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Voucher Funds
in Transitional Economies
The Czech and Slovak Experience

Robert E. Anderson

Voucher funds — akin to western mutual funds, except that shares are bought with vouchers not cash — appear to be influencing the governance of enterprises. This could be their most valuable contribution to economic reform.

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Summary findings

Voucher funds have arisen in the transitional economies of Eastern and Central Europe that have used voucher privatization. These funds collect vouchers from citizens and use them to buy shares in enterprises.

In the Czech and Slovak Republics, voucher funds are typically organized as corporations owned by the citizens who contributed their vouchers. Recently, they have also been organized as unit trusts (either open-ended or closed). A management company manages the funds under a contract that specifies the management fee. The management company is typically owned by the initial sponsor of the fund — for example, a bank.

Voucher funds can give owners a diversified and professionally managed portfolio. More important, the funds select who sits on an enterprise's governance boards (which oversee management and profitability).

Although experience is limited, the funds in these two countries have probably stopped most fraud and self-serving by enterprise managers and are beginning to encourage the restructuring needed for profitability. A few funds have replaced poorly performing or dishonest managers; more often, because qualified replacements are few, they encourage managers to improve performance.

There have been complaints about funds' performance. Some have made unrealistic promises to voucher holders and have appointed poorly qualified members to

management boards. There is concern about conflicts of interest in bank-sponsored funds and excessive control of enterprises. Funds typically lack capital or expertise to undertake restructuring — but few other potential owners are likely to be better qualified.

Anderson examines 27 regulations that have been proposed for funds. Regulations in transitional economies, unlike regulations in most western countries, should encourage funds to play a strong role in corporate governance, he contends, as few potential owners have this ability.

Most important, regulations should require that funds disclose information about their operations so their owners can monitor and control fund managers.

The regulatory regime, he says, should discourage monopolies and anticompetitive behavior; create incentives for fund managers to improve fund performance; discourage self-serving or fraudulent behavior by fund managers, and conflicts of interest; and eliminate high-risk investments unacceptable to fund owners.

Because there is so little experience with these funds, the regulatory regime should not be unduly restrictive. As problems arise, regulations to deal with them can be added.

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Robert E. Anderson

**Technical Department
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Glossary of Terms

Term	Definition
Cash Fund	A mutual fund in which the members contribute cash. The fund uses this cash fund to buy enterprise shares.
Voucher Fund	A mutual fund in which the members contribute vouchers. The fund uses these vouchers to buy enterprise shares in voucher auctions.
Enterprise Shares	Shares issued by former State-owned enterprises now held by various owners including voucher funds.
Enterprise Shareholders	The holders of enterprise shares and thus the owners of enterprises. Major shareholders may be the voucher funds.
Fund Shares	Shares issued by the voucher funds to their own shareholders.
Fund Shareholders	The holders of fund shares and thus the owners of the funds.
Board of Supervisors	The senior governance board in those companies with a two tier board.
Management Board	The junior governance board sometimes called the Board of Directors in Germany or Executive Board in the Czech and Slovak Republics
Investment Company	A type of voucher fund established as a corporation. The members are shareholders of the fund.
Unit Trust	A type of voucher fund established as a contractual trust. The members are holders of participation units.
Open End Fund	A type of cash or voucher fund that permits its members to redeem their shares/units from the fund for its net asset value.
Closed End Fund	A type of cash or voucher fund that permits its members to sell their shares or participation units to other investors but not to redeem their shares/units from the fund for cash.
Management Company	A company that is hired to manage a fund. Sometimes referred to as investment companies.
Sponsor	An individual or a company such as a bank that establishes the fund and initially hires the management company for the fund.
Privately-Sponsored Fund	A voucher fund whose sponsor is a private individual or company.
Government-Sponsored Fund	A voucher fund whose sponsor is the government.

Voucher Funds in the Transition Economies: The Czech and Slovak Examples

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1. Description of Funds

1.1 This paper analyzes the role of the new voucher funds that have arisen in those Central and Eastern European countries that have implemented voucher privatization. These funds have been given different names in different countries, but their functions are similar. Such funds are similar to Western mutual funds except their members buy shares in the fund using vouchers, and the funds then use the vouchers to buy shares in enterprises. The term "voucher fund" is used rather than mutual fund or investment fund to make it clear that the participants contribute vouchers rather than cash to these funds.

1.2 The following primarily analyzes the experience of the Czech and Slovak Republics though some comparisons are made with other transition countries in the region. The two key issues are:

- **the success of voucher funds in monitoring and supervising the enterprises in which the funds have purchased shares in order to improve performance and profitability of these enterprises, in other words, the role of voucher funds in "corporate governance"; and**
- **design of a regulatory framework that encourages funds to play a positive role in the development of the economy and limits any undesirable or harmful activities of funds.**

1.3 The analysis is based on discussions with government officials in these two republics, interviews with three funds in the Slovak Republic and six funds in the Czech Republic, and interviews with six enterprises in the Czech Republic and four enterprises in the Slovak Republic that are now primarily owned by the voucher funds.² The analysis also draws on

¹The findings, interpretations, and conclusions expressed in this paper are entirely the author's and should not be attributed to the World Bank, its Board of Directors, its management, or any of its member countries.

²The author was accompanied in some of the interviews in the Czech Republic by Mitchell Orenstein and Karla Brom of the European Studies Center of the Institute for EastWest Studies in Prague. They have used the results of these interviews as well as others to prepare a report on the new private sector in the
(continued...)

several papers presented at a conference on voucher funds sponsored by the Central and Eastern European Privatization Network (CEEPN) held in Prague on October 29-30, 1993.

Types of Funds

1.4 Voucher funds in transition economies can be divided into two types according to their sponsors. In some countries, funds were founded almost exclusively by private individuals, companies, or institutions. These countries include the Czech Republic, Slovakia, Russia, and Lithuania. In other countries, however, the government plans to create the funds or has already done so though the intention is to eventually transfer these funds to private ownership. These countries include Rumania and Poland. This report will primarily analyze the experience with privately-sponsored funds, though some conclusions are also applicable to government-sponsored funds.

1.5 Privately-sponsored voucher funds have arisen in those countries that are selling State-owned enterprises for vouchers (coupons) rather than cash. Such vouchers are provided free or for a nominal charge to all citizens. Two distinct types of voucher auctions have been used:

- (i) a centralized auction (the Czech and Slovak Republics) in which the shares of many enterprises are sold simultaneously in a single auction; and
- (ii) enterprise by enterprise auctions (Russia, Lithuania, and Mongolia) in which each enterprise is sold over time independently of the others.

Various theoretical and practical arguments can be made in favor of each type of auction. The type of auction used, however, does not significantly change the role of the funds.

1.6 Privately-sponsored funds have been founded by both domestic and foreign entities including banks, insurance companies, enterprises, and individual businessmen. Citizens then turned over their vouchers to the new funds in exchange for shares in the funds themselves. The funds used the accumulated vouchers to bid for shares in the auctions of enterprises. In the end, the funds acquired a portfolio of shares in former State-owned enterprises on behalf of their own shareholders.

1.7 Because the funds themselves are usually corporations that issue shares to their owners, there is often confusion when the terms "share," "shareholder," or "owner" is used. Do these terms refer to the former State-owned enterprises that are now private companies or to the voucher funds that are themselves private companies? Hereafter, the terms "enterprise share"

²(...continued)

Czech Republic and their analysis supplements and in certain cases expands on the issues dealt with in this paper. See Brom and Orenstein (1993).

and "enterprise shareholder (owner)" refer to shares issued by the former State-owned enterprises because of privatization and now held by a variety of owners including voucher funds. The terms "fund share" and "fund shareholder (owner)" refer to the shares issued by the funds and now held by the owners of the funds, namely, the former voucher holders who gave their vouchers to the funds. Fund shares may be traded on the stock market along with the enterprise shares though the value of fund shares obviously depends on the underlying value of the enterprise shares owned by the funds.

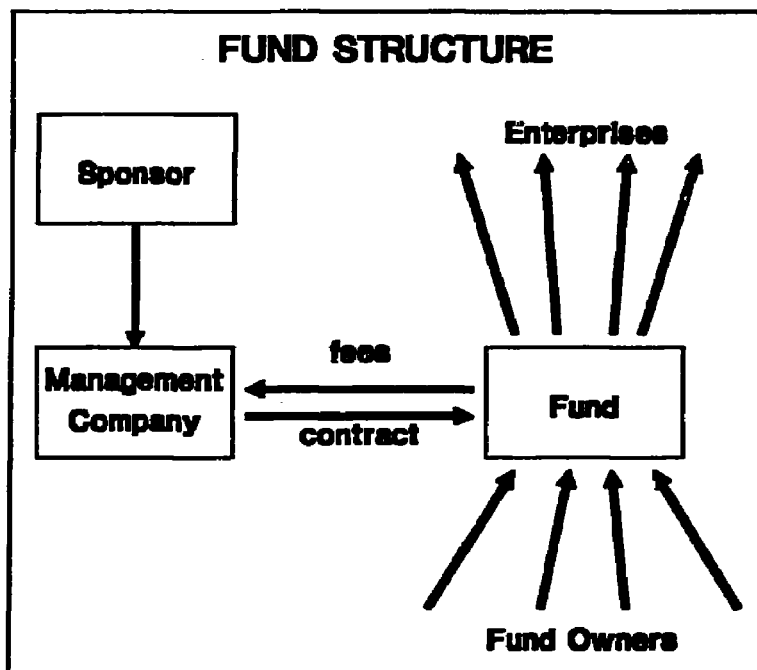
Structure of Funds

1.8 As noted above, funds are typically corporations and thus are subject to general legal provisions concerning the organization and structure of such companies. Some countries, however, have instituted a special legal framework for funds that include requirements not applied to other corporations. As discussed below, funds may also be established as unit trusts, but most of the analysis in this report assumes that funds are established as corporations. The structure and organization of funds will depend on the particular legal environment in each country.

1.9 The structure and organization of the funds in many transition countries are similar to that in the Czech and Slovak Republics. Using these two countries as examples, it is necessary to distinguish between three legal entities associated with a fund (see Fig. 1). These are: (i) the fund itself, (ii) the sponsor of the fund, and (iii) the management company for the fund. These three entities are sometimes not clearly distinguished and often collectively called the "fund."

1.10 As a corporation, the fund is owned by its shareholders, namely, citizens who transferred their vouchers to the fund. At the annual meeting, these shareholders elect the governance boards (for example, Board of Supervisors or Management Board) that are responsible for the management of the fund between the annual meetings. As discussed in more detail below, the number, functions, and structure of these boards depend on the specific corporate law in each country. Like other corporations, the funds in the Czech and Slovak Republics have both a Supervisory Board and a Management Board.

Fig. 1



1.11 The sponsor of the fund may be any legal entity or individual that organized and established a management company that in turn organized and established the fund. The management company is usually a corporation itself. The sponsor typically will continue to be the owner of the management company, but neither the sponsor nor the management company is the permanent owner of the fund.

1.12 The management company established by the sponsor, however, is likely to be the initial but temporary owner of the fund until the fund shares are distributed to the voucher holders. The management company also provides the initial operating expenses for the fund until the fund obtains its own sources of income, for example, dividends from shares in its portfolio or from selling shares. The funds in the Czech and Slovak Republics have been pleased to see the large increase in share prices on the Prague stock exchange over the last few months because they can more easily sell some shares to cover their operating expenses. The sponsor also expects that the management company will continue to advise the fund on the management of its portfolio and carry out most of the other activities of the fund under a management contract. The fund typically pays a management fee to the management company stated as some percentage of the value of the fund's assets. As discussed below, countries with voucher funds often regulate the size and structure of this fee. This use of management companies is copied from the structure of mutual funds in the United States and Western Europe. In theory, however, there is no reason why a fund like any other corporation could not be managed by its own staff rather than a management company.

1.13 After the voucher holders become the owners of the fund, they have complete legal authority to select another management company and sever any connection with the sponsor of the fund. Until the annual meetings of fund shareholders have occurred, however, it is not clear whether shareholders will exercise this right. An important test of the ability of the thousands of fund shareholders to control the funds will be whether they can change management companies and thus place pressure on the sponsors and their management companies to better manage the funds. Alternatively, funds may become similar to many large companies in the United States with widely dispersed ownership, and as a result incumbent managers effectively control the companies.

1.14 The income of the fund will come from dividends paid by companies in which the fund owns shares and from selling shares from its portfolio. The fund can then use this income for three purposes: (i) paying dividends to its own shareholders, (ii) paying the expenses of the fund, for example, the fee paid to the management company, or (iii) purchasing additional shares of companies. This income could become a new source of capital for enterprises if the fund decides to invest in newly issued shares of enterprises rather than pay dividends to the fund's shareholders. This does not appear to have happened yet to any great extent in the Czech and Slovak Republics, at least in part, because funds have received only a small amount of dividend payments from companies in their portfolios.

1.15 An important issue is the taxation of the income of the funds that is related to the taxation of corporations in these countries in general. If all corporations including funds are required to pay a corporate income tax, this could lead to "double taxation" of the income of enterprises. Double taxation would arise in the following situation. First, suppose that enterprises must pay a corporate income tax on their earnings and then pay dividends to their shareholders from after-tax income. Next, suppose that the dividends paid by the enterprises to the funds is also considered income for tax purposes on which the funds must pay the corporate income tax. Thus, this tax is paid a second time on the same income. This could greatly discourage participation in voucher funds because doing so would double the taxes that voucher holders would have to pay on their future income from owning shares.

1.16 There are a variety of ways of avoiding this double taxation. One example copied from the U.S. would be to allow voucher funds to deduct from their taxable income all dividends paid to their own shareholders. Thus if the voucher funds paid dividends equal to the dividends they receive from enterprises as well as income from selling shares (called "capital gains"), they would not have to pay corporate income taxes.³ This, however, would discourage funds from reinvesting their income back into the enterprises and instead would encourage them to pay all of their income as dividends to their own shareholders.

2. Functions of Voucher Funds

2.1 Voucher funds can have three major functions that can contribute to the success of voucher privatization and economic reform in general. Voucher holders deciding whether to entrust their vouchers to a particular fund must make some judgement as to the ability of that fund to carry out these functions. The following discusses each of these functions.

Portfolio Diversification

2.2 The first function is portfolio diversification. By transferring their vouchers to a fund, voucher holders can obtain a proportional ownership of a large diversified portfolio of shares in many enterprises. Since the value of a voucher is typically small, an individual voucher holder can buy only a few shares in one or two companies. For example, in the first wave of

³Another more technical problem for voucher funds is how to calculate the income received by a fund when it sells shares, commonly referred to as capital gains income. Capital gains is usually measured as the difference between the price at which the fund sold shares from its portfolio and the price it paid for the shares originally. If the price has gone up, the fund is said to have a "capital gain." If the price has gone down, the fund is said to have a "capital loss." The problem is that the funds did not pay a cash price for shares in their initial portfolios. They bought the shares using vouchers. Thus it is unclear what the initial purchase price for these shares should be for purposes of calculating capital gains and losses. For example, should a price of zero be used or the nominal ("par value") of the shares which was set at 1,000 crowns for all shares sold in the voucher auctions.

the Czech and Slovak voucher auctions, a typical enterprise share was initially priced at 33 points per share. Thus, a single voucher worth 1,000 points could be used to purchase only about 30 shares at this price. Owning part of a diversified portfolio reduces risk for the voucher holder since the future value of shares in any one company is likely to fluctuate much more than a diversified portfolio composed of shares in many companies. The ultimate in a diversified portfolio is a so called "indexed" fund that owns a fraction of the shares of a large number of enterprises.⁴ No fund in the Czech or Slovak Republics appears to have advertised itself as an index fund, but regulations in those countries require that all funds invest in at least 10 enterprises. Larger funds invested in many more than the minimum, sometimes as many as 100 or 200 enterprises.

Portfolio Selection

2.3 The second function is portfolio selection. The sponsor of a fund and the management company hired to manage the fund may be better able to choose enterprise shares in which to invest compared to an individual voucher holder. In other words, voucher holders may transfer their vouchers to a fund because they believe that the fund can "pick winners" from the large number of enterprises being offered in the voucher auctions. In voucher auctions, being able to pick winners does not mean simply choosing those enterprises that are likely to be more profitable than others. It means picking enterprises whose prices quoted in the auction are low compared to their estimated future earnings. Like any investor in the stock market, the management company of a fund will try to select "undervalued" companies and avoid "overvalued" companies.

2.4 In Western stock markets, a body of financial theory says that it is not possible to pick undervalued companies because the markets in these countries are "efficient."⁵ An efficient market is one in which prices of shares instantly adjust to reflect all of the available information about each particular enterprise. Thus in such a market it is not possible to find an undervalued company or an overvalued company, and the market price of each company's shares accurately reflects everything that is currently known about its future earnings potential. An "efficient" market does not mean, however, that current estimates of future earnings are always correct. Because of events that no one could anticipate, future earnings may be higher or lower than now predicted, and the future price of shares may rise or fall from current levels. There is no reason to believe, however, that the probability is higher that the price will rise or that the price will fall.

⁴Such a fund is called an "indexed" fund because the value of its portfolio is designed to track closely one of the popular indexes of overall stock market value. To do this, the fund includes in its portfolio shares of each enterprise that is covered by the selected stock market index.

⁵For a non-technical description of the theory of an "efficient" stock market, see Malkiel (1990) pp. 130-211.

2.5 Because of the lack of generally available financial and other information about enterprises sold in voucher auctions, one can reasonably doubt whether the voucher auction market in the Czech and Slovak Republics or in other transition economies would be an "efficient" market in which the voucher funds could not find undervalued companies. In any event, it is likely that voucher holders felt that funds could pick undervalued companies thus contributing to the popularity of these funds. In the Czech and Slovak Republics, the most popular funds were those managed by banks. On the one hand, this may have been due simply to the fact that these banks were widely known and had the resources to advertise. On the other hand, individuals may have believed that banks had inside or better information about the future earnings potential of enterprises. These banks were the major lenders to enterprises and thus perhaps in a better position to pick undervalued companies and avoid overvalued companies in the voucher auctions.

2.6 There is inadequate information now to judge whether the funds in the Czech and Slovak Republics could pick undervalued companies. Funds did typically buy shares in those enterprises that had a high price compared to their book value.⁶ In other words, the funds were more likely to buy shares in those companies that had an above average earnings potential. This does not mean that such enterprise shares were undervalued, however. In fact, the prices paid for the shares in these enterprises could have been too high compared to their future earnings potential, and the funds might have been better off choosing lower priced shares. The ultimate test will be whether the prices of the shares bought by the funds rise faster in the secondary market than other shares. As other investors realize that the funds were able to pick undervalued shares, the prices of shares held by funds should rise faster than other shares.

2.7 The efforts of the funds in evaluating companies did help to bring about a more efficient market, and individual voucher holders received in some sense a free ride on the efforts of the funds. If the funds did discover undervalued companies, these funds would rush to buy such shares and thus bid up their prices. Similarly, the funds would avoid buying shares in overvalued companies thus forcing down their prices. The irony is that the effort of the funds to find undervalued shares led to a more efficient market in which fewer shares were undervalued or overvalued.

2.8 As the voucher auctions became more "efficient" due to the efforts of the funds, voucher holders who did not entrust their vouchers to a fund could do reasonably well by picking shares simply at random. In other words, individual investors could not make a serious mistake in buying shares no matter which shares they purchased because no shares were overvalued. All share prices roughly reflected the future earnings potential of the companies thanks at least partially to the efforts of the funds. Individual voucher holders may not have been able to invest in a diversified portfolio without transferring their vouchers to a fund, but they are unlikely to have paid an excessively high price for the shares they did purchase. Thus it can be

⁶See Shafik (1993), p. 34.

argued that all investors in the auctions were treated with rough justice at least in part due to the effort of the funds to evaluate companies.⁷

2.9 Just as important as buying shares for the fund's portfolio is the selling of shares from the portfolio. The selling of shares by a fund allows the ownership of an enterprise to pass to another investor, for example, a foreign company operating in the same industry, who may be better able to supervise and control the enterprise and thus increase its efficiency and profitability. This is sometimes called the market for corporate control.

2.10 Those who oppose voucher privatization argue that the government instead ought to sell an enterprise to large foreign or domestic investors who can bring both additional capital and expertise to the management of the enterprise. They argue that voucher funds have neither

⁷Though the purpose of this paper is not to evaluate alternative types of voucher programs, the type of voucher auction used does impact on whether the resulting market for shares is "efficient" and whether participants are treated fairly. The type of voucher auction used in the Czech and Slovak Republics had one feature that made it less likely to be "efficient" and thus arguably detracted from the fairness of the program. This feature was that the auction method forced some voucher holders to invest in shares that were overpriced and thus received less value for their vouchers relative to other voucher holders. The general approach used in these auctions was to have multiple rounds of bidding with prices adjusting from round to round to bring about a balance between supply and demand for the shares of each enterprise. For example, if the initial price for the share of an enterprise resulted in excess demand, the price was raised in subsequent rounds. The exception to this general approach was that shares in some companies were sold at the current price even though they were under-subscribed. In these cases, the general view of the market was that the current quoted price for these enterprises was too high and thus demand was less than supply. Those voucher holders, however, who did make an offer at that price were forced to buy the shares at that price. The unsold shares were offered again in later rounds at a lower price to attract more buyers. In these cases, the market was clearly not "efficient" since the price actually paid by some participants did not reflect all of the information about the enterprise available to the other participants. Those who were forced to buy under-subscribed and thus overvalued shares were in some sense not treated fairly.

The auction system used in Russia and some other countries is even less likely to approximate an efficient market and the inequities are even greater. This is because the Russian system sells enterprises one by one independently of each other rather than simultaneously as in the Czech and Slovak auctions. A bidder in a Russian auction has no way of knowing what the prices will be for shares in other enterprises or even what enterprises will eventually be offered for sale. In the Czech and Slovak auctions, a bidder could evaluate whether an enterprise was undervalued or overvalued compared to other enterprises and thus choose an enterprise that seemed to offer the best ratio of price to future earnings potential. This is simply not possible in the Russian type of auction. Thus such an auction can not even remotely resemble an "efficient" market, and the value of the shares purchased is likely to vary much more from individual to individual than in the Czech and Slovak auctions. Russian government officials recognized these theoretical weaknesses but chose that type of auction because of various practical considerations.

capital nor expertise to carry out needed restructuring of the enterprise. Those who support voucher privatization, however, argue that the funds will be willing to sell their shares to a large investor if the investor could do a better job of managing the enterprise. Voucher privatization does not preclude the later sale by the funds to a large investor if such an investor is interested. The reason the voucher funds would be willing to sell is that the investor should be willing to pay an attractive price for the shares of the company. Because the investor has a better plan to improve efficiency and profitability, this investor can afford to pay a higher price than now quoted on the stock market. Such sales should be encouraged because the overall efficiency of the economy would be improved.

Corporate Governance

2.11 The third and perhaps most important function of the funds is to govern those enterprises in which they own shares. Though the first two functions of funds (portfolio diversification and selection) are important, they primarily involve issues of equity or fairness, in other words, how individuals are treated in the voucher auction system. Whether an individual can obtain a diversified portfolio or whether the value of his or her portfolio is high or low does not greatly affect the general functioning of the economy in general or enterprises in particular.

2.12 When voucher privatization was first proposed, the most serious criticism was that it would not result in "good" owners who would take an active interest in the future efficiency and profitability of enterprises. In particular, it was feared that shares of enterprises would be dispersed among millions of voucher holders who could not influence or control the enterprises that they owned. Though not anticipated in the initial planning for the Czech and Slovak voucher program, the spontaneous creation of funds by private individuals and institutions has at least partially eliminated this weakness of voucher privatization.

2.13 Doubts about the effectiveness of privately-sponsored funds in governing enterprises, however, have led some countries, most notably Poland, to create government-sponsored funds. In these cases, the government would choose the management company for each fund, establish the terms of the management contract, and select the portfolio of enterprises that each fund would own. The goal is that the ownership of such funds would be transferred eventually to the citizens of the country and thus be privatized.

3. Models of Corporate Governance

3.1 The debate over the role of funds and whether privately-sponsored or government-sponsored funds are best in transition economies stems in part from differences in views about the role of owners of large companies. To illustrate these differences, the following presents three different models for corporate governance that are applicable to transition economies. Table 1 lists the three models and the likely percentage of shares owned by the largest investor in each model.

Dispersed Ownership

3.2 In the first model, ownership of large public corporations is widely dispersed with no single owner or even a coalition of owners having a strong voice in the governance of the enterprise. The largest individual shareholder has less than 10 percent of the shares and does not have a representative on the governance boards of the enterprises.

3.3 Most large companies in the United States are examples of dispersed ownership. In the U.S., small individual investors own about half the shares. Though the other half the shares are owned by financial institutions such as mutual funds, pension funds, and insurance companies, each institution only owns a small fraction of the shares in a particular company. For example, the five largest shareholders in large U.S. companies typically own in total less than five percent of all shares.⁸ Thus, even the largest shareholders usually play a passive role in corporate governance.

3.4 Government regulation and tax laws limit the ability of financial institutions to play an active role. For example in the United States, the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956 restrict banks from owning shares in enterprises or sponsoring mutual funds. Consequently, the governance board that officially represents the interest of shareholders in U.S. companies (the Board of Directors) is often under the control of management and may only intervene in the management of the company in extraordinary circumstances. As opposed to direct pressure from the owners, indirect pressure on management to improve performance comes from market competition, the quoted stock market price, the threat of take overs, oversight by lenders such as banks, debt ratings by such institutions as Moody's and Standard and Poors, and threat of bankruptcy.

3.5 It is questionable whether these indirect pressures on management work well even in the United States. Complaints are often made that managers in the United States pay themselves excessive salaries though their company is performing badly, oppose a new owner buying a controlling block of shares in their company because they are concerned about losing their jobs (so called "hostile takeovers" because existing management is hostile to the new owner), and squander the financial resources of the company on new investments and expansion plans that increase the prestige and salaries of the managers but provide a low rate of return to the shareholders. In any event, these indirect pressures are even weaker in many transition economies, and thus the model of dispersed ownership is probably not well suited to these countries.

Table 1

Models of Corporate Governance	
Model	Ownership by Largest Investor
Dispersed	less than 10%
Institutional	10 to 50%
Holding Company	51 to 100%

⁸See Baums, Buxbaum, and Hopt (1993), p. 28.

Institutional Ownership

3.6 In the second model, financial institutions such as banks, pension funds, or mutual funds are the dominant shareholders. Several of these institutions would each typically own somewhere between 10 and 50 percent of the shares. Thus they have an incentive to closely supervise and monitor the performance of management and to demand representation on the governance boards for that purpose.

3.7 This model is exemplified by Germany where the banks play a dominant role in corporate governance. German banks often control a large proportion of the shares of the largest enterprises.⁹ The shares controlled by these banks consist of shares owned directly by the banks, shares held by the banks for individual investors who purchased the shares through the banks since banks are also the largest brokers in Germany, and shares in affiliated mutual funds. In the Czech and Slovak Republics, large banks are the sponsors of the largest voucher funds and thus probably can control the shares owned by these funds.

3.8 In spite of the general pattern of widespread and passive share ownership in the United States, institutional investors in that country have begun to play a larger role in corporate governance. This trend is sometimes called "relationship investing" because the large institutional shareholder wants to influence the managers to improve the performance of the company and thus enhance the return on the large shareholder's investment in the company. The most cited example of such an institution is the California Public Employees Retirement System (Calpers), a large public pension fund. Some mutual funds have also adopted this philosophy.¹⁰

3.9 Institutional owners monitor performance, but are not themselves experts in the management of any particular business or industry. The owners review and approve business and financial plans for the enterprise prepared by management but do not typically develop the plans or arrange for financing themselves. If the managers are incapable of developing appropriate plans and strategies for improving efficiency and profitability, the response of the large institutional owners typically would be to replace the managers rather than carry out the duties and responsibilities of the full-time managers.

Holding Companies

3.10 The third model only exists in a minority of companies in Western countries, but seems to be the basis for proposals to create government-sponsored funds. This model is the relationship between a holding company and its closely held subsidiaries. Other examples might

⁹For example, in 42 of the largest German companies, three banks control on average 45 percent of the shares in these companies. See Baums, Buxbaum, and Hopt (1993), p. 75.

¹⁰See "Corporate Governance Survey," p. 16.

include venture capital funds and "turn-around" funds that specialize in providing management expertise and capital to improve the operations of enterprises in which the funds are the major owner. In this model, the holding company would own at least 51 percent of the shares of the subsidiary and often much more.

3.11 The holding company plays a more direct and active role in the day-to-day management of the subsidiary. Representatives of the holding company may be the only members of the governance boards of the subsidiaries. Managers from the holding company may transfer to positions in the subsidiary companies and vice versa. The subsidiary is expected to provide much more frequent and detailed reports to the holding company than would normally be provided to shareholders. The holding company provides management and technical expertise to help the subsidiary develop its business plan and improve its operations. The holding company reviews investment decisions above a certain threshold and may also be responsible for raising capital for the subsidiary.

3.12 Because the holding company owns most or all of the shares of the subsidiary, it will reap most or all of the gains in efficiency and profitability of the subsidiary and thus has an incentive to devote a substantial amount of its own resources to improve the operation of the subsidiary. A holding company that owned a smaller percentage of the shares would find that increases in profits and dividends must be shared with other owners of the company. In other words, the other owners would be "free riders" on the efforts of the holding company. This would reduce the incentives for the holding company to devote a large amount of resources, such as scarce managerial talent, to improving the operation of the subsidiary. Also, a large ownership percentage helps to guarantee that the holding company can control the enterprise and ensure that its restructuring plan is carried out.

3.13 Those who favor government-sponsored funds seem to support the third model of corporate governance similar to a holding company structure with the funds acting like a holding company. In these cases, the government would determine the portfolio of each fund, appoint the governance boards for the fund, and select a management company for the fund. Management companies for the funds would be staffed by management and financial experts drawn from international consulting firms who can take an active day-to-day involvement in the management of the companies and provide the managerial and technical expertise that may be lacking. Furthermore, a fee structure would be established for the management companies that will give them a strong financial incentive to improve performance of the enterprises owned by the funds. Supporters of government-sponsored funds doubt that private funds will ever have this expertise and insist that only the government has the resources to create such funds. Note that a particular fund should then own a large proportion of the shares of a particular enterprise (certainly more than 50 percent) to create maximum incentives for the fund to invest resources in improving the operation of the enterprise.

3.14 As an example, the mass privatization program in Poland is centered on government-sponsored funds. In this case, however, only 33 percent of the shares of a company will be owned by a single fund called the "lead" fund with smaller amounts of shares held by other funds. This seems to raise questions about whether the "lead" fund and its management company will have the necessary incentives to improve the efficiency and profitability of enterprises. Incentives may be reduced for the lead fund because over two-thirds of all increase in profits would accrue to other owners of the enterprise, creating a "free rider" problem.

4. Governance in the Czech and Slovak Republics

4.1 In the Czech and Slovak Republics, the funds initially assumed the first model of dispersed ownership. The managers of these funds say that they modeled themselves after mutual funds in the United States and Western Europe and were primarily interested only in providing a diversified and attractive portfolio of shares for the voucher holders. Some sponsors of funds following Western models even attempted to offer a family of funds, for example, a growth fund, an income fund, a small capitalization fund, sector funds, and so forth. Most fund managers did not have any plans initially to play an active role in the governance of enterprises.

4.2 These funds, however, realized that the situation was different at the first annual meeting of the shareholders and have adopted the second model of institutional ownership. They discovered that three or four funds together typically owned a majority of shares in a particular enterprise, and thus they had the obligation to elect the members of the Supervisory and Management Boards. Not surprisingly, the funds elected their own representatives to sit on the boards. After that, the representatives of the funds on the new boards had no choice but to supervise and monitor the performance of management and to review and approve business and financial plans.

4.3 The funds in the Czech and Slovak Republics, however, have not yet adopted the third model of corporate governance typical of holding companies. In general, they have not tried to become the day-to-day managers of the enterprises or take on the responsibility of raising capital for restructuring or expansion. They have been forced to limit themselves to encourage existing managers to improve operations and, if necessary, to replace managers who have proven to be incapable. This may be because the funds simply do not have the expert staff or access to capital necessary to implement the third model. Also, as discussed in more detail below, any single fund or group of funds with the same management company is prohibited from owning more than 20 percent of the shares of an enterprise, thus effectively prohibiting a fund from becoming a holding company. If any one fund spent substantial resources trying to improve the profitability of a particular enterprise, the other owners would receive a large share of the benefit.

Governance Boards

4.4 In all countries, the shareholders of a company exercise their ownership rights through the annual meeting of shareholders at which they elect one or more boards that meet regularly throughout the year. These boards have various names depending on the country but are hereafter referred to collectively as "governance boards." The key to improved corporate governance is the role, functions, and composition of these boards. The structure of governance boards in the Czech and Slovak Republics seems to be different from most other countries.

4.5 A source of confusion in trying to understand the structure and membership of these various governance boards is the different uses of the term "director of a company." In the United States, companies have a single board which is called the Board of Directors, and a member of the board is called a director of the company. In Germany, the term director instead refers to a senior manager of the company, and the term Board of Directors means a board of senior managers. Thus, a Board of Directors in Germany is similar to a senior management committee in the United States. To avoid this confusion, the term director hereafter is only used to refer to the members of the Board of Directors in the United States. Senior managers in all countries are simply called managers, and a board of managers is called a Management Board rather than a Board of Directors.

4.6 Also it is important to distinguish between four types of individuals who may sit on the governance boards in the Czech and Slovak Republics and other countries. These are:

- (i) outsiders. These are prominent figures in business or academia who are asked to represent dispersed shareholders. They are not managers or workers in the company and do not represent any particular owner or group of owners.
- (ii) major owners. If particular owners such as funds own substantial blocks of shares, they can select individuals to sit on the governance boards.
- (iii) managers. Senior managers of the company can be members of certain governance boards depending on the law in each country.
- (iv) workers. Workers may sit on governance boards as representatives of the employees of the company as a group or class depending on the law in each country.¹¹

4.7 Because powerful interest groups such as major owners, managers, and workers may elect individuals to sit on the governance boards, it is sometimes assumed that they are the

¹¹In those companies with substantial worker ownership of shares (for example, "ESOP" companies in the United States), workers may also sit on the boards representing those workers who are shareholders rather than workers as a group or class. In this latter case, such board members would be included in the second category listed above, namely, representatives of major owners.

representatives of those interest groups and their primary responsibility is to protect or promote the interest of those groups. This is analogous to a member of Parliament who represents the interests of his or her constituency. Legally, however, a member of a governance board is usually required to represent the collective interest of all shareholders rather than any specific shareholder or interest group. In some countries, shareholders can bring legal action against board members who violate this "fiduciary" responsibility to promote the interest of all shareholders. Whether this happens in practice is another matter. Though this paper refers to "representatives" of major interest groups sitting on the governance boards, this is perhaps a misleading characterization of their legal position on the boards.

4.8 To understand the structure and functioning of governance boards in the Czech and Slovak Republics, it is useful to compare them with similar boards in Germany and the United States (see Table 2). The German and Czech/Slovak models are similar in that they have two governance boards while the United States has only one. The functions and composition of the two boards in the Czech/Slovak model, however, are substantially different from the German model, and some argue that the Czech/Slovak model more closely resembles the U.S. model because most power is concentrated in a single board.

Table 2

Composition of Governance Boards		
United States	Germany	Czech and Slovak Republics
Board of Directors ● Outsiders ● Managers	Supervisory Board ● Outsiders ● Major Owners ● Workers	Supervisory Board ● Outsiders ● Workers
	Management Board ● Managers	Management Board ● Major Owners ● Managers

4.9 In the U.S. model, the single governance board is the Board of Directors and is elected by the shareholders at the annual meeting. Large companies typically have a dispersed ownership structure with no single investor owning more than a few percent of the total shares. Company management plays a major role in selecting who will sit on this Board through its control over the voting process at the annual shareholders meeting. Not surprisingly, company managers prefer that they be elected to the Board. Management also nominates and recommends to the shareholders for their approval "outside" directors who are not themselves managers of the company. It is argued that this results in a Board largely dominated and controlled by the incumbent managers of the company that often puts the self interest of the

managers ahead of the shareholders. Workers have no automatic right to have representatives on the Board unless workers happen to be significant shareholders.

4.10 In the German model, representatives of shareholders and the managers sit on two separate boards. Shareholders are represented on the Supervisory Board. Because large German companies often have major shareholders that own a large block of shares (most notably, banks), these shareholders elect their own representatives to sit on the Supervisory Board along with outside members who represent the many small shareholders. Under the German policy of "co-determination," workers are allowed to elect one-half of the Supervisory Board. The Supervisory Board in turn appoints senior managers to a Management Board. The Supervisory Board sets broad corporate policy while the Management Board is in charge of the day-to-day implementation of that policy. A case can be made that the German model is superior to the U.S. since representatives of large shareholders dominate the Supervisory Board. This avoids the conflict of interest and confused objectives that seems to characterize the Boards of Directors in U.S. companies that are largely dominated by the managers of the company.

4.11 Like the German model, the Czech and Slovak model has two boards, but the representatives of the major shareholders in most but not all companies have chosen to sit on the Management Board rather than the Supervisory Board. The current corporate law in these two countries appears to permit the shareholders at their annual meeting to elect members of both boards. Thus the shareholders of a Czech or Slovak company could choose to follow the German model and elect only managers to sit on the Management Board. Instead, the shareholders (typically the voucher funds) in most companies have chosen to elect their own representatives to sit on the Management Board along with managers. Some managers and government officials have complained that this was not the intent of the law.

4.12 In this unique Czech and Slovak model, the Management Board is composed of representatives of the funds and senior managers though the proportion varies from company to company. Because of the difference in composition between the boards in Czech/Slovak companies and German companies, the functions and role of the two boards are also different. Both broad corporate policy and day-to-day implementation are the responsibility of the Management Board in most Czech and Slovak companies. This board typically meets monthly. In this regard, the Czech and Slovak companies are similar to U.S. companies where power is concentrated in a single board.

4.13 The Supervisory Board typically consists of two-thirds outsiders and one-third worker representatives though sometimes the funds have also elected their representatives to this board as well as the Management Board. This board typically represents the interest of smaller shareholders and the workers and only meets every two to four months. One of its major functions is to appoint the accounting/audit firm for the company and to certify that the financial accounts of the company are true and accurate.

4.14 The fact that the funds chose to be represented on the Management Board rather than the Supervisory Board suggests that they do wish to play an active and strong role in corporate governance and want to be involved in the management of the company. In this respect at least, the Czech and Slovak model is like the holding company model. When asked whether mixing representatives of major shareholders and managers on the Management Board might cause the same conflict of interest and confused objectives as is argued to occur in U.S. companies, the response from funds was a clear "no." The funds as major shareholders always maintain the upper hand over managers because they elect both boards at the annual meeting and thus can, if necessary, replace managers who are on the Management Board.

Ownership Structure

4.15 The final structure of ownership of Czech and Slovak companies including the importance of funds cannot be known with certainty until privatization is complete in these countries. In the Czech Republic, this could be within a few months when the second wave of voucher privatization is completed. In the Slovak Republic, a second wave is not scheduled to begin until the second half of this year. The Slovak Republic also intends to use more "standard" methods of privatization in which enterprises are sold for cash rather than for vouchers. In these cases, the funds would not become the major owners of the enterprises.

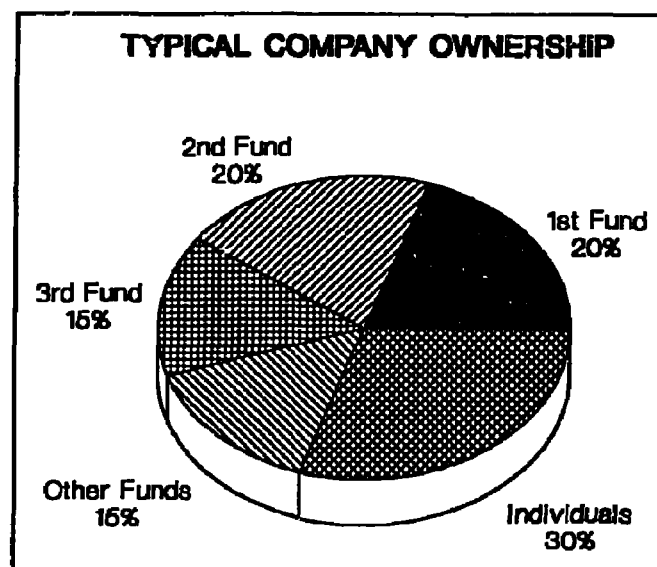
4.16 Majority ownership of an enterprise by three or four funds is likely to be quite common in the Czech Republic and perhaps to a lesser extent in the Slovak Republic (for an example, see Fig. 2). This pattern is the result of two factors:

- about 70 percent or more of vouchers are likely to be entrusted to voucher funds; and
- current regulations in both countries do not permit a single fund to own more than 20 percent of the shares of an enterprise.

Because many funds prefer to own the maximum proportion of shares permitted, three or four funds are likely to each own near the maximum of 20 percent of shares with the balance split between other funds and individual shareholders, resulting in the pattern of ownership illustrated in Fig. 2.

4.17 Similarly, the number and size of funds cannot be known with certainty until after privatization is complete. After the first wave, the total number of funds was 264 in the Czech

Fig. 2



Republic and 165 in the Slovak Republic. Though the number of funds was large, ten to twenty large funds dominate the industry. The first wave resulted in the ten largest funds in each country owning about 24 percent of the shares of all companies. Many of the largest funds were founded by the largest domestic banks in the two countries while the others were founded by insurance companies, private individuals, and foreign banks.

4.18 In addition to the first restriction noted above that a fund (or group of related funds) cannot own more than 20 percent of the shares of a particular enterprise, a second restriction is that a fund cannot invest more than 10 percent of its total assets in the shares of a single company. These two quantitative restrictions on the portfolio of a fund are sometimes confused but have very different objectives. The first restriction limits the ability of a fund (or group of related funds) to exercise control over a particular enterprise. This second restriction forces funds to own shares in at least ten different enterprises and thus have a diversified portfolio. For large funds, this ten percent limit was generally not binding, while the 20 percent limit on ownership of the shares of a single company was binding. A large fund could own 20 percent of the shares of the largest companies, and yet these shares would not amount to more than ten percent of the fund's total assets. For smaller funds, the ten percent rule could be binding and force such funds to invest only in smaller companies if they wanted to own the maximum of 20 percent of the shares or else own a smaller percentage of the shares in larger companies.

Comparison with Other Countries

4.19 Perhaps more by chance than by design, the Czech and Slovak Republics have adopted a system of corporate governance that resembles the system in Germany more than any other country. The ownership of enterprises in the Czech and Slovak Republics is dominated by a few large financial institutions, namely, the voucher funds. Most of the largest funds were founded by the large banks. Thus, like banks in Germany, the banks and their affiliated funds in the Czech and Slovak Republics will play a major role in corporate governance.

4.20 Though no system of corporate governance is perfect, the German model based on strong institutional ownership may be the best for these two countries and perhaps for other transition economies as well. The U.S. model based on dispersed ownership has been subject to increasing criticism because shareholders have few ways to influence poorly performing managers. In such cases, the only option may be a "hostile takeover" in which a large investor or consortium of investors attempts to buy a controlling block of shares and replace the current managers. Critics of the U.S. system argue that laws should be changed to permit financial institutions, such as banks and mutual funds, to play a larger role in corporate governance.

4.21 One important difference between the system of corporate governance in Germany and in the Czech and Slovak Republics is the role and composition of the Management Board. Representatives of the large institutional investors in the Czech and Slovak Republics (voucher funds) have chosen to sit on the Management Board while representatives of such investors in Germany (typically large banks) sit on the Supervisory Board.

4.22 The Czech and Slovak model may be an improvement over the German model. In Germany, the Supervisory Board may not be able to adequately supervise and control the Management Board in all cases for at least two reasons. First, because workers are represented on the Supervisory Board, managers and representatives of the large investors may be reluctant to discuss critical issues or to disclose key information to this board. Second, the Supervisory Board only meets a few times each year and thus may not give adequate attention to the detailed problems of the company. The weaknesses of the Supervisory Board in Germany are illustrated by the recent financial difficulties of Germany's 14th largest firm, Metallgesellschaft. In this case, the Supervisory Board admitted that it was not aware of the financial problem of this company until it was almost bankrupt.¹²

4.23 Voucher funds in the Czech and Slovak have indicated a desire to play an active role in the management of the company by choosing to be represented on the Management Board along with the managers of the company. In particular, given the need for major restructuring of enterprises in these countries, this active role by the voucher funds should be encouraged. Though mixing representatives of owners and managers on the Management Board may create some unforeseen difficulties, this type of board has long existed in the United States where the Board of Directors consists both of managers and representatives of shareholders.

Experience to Date

4.24 How successful have the voucher funds been in governing the enterprises in the Czech and Slovak Republics? In other words, have the new owners brought about needed improvements in efficiency and profitability of enterprises? Unfortunately, the answer to this important question is that it is probably too early to tell with any degree of certainty. The voucher funds became the owners of the enterprises legally only after April 1993 when the shares of the enterprises were distributed to the voucher holders who successfully bid for the shares. The first annual meetings of shareholders of the companies typically occurred shortly after the distribution of shares. It was at this first annual meeting that the voucher funds could elect their representatives to the governance boards of the enterprises and officially exercise their rights of ownership.¹³

¹²See "Corporate Governance Survey" (1994), p. 14.

¹³Some funds did begin to exercise their ownership rights in the fall of 1992 under the sponsorship of the National Property Fund (NPF). Until the shares were distributed to the funds and other new shareholders, the National Property Fund exercised the ownership rights of the State. During this time, the NPF appointed board members for those enterprises included in the voucher privatization. The NPF chose to take a passive role and appointed representatives of the voucher funds who had purchased shares in the enterprises in the voucher auctions to sit on the boards of enterprises as early as the fall of 1992, even though the voucher funds were not yet technically the owners.

4.25 Funds have various policies about who will represent them on the boards of enterprises. The management company for a large fund may have something like 50 employees and have representatives on 90 or more boards. Funds may also appoint non-employees to sit on the boards to supplement their own employees. Attending board meetings is an important and time consuming activity for the fund's employees. Most companies pay a fee to board members for each meeting attended. The typical fee is between 2,000 and 5,000 crowns in either the Czech or Slovak Republics (roughly \$64 to \$160 at the current exchange rates). This fee is kept by the board member rather than the fund and, in effect, helps to pay the salaries of fund employees. Some companies complained that some board members wanted to increase the number of meetings to increase their fees. Others said that at least one fund had tried to raise the fees paid to board members.

4.26 The quality and experience of board members no doubt vary considerably. On the one hand, a fund sponsored by a foreign bank claimed that its board members were experienced businessmen and could make substantial contributions to the management of the enterprises. On the other hand, some managers complained about the board representatives from the funds founded by large domestic banks. These bank funds often appointed local bank branch managers to sit on the boards. One complaint was that they contributed little to the management of the company and were only interested in receiving the fee paid to board members. Another complaint was that some board members sit on too many boards. It is argued that they do this only to collect the fees and are unable to give adequate time and effort to each board.

4.27 One concern of some fund managers is the government requirement that a fund may not own more than 20 percent of the shares of a single company. They argue that this creates difficulties in supervising and controlling managers and selling a controlling block of shares to an outside investor. The funds that own large blocks of shares in the company must agree on major changes in the management of the company. In effect, a single fund can often veto and block these changes. Similarly an outside investor who wishes to buy a controlling block of shares, say more than 51 percent, must negotiate and reach agreement with several funds. Each may be a holdout with unrealistic demands for a high price for its shares in the company.

4.28 Discussions with fund managers suggest that their activities to improve governance and restructure enterprises can be divided into three categories. These are:

- eliminating fraud and self dealing by managers. A common complaint in all transition economies is that the managers of some enterprises have schemed to transfer the assets of the enterprises to themselves or to benefit unfairly at the expense of the future private owners of the enterprises. This is sometimes called "spontaneous privatization." For example, one scheme allegedly used by managers of a State-owned company is to create a private company owned by the managers perhaps with a foreign partner and then enter into contracts with the State-owned company that unfairly enriches the private company. The funds say that they have been able to stop most such schemes by the managers and in effect preserve the assets of the enterprise for the new owners.

- **low-cost efficiency/profitability improvements.** The funds say that they initially have emphasized low-cost improvements in the operations of the companies. Contrary to the belief held by some, the funds argue that much restructuring can be carried out without large new investments. These include reducing the work force, closing unprofitable facilities, improved marketing efforts, and increased attention to quality. Though the funds say that they are promoting such low-cost efficiency improvements, there is mixed evidence that former State-owned enterprises now under the control of funds are in fact reducing the size of their work forces. The unemployment rate in the Czech Republic is remarkably low, about three percent, in spite of the common belief that Czech enterprises previously had substantial surplus workers that were not needed. This suggests that enterprises have not been reducing the size of their work forces. Others argue that the booming private sector has hired most of the workers that have been fired by the former State-owned enterprises thus keeping unemployment low. There does not seem any clear answer to this question.
- **high-cost restructuring.** Until the managers have shown that they can introduce the low-cost efficiency improvements, some funds are unwilling to consider large new investments for modernization and expansion. Also the low-cost efficiency improvements will generate additional cash flow that can help to finance the high cost improvements. The funds themselves, however, typically do not have any special access to capital for large new investments. They can only encourage the enterprises to increase internal cash flow and to seek funds from traditional sources such as bank loans.

4.29 Sometimes, the funds have forced companies to remove corrupt or incompetent managers. There are at least two reasons, however, why funds have refrained in most cases from replacing managers:

- The first reason is that there is a general shortage of managers with the necessary training and experience. This is not surprising since the managers of enterprises in these countries though usually highly intelligent and hard working may have little experience with the operations of a market economy. Thus the funds say that it is often better to help the existing managers improve their skills rather than try to find replacements which may not have the necessary skills either. It must also be noted that fund managers are also likely to be inexperienced and lacking in skills. Just like enterprise managers, fund managers must improve their skills and knowledge of the operations of a market economy.
- The second reason is that there may be some political or public pressure not to remove managers. In general, there is political opposition to large powerful funds, and the funds may be reluctant to take steps that are unpopular though necessary for the long term improvement of the economy, for example, replacing managers or reducing the work force of an enterprise. One fund manager suggested that after the second wave of voucher privatization is completed, the funds may be more willing to replace managers

and make other major changes in the operations of the companies, including reducing the work force.

4.30 Though only a few enterprise managers were interviewed, they in general seemed to favor the role of funds as the new owners of enterprises. Some managers felt that the enterprises were unable to take action to improve their situation during the privatization process and while under State-ownership. Only now with private owners do the managers feel free to make major changes in their companies. They are relieved to be able to propose new plans to their new owners and obtain approval and authorization from them to carry out those plans.

4.31 This is not to say, however, that there are no complaints about the role of the funds in corporate governance. Criticism of the role of funds is more pronounced among government officials and others in Slovakia. This may result from the belief of some Slovaks that voucher privatization and the voucher funds were created by Czechs in the former combined Republic and imposed upon Slovakia. Some argue that the managers of the new voucher funds are not good owners of enterprises. They are described as "cowboy" capitalists who made unrealistic promises to voucher holders, will sell shares in the newly privatized companies at low prices to foreigners to raise cash to fulfill these promises, are only interested in short-term profit at the expense of the long-term development of the economy, and have no capital or expertise to contribute to restructuring of enterprises. In addition, most large funds were created by banks and further increase what some view as the already excessive economic power of banks over enterprises. Other funds were created by managers of enterprises to buy shares in their own enterprises and thus limit outside control. Some managers of enterprises are complaining about the interference of the funds in their management of the companies, believe that managers are best qualified to be the new private owners, and thus favor privatization programs that give managers and workers majority ownership.

4.32 As noted above in para. 2.9, an important function of the voucher funds is to sell their shares to another investor, for example a foreign company, if that investor is likely to have a better plan for the management of a company. In practice, there seems to have been few examples thus far of the funds in the Czech and Slovak Republics selling a controlling block of shares to a new investor who wanted to take over the management of an enterprise. Several reasons have been given for this including:

- few investors have been interested in purchasing an existing Czech or Slovak company. Instead they have preferred either to start a new company or to form a joint venture with an existing company;
- the funds have unrealistic expectations as to the value of the enterprise shares and believe that they can do as good a job as the outside investor in improving the efficiency and profitability of the company;

- the prices for shares, in particular, in the Czech Republic, have risen to high levels on the stock market, and investors are unwilling to match these prices; and
- investors find it difficult to arrange a purchase of a company because the ownership is spread among three or four voucher funds plus many small owners. In particular, the funds cannot agree among themselves whether to sell.

4.33 One issue is the guarantees or promises that some funds made to voucher holders to convince them to become shareholders in the funds. The most notable example was the Harvard Fund that promised that a share in the fund would be worth ten times the registration fee charged by the government for a voucher. This fund was the first large fund to be established, and some say that its success in attracting members was a major factor in the popularity of funds and encouraging citizens to participate in the voucher program. Some other funds made promises of various types as well. Initially there was some concern about the impact of these promises, for example, would the funds have to sell shares in their portfolio to raise cash to honor their promises. The feeling among government officials and fund managers now is that these promises or guarantees are not a serious problem. At least in part, this is due to the high price of enterprise shares on the secondary market, in particular, in the Czech Republic, and thus the high value of fund shares compared with the value guaranteed or promised by the funds.

5. Three Enterprise Case Studies

5.1 The following gives three examples of how enterprises in the Czech Republic largely owned by the voucher funds are governed and the success to date of the new owners in improving efficiency and profitability. The examples include a successful company, an average company, and a failing company. These enterprises are now predominately owned by funds but are still partially owned by the State (shares are typically held by the National Property Fund).

Successful Company

5.2 Beginning in 1959, the former Czechoslovakia owned an ocean shipping company called Czechoslovak Ocean Shipping. It currently has about 18 ships transporting cargo all over the world and a labor force of about 1,000. In the first wave of voucher privatization, four funds ended up owning more than 50 percent of the company. About 30 percent of the company is still owned by a special State holding company called FINOP though this is likely to be sold to private investors.

5.3 This company can be called successful but not because of the efforts of the current owners. In contrast to most other enterprises in the Czech and Slovak Republics, this company has always operated on commercial principles and had to compete with many other private ocean shipping companies. It was successful because Czech crews were low cost but had a

reputation for high quality. It had access to loans from foreign sources because the ships could be used as collateral. This company does not suffer to the same extent as other Czech companies from the current recession in the Czech economy since its customers are from many countries. It does not have significant surplus labor, and no major restructuring is required.

5.4 The only complaint by the managers is that the funds do not understand the ocean shipping business though there are no major conflicts between the owners and the managers. The Management board plays the major role in corporate governance and meets once a month. It is composed of the Managing Director of the company, representatives of the four funds, and a representative of FINOP. According to managers, the fund representatives tend to emphasize short-term gains in efficiency and profitability while the managers tend to emphasize long-term growth and expansion. The Supervisory Board consists of two employees and a representative of FINOP. Its primary functions are to approve the financial statements of the company and the dividend payout.

Average Company

5.5 An example of an average company is Stavomont Praha, a construction company specializing in fitting out office buildings. It was split from a large construction conglomerate in 1990. Managers and employees had hopes that they could purchase the enterprise, but in the end it was sold primarily to the voucher funds. Three large funds own about 52 percent of the shares with the balance split among other funds, the workers, individual investors, and the National Property Fund. The employees ended up owning 13 percent. The National Property Fund only owns 10 percent, and this is likely to be sold in the second wave of voucher privatization.

5.6 The Management Board is dominant and is composed of representatives of the three funds, the General Director, and the Production Director. It meets once a month. The Supervisory Board is composed of an employee representative, representatives of two of the large funds, and a well-known professor of economics. It meets eight times a year (about every six weeks).

5.7 The company faces increased competition from other former State-owned enterprises and new private companies. In particular, competition is intense from companies that use low-wage foreign workers from such countries as the Ukraine and Rumania. It has sold some of its production facilities and reduced its work force from 1,200 to 550. The fund representatives on the Management Board have approved and encouraged this restructuring, and there are no major conflicts between the managers and the owners. With good management, this company is likely to survive even in the face of increased competition.

Failing Company

5.8 Tesla Karlin is an example of a company that must drastically downsize and may eventually cease to operate because of fundamental changes in the Czech economy and its trading relationships with other countries. This company was once part of the large telecommunications conglomerate in Czechoslovakia, and it specializes in the manufacture of telephone switching equipment.

5.9 Before the break up of the former Eastern European trading block, this company was one of just a few companies that supplied telephone switching equipment for the entire Eastern block and was considered one of the most technologically advanced companies in the region. It was unable, however, to keep up with the latest advances in switching technology because it did not have access to the more modern Western microprocessors that are at the heart of modern digital telephone switches. As a result when the telephone switching market in the Eastern block countries was opened to foreign competition, Tesla could not compete with Siemens, Alcatel, and other Western companies.

5.10 The company may survive for a few years due to a joint venture partnership with Siemens. When Siemens was given a contract to supply digital switches for the Czech telephone network, it was required to carry out some manufacturing locally and thus formed the joint venture with Tesla. After the end of the current contract, however, the joint venture will end, and Tesla will not be able to compete in the market for digital switches. Tesla probably can continue to produce certain ancillary equipment for switches or replacement equipment for older switches, but this will require a much smaller work force.

5.11 Not surprisingly, Tesla was not considered an attractive company in voucher privatization. Funds only purchased 31 percent of its shares but still ended up controlling the company. The National Property Fund still owns 20 percent with the balance held by small investors. The dominant Management Board consists of representatives from the three largest funds, the General Director of the company, the Finance Director, a representative of the joint venture company, and a representative of the National Property Fund. It meets monthly. The Supervisory Board consists of two workers, two representatives of the smaller funds, and two outsiders representing the individual shareholders. It only meets twice a year.

5.12 The Management Board asked for and received a business and financial plan to deal with the necessary fundamental restructuring of the company. With Board approval, the company plans to reduce staff from 1,400 to 1,000 by the end of 1993 and further reductions are likely. The managers seemed happy with the quality of the representatives on the Board. The representative of a fund founded by a large Czech bank is the former branch manager for that bank that primarily dealt with the company. In contrast to complaints from some managers of other companies about local bank managers, the managers of Tesla believe that this board representative is familiar with the company and is an effective member of the board. The

representative of a fund founded by a foreign bank is a Czech citizen with considerable Western business experience who has provided advice on the restructuring of the company.

6. Undesirable Fund Behavior

6.1 Perhaps the key policy issue for countries with a voucher privatization program is the regulatory framework for funds. Even if the government does not wish to see funds established, it is very difficult to stop millions of citizens from forming organizations of various kinds to pool their vouchers if they see a benefit from doing so. Such a pooling of vouchers could be done by existing companies, members of an extended family, groups in the work place, private clubs, and so forth. Thus recognizing that privately-sponsored funds will be created, the best policy is to put in place a regulatory framework to mitigate any adverse impacts of their operations and to accentuate their positive contributions.

6.2 One option for a regulatory framework is to treat funds like all other corporations. In other words, whatever regulatory framework is set up for corporations would also apply to voucher funds. In Western countries, the regulatory framework for mutual funds and for corporations are similar. Thus, the analysis below of the appropriate regulatory framework for voucher funds also largely applies to all corporations.

6.3 Before discussing a regulatory framework, it is desirable to explicitly identify the types of fund activities or behavior that are harmful to the operation of the economy and thus which may need to be controlled through regulation. Too often discussions of proposed regulations do not identify the behavior that the regulation is meant to control. In many transition economies, vague complaints and concerns are expressed about the operation of funds, but little analysis has been made as to whether these concerns are valid and justify regulation.

6.4 Much of the concern about the new funds is the result of suspicion of any new powerful organization that may control vast economic resources. Funds are a new idea to the governments and citizens of transition economies, and they are concerned about the potential economic or political power of the funds. After having thrown off the yoke of Communist central planning, citizens may be worried that their economic future is now in the hands of a few large funds over which they have no control. This suspicion of concentrations of economic power and wealth also has a long tradition in Western countries leading to "populist movements" that demanded the government control and regulate holding companies, combines, trusts, and other "malefactors of great wealth."

6.5 The essence of a market economy, however, is that apparent economic power is greatly limited by competition. Huge seemingly powerful organizations such as General Motors or IBM have been humbled by competitive pressures. Ownership of large economic resources does not necessarily translate into economic power if markets are competitive. Furthermore, the funds need to have the power necessary to exercise control over the managers of enterprises

if the funds are going to play a useful role in corporate governance and the restructuring and modernization of enterprises in the transition economies. Eliminating the power of funds over the enterprises out of vague concerns about undesirable concentrations of economic power could cripple the functioning of the transition economies for years to come.

Monopolization

6.6 Voucher funds may engage in four types of undesirable behavior that might justify government regulation. The first is monopolization. A single fund may obtain an influential or controlling ownership interest in two or more enterprises in the same industry or market. The fund could then influence the two enterprises to cooperate in setting prices instead of competing. This increased market concentration could lead to reduced competition and higher prices.

Shirking

6.7 The second type of undesirable behavior is shirking. Managers of funds including the management companies may shirk their responsibilities to increase the value of the funds assets on behalf of the shareholders of the fund -- in other words, they simply do not try very hard. The management company has been hired to carry out the three functions noted above beginning on para. 2.1 (providing a diversified portfolio, picking undervalued companies, and corporate governance). Instead, the management company may simply be content to receive a management fee from the fund but devote few resources to improving the management of the fund's portfolio.

6.8 As a comparison, shirking by managers of large companies is argued to be a serious problem in both Western and transition economies and is the basic reason some argue that the system of governance of large companies needs to be improved. As the major owners of companies, the funds in transition economies can play an important role in improving the governance of companies. The problem, however, is the governance of the funds themselves to assure that fund managers are performing to their maximum potential. Thus, the introduction of voucher funds in transition economies may only have shifted the problem of corporate governance from the companies to the new funds.

6.9 A key issue is what government regulations can be put in place to improve the incentives for fund managers to better manage the fund. As a starting point, what are the likely incentives for fund managers to work hard to improve the performance of the fund? There are at least three incentives:

- the management company receives a fee usually stated as a percentage of the value of the fund's assets. If the management company can increase the value of the fund's assets, its fee increases. A management company can do this in at least two ways: (i) buying shares in undervalued companies whose prices will rise when other investors

realize the true value of these companies; and (ii) working to improve the performance of the companies in which the fund owns shares and thus increasing the value of those shares. The second of these two ways is the most important for the improved performance of the economy and thus should be encouraged by government policies and regulations;

- the fund shareholders at the annual meeting of shareholders can elect a different Supervisory or Management Board if the shareholders are dissatisfied with the performance of the fund. These boards then have complete legal authority to replace a poorly performing management company with another company that they think will perform better. Though the many shareholders in the large funds may find it difficult to organize effective opposition to the current fund managers and elect a different Supervisory or Management Board, this is a risk that the management company must face if it is performing poorly; and
- the management company will wish to improve its reputation as a good manager of funds. If it develops a good reputation, the company may be asked to manage other funds or it may be successful in establishing new funds that attract many investors.

Self Dealing

6.10 The third type of undesirable behavior is self dealing. Even worse than shirking by the fund managers is if they use their control over the fund's assets to enrich themselves or promote the interests of individuals or organizations other than the shareholders of the fund. This type of behavior can be termed self dealing, conflict of interest, or outright fraud. Any activity of the fund's managers should have only one objective, namely, promoting the interest of the fund's shareholders.

6.11 As a comparison, managers of enterprises in the transition economies have often been accused of such self dealing, and thus it is argued that the enterprises need strong owners who can control this behavior. The funds can be these strong owners. The problem, however, is what will stop the managers of the funds from engaging in the same type of behavior that the managers of the enterprises have been accused of in the past? Conflicts of interest or self dealing may occur between the fund managers, the management company, the sponsor of the fund (for example, a bank), and the companies owned by the fund.

6.12 An example of self dealing might be if the fund managers sell shares at an unreasonably low price or buys shares at a high price. The purpose of such transactions might be to benefit the sponsor of the fund, the management company or its employees, or other affiliated companies. In such transactions, the shareholders of the fund are harmed because the value of their portfolio of shares is reduced.

6.13 The major problem in identifying and controlling this type of behavior is defining what is meant by an unreasonably "low" price or "high" price. For example, when a fund sells any shares from its portfolio, it is always subject to the criticism that the price would have gone up in the future and thus the fund sold too early. This type of decision, however, is not the type of behavior that is of concern since the fund management must always make decisions about when is the right time to buy or sell shares. What is of concern is if the fund managers sell the shares to a favored buyer for less than the fund could receive from another buyer or pay more to a favored seller than they would have to pay to another seller.

6.14 As a second example of self dealing, regulatory authorities in the United States have recently raised concerns about fund managers using the fund's immense financial resources to manipulate the prices of shares owned by the managers themselves. If a large fund decides to buy shares of a particular enterprise, this could cause the share price to rise. If the fund managers personally own shares in this enterprise in addition to shares owned by the fund, they could use their ability to control the fund to raise the price of these shares for their own benefit.

6.15 An example of an alleged conflict of interest is that large funds in the Czech and Slovak Republics are controlled by the large banks. Thus banks are major lenders to an enterprise and probably can control the management of the enterprise through their control of the funds. It is argued that the banks may force enterprises to adopt policies that benefit themselves as the lenders rather than benefit the fund shareholders. For example, a fund under the control of a bank might insist that an enterprise only borrow from the bank and on terms favorable to the bank. Of course, this situation also exists in Germany where banks are both lenders and major shareholders of large enterprises. A further complication is that the funds founded by the banks are also owners of shares in the banks. Bank control of funds could become a way for bank managers to stop any outside investors from controlling the banks.

6.16 A second example of conflict of interest is the concern in Russia that managers of large enterprises or industry associations may establish funds for the sole purpose of controlling their own enterprise or industry. The managers may be able to force workers in their enterprise to turn over their vouchers to funds created by the managers or even use enterprise capital to buy vouchers.

High Risk Investments

6.17 The fourth type of undesirable behavior by funds is making high risk investments. Managers of funds may have incentives to engage in risky investment strategies that are not in the interest of fund shareholders. It is difficult to see, however, why fund managers would have a greater incentive to engage in high risk investments compared to the fund shareholders. It is conceivable that such incentives may arise from the system for compensating or rewarding the management companies. If a compensation system rewards a large increase in the value of the fund's portfolio but does not equally penalize a large decrease, then the management

companies may choose a high risk investment strategy causing the value of the fund's assets to fluctuate greatly.

6.18 In the Czech and Slovak Republics, for example, the compensation for the management company is set equal to a fixed percentage of the value of the assets of the fund, typically, one to two percent. Thus if the value of the fund's assets rise, the management company benefits proportionately. If the value falls, the management company suffers proportionately. With this kind of compensation system, the management company would have no reason to prefer highly risky investments. Though regulatory authorities in many countries try to prohibit funds from engaging in high risk investments, it is not clear that there is a great need for such regulation.

7. Options for Regulation

7.1 There are many possible regulatory options for controlling or limiting the four types of undesirable behavior described above. Table 3 provides a list of 27 options including those that are sometimes used in Western countries (shown in *italics* in the table) and others that have been proposed for transition economies. The table also shows the paragraph number of this report in which that option is discussed in more detail. The fact that many regulations have been proposed does not necessarily mean that detailed and complicated regulation of funds is desirable. As discussed in more detail below, it is probably best that the regulation of funds be kept simple until experience shows which regulations may be needed. Many of these options may already be included in the corporate law governing the structure and operations of all corporations. The following discusses these options and how they might be applicable to transition economies with funds.

7.2 These regulatory options can be divided into five broad types:

- regulations that promote competition;
- regulations that require greater information disclosure so that fund shareholders can better monitor and control the performance of fund managers;
- regulations that give fund shareholders greater rights and powers in the governance of the funds;
- regulations that limit or control certain undesirable operations and activities of the funds; and
- regulations that limit the investments that a fund can make.

Table 3

Regulatory Options	
Undesirable Behavior	Possible Regulation <i>(Italics indicates regulation sometimes used in Western countries.)</i>
Monopolization	<ol style="list-style-type: none"> 1. <i>apply merger laws to funds (see para. 7.4)</i> 2. <i>limit fund ownership to 5% of company (para. 7.6)</i> 3. <i>limits on total size of a fund (para. 7.7)</i>
Shirking	<ol style="list-style-type: none"> 4. <i>disclosure of audited financial results (para. 7.11)</i> 5. <i>shareholder rights, e.g. procedures for proxy solicitations (para. 7.23)</i> 6. <i>incentive contracts with management companies (para. 7.31)</i> 7. <i>selection of management company and contract must be approved at annual meeting of shareholders (para. 7.26)</i> 8. <i>management fees paid in fund shares with no resale for fixed period (para. 7.31)</i> 9. <i>require funds to be "open ended" (para. 7.18)</i> 10. <i>require funds to be corporations rather than unit trusts (para. 7.20)</i> 11. <i>minimum capital requirements (para. 7.29)</i>
Self Dealing, Conflict of Interest, or Fraud	<ol style="list-style-type: none"> 12. <i>limits on management fees (para. 7.31)</i> 13. <i>separate custody of fund assets (para. 7.29)</i> 14. <i>audits of financial statements (para. 7.11)</i> 15. <i>disclosure of ownership connections between sponsor, management company, fund, and enterprises (para. 7.12)</i> 16. <i>disclosure of all commercial agreements between sponsor, management company, fund, and enterprises (para. 7.12)</i> 17. <i>disclosure of prices paid and received for sales of shares in fund portfolio (para. 7.13)</i> 18. <i>prohibition against sale of shares at below current "market price" or purchase at above current "market price" (para. 7.32)</i> 19. <i>restrictions on who can sit on governance boards (para. 7.24)</i> 20. <i>prohibition of certain ownership connections, e.g. banks may not be owners of management companies or funds may not own shares in management companies/sponsors (para. 7.33)</i> 21. <i>prohibition of commercial agreements, e.g. between management company and enterprises owned by fund (para. 7.36)</i> 22. <i>limit on percent ownership of an enterprise by a fund, e.g. 20% (para. 7.38)</i>
High Risk Investments	<ol style="list-style-type: none"> 23. <i>disclosure of investment strategy (para. 7.14)</i> 24. <i>shareholder approval of changes in investment strategy (para. 7.26)</i> 25. <i>limits on fund borrowing or leverage (para. 7.37)</i> 26. <i>limit on percent of fund assets invested in single enterprise, e.g. 5% (para. 7.37)</i> 27. <i>limits on investment in risky assets (para. 7.37)</i>

The following discusses each of these types of regulations and how they reduce one or more of the four kinds of undesirable behavior.

Promote Competition

7.3 Funds should not become vehicles for creating monopolies or engage in anti-competitive behavior that results in high monopoly prices paid by consumers. In particular, this may occur if a fund owns a significant shareholding in two or more companies selling similar products in the same market. As an influential owner, the fund can direct the two companies to charge higher prices and avoid price competition. In effect, the common ownership by the fund can amount to a merger between the two companies and a joint business and pricing strategy. If the two enterprises together only account for a small share of the market (including imports if the product or service can be imported), such a merger would not significantly reduce competition and is thus of little concern.

7.4 Such a merger via a fund is no different, however, from other types of mergers (for example, one company buying all or part of another company, or two companies joining to form a combined third company). Government laws and regulations dealing with mergers or other anti-competitive behavior should also apply to activities of funds. If the competition laws of the country are soundly constructed, there should be no need for special laws or regulations applicable only to funds.

7.5 For example, many countries require two or more companies that are planning to merge to notify the anti-monopoly agency and obtain advance approval from that agency if the merger would significantly reduce competition. Two companies are considered to have merged if a third company such as a fund has purchased shares in the first two companies sufficient to give it influence over their business activities. Naturally, the merger or competition law in a particular country has to define how large a shareholding must be before the fund is considered to have influence over the business activities of the companies in its portfolio, but this definition should apply equally to a fund or any other company buying shares in another company. For example, if a fund purchases more than five percent or more of the shares in two companies operating in the same market then this could be considered a merger and subject to review by the anti-monopoly agency.

7.6 This concern about funds reducing competition could also be dealt with by prohibiting a fund from owning more than a small fraction of the shares in any company, say up to five percent. As a result, a fund has no influence over any enterprise and thus cannot engage in anti-competitive activities. Though such a restriction might be effective from a competition policy point of view, it would eliminate any positive role that funds could play in corporate governance and improving the efficiency and profitability of enterprises. Such a draconian provision is not necessary if the government has an effective merger policy that applies to funds as well as other enterprises.

7.7 Beyond encouraging competition among enterprises, regulations may also encourage competition among funds. An option to promote competition among funds is to limit the total size of a fund. In the Czech and Slovak Republics, a fund or group of related funds may not own more than ten percent of all the shares held by funds. Such a restriction may promote competition in the market for fund services or in the fund industry. Voucher funds make up an industry just like any other industry providing services to consumers. Such a restriction would ensure that no single fund obtains a monopoly in this industry and that at least ten funds must exist. One problem with such a regulation, however, is its enforcement. For example, how does one fund know the total value of shares held by all other funds. What happens if a fund is very popular among voucher holders and thus the fund violates this regulation because it is given too many vouchers? Should the fund stop accepting vouchers and turn away new members?

Require Greater Disclosure

7.8 Perhaps the most widely used regulatory option is to require funds (as well as other corporations) to disclose information about their operations. The objective is to give fund shareholders adequate information so that they can judge the performance of the fund management. If current shareholders are dissatisfied with the performance, they can elect a different Board of Supervisors or Management Board at the next annual meeting of shareholders that in turn can select a new management company. This presumes, however, that the current management is not able to control or manipulate the voting at the annual meeting and that the widely dispersed shareholders take enough interest in the operation of the fund to vote at the annual meeting. If adequate information is disclosed, potential new shareholders that are thinking of investing in a particular fund can also evaluate and compare past performance and investment strategies of one fund against another.

7.9 This type of liberal or "light handed" regulation is probably the least controversial because it does not limit or control the management and investment strategy of the fund as long as the shareholders approve of that strategy. The philosophy is that funds can adopt any strategy as long as they fully and honestly disclose this to their shareholders. The cost of compliance with this type of regulation is not large being merely the cost of gathering and publishing the required information about the fund's operations. Government regulators do not impose their own judgement about how funds should be managed and let fund shareholders and market forces determine successful strategies.¹⁴

7.10 Disclosure regulations can go at least part way to controlling three out of the four types of undesirable behavior on the part of funds (see Table 3). Disclosure by itself is not adequate

¹⁴Even this type of regulation has been criticized, however, as imposing unnecessary costs on companies and funds and benefitting special interest groups (brokers and dealers) at the expense of the shareholders. See Phillips and Zecher (1981).

to control monopolization by funds. In this case, shareholders of a fund have no incentive to stop fund managers from engaging in this type of behavior since it increases profits for the fund and the shareholders rather than reducing them. The government must intervene to control this type of behavior as discussed above in para. 7.3.

7.11 Regulations can require the disclosure of a variety of information about a fund's activities. Disclosure of past financial results in the form of balance sheets, profit and loss statements, change in portfolio of shares held, and so forth can give shareholders information about the funds operations, discourage shirking by fund managers, and create incentives for better performance. Requirements to provide financial statements audited by approved accounting companies can also help to discover fraud or self dealing.

7.12 Disclosure of any ownership connections, commercial agreements, or business dealings between the management company, the sponsor, the fund itself, and enterprises owned by the fund reveals potential conflicts of interest that can lead to self dealing or even fraud. If such conflicts of interest are a serious problem then the shareholders can change the fund management at the next annual meeting.

7.13 In particular, a fund could be required to disclose the prices paid for shares or received from the sale of shares. This would help to eliminate the possibility that a fund was selling its shares for an excessively low price or buying shares at a high price since these prices could then be compared with other prices paid for the same shares at the same time. In general it would not be necessary to disclose the other party to the sale unless that party was affiliated in some way with the management company or the founder of the fund. Such transactions should be given special scrutiny to guard against self dealing.

7.14 Disclosure of a fund's investment strategy can limit high risk investments not acceptable to the fund's shareholders. For example, the fund should disclose whether it will have a diversified portfolio or invest in only a few industries or enterprises, the extent of borrowing by the fund (leverage), and the type of securities to be purchased (for example, common stock, shares of other funds resulting in pyramids of ownership, debt instruments, shares listed on recognized stock exchanges or unlisted shares, real estate, foreign or domestic securities). There is nothing inherently wrong with a fund engaging in a high-risk investment strategy as long as the shareholders are fully informed and approve of the strategy.

Increase Rights of Fund Owners

7.15 The third type of regulation includes those that regulate the internal governance of the fund, in other words, how shareholders exercise their ownership rights over the fund's managers. If the shareholders have weak control over the fund managers, the managers may be prone to shirking, self dealing, and high risk investments. Strong oversight and control by shareholders of the fund will improve performance by fund managers and in turn improve performance by enterprises owned by the fund.

7.16 An important issue in this regard is the legal form of the voucher fund since this determines the rights of the fund's owners. Though details and terminology vary from country to country, an investment fund can be established in two basic ways -- as a corporation or as a unit trust. For example in the Czech Republic, voucher funds initially could only be created as a corporation but later could be created as unit trusts. It is not always easy to decide which of these basic legal forms are being referred to especially in translation since the terms used to describe these various types of funds are not standardized. This paper will use the term investment company for funds that are established as corporations and unit trust for funds established as trusts.¹⁵ Much of the analysis in this paper assumes that a voucher fund is established as an investment company.

7.17 The basic difference between these two legal forms is that a unit trust is not a separate legal person as is an investment company. A unit trust has a legal structure based on a contract typically between a management company, a depository or trustee, and the participants or investors. The participants in a unit trust receive "participation units" instead of shares and typically have a right to receive a pro rata share of all the trust's assets and income. The owners of participation units usually have very limited rights or ability to control the activities of the trustee or the management company. Thus, the unit trust form of organization seems to result in a poor system of corporate governance of the funds.

7.18 A second issue in establishing the basic structure of a voucher fund is whether it is "open ended" or "closed ended." In principle, both types of funds (investment company or a unit trust) can be set up as open ended or closed ended. The difference between these two concepts is that an open-end fund must agree to redeem shares or participation units for cash if requested by the fund participants. In effect, participants can sell their shares or units back to the fund. The shares or units are redeemed for the "net asset value" of the fund that is the total market value of the fund's assets divided by the number of shares or units of the fund outstanding. Naturally, if many shareholders demand redemption, the fund must sell some of its portfolio of enterprise shares to raise the necessary cash. In contrast, shareholders in a "closed-end" investment company or holders of participation units in a "closed-end" unit trust can only sell their shares or participation units to other investors. If the fund is performing badly, the price for these shares or units may be below their net asset value.

7.19 The advantage of open-end funds from the point of view of promoting good corporate governance is that a poorly managed fund may simply wither away as its shareholders demand that their shares be redeemed for cash. This would put substantial pressure on fund managers to improve the performance of the fund. In a closed-end fund, however, the shareholders can only sell their shares to another investor if the fund is performing badly, the fund itself is not

¹⁵The terminology for these various types of funds is made more confusing by the similar terminology used for the companies that are hired to manage the funds. In the Czech and Slovak Republics, for example, such management companies are also referred to as "investment companies."

reduced in size, and the fund managers may continue to manage a large fund paying themselves substantial fees in spite of their poor performance.

7.20 Fund participants have the greatest rights and can put the most pressure on management to perform if the voucher fund is established as an open-end corporation (see Table 4).

Table 4

Owners' Rights Under Various Forms of Voucher Fund Organization		
	Open End	Closed End
Corporation	High	Medium
Unit Trust	Medium	Low

In this case, fund owners have two ways of exercising their rights as owners and thus creating pressure on fund managers: (i) vote for a new Board of Supervisors or Management Board at the next annual meeting who will change the management company or

(ii) redeem shares for cash and force the fund to become smaller. In a closed-end corporation, the shareholders have only the first way of exercising their rights, i.e., elect a new Board of Supervisors or Management Board. In an open-end unit trust, the unit holders have only the second way of exercising their rights, i.e., demand redemption of their participation units. Even worse in a closed-end unit trust, the fund participants have almost no way of putting pressure on the fund managers.

7.21 Though open-end funds improve fund governance, they have one disadvantage at least in the early period of transition in these economies. Such funds may be forced to sell large amounts of shares on the secondary markets if fund shareholders demand redemption. Since secondary markets in these countries are initially poorly developed and illiquid, funds may simply not be able to sell their enterprise shares or such large-scale selling of shares could cause a collapse of these markets.¹⁶

7.22 It is a troubling development in the Czech Republic that some funds in the second wave of voucher privatization are setting themselves up as closed-end unit trusts and a large number

¹⁶An argument advanced against open-ended funds by some fund managers is that too many fund shareholders will make the wrong decision about when to redeem their shares and thus hurt the overall performance of open-ended funds. These managers argue that unsophisticated investors will rush to redeem their shares in the funds when stock market prices are at a cyclical low level and, conversely, rush to buy new shares from the funds when stock market prices are at a cyclical high level. In other words, small investors systematically make the wrong decisions about when to enter and leave the stock market. This in turn forces an open-ended fund to buy shares when prices are high and sell shares when prices are low – an investment strategy exactly the opposite of what is desirable. This argument is similar to the "odd lot" theory of stock market trading in the United States. This theory says that when small investors are selling shares (small blocks of shares are called "odd lots"), the smart or sophisticated investor knows that this is a good time to buy because such "odd lot" traders are usually wrong. Similarly when the odd lot trader is buying shares, this is a sign that the market is overvalued, and the sophisticated buyers then sell their shares.

of voucher holders have transferred their vouchers to this type of fund (see Table 5). This organizational form gives the participants in the fund the least control over management. Thus one regulatory option is to require that funds be established as open-end corporations to maximize the ability of the fund participants to influence and control the managers of the fund. Given the concern expressed above that open-end funds could cause instability in the new secondary markets for shares, a compromise might be to require that funds establish themselves as closed-end corporations initially but become open ended after an initial transition period, say three years.

7.23 In the analysis that follows, it will be assumed that the voucher fund is established as a corporation rather than a unit trust. General corporate law will probably specify certain shareholder rights that apply to all corporations including voucher funds. These include:

- votes per share, in other words, whether some classes of shares may be non-voting or have more than one vote;
- number of shareholders that need to be present for a quorum to exist at the annual meeting of shareholders (for example, 30 percent of all shareholders);
- percentage of shareholders represented at the annual meeting that need to approve election of governance boards (typically a simple majority); to approve general resolutions (typically a simple majority), and to approve fundamental changes in the company's articles of association (typically 66 to 75 percent);
- whether cumulative voting is possible, i.e., can shareholders allocate their votes to a single member of a governance board or must they vote for a complete slate of members; and
- provisions for soliciting and voting proxies of those shareholders who cannot attend the annual meeting.

7.24 If a voucher fund is established as a corporation, an issue is who will be allowed to sit on the governance boards of the fund to represent the many shareholders. Because ownership of a large fund is dispersed among thousands of shareholders, there is the risk that the manage-

Table 5

Legal Form of Czech Voucher Funds in the Second Wave		
Legal Form	Number	Points* (million)
Corporation – Closed End	195	1,570
Unit Trust – Closed End	121	1,480
Unit Trust – Open End	37	870
Total	353	3,920
*Voucher points transferred by Czech citizens to this type of fund.		

ment company will decide who sits on the governance boards and that these boards will not adequately supervise the management company. It seems desirable that the members of the Supervisory Board should be independent of the sponsor, the management company, or any related or affiliated company. Thus, one regulatory option is not to allow any employee or shareholder of the sponsor, the management company, or any affiliated company to sit on the Supervisory Board.

7.25 The membership of the Management Board raises another issue. The Management Board is expected to carry out the management of the company. In the case of voucher funds, however, the management is typically carried out by a management company under contract to the fund. In this case, a Management Board may be largely superfluous and unnecessary. In any event, there does not seem to be any reason not to allow employees of the management company to sit on this board since they are the individuals actually managing the company.

7.26 Special shareholders' rights have been proposed for voucher funds that would not be applicable to corporations in general. These include:

- shareholders at their annual meeting must approve the appointment of the management company and the terms of the contract with the company; and
- shareholders must also approve any basic changes in the investment strategy of the fund.

7.27 Like regulations that require greater disclosure, regulations that increase the rights of fund owners are relatively non-controversial in the sense that such regulations are generally recognized as necessary to improve governance of companies including voucher funds. Experts may disagree, however, on what specific regulations will best promote effective governance by shareholders. For example, is cumulative voting better than non-cumulative voting or what proportion of shareholders should be required for a quorum?

Control Fund Operations

7.28 A fourth type of regulation includes those that control and limit the actual operations and activities of the funds. These are more controversial than the previous types of regulations because they impose the government's judgement about the proper role of funds and may override the preferences of the owners of the funds. In contrast, regulations that require information disclosure and increase shareholder rights are designed to allow the shareholders to make better decisions about the functioning of the funds and to control and direct the managers of the funds so that they promote the interest of the shareholders. Such regulations, however, still leave the basic decisions about the role of the funds to their owners.

7.29 The following are examples of possible government regulations intended to control and limit the operations and activities of the funds. To control the risk of fraud or theft from the fund, several countries require that funds deposit their assets such as shares or cash with

licensed depository institutions that can control any sale or transfer of these assets. A regulation in the Czech and Slovak Republics is that the sponsors of a fund must contribute a certain minimum start up capital for the fund to assure that it has the resources to carry out its functions until income is earned from its investment portfolio. The required capital, however, is not large -- only one million crowns or about \$30,000.

7.30 To discourage shirking by managers and create incentives for better fund performance, regulations might specify the terms of the management contract between the fund and management company -- for example, the requirement in the Czech and Slovak countries that annual fees paid to management companies may not exceed two percent of the funds assets and the requirement in Russia that such fees may not exceed five percent. These regulations are designed to place an outer limit on fees paid to management companies and to avoid situations in which the management companies have taken effective control of the funds away from the fund's shareholders and are paying themselves excessive fees at the expense of the fund shareholders.

7.31 More questionable, however, are government regulations that specify the detailed structure of fees or other terms of the management contract between the fund and the management company. One proposal in Slovenia is that part of the fees paid to management companies should consist of shares in the fund, and the management company may not sell the shares for a fixed number of years. Similarly in Poland, the proposal is to compensate management companies by a mix of cash and shares in the fund. These proposals are designed to give the management company greater incentives to increase the value of the fund's assets because the management company itself holds a large number of fund shares. It has also been proposed that a government regulatory agency approve all management contracts. In these cases, the government has decided that it knows the best terms of the management contract and that the owners of the funds cannot decide on the best terms or cannot impose these terms on the management company. Detailed government regulations may be harmful because the government may not know the best terms of a management contract, and such regulations limit the ability of funds to experiment or try other forms of a management contract.

7.32 To reduce self dealing and conflicts of interest when a fund buys or sells shares, the Czech and Slovak Republics require that the price paid for shares must be no higher than the current "market price" and the price received for shares must be no lower than the current "market price." It is not easy to enforce such a regulation because of the difficulty in defining what is the current market price. This is particularly true in the emerging stock markets in the transition countries. In such markets, shares may be traded only infrequently or in small volumes on the public stock exchange. The prices for small trades may not be applicable to the large trades that a fund is likely to make, for example, when a fund sells a large block of shares directly to another fund without going through an exchange.

7.33 Also to reduce self dealing and conflicts of interest, it has been proposed that the government should strictly regulate both who can own management companies and all commer-

cial arrangements between the sponsors, the management companies, the funds, and the enterprises owned by the funds. For example, it has been proposed that banks not be allowed to sponsor funds or be the owners of management companies because of the conflict of interest that some see between being a lender to an enterprise and representing the owners of the enterprise. In response, banks have proposed "Chinese walls" that would stop any flow of information between the lending operations of a bank and the management companies owned by the bank. This dual role of banks, however, is quite common in Germany and Japan where banks are both lenders and owners of enterprises and does not appear to have caused significant concern about conflicts of interest and self dealing in those countries.

7.34 Also prohibiting banks from sponsoring funds or owning management companies may mean that funds and management companies may be operated by less qualified individuals or organizations. Transition economies do not have large numbers of people with the necessary training and experience to manage funds. Banks and their employees may have more of the necessary training and experience than almost anyone else.

7.35 In the Czech and Slovak Republics, funds may not own shares in its management company or in the owners of the management company (for example, a bank that founded the management company and the fund). The concern here is that the fund's ownership of shares in the bank that sponsored the fund may allow the bank managers to largely control the ownership of the bank and prohibit any other investor from gaining control over the bank. A related concern might be that the fund will be used to manipulate the price of shares in the bank.

7.36 For similar reasons, others have proposed that a management company or its owners (for example, a bank that founded the fund) should be prohibited from having any commercial agreements with enterprises owned by the fund. Such prohibited commercial agreements would include lending to the enterprises, consulting agreements, and selling any products or services to the enterprises. Such a comprehensive provision seems to effectively exclude any existing enterprise or business from establishing a management company because that enterprise or firm would have to give up any other business activity. This seems to have the effect of requiring that a fund be founded by someone with no business or financial experience. In contrast, the assumption behind disclosure requirements is that fund owners can control any self dealing or conflicts of interest that may arise if ownership connections and commercial agreements are required to be disclosed.

Limit Fund Investments

7.37 To control or limit high risk investments by funds, some countries have imposed various restrictions on the types of investments that a fund can make. For example as discussed above, the Czech and Slovak Republics require that a fund not invest more than ten percent of its assets in the shares of any one enterprise. The objective is to limit risk by requiring a diversified portfolio. Such a restriction, in effect, requires a fund to invest in at least ten different

enterprises. The reality in these countries is that the large and most important funds invest in many more than ten enterprises though this rule may be binding on smaller funds. It has also been proposed in other countries that funds not be allowed to invest in certain types of assets (for example, real estate, non-listed, or illiquid securities) or to borrow to make investments because such leverage is excessively risky. Again such regulations assume that the fund owners cannot choose an appropriate investment strategy or cannot control the fund managers.

7.38 Most Western countries and some transition countries impose controls on the proportion of shares in a single enterprise that may be owned by a fund (or group of related funds). For examples, see Table 6. Though this type of regulation is widespread, it is difficult to find an explanation of why it is needed.

7.39 The fact that this type of regulation is common in Western countries is sometimes used as an argument why a similar regulation is needed in transition economies. This, however, may lead to the result that a poor or harmful regulation in Western countries is simply transferred to transition economies without analysis of why it is needed or possible adverse consequences. In other words, transition countries should not blindly make the same mistakes as Western countries in their regulation of funds.

7.40 There is often a lack of clear government statements as to why these limitations on fund ownership were adopted in Western countries, but some reasons might be that:

- funds in some countries are set up as trusts rather than corporations, have only limited legal rights, and are not considered appropriate legal entities to own and control companies;
- in the United States, funds can technically own more than five percent of the shares of a company but are inhibited from doing so by regulatory and tax restrictions;¹⁷

Table 6

Restrictions on Fund Ownership of Shares in a Single Company	
Country	Maximum Ownership
Czech Republic	20%
Slovakia	20%
Russia	10%
Lithuania	50%
United States	5%
France	10%
Germany	10%
OECD Recommendations	5 - 15%

¹⁷See Gray and Hanson (1993) p. 6.

- in many Western countries, there is widespread suspicion of what appears to be large concentrations of economic power in funds and a desire to control that power in some way. For example, demands for stricter regulation of investment funds by the Federal Government of the United States began in the 1930's when concerns about concentrations of economic power were at their height due to the Great Depression;
- in the European Economic Community, there may be concern that a fund established in one country could control enterprises in another country; and
- managers of enterprises may fear control by large institutional investors and thus support limitations on ownership by funds.

7.41 Such regulations can seriously impair the ability of funds to play a role in corporate governance and thus reduce the benefits from voucher privatization. If a fund cannot own more than 10 percent of the shares of an enterprise, the government is implicitly adopting the first model of corporate governance described above, namely, dispersed ownership with no large owner exercising control over an enterprise. If a fund cannot own more than 50 percent of the shares of a single company, then the third model of corporate governance based on a holding company structure cannot be implemented. If a fund can own somewhere between 10 and 50 percent of the shares in a single enterprise, then the second model of corporate governance is still feasible, namely, institutional ownership. As discussed above in the case of the Czech and Slovak Republics where a fund can own up to 20 percent of the shares of an enterprise, the limited initial information seems to suggest that this model of corporate governance is working reasonably well. Thus, limits on fund ownership of about 20 percent do not seem to greatly impair the ability of funds to govern enterprises.

7.42 Thus it would appear that countries such as the Czech Republic, Slovakia, and Russia are adopting the institutional ownership model but in effect prohibiting the holding company model. There may be one valid argument for effectively prohibiting the holding company model because of the weak legal system in these countries and inability of regulatory authorities and the courts to protect the rights of minority shareholders. In the institutional ownership model, all owners are minority owners, and a coalition of such owners is necessary to control the enterprise. In the holding company model, however, a single majority owner can largely control the enterprise in spite of the wishes of minority shareholders. In this case there would seem to be more potential for conflicts of interest and self dealing. The majority shareholder could influence and control the enterprise for its own benefit even though the interests of the minority shareholders would be harmed.

7.43 One example of self dealing by a majority shareholder was given by a fund manager in the Czech Republic. In this case, however, the majority owner of a Czech company was a foreign company, and the fund was a minority owner. The majority owner was requiring the enterprise managers to sell products to the majority owner for distribution in a foreign country. The fund and other minority owners, however, believed that the transfer price was too low thus

unfairly reducing the profits of the Czech company and the dividends paid to the minority owners. If this allegation is true, the majority owner was controlling the Czech company for its own benefit rather than the benefit of all shareholders, in other words, a clear case of self dealing.

7.44 Thus, it may be desirable to limit funds to being minority but still large shareholders of enterprises. The funds as large minority shareholders would still have an incentive to devote resources to monitoring the performance of the enterprises, to assign staff to be on the governance boards, and to intervene in cooperation with other owners if it appears that the enterprise is mismanaged. To effectively control the enterprise, however, a fund would have to join a coalition with other funds. This would guarantee that the enterprise could not be used to promote the interests of just one shareholder at the expense of other shareholders. Such a coalition of large shareholders would still be able to effectively govern the enterprise and thus not sacrifice the increases in efficiency and profitable that is the objective of privatization.

7.45 Such a limitation on ownership by funds, however, effectively rules out the holding company model of corporate governance. It must be noted that this concern about conflicts of interest and self dealing would also arise when an owner of an enterprise other than a fund owns more than a majority of shares but less than 100 percent ownership. If funds are prohibited from becoming majority shareholders, then this should apply equally to other types of owners as well. There is no clear reason why funds should be singled out for this type of restriction.

8. Recommendations

8.1 The transition economies where privately-sponsored funds have arisen must develop a flexible and evolving regulatory regime for these new institutions. Because these funds play a different role from similar funds in Western countries, models of regulation used in those countries are probably not applicable without modification. In contrast to some Western countries, funds in transition economies should be encouraged to play a positive role in corporate governance and thus help to overcome a major weakness in these countries, namely, a lack of good private owners for enterprises. Regulation of these new funds should be experimental and change over time when various problems arise in the operation and management of the new funds.

8.2 One regulatory strategy is for the governments in these countries to refrain from initially imposing any special regulatory requirements on funds other than those that would apply to all corporations including competition laws. Presumably corporate law in these countries already requires corporations to disclose information about their operations and specifies the rights of shareholders in controlling the managers. If special problems arise in the operation of the funds in the future, the government could then add additional regulations specifically designed to meet those problems.

8.3 A second strategy would be to try to anticipate all of the possible problems that might arise with the funds and put in place now a lengthy and complex set of regulations designed to deal with those problems. Such a regulatory framework would go beyond simply requiring funds to disclose information about their operations and specifying the rights of shareholders and would impose quantitative controls on the operation of funds and on fund investments. These might include limits on the proportion of shares that a fund can own in a company, required provisions in management contracts including the fee structure, prohibitions on certain individuals and enterprises founding funds or owning management companies, limits on business relationships between the funds and other parties, limits on high risk investments, and so forth.

8.4 There are several difficulties with the second strategy. It assumes that shareholders will not effectively control the funds because of weak shareholder rights or because fund managers will not provide adequate information about their operations. It also assumes that the government can predict the impact of these detailed regulations. The risk in imposing detailed quantitative regulations is that they may distort incentives and have unintended and undesirable consequences. For example, a complex fee structure may induce management companies to adopt an undesirable investment strategy that no one could foresee when the structure was adopted. Another example is that prohibitions against certain individuals or institutions owning management companies may result in such companies being run by poorly qualified individuals. Also such detailed regulations may not allow the operation and structure of funds to evolve as market conditions change.

8.5 On balance, the best strategy at least initially is to subject the funds only to the normal requirements of corporate and competition law that apply to all corporations but with just a few additional regulations to deal with special problems of voucher funds that can now be clearly identified. These additional regulations would primarily require the funds either to disclose additional information or give shareholders greater rights in the management of the funds. Detailed regulations that control fund operations or restrict investment decisions do not appear to be needed at present though such regulations could be introduced in the future if problems arise in the operations of the funds.

8.6 The recommended special regulations for funds not applicable to other corporations are that:

- a fund should be established as a corporation rather than a unit trust;
- members of the Supervisory Board may not be employees or shareholders of the management company, the owners of the management company (for example, a bank that sponsored a fund), or any affiliated company;
- a limit should be placed on the total annual fees that a fund may pay to a management company. Such a limit should be designed to stop clearly excessive fee payments. For

example in the Czech and Slovak Republics, total annual fees paid to a management company cannot exceed two percent of the fund's asset value.

- funds should submit their selection of a management company and the management contract for approval at each annual meeting of the shareholders;
- funds should also submit their investment strategy for approval at the annual meeting;
- funds should disclose any ownership connections or commercial relationships between the management company, its owners, the fund, and all of the enterprises in the fund's portfolio;
- funds should disclose the prices they paid for or received from the sale of shares in their portfolios including the date the transaction was made;
- fund should disclose the other party to any purchase or sale of shares as well as the price if the other party is affiliated in any way with the management company, the sponsor of the fund, or major shareholders of the fund or if the other party is another fund also being managed by the same management company; and
- funds should be required to place their shares and other assets in the custody of an approved depository institution to avoid possible theft and fraud.

8.7 As discussed above, an argument can be made that funds should also be limited to owning no more than 20 or 30 percent of the shares of an enterprise to avoid conflicts of interest and self dealing that might arise if funds were allowed to be majority shareholders of a company. In effect, this restriction would require a fund to share control of an enterprise with other funds. Such a restriction would, however, effectively rule out the third model of corporate governance based on a holding company. Our knowledge of the various models of corporate governance is not sufficient to say that any one model is clearly superior to another. If it appears that serious conflicts of interest or self dealing arises when a fund owns a majority shareholding in a company then limiting a fund's shareholding is an option for the future. In any event, if such a restriction is applied to funds, it should also be applied to any other owner of shares in a company.

8.8 Also a strong argument can be made that funds should eventually be required to be open-end funds in which shareholders can demand that the funds redeem their shares for cash. This would place substantial pressure on fund managers to improve performance or else see the fund and thus their management fees decline in size. This requirement, however, should only be introduced after the secondary market for shares has developed and matured and thus large selling of shares by funds would not unnecessarily disrupt the market.

8.9 Since the funds in the Czech and Slovak Republics have been owners of enterprises for no more than one year, it is difficult to draw firm conclusions about the role of these funds. Also, this report is based on a limited number of interviews with government officials, funds, and enterprises. The experience to date, however, does suggest that the funds are beginning to play a useful role in corporate governance which is potentially their greatest contribution to the successful reform of the transition economies in Central and Eastern Europe. No concrete evidence of serious problems with fund management has yet arisen. Since the role and functions of these funds are evolving and experience with this type of fund in Western countries is limited, it is difficult to specify the best regulatory framework for these funds. In these circumstances, the best regulatory strategy is to adopt initially a relatively light handed or liberal approach to regulation that allows the funds to evolve and change. Only when serious problems or weaknesses arise in the performance and behavior of funds should the government impose additional regulations designed to deal with those specific problems.

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