to the legal and business communities in Serbia.

On the other hand, in Serbia there is a vast majority of open/public public companies that have not become public by the intention of their founders, but by the force of the Privatization Law. Only three open/public public companies are also listed and have intentionally opted to have their shares listed on the market. In all others, business operations and implementation of CL are usually formally complied with, with no true interest of the parties that participate in corporate governance. When and how the situation is going to change depends mostly on their willingness and readiness of the Serbian companies to provide funding for their operations on the stock market. The Company Law makes no hindrances whatsoever; instead, it provides a solid legislative framework and more or less unequivocal rules.

However, even now, and particularly in the light this possible chain of events in the future it is necessary to highlight some inconsistencies and need for improvement of some CL provisions and other laws that should be harmonized accordingly. These provisions and direction of their possible changes have already been elaborated in detail in the chapter discussing the open issues and possible solutions. Therefore, only the most important ones will be focused here.

In terms of *rights of shareholders* the most important is the following:

- *Harmonization of CL and Securities Law (SL) on the mode and procedure for empowerment for representation of shareholder at the Meeting (representative or agent)*. Unfortunately, the proposed draft amendments to the SL failed to include this harmonization. Since this is actually the matter of the right of shareholders that should be covered by the CL, and that the current SL provisions are administratively bulky (imposing the duty for companies to furnish a form of Proxy's statement to each shareholder, regardless of whether they want to have a proxy or not), it would be best to enter a provision referring to CL, instead of entering a new definition of Proxy's statement.
- *Precise list of company records that a shareholder is entitled to have insight to*. Clearly enough, any shareholder, regardless of the size of his/her stake in the company capital has to be entitled to all information required for valid decision, for the voting at the Meeting and keeping or selling his/her shares. It appears, however, that by granting the right to insight into the company

books and statutory (broad) list of pertinent documents, the possibility of abuse of the right and its untoward use have been underestimated together with the cost that the company incurs in the process. In parallel, the possible benefits that such right may bring to an individual shareholder and the company itself have been overestimated. SL has already stipulated a duty for open/public public companies that the general public, Commission and Stock Exchange have to be notified on all relevant events, and that they have to update the prospectus regularly and publish financial reports with auditor's opinion. This information in itself provides sufficient grounds for valid decision making. In addition to this (already available) information, the CL should specify that any shareholder should be entitled to see the Memorandum of Association, Articles of Association and all documents relating to the Meeting proceedings (minutes, decisions). Additionally, his right to request notification on the amount of remuneration of members of the Managing and Executive Boards, and external auditor may also be stipulated. It goes without saying that any shareholder should be entitled to request that the company prepares and presents all notifications that are published or should be published pursuant to the SL provisions. Thus, the CL should clearly differentiate between notification and documents that each individual shareholder is entitled to see, from the documents that the company is obliged to keep following the CL provisions. As to this list, the documents should by no means include those that fall under the competence of the Central Depository (e.g. transfer of shares...).

In the area of *managerial bodies and their compositions*, the following issues have been recognized:

- *Definition of a listed open/public public company.* Although the SL indirectly suggests that only companies present at the stock exchange are listed, in the current Serbian circumstances it is not quite clear whether public companies whose shares are traded over the counter may be subjected to the duties that the CL stipulates for the listed ones. Therefore, to clearly specify the duties of public companies in the SL, it is necessary to precisely define which ones will be treated as the listed ones. For the time being, the concept used in the CL has no corresponding term in the SL. Harmonization of terminology in CL with the one used in SL is also an option.
- *Number of Board of Directors Members that may be appointed by cooptation.* The current solution practically enables replacement of all Board of

Directors members between two annual Meetings by cooptation. In the light of the fact that one of the most important roles of the shareholders' Meeting is to elect and appoint Board of Directors members, the number of members that may be appointed should be explicitly restricted. The rule of thumb suggests that the number should be less than a half of the Board of Directors members.

- *Limitation of the Board of Directors member mandate to one year.* Although the legislator's intention to enable easy replacement of the Board of Directors members is legitimate, bearing in mind the current transitional circumstances in Serbia, it nevertheless appears that the stipulated mode is too rigid. It shortens the horizon within which each manager evaluates opportuneness of certain decisions. This particularly applies to non-executive and independent Board of Directors members whose managerial position is subject to the risk of (re)election. In the Serbian situation, predominated by companies where a majority shareholder owns more than two thirds of the shares, this CL provision may have an effect completely opposite to the intended one. It would be advisable, therefore, to implement the idea of easy replacement of the management in some other manner. This may be achieved, say, by introducing a provisions stipulating that the mandate of Board of Directors members shall be terminated instantly, should the Meeting refuse to adopt the annual Board of Directors report, or financial statements and/or the company operates with a loss.
- *Role of non-executive Board of Directors members.* Due to the already elaborated reasons there is no substantial difference between an Executive Board member who is also a Board of Directors member and his non-executive colleague who is employed at the company. Besides, if we assume that the Executive Board, as a collective body, needs to have at least three members, it appears that open/public public companies need to have at least seven Board of Directors members. It is quite doubtful whether and how much this contributes to the Boards' impact, substantiation of its decisions and quality of corporate governance under the Serbian circumstance. Explicit statutory requirement to have a majority of non-executive Board of Directors members was probably aimed at limitation of the direct influence of executive power of the company to the Board of Directors decisions. Maybe an attempt was made to give opportunity to non-managerial company staff to be Board of Directors members, e.g. representatives of employees and/or trade unions, enabling representation

of all stakeholders, not only the shareholders. Inasmuch as the intention is justified, it cannot be put in practice in the manner in which the CL stipulates the Board of Directors composition and election of the Executive Board members. Due to the already presented rationale, the current CL provisions actually pave the road for full domination of the Executive Board over the Board of Directors. Therefore, to consistently implement the legislator's intention – establishment of unequivocal domination of the Board of Directors over the Executive Board – differentiation of the two Boards, member-wise, is needed. In other words, it should be stipulated that members of the Executive Board may not be members of the Board of Directors, i.e. rule out the possibility of executive members of the Board of Directors. The only exception to this rule is the Board of Directors Chairperson who may, as stipulated in the current CL, chair the Executive Board as well. This would be a guarantee enough for coordination and shared information on operations of the two boards, which was the underlying reason for the present CL solutions.

- *Definition of an independent member.* The causative relationship between the presence of independent members of Board of Directors and quality of corporate governance has not been proven in economies with more mature market of capital than the Serbian one. In Serbia, contribution of these members has been questioned a great deal. Two independent members of the Board of Directors and no less than five members employed at the company out of whom three are also members of the Executive Board in the situation in which there is one controlling shareholder with over two thirds of shares (which is the most common situation in Serbia), can hardly be expected and motivated or practically able for that matter to essentially influence business policies and quality of corporate governance in the company. Therefore, the need for any such stipulation should be reconsidered. If we assume (regardless of the above) that the Serbian law should follow contemporary trends and require open/public public companies to have independent Board of Directors members, it appears that the specification of requirements to be met by independent Board of Directors members has a major flaw. Namely, one can hardly be independent and also employed at the company or be in another contractual relation with the major company shareholder. Formally speaking, however, requirements stipulated in the CL treat such persons as independent. Accordingly, for consistent implementation of the independent member idea, the requirements should be incorporated into the CL.

- *Notification of Board of Directors decisions made without the meeting.* The praiseworthy intention of the legislator to enable flexibility of the Board of Directors operations is recognized, enabling valid decisions to be made even without the Board of Directors meeting. It appears, nevertheless, that by failing to specify the deadlines and modes of notification of the Board of Directors members who did not participate in such decision making, it has been (unrealistically) assumed that all Board of Directors members are mutually fully supportive and open for collaboration. It would, therefore, be advisable to spell out the pertinent rules.

When the mode in which the CL refers to the AAL to cover the issues of internal supervision, the following issue has been identified as the key one:

- *Required qualifications for an internal auditor or member of the Board of Auditors.* CL opts to refer to a special piece of legislation for the requirements to be met by an internal auditor; the requirements stipulated in the AAL suggest a very narrow role of an internal auditor, i.e. board of auditors. Namely, the requirement that both the internal auditor and members of the board of auditors have specific accounting qualifications reduces the role of internal supervision to almost exclusively oversight of compiling of financial statements and their contents, regardless of the fact that CL empowers them for a much broader scope of issues. Appreciating the major, maybe the key importance of financial statements for true insight into the company operations, combined provisions of CL and AAL unjustifiably give only secondary importance to all other features and modes of operation. Basically, the key role of internal supervision is to establish and oversee procedures of enactment and implementation of business decisions and reporting on results thereof, in other words, establishment and oversight of all internal, not only the accounting, rules that provide for lawful and purposeful operations of the company. Therefore, CL should delete the provision on requirements stipulated in another law (AAL), since it practically reduces the role of internal supervision to oversight of financial reports, although it has a much broader meaning. Thus, ability of these persons to have a substantiated position on financial reports would not be impaired, since the CL, as it is, gives explicit right to the internal auditor or board of auditors to hire external experts for pertinent areas in order to perform their duties competently. On the other hand, this would enable a broader set of experts in various fields (economics, law or natural or technical sciences) to pursue this important role.

The manner in which AAL (in)appropriately regulates the role and position of *external (independent) audit of financial reports* has already been substantiated sufficiently. The main recommendations include:

- *Unequivocal terminological differentiation of internal supervision from external audit.* For faster establishment and understanding of different roles played by internal supervision, internal auditor or board of auditors and external audit in business operations and corporate governance of a company, it would be necessary for CL to differentiate them terminologically in a consistent manner. The best thing to do may be to use the adjectives internal whenever the provisions refer to persons such as internal auditor or members of the board of auditors. Current wording of certain CL provisions requires interpretation of the context to differentiate among internal and external auditors.
- *Right of the Meeting to establish remuneration or be informed on the amount of remuneration for the external auditor.* The key recommendation in this area for CL improvement is to stipulate either the right of the Meeting to set the amount of remuneration for the external auditor or the duty of Board of Directors to notify the Meeting on the set remuneration. In addition to providing the important information to shareholders, it is the right they are logically entitled to and their scope of competence, since independent auditors check the truthfulness of financial statements prepared by the company management on their account and on their behalf.
- *Eligibility requirements for persons to conduct audit.* We would here refrain from discussing all issues opened in respect to the scope and mode of exercising the powers vested with the Chamber of Chartered Auditors and Ministry of Finance by the law regulating this profession. Instead, it is important to underline that the AAL should limit stipulations of the requirements for the persons performing auditing duties to chartered auditors, i.e. persons (legal and natural) who conduct external audit, and not the internal supervisions, as the provisions currently suggest.
- *Coverage of companies that AAL requires to conduct external audit.* AAL should harmonize the provisions relating to the mandatory external audit with those in CL, i.e. annual provisions requiring companies that are not open/public public companies to have their financial statements subjected to external audit.
- *Duty to submit financial statements to NBS.* The underlying logic of the need to compile and publish (in case of open/public public companies)

financial statements requires annulment of the requirement to submit financial and auditing reports to the NBS. The justified need of the state to have statistical data may be met through the National Statistics Office (NSO) by introducing the duty of all companies to submit information necessary for the calculation of GDP or other macroeconomic indicators to the NSB. This would, *inter alia*, overcome the need to differentiate between “approved” and “adopted” financial statements that makes no sense from either the standpoint of corporate governance or collection of statistical data, or information of the public.

When *other regulations* are concerned, that have most blatant provisions in collision with CL provisions that have to prevail in the pertinent matters, and require, accordingly urgent amendments, the following are salient:

- *Right of employees to participate in the profit.* Although this right is introduced as an optional, not a mandatory one, this provision should nevertheless be deleted since it is incompatible with provisions of both CL and IAS. Namely, only shareholders are entitled to participate in the distribution of profits. It does not rule the possibility for employees to get certain bonuses based on successful operation of the company, but they may not be entitled to distribution of profits.
- *Definition of participation of employees in company profits as the income from capital.* This provision of the Law on Income Tax should be deleted in the first oncoming amendments due to quite obvious rationale.
- *Establishing the deadline to submit tax returns for corporate tax in relation to the deadline to submit financial statements to NBS.* The Law on Corporate Tax should specify the content of tax returns to match the need to establish the taxable base and differentiate them clearly from the rules that IAS prescribes for financial reporting. Deadlines for submission of tax returns should be independent of those for submission of financial reports, but care should nevertheless be taken to harmonize them with terms stipulated in the CL whenever it is needed (say, require open/public companies to submit their auditor’s report to the tax Administration, as well, but the deadline for such submission may not be independent of the deadline specified in CL for adoption of the documents).
- *Treasury shares defined in the Privatization Law.* Refraining from to questioning the legislator’s intention to stipulate special treatment of increased capital of the buyer of socially owned capital under the contractual obligation to invest into the subject of privatization, the treasury shares

generated in this manner pursuant to the Privatization Law should, at least terminologically, be differentiated from treasury shares defined and regulated under the CL. Although better solutions could be found for failure to meet the contractual obligations in the privatization processes, the simplest one would be to introduce pertinent fines.

- *Company duty to issue shares to all holders of right to free shares and monetary compensation.* The recently introduced manner to resolve the issue of shares held in the Privatization Register (in addition to the fact that it may not be enforced without violation of the CL provisions) is also a kind of violence over fundamental rules of market economy. Namely, if there are no interested buyers to purchase the shares at the lowest price set in the Law on Free Shares (LFS), the company in which the Privatization Register holds shares is obliged to issue them to all holders of the right, about 5 million in all. Thus, a substantial number of companies is laden with administrative problems associated not only with huge cost, but almost insurmountable problem of finding a venue for the meeting of such an enormous number of shareholders. Although one may assume that most of the shareholders would not respond to the summons to attend the Meeting in the first place, this does not rule out the duty of the company to comply with CL provisions and send pertinent summons to all of them. Obviously, benefits of each individual shareholder associated with ownership of a share, that may have negligible face value, would be meaningless, to say the least. The damage, however, inflicted by this hasty solution to the very idea of shareholdership and its development in Serbia is far from negligible. Therefore the LFS should be amended by the end of this year before unnecessary serious harm is done.

Corruption and corporate governance

INTRODUCTION

All studies of the phenomenon of corruption in Serbia so far suggest a fairly high level of spread, although it is fairly certain (pursuant to an empirical survey conducted by CLDS in 2006)¹⁴⁰ that after 2001 both intensity and spread of corruption in Serbia have had a falling trend. In comparison with other countries, regardless of numerous associated methodological problems, a relatively high level of prevalence of corruption in Serbia is indicated yet again. It, therefore, appears pertinent to investigate the link between corruption, on the one hand, and corporate governance, on the other, both theoretically and in concrete example of Serbia as a country in transition, which is characterized with the already mentioned level of corruption, and the specified issues of corporate governance, which have already been elaborated in other chapters of this book.

In theoretical terms, several links between corruption and corporate governance issues may be identified. The issue of direction of the causative relation is always relevant: do the problems of corporate governance affect the increase of intensity and spread of corruption or, conversely, corruption affects the corporate governance issues. There is no single, generally pertinent answer to that question. Instead, each particular case has to be interpreted by its own merits. Accordingly, concrete cases of links between corporate governance and corruption need to be studied.

First of all, problems in the area of corporate governance lead to the so called corruption of the private sector, i.e. corruptive transactions in which both parties (corruptor and corrupted) are in the private sector. Obviously, without problems in corporate governance, this type of corruption would not be present since owners of private resources increase their wealth on the market, maximizing the profit they appropriate. Therefore, this type of corruption, more than any other (e.g. extortion) is greatly associated with corporate governance issues, where the problems, i.e. weaknesses of corporate governance lead to the private sector corruption, instead of vice versa. Accordingly, those claiming that upgrading of corporate governance is a solution for corruption

¹⁴⁰ *Corruption in Serbia five years later*, CLDS, 2007

in the private sector are right, i.e. resolution of corporate governance problems resolves the issue of corruption in the private sector.

Since corruption of the private sector is the most important form of corruption brought about by corporate governance issues, it should be prioritized. Namely, offer of corruption in this case comes from corporation managers. It has already been said that the problems of corporate governance result from the agency issue, deteriorated by the information asymmetry. Aims of company managers differ from those of owners, and information asymmetry prevents owners from effective oversight. Therefore, under conditions of severe agency issue, it may happen that a manager finds it beneficial to conclude a contract with third party with is not the most favorable deal for the company, and generates certain benefits for agreeing to enter into such deal. To exemplify, Director General intentionally concludes a contract on procurement of certain inputs, i.e. products (goods or services) for the corporation, selecting a supplier whose offer is not most favorable in either the price (for the given quality) or quality (for the given price). By the purchase of a more expensive, i.e. inferior quality product, the manager increases expenses of the company, i.e. reduces the profit, meaning that he does not operate in the interest of the owners of the company capital. In this situation, with severely prominent agency issue, the interests of owners and managers collide. Conversely, the interests of the manager coincide with the interests of third party, his partner in corruption, i.e. the only remaining outstanding issue is the distribution of the corruption proceeds generated by such deal.

For example, if a corrupt manager purchases one million beer bottles at the price 5 dinars above the market one, the beer factory registers increased expenses by 5 million dinars, and the amount has to be distributed between the partners in the corrupt deal.¹⁴¹ They may disagree on how to split it, but both are motivated to reach such agreement, since with realization hereof they will appropriate any amount of rent. In other words, this form of corruption is dangerous for a society, since both parties in corruption are motivated to cooperate, making their agreement sustainable, profit i.e. rent generating for both,. The only loser in this case is the company owner(s), so that promotion of corporate governance is the key prerequisite for elimination of this type of corruption.

¹⁴¹ This calculation of rent is based on the assumption that the manufacturer delivering the bottles in the course of sale at the market price does not appropriate any rent, bit only the normal profit, i.e. covers the opportuned capital cost.

CORRUPTION AND CORPORATE GOVERNANCE IN SERBIA

Studies of corruption in Serbia so far have not suggested that this type of corruption, private sector corruption, is very intensive, i.e. it has not proved to be widespread. Corruption of the public sector has been focused much more – in conducted surveys entrepreneurs complain on corruption associated with public procurements for public companies, but very few complain on corruption associated with procurement in private corporations. Although these findings have not been subjected to greater elaboration and investigation of results obtained in surveys of entrepreneurs, it is undeniable that the structure of corporate ownership in Serbia is a potent obstacle to corruption in the private sector. Namely, as the survey conducted for this study has substantiated (see Chapter III), as many as 63% of the surveyed corporations in Serbia have a majority owner, i.e. concentrated ownership structure, where the origin of such ownership structure has already been discussed. Also, analyses presented in previous chapters illustrate the trend of pooling of company capital ownership, i.e. trend of open/public public companies to turn private, meaning the trend of increasing motivation of the owner, reducing the issues of class action for the owner on the level of direct control of the company management, i.e. manner in which the managers govern the company. Obviously, owners of capital still find the indirect methods of corporate management supervision fairly ineffective, so that they opt for strengthening of the direct methods, which is achieved best by pooling of the ownership and, thus, overcoming the agency issue. In other words, it appears that the low level of corruption in the private sector is an indirect indicator of the fact that the agency issue, i.e. corporate governance problems are not very prevalent in Serbia.

Corruption of the public sector, regardless of whether administration corruption or state governance are concerned, particularly the one based on extortion by public officials (when civil servants solicit bribes in order to do their job and implement regulation, i.e. when they solicit bribes from parties to let them exercise their rights) does not depend on corporate governance to any major degree. Namely, in case of extortion the interests of corporation, i.e. its owners on the one hand, and managers entrusted with corporation management on the other, are similar, i.e. substantially identical. The same mechanism is present in case of corruption in collusion, when two parties in a corrupt deal agree to breach the rules for the mutual benefit. Finally, interests of owners and managers also coincide in case they overpower the state, which apparently makes it possible to corrupt those that formulate the rules, so that these

rules are beneficial for such corporation, i.e. the branch in which it conducts business.

Contrary to the corruption of the private sector, it has been established that the agency issue, i.e. corporate governance issues do not exert such an influence on extortion which is typical for the public sector corruption. Namely, in such a case the interests of owners and managers do coincide – to pay the required amount of bribe. The owner's interest is for the company to operate uneventfully and generate profit, so that he is willing, say, to pay a certain amount to obtain all urban planning permits although he does not fulfill all the requirements, as long as the amount is lower than the cost, i.e. loss that would be incurred due to delay of construction works on the building for which the permit is required. The manager's interest is to show the owner that he is able to cope with all "challenges" a developer encounters in Serbia, even if it implies bribing a public official. Until this moment the interests of owners and managers do coincide. The problem from the corporate governance standpoint may occur when the amount of the bribe is set. The owner wants to pay as little as he possibly can, i.e. as much as it is absolutely necessary to "smooth his way through", with the lowest associated cost. Accordingly, it is in the best interest of the owner that the manager negotiates the lowest amount of bribe. Conversely, the manager finds no interest of his own in negotiating the lower amount of bribe – there is nothing in it for him. Quite the opposite, the manager is motivated to report a higher amount of the bribe to the owner (higher than the one actually requested by the public official), i.e. keep a part of the money earmarked by the corporation for "resolution" of the problem for himself. The probability of such chain of events increases under conditions of decreasing spread and intensity of extortion, which has exactly been the case in Serbia in the last five years. Under these conditions, a manager may use "outdated" information to hide the true amount of bribe, even hide that the bribe is not solicited any longer; instead he may increase the cost of the corporation incurred for "oiling the wheels" of business, where the wheels do not need any oiling, but the manager appropriates the amounts for himself.

In the case of administrative corruption, in addition to one direction of causative relationship (from corporate governance to corruption), there is another one, as well: the greater the corruption, the poorer the corporate governance. And this is exactly the case: if extortion as a form of corruption is widespread, and the whole bribing deal is, naturally, in the hands of the manager, asymmetry of information held by the management and owners is increased. Since corruption, in its essence, is a hidden activity, company owners have no

information on hidden transactions made by the company managers on their behalf. General impression that corruption is widespread is a very good excuse for managers to get involved into supposedly corruption-related deals, i.e. to increase the information asymmetry, deteriorating the corporate governance issue. Therefore, in this case, reduction of the level of corruption, i.e. elimination of extortion in a country, shall lead to improved level of corporate governance even if all other, otherwise more important factors of corporate governance, remain the same. In other words, corruption undoubtedly affects the corporate governance issues.

CLDS studies in the least several years have shown substantial recession in the spread of extortion as a form of corruption particularly in some areas of public administration, such as customs administration. Therefore, in this area extortion-wise information asymmetry between owners and managers is fairly low. It has also been shown, however, that administrative corruption, i.e. extortion, has not been substantially improved in some other areas, such as building land and construction permits. Moreover, since implementation of urban planning regulations is under the competence of local government, it is quite probable that major differences are present among areas in Serbia, implying different impact of corruption on corporate governance.

It may, nevertheless, happen that reduction, i.e. complete elimination of extortion was associated with intensification of other forms of corruption in the public sector, i.e. other form of administrative corruption, which is corruption in collusion – the type of corruption with voluntary corruption agreement. Interests of company managers and owners coincide to a certain extent. If a corporation, based on realized corruption agreement, reduces its expenses or increases the income, the amount of profit that may be appropriated is also increased. These coinciding interests make this type of corruption persist, and it is not very likely that promotion of corporate governance will curb this type of corruption to any major degree. The problems of information asymmetry may, like in the case of extortion, occur with specification of the true amount of bribe that should be paid, but the quality of corporate governance simply has no effect to this type of corruption. Indirectly, this is substantiated by the fact that on the occasion of breakdown of corruption deals within the Customs Administration in the fall 2006 in Serbia, where the main deals were based on corruption in collusion, all corruptors were limited liability companies, with a single owner, who is also the company manager. So, the corruptors were companies where the issue of corporate governance was not applicable.

The corporate governance issue is not an important factor of corruption as a method of state overpowering, since in this case interests of company owners and managers again coincide. Both have an interest in adjusting the rules of business to the needs of their company, i.e. branch in which the company conducts business. Increased customs protection, for example, results in increased overall income of the company (due to increase of the adjusted price on the local market), opening the field for concomitant increase of managers' remuneration and owner's profit. Although the information on this type of corruption is very scarce, it is not difficult to imagine a situation in which not the manager, but the company owner plays the role of a corruptor.

A special type of corruption related to corporate governance is associated with establishment, i.e. change of ownership structure, primarily in the stage of company takeover, i.e. the role of state owned-shares in this process. Namely, in Serbia various privatization models were in place, and implementation of the 1997 privatization model led to the fact that in many cases ownership of the company capital was on the one hand dispersed among a large number of company employees (former and current), and on the other, substantial amount of the company capital was allocated to the state, the shares being assigned to the Share Fund. Such ownership structure was simply not stable enough, i.e. was not sustainable. The current minority shareholders were strongly motivated to dispose of the shares they got for free, and the state policy relating to the sale of shares from the state portfolio, held by the Share Fund, was neither clear, nor consistent. Moreover, the takeover rules, and other rules of trade in securities, before enactment of the 2006 laws, were not quite precise, and favored those that take the company over, providing relatively low level of protection to the current (small) shareholders. All this opened the field for abuse, i.e. corruption, in the process of corporation takeover and consolidation. Namely, corruption of officials making pertinent decisions, or corruptive insider information was conducive to lucrative profits in the process of takeover of companies privatized before 2001, where the amounts paid per share were lower than they should have been. Although the substantiating evidence is not available, major scandals relating to privatization are mainly associated with cases of takeover of companies privatized pursuant to the procedure in force before 2001, such as *Knjaz Milos, Vital*, et.

Generally speaking, in Serbia the philosophy of abiding by the law has not taken root among owners and managers, as it is the case in many major corporations in developed countries. The difference in the level of compliance of the law probably is not so much caused by moral characteristics of one and

the other, but by the business climate: in Serbia, reputation of management and company is much less important than in developed countries, and the rule of law and power of institutions (investigating and judiciary alike) are much weaker. To put it simply, in Serbia it is more cost-effective to breach the laws, including the anti-corruption ones. This is partially compounded by lower transparency of business deals and decision making, which makes it easier to pursue corruption.

Similarly, in Serbia, anti-money laundering regulations are in place; they are on the level of European ones in the parts relating to collection of data on suspicious transactions, but there are practically no analyses let alone possible investigations on the basis of these data. Weaknesses in the anti-money laundering activities undoubtedly facilitate, even enable corruption in the corporate sector.

REQUIRED CHANGES

In order to impair any possibility for corruption in the takeover process, i.e. in the process of corporate governance consolidation, but not only because of that, it is necessary that the state disposes of its share, i.e. its ownership of privatized companies, and to do that as soon as possible. Accelerated and transparent sale of these shares will enable not only removal of any breeding ground for corruption, but also will increase the predominance of majority owners of these companies, even eventual closure of the companies, i.e. their transformation from open/public public companies to limited liability companies, leading to improved corporate governance. Unfortunately, in the Government of Serbia itself, i.e. in some of its ministries, some voices have been heard advocating the idea of merging the shares currently held by the Share Fund with the portfolio of shares that will be distributed to the citizens of Serbia free of charge. Since about 5 million people have been registered for distribution of free shares, the procedure will, regardless of corruption, deteriorate the situation in terms of corporate governance. Not only the ownership dispersion would be increased, but closing of corporations will be more difficult, i.e. their transformation from open/public public companies into the forms of companies predisposed to better corporate governance (closed/private public company and limited liability companies). Namely, the Takeover Law stipulates the possibility of compulsory sale of shares if one of shareholders has taken over at least 95% of shares, providing the conditions to squeeze out small shareholders,

i.e. closure of such company and its withdrawal from the stock market. By such inclusion of the shares owned by the state and held by the Share Fund, a large number of companies would be further away from this cutoff point, which will hinder the process of corporate governance development in Serbia.

Accordingly, accelerated privatization should be supported, i.e. sale of shares that are still owned by the state, and the state should disclose its pertinent decision to the general public so that all interested stakeholders are informed. The current takeover legislation enables the whole process to be conducted transparently, leading to ownership consolidation. In this way, not only the more appropriate ownership structure will be provided from the corporate governance point of view, but all future takeovers will be effectuated within the private sector, impairing the risk of corruption.

As it has already been said, reduced intensity and spread of corruption in the public sector undoubtedly provide prerequisites for improvement of corporate governance, but this will not play a decisive role. Nevertheless, it still remains to identify the current key elements in anti-corruption activities in Serbia, i.e. the key elements that should be in place. There are four crucial ones.

The rent appropriated by the corrupted person is always the source of corruption. By adoption of the state policies eliminating the rent, the motives of corruptors are also eliminated – nobody is motivated to corrupt, unless he is rewarded by the pertinent rent. Analyses of such rent in Serbia or any other country for that matter, have clearly shown – corruption decreases with the level of state involvement. Accordingly, liberalization and deregulation are an effective response to corruption that yields high rent for the corruptors, i.e. they are the first line of anti-corruption activities in Serbia, although liberalization and deregulation do not affect corruption in the private sector. After 2000, a lot has been achieved in terms of liberalization in Serbia (prices, foreign trade, foreign exchange market, market of capital, etc.) and deregulation (again, foreign trade, registration of businesses, etc.), but it still remains a lot to be done. Further foreign trade liberalization is related to ratification and implementation of Stabilization and Association Agreement (SAA), establishing the area of free trade between Serbia and its main foreign trade partners in the EU.

Reform of the public sector is another element of anti-corruption activities. The reform pertains to substantial change of behavior, i.e. conduct of public officials, implying their different selection, training, downsizing, and empowerment for effective work, definition and implementation of strict

ethical standards (code of conduct), and increased salaries of civil servants. The last item on the list of anti-corruption activities may be controversial. While the public believes that the proposed salaries are too high, i.e. that the increase is too steep, civil servants generally insist that their salaries are too low. Can this controversy be resolved? The only way to resolve it is to set the salaries in public administration at the level somewhat above the one set in the private sector (labor market), but to have also an effective oversight system of civil servants, and make sure that all those involved in corruption are fired and, accordingly, left without pay. Thus, the salary, i.e. risk of losing it, will stimulate civil servants to perform their duties effectively and impartially.

Providing the prerequisites for establishment of the rule of law is another important element of anti-corruption activities. Effects of full rule of law are twofold. On the one hand, effective judiciary enables legal processing of corruption cases; accordingly, only with such judiciary is it possible to enforce effective punitive measures against the corruption-related offences. Serbia lags behind substantially in this particular area, i.e. the reform that is supposed to result in proper rule of law. Besides, in recent years, Serbia has wandered trying to find a proper institutional framework to curb corruption. Special bodies have been set up, ad hoc teams, even the Anti-corruption Council has been established which, according to many, failed to fulfill its purpose. Only recently the focus is redirected to its proper place: regular institutions, i.e. competent governmental bodies: police, prosecutor's office, etc. By the end of this year, we expect adoption of the pertinent laws to enable establishment of Anti-corruption Agency which will, primarily, focus political corruption, the one that may hinder operation of regular institutions, which may be influenced by the executive or legislative power, the parts of the power where political corruption may occur.

Finally, harsher punitive measures, i.e. strict, consistent and effective implementation of stipulated sanctions are among the strategies of anti-corruption activities. High fines, i.e., drastic criminal legal sanctions as well as high risk of discovery of perpetrators of the criminal offence of corruption and valid judgments for the crime have important deterrent function. This element of the strategy in corruption curbing activities is inevitably related to the previous one – establishment of the rule of law. Namely, punitive policy may be harsh; the sanctions stipulated very strict, but without implementation thereof, i.e. low probability of the verdict becoming a valid one, they do not play the intended preventive role. Initial cases of valid judgments pronounced against high governmental officials recorded in 2007, such as one against a Supreme

Court Judge, illustrate higher probability of punishment for those practicing corruption, regardless of the position they hold. A large number of detected corruption networks in the last two years, relating to various areas of public administration (Customs Administration, Commercial Court, toll collection, etc.) also illustrate that in Serbia, the times in which one could enjoy the fruits of corruption revenue in a carefree manner are definitely behind us. The information in itself is a warning to people to stay off corruption.

The link of corporate governance issue and corruption is fairly potent in case of corruption in the private sector. The sources may be perceived in poor corporate governance. In case of corruption in the public sector, the link of corporate governance issue and corruption is not salient. This may explain the situation in Serbia where, on the one hand, there is a fairly widespread corruption in the public sector, and on the other, relatively favorable ownership structure from the corporate governance point of view.

Concluding remarks

INTRODUCTION

In five years, from the previous CLDS survey on corporate governance in Serbia,¹⁴² major changes have taken place. In 2003 the predominant form of ownership was the socialist one, i.e. social property, with all associated defects. Corporate governance was one of the greatest weaknesses of Serbian economy: unqualified management usually reported to the state or ruling party, or employees or nobody but themselves, and the private property had only begun to take roots with onset of privatization. Consequences on success of companies and responsibility to society were dire.

The first survey conducted by CLDS identified the very poor situation, although it was hardly a surprise, but it nevertheless suggested a path to take. It promoted and advocated extensive reform of the overall environment – from efforts to establish the rule of law and institution strengthening (particularly the judiciary), via important amendments to the company and finance legislation all the way to changes of regulations in various aspects of economic life (ownership, accounting and audit, competition, anti-corruption activities, etc.). As many as three CLDS team members who wrote the study had the opportunity of promoting their ideas in the working group that prepared the draft Company Law in 2003-2004.

CHANGES IN THE COURSE OF 2003-2008

In the last five years, as we have seen in the previous chapters, a lot has been done in relation to corporate governance.

First of all, most of the so-called socially owned capital was privatized in the commercial sector of the economy, together with the financial and banking sector. Most of the state sector covering infrastructure, telecommunications, energy and the like has remained unprivatized. Many large companies have been taken over by foreign capital. Privatization has, undoubtedly, brought about essential changes in corporate governance, since the private owners have replaced social/socialist ones and introduced healthier commercial motives.

¹⁴² *Unapređenje korporativnog upravljanja (Improving Corporate Governance)*, CLDS, 2003

Second, privatization has mainly been accomplished by sale of 70% package of shares to a single investor, which has decisively formulated the ownership structure and management model, benefiting the majority owner who has both the ways and interests to control the company management firmly. Thus, instead of the conventional principal –agent issue, the principal-principal issue emerged as the predominant one, i.e. how to protect a minority owner from expropriation.

Third, company privatization automatically meant its transformation into an public company, meaning that small companies (e.g. local hairdressing parlor) also had the same form. This was, needless to say, strange and unsustainable for a longer term.

Fourth, in the post-privatization period, further concentration of ownership in Serbia has continued: both due to insufficient protection of small shareholders, and due to aspiration of controlling owners to increase their package and desire of most employees to dispose of their shares since they are not genuine investors.

Fifth, in these five years, substantial regulatory innovations have been introduced, that have greatly changed the nature of corporate governance in Serbia. In 2004 the new Company Law was enacted, regulating the issues of company law, including corporate governance, in a much better way. It has been harmonized with OECD corporate governance principles and EU Directives. In the course of 2006 new laws in the area of finances were adopted (on market of securities, takeover, investment funds) that have generally improved the market of capital and financial area as a whole.

Sixth, an attempt has been made with voluntary codes of corporate governance, which were promoted by the Serbian Chamber of Commerce (2006). They were supposed, following the role model of western countries, to compound statutory regulations with voluntary self-regulation, in the interest of investors. This attempt has not, at least not yet, yielded desired outcome.

Seventh, the main reason of not only the poor launch of the voluntary codes, but even more importantly, insufficient transparency of operations and insufficient (even from the statutory point of view) publication of information by public companies may be explained by the state of corporate governance. Namely, many companies have the public structure not by intention, but by the force of law (originating from privatization), so that they do not raise new capital on the market. Instead, they trade in their shares primarily aiming at the change of status form – from open/public public company to limited liability

company, for simplification and reduction of cost of operations of relatively small companies. When new capital is not raised at the market, the strongest motive for proper behavior and maximum transparency to improve the reputation and rating is not even present.

Thus, corporate governance in Serbia at this point of time experiences a transitional phase with partial normalization of ownership and status structure. Shares change hands from employees to proper investors, and owners of most public companies want their status changed, i.e. they want to become limited liability companies. These circumstances undoubtedly affect the nature, as well as weaknesses of corporate governance in Serbia. Others are related to institutional weaknesses, certain immaturity of shareholdership, intentional abuse by controlling owners, and the like.

FURTHER PROMOTION OF CORPORATE GOVERNANCE

There is no doubt that the aim of corporate governance should be to maximize long-term value of the shares by improvement of decision-making processes and performance of public companies through good structure of relationship between investors, management and other stakeholders (creditors, clients, employees). It implies establishment of rules and incentives that serve the company's interests best, and at the same time respect all duties to other participants.

The mentioned normalization of ownership and status structure is a necessary requirement for further promotion of corporate governance in Serbia. The final transfer of shares from the hands of employees to the hands of investors will end the conflicts between the group of employees that are also shareholders and the controlling owner, i.e. management of issues that are not directly related to operations, but to the salaries, employment security and the like, which are all trade union issues. Further, conversion of public companies, particularly the small ones, into limited liability companies will simplify the managerial structure by getting the owner closer to the operational management, and accordingly, narrow down the areas of corporate governance problems.

Upon completion of normalization, the role of the market of capital and banks will be greater as a source of new capital. Alongside, the reputation of public companies will be increasingly important for those that hold the capital

they count on. First, many of the remaining public companies will search for additional capital, but other new public companies will be set up, either *ab ovo*, or when prosperous limited liability companies go public. The importance of corporate governance will rise in parallel, since it is a major if not the decisive factor of the investment, i.e. credit rating.

We have, thus, mentioned the first and the foremost motive of corporate governance promotion in mature economies – own interest. This is not, therefore, a legal obligation or the business ethics issue, but the key aspect of good understanding of interests of company and shareholders. Well organized corporate governance contributes substantially to improved company performance and its image in the outside world.

The greatest progress may be achieved by the effort of public companies themselves. While corporate governance in Serbia is on a decent level in companies that are owned by foreign reputable companies, there is much room for improvement in the locally owned companies. As substantiated by the survey conducted for this study, as well as anecdotal evidence, many members of company managements have either insufficient knowledge on corporate governance and associated issues, or have no pertinent knowledge whatsoever. Accordingly, the system of current company management cannot be organized well, regardless of the level of compliance with the pertinent legislation.

Additional motivation for proper understanding of ownership interests may be provided by the environment, private and state, alike.

Within the private sector, various programs may be initiated, such as:

- Activation of voluntary codes of corporate governance that have been proven successful in some countries; the current ones may be revitalized, compiled by the Chamber of Commerce, and new may be formulated in proper cooperation of public companies; the principle “obey or explain” could be very powerful in this respect, where aberration from the rules stipulated in the code is quite acceptable as an expression of voluntarism and autonomous right of a company, but the aberration needs to be explained,
- Establishment of the rating system to measure the quality of corporate governance, to try to really measure the level of corporate governance in certain companies; the rating could become quite influential in the business community, with rating agencies and among investors,
- Training of owners and managers on corporate governance, where good technologies and good practices could be explained to those who could then implement them in real life,

- Public advocacy and promotion of the need to promote corporate governance and good ways to do so, etc.

The first activities that a state should undertake are undoubtedly the legislative ones. In the last five years, legislation that regulates corporate governance has been thoroughly changes – new laws have been enacted on companies, market of securities, takeover, etc. In comparison with the previous regulations, they have mainly brought about progress, but they are still not perfect and the system of corporate governance could be improved further. Therefore, in the previous chapters of this study an effort has been made to suggest possible legislative improvements not only in the mentioned laws, but in others directly relating to corporate governance, as well.

The company law stipulates acceptable concepts, although alternative ones, relying more on Anglo-Saxon principle may be contemplated as well. This time, we focused practical issues, so that the proposals for improvement of the law were dominated by operational solutions that should remove some of the shortcomings and imprecisions recognized in the law over the four years of its application. The only “conceptual” issue is the composition of the Managing Board, where we suggested complete personal separation from the Executive Board, which would be more in line with the underlying philosophy of this piece of legislation. We also believe that the proposals relating to mutual harmonization of this and other laws (on accounting and audit, market of securities etc.) are also important.

More important amendments were suggested in the financial laws. The Law on Securities should be corrected in at least two important segments: the first is the issue of poor quality securities originating from privatization, and the second is better organization of the Securities Commission. We also suggest adoption of the new Takeover Law, since the current is not satisfactory.

Another line of activity of the public sector could focus strengthened implementation of the law (judiciary) and other rules (Belgrade Stock Exchange and other regulatory agencies). As it has already been said, in Serbia the greatest weaknesses are identified in this area, and they endanger operation of the law and private rules of these institutions and prevent the system of corporate governance from peaking. For example, the law prohibited the use of insider information long ago, but nobody has ever been sanctioned for doing so, and it is a common knowledge that huge capitals have been made on the basis of insider information. These and similar cases clearly support the notion that “crime pays”, i.e. they demotivate law abiding and socially responsible

behavior. Instead, they direct the actors to the dubious road of success at all cost, including violations of the law and other rules.

We shall refrain from discussing the issue of how to provide for more effective judiciary, but we shall remind you that the problem of insufficiently solid judiciary has been identified long ago, and on the state level the strategy of comprehensive judiciary reform was adopted in 2004, but practically nothing has been done on implementation of this strategy since.

The study highlights recommendations for legislative amendments, although the main problems are actually not there, but are in implementation of the law and companies themselves. Nevertheless, we have opted for the legislative direction of recommendations, since we believe that this is the area in which rapid progress can be achieved more easily than in other mentioned and unmentioned areas.

