

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Corporate Governance Country Assessment BULGARIA

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This Corporate Governance Assessment was conducted in November 2001 as part of the joint World Bank-IMF program of Reports on the Observance of Standards and Codes (ROSC). It benchmarks the country's observance of corporate governance against the OECD Principles of Corporate Governance and is based on a template developed by the World Bank. This assessment was undertaken on the basis of the template and report prepared by Professor Boeva Bistra for the World Bank. Acknowledgments are due to the Bulgarian National Securities Commission, the Bulgarian Stock Exchange, the Ministry of Justice, the Ministry of Finance, Ministry of the Economy, the Council of Ministers, the Central Depository, the Privatization Agency and numerous fund managers, institutional investors, stakeholder groups and other market participants. The final report was drafted by Sue Rutledge of the Europe and Central Asia Region in collaboration with the Corporate Governance Unit Private Sector Advisory Services of the World Bank. The ROSC assessment was cleared for publication by the Ministry of Finance on September 12, 2002.

I. EXECUTIVE SUMMARY

Market capitalization of the Bulgarian Stock Exchange (BSE) is low at four percent of GDP, having fallen from a peak of seven percent in 1998. Similarly, market turnover remains low, even by the standards of transition economies. However in recent years, Bulgaria has made substantive concrete improvements in its legal and regulatory framework, in part in preparation of accession to the European Union (EU).

The Bulgarian National Securities Commission (BNSC) was established in 1996 and subsequent amendments to both the commercial and securities legislation strengthened the corporate governance framework. In particular, the 2001 revisions and amendments adopted in June 2002 to the Law on Public Offering of Securities (LPOS) substantially strengthened shareholder rights for “public” companies, i.e. corporations whose shares may be publicly traded. In addition, proposed additional amendments will ensure pre-emptive rights of existing shareholders and will require legal entities to disclose both direct and indirect ownership interests in Bulgarian companies, where such interests are at five percent or more of the company.

The assessment recommends three additional areas of improvements:

- 1) Amend the Commercial Law (CL) to establish a minimum quorum for shareholders’ meetings and strengthen the duties of members of (supervisory) boards of directors;
- 2) Encourage private sector organizations and business associations to prepare a corporate governance code, encouraging improved corporate governance practices in the corporate sector; and
- 3) Encourage the private sector to establish an Institute of Directors that could provide training and disseminate international practices for (supervisory) boards of directors.

II. CAPITAL MARKETS AND INSTITUTIONAL FRAMEWORK

The Bulgarian capital market is in the process of transition as the Government prepares the economy for accession to the European Union (EU). As of October 2001, market capitalization stood at just four percent of GDP, having fallen from a peak of seven percent in 1998. At the same time, market turnover remains low at BL 38 million (USD 19 million) and free float is estimated at just 14 percent of total equities available for trading.

All organized trading of corporate securities occurs on the Bulgarian Stock Exchange (BSE), for which corporate equities are divided into two categories, the Official Market and the Free Market. About 30 companies are listed on the Official Market and another 470 on the Free Market. Companies on the Official Market must follow strict listing rules, which include publication of annual audited financial statements prepared in accordance with International Accounting Standards (IAS). Most, but not all, of the companies traded on the Free Market were former state enterprises, privatized through the voucher and other privatization processes of the mid-1990s.

Whereas in most transition economies in the Europe and Central Asia Region, share trading primarily takes place among the companies listed in the top tier category, in Bulgaria most trading occurs among companies on the Free Market. An estimated 86 percent of all trades on

the BSE are conducted as block trades, largely among the holding and investment companies that were formerly privatization funds. In addition, 40 percent of all trading on the Free Market occurred in December 2000, as year-end mark-to-market provisions of accounting regulations required that short-term investments be valued at the stock market prices.

The number of companies available for trading fell in 2000. While 14 companies were newly admitted to trading in 2000 (two on the Official List and the balance on the Free List), over 350 companies were de-listed. Most of the de-listing occurred as the companies changed their legal status from “public” companies (i.e. companies whose shares are available for trading) to other legal forms, including limited liability companies, whose shares cannot legally be traded on the organized exchange. However the trading volume of the de-listed companies was so low that the reduction in companies on the BSE had little impact on market turnover in 2000.

The BSE expects the trend toward reducing the number of listings to continue over the near term, as the Bulgarian corporate sector continues its restructuring and consolidation. In a survey of 436 companies, the BSE found that 24 percent of the companies had a single shareholder and 83 percent had a single shareholder with at least 50 percent of the company’s total shares. Thus the BSE forecasts that as many as 266 companies will be de-listed during 2002.

At the same time, Bulgaria is in the process of reforming its pension program from a pay-as-you-go (PAYG) system to a multi-pillar funded system. As a result, demand for investment quality securities on the Bulgarian stock exchange is expected to increase.

Part of Bulgarian stock market’s weakness was, in the past, due to an insufficiently developed legal and regulatory framework. However the Bulgarian National Securities Commission (BNSC) was established in 1996 as an independent state body. Its functions are to regulate and control the public offering of and trade in securities, regulated securities markets, the Central Depository, investment intermediaries, investment companies and management companies all with a view of protecting investors and enhancing the development of a transparent and efficient securities market. The BNSC has wide powers of surveillance investigation and enforcement, and it has used these powers to render fines and other sanctions. The detail of the regulations has been drafted to comply with international standards of good securities regulation. The BSE also has wide powers of investigation and discipline under its rules. In addition, substantial corporate governance improvements have been seen in the Law on Public Offering of Securities (LPOS) as amended in 2001 and adopted in 2002 and the 2000 Commercial Law (CL). Further strengthening of the corporate governance framework is envisaged under additional changes to the CL, including the strengthening of provisions relating to the responsibilities of (supervisory) boards of directors.

An additional strength is active involvement of non-government organizations and shareholder associations that have been active in raising corporate governance issues and developing a consensus for corporate governance reform in Bulgaria.

III. REVIEW OF CORPORATE GOVERNANCE PRINCIPLES

This review assesses the compliance of Bulgaria to each OECD Principle of Corporate Governance which are set out in Annex A. Descriptions of practices and policy recommendations are offered each time a principle is less than fully observed. **Observed** means that all essential criteria are generally met without any significant deficiencies. **Largely observed** means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the OECD Principle, practices and enforcement diverge. **Materially not observed** means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means that no substantive progress toward observance has been achieved.

Section I: The Rights of Shareholders

Principle IA: Largely observed

Description of practice: The corporate governance framework provides a largely reliable form of securing methods of ownership and of conveying and transferring shares. The CL requires that joint stock companies maintain a shareholders' register. For public companies, the LPOS requires that the companies register their shares with the Central Depository, which maintains a registry of dematerialized shares. Except for the clients of foreign broker-dealers, the names of the ultimate shareholders must be registered with the Depository. According to market participants, the Depository operates efficiently and accurately and provides a reliable form of ownership registration of shares. Except for shares issued (or sold) to employees, which may or may not be tradable, all shares of public companies are freely transferable.

The Depository, established in 1996, provides clearing and settlement services and has had no experience of failed trades. The Depository operates on a trade-for-trade basis, i.e., without netting or having the Depository act as a central counter-party. The clearing and settlement cycle is T+3 with Delivery versus Payment (DVP.) The Depository maintains a reserve fund of BL 150,000 (USD 75,000) held with the BSE.

Some information regarding corporations is publicly available. Under supervision of the Ministry of Justice, a commercial register is maintained by each of the 28 regional commercial courts. The information in the commercial register includes copies of the company statutes, the list of founders and minutes of decisions by shareholders' meetings regarding changes in charter capital. In Sofia alone the commercial court register covers over 90,000 enterprises, including partnerships and sole proprietorships, of which about 1,000 are joint stock companies. Information in the commercial charter is not fully centralized. To obtain copies of a company's statutes, one must visit the regional court register in person, or obtain unofficial copies from a non-government company known as Information Services. Provision for centralized computer access is being discussed as part of the EU support for reform of the court administration.

With regard to financial disclosure, under the Law on Accounting companies must prepare an annual audited financial report, consisting of a balance sheet, a profit and loss statement, cash

flow statement and a statement of changes in shareholders' equity. The balance sheet and profit and loss statement must be published in a daily or financial newspaper within five months of the calendar year-end. The LPOS requires that the annual report submitted to the BNSC also include information regarding the members of the management and supervisory boards and persons holding more than ten percent of the votes at the shareholders' meeting (or otherwise able to control the issuer).¹ The report must be submitted within 90 days of the end of the fiscal year. Joint stock companies are subject to a mandatory audit by a certified public accountant. The financial statements are available to the public directly from the company or from the National Securities Commission, although as noted below, the quality of financial reporting is generally in need of improvement. (See also section below on disclosure.)

With regard to voting rights, the CL allows for different classes of shares with different voting rights although virtually all traded companies use one-vote one-share voting. Proposed changes to the LPOS would require all traded companies to adhere to the one-share one-vote rule. Under the LPOS all shares must be fully paid up in order to receive voting rights. (See also section below on conduct of shareholders' meetings.)

Members of the supervisory board are elected by the shareholders' meeting and members of the management board by the supervisory board. Members of both boards may be elected for a term of no more than five years, unless a shorter term is provided in the company by-laws. Directors may be re-elected for any number of terms and they may be dismissed from their duties before the end of the mandate. There is no requirement for cumulative voting to be used in the election of board members, although there are no provisions that would prohibit companies from adopting cumulative voting for board members. (See also section below on voting procedures and directors contracts.)

Shareholders have the right to receive dividends. Under the LPOS the shareholders' meeting decides on the distribution on the company's profit. The company must disburse payment of the dividend within three months of the general meeting and payment must be made through a bank transfer through the Central Depository. However the CL restricts the payment of dividends if the company's net assets would fall below the company's capital plus any reserves held or required to be held by law or company statute. However generally unreliable financial reporting reduces the ability of shareholders to verify if they are participating in the company's profits.

Policy recommendations: The CL should require cumulative voting for companies with a large number of shareholders. The commercial register should be computerized and information made available through the internet.

Principle IB: *Materially not observed*

Description of practice: Under the CL, the shareholders' meeting has sole authority to approve: (a) amendments to the company by-laws, (b) increase or decrease the company's capital stock and (c) transform or wind-up the company. The CL establishes no requirement for a minimum percentage of capital to be represented (quorum) in order to represent a valid meeting, leaving the issue to be determined by each company's by-laws. In addition the CL allows for a

¹ Amendments to the LPOS adopted in June 2002 include a requirement (Art 95, Para. 1) for the submission of quarterly reports by issuers.

“diminishing quorum” or “collapsing quorum,” whereby if the first level of a quorum is initially not met, a second meeting can be held one or two hours later for which the quorum requirement is still lower. Thus in principle, shareholders with as little as five percent of capital could constitute a quorum—a not-unheard-of occurrence, according to market participants. Under the LPOS, where the meeting is reviewing the transfer or grant of use of assets exceeding 50 percent of the company’s book value of total assets, three-quarters of the capital must be represented. With regard to the other decisions which must be made by the shareholders’ meeting, two-thirds of the capital participating in the meeting must approve the change, but the LPOS allows the company by-laws to set the quorum requirements. A review made by the BNSC found that in the by-laws of over 95 percent of public companies, the quorum was set at 50 percent of the capital plus one share.

Share dilution is an area of complaint from market participants and in the opinion of one fund manager, share dilution covers in over 80 percent of major Bulgarian public companies. There are several ways in which such share dilution occurs. For example, the CL specifies that the shareholder’s right to a pro rata participation in the capital increase may be forfeited by a shareholders’ meeting, the decision was approved by two-thirds of the shares represented at the meeting. However, with no minimum quorum set by law, a small number of shareholders may make the decision to waive some shareholders rights to participate in a share issue. The CL also allows for capital to be increased by means of private placement to designated persons at an agreed upon price (i.e. without allowing existing shareholders to participate in the new share issue), thus providing a means to bypass pre-emptive rights of shareholders. However, proposed changes to the LPOS would further strengthen shareholders’ rights by providing for a mandatory pre-emptive rights for capital increases of traded companies.

Policy recommendation: The CL should establish a minimum quorum for all joint stock companies. In transition countries, the first quorum is generally set at 40 or 50 percent of capital and the second quorum at 30 percent of shareholder capital.

Principle IC: Largely observed

Description of practice: Under the CL, companies are required to convene a general shareholders’ meeting at least once a year. If losses exceed one-half of the company’s capital, the meeting must be held within three months of the calendar year’s end. Extraordinary shareholders’ meetings may be held at the request of shareholders of ten percent or more of company capital and shareholders may request that the District Court call the meeting or appoint a representative to call the meeting. Under the LPOS, the shareholders’ meeting and its agenda must be announced 30 days in advance and published in two central daily newspapers. The agendas for shareholders’ meetings are set by the company. Under the CL, the papers concerning the agenda of the shareholders’ meeting must be made available to shareholders no later than the mailing of the agenda. The CL allows shareholders to add items to the meeting agenda prior to its publication in the *State Gazette*. During the meeting, shareholders may also add items to the agenda, providing that all shareholders are present at the meeting and all agree to the additional item. The 2002 amendments to the LPOS (Art. 115, Para. 4) bestowed upon shareholders the right to ask management questions during shareholders’ meetings. In addition, Art. 116g of the LPOS states that the management board is to appoint a manager of public/investor relations to respond to shareholder inquiries and questions regarding the company’s current financial state, as well as any other information to which shareholders/investors are entitled by law. The

shareholders may make decisions on issues not on the agenda, if all shareholders with votes unanimously agree to do so. To be valid, decisions by the shareholders' meeting must be signed by the chairman of the meeting, the secretary and the vote-counters. The company must keep a copy of the decisions by shareholders' meeting on file for five years and make them available to shareholders upon request. The shareholders' meeting approves the appointment of the auditors but does not approve the level of fees paid to the auditors.

The CL does not define the location of the shareholders' meeting, and some meetings have been known to be held outside of Bulgaria. The 2000 amendments to the LPOS addresses the issue by requiring that the shareholders meeting be held in the urban areas where the company is registered. Shareholders who acquired shares at least 14 days before the shareholders' meeting (i.e. the date of record) are entitled to vote. There is no requirement that trading in the shares be blocked prior to the shareholders' meeting.

The CL allows for the use of proxies at shareholders' meetings and the LPOS provides specific provisions for the use of proxies, including the requirement that a proxy be notarized and that it be given for a specific meeting and for voting in favor or against a particular decision. The LPOS also requires that any person representing shareholders with more than five percent of the voting shares must notify the company at least ten days before the meeting, and the company must notify the BNSC. In addition, the proposal to represent any other shareholder must be published in a newspaper or sent to every shareholder. Neither the CL nor the LPOS envisages voting by mail or electronically. The notarization requirement for proxy voting is thought to discourage some investors from using proxy voting, where for some shareholders the costs of notarization may exceed the expected dividends. However, in the past, the cheaper alternative of voting without notarization of proxies allowed violations in shareholding voting.

Policy recommendations: Shareholders representing five percent of capital or more should be able to propose resolutions for the agenda, and the new agenda should be distributed to all shareholders at company expense. each shareholders' meeting should include a question and answer session in the agenda.

Principle ID: *Partially observed*

Description of practice: Under the CL, provisions for any alternative voting rights (i.e. different from one-share one-vote) are laid out in the company by-laws, and these appear to be easily accessible to shareholders. However there is no requirement for disproportionate voting rights to be disclosed in an annual report to shareholders.

Policy recommendations: The legislation should require the disclosure of disproportionate voting rights in an annual report to shareholders. The corporate governance framework should also allow shareholders to identify cross-shareholdings and any possible pyramid holding structures affecting voting rights.

Principle IE: *Largely observed*

Description of practice: Changes in control of a public company are regulated by the LPOS, which requires that a person who has acquired directly or through related persons more than 50 percent of the votes of the company must register with the BNSC and within 14 days must make

a tender offer for the outstanding shares, or reduce the holding to less than 50 percent. The price of the tender offer may not be lower than the average share price over the prior three months, or in the absence of any trading, the highest price offered by the offeror over the prior six months. The LPOS also sets provisions to require that the offeror treat all shareholders equally. The offeror must thus provide sufficient time and information to the shareholders to enable them to evaluate the offer and make a reasonable decision as to whether or not to accept. Under the LPOS, company management must, within three days of receiving the offer, express its opinion to the BNSC and the offeror. The opinion should consider the interests of the company, its shareholders and its employees on a labor contract and should also contain information regarding: (a) any agreements on exercising voting rights (if known to company management), (b) the number of shares held by management and (c) whether management proposes to accept the offer. The LPOS also stipulates that during the offer period, the company may not issue securities that can be converted into voting shares, redeem shares, make agreements which make significant changes to the company's property, or otherwise attempt to frustrate the acceptance of the offer or create significant obstacles or additional costs to the offeror. The BNSC may terminate a tender offer that fails to follow the legal requirements, as it did in at least one case in August 2001.

In accordance with the Law on Protection of Competition, approval of the Commission for the Protection of Competition may be needed to complete the transaction where the merger would meet the market criteria set by the law, although to date the Commission has not yet blocked any potential mergers. Note also that the market for corporate control in Bulgaria is also substantially inhibited by the low levels of liquidity on the BSE, described under the above section on Market Structure.

Policy recommendation: Shareholder approval should be required for anti-takeover devices.

Principle IF: *Not observed*

Description of practice: Currently there are few institutional investors, and shareholders do not generally systematically evaluate the costs or benefits of exercising voting rights.

Policy recommendation: Once institutional investors have become more prevalent, they should be encouraged to evaluate the costs and benefits of participating in shareholders' meetings.

Section II: The Equitable Treatment of Shareholders

Principle IIA: *Largely observed*

Description of practice: Both the Commercial and LPOS require that shareholders of the same class be treated equally with information available on voting rights and changes subject to a shareholder vote. The CL notes that the company charter should specify the rights of the shareholders of each class, thus requiring that information regarding the rights of the class be available to all shareholders. Under the CL, any changes to the voting rights of a shareholder class would require an amendment to the company charter, thus requiring a vote of the shareholders' meeting.

Derivative actions are permitted. Under the LPOS, shareholders with five percent of the company's share capital may take action against the company's directors (of both management

and supervisory boards) to obtain compensation for losses suffered by the company. Shareholders also have the right to sue under the commercial court for violations of their rights, including for decisions taken by the company's management board. In addition under the Law on Obligations and Contracts, shareholders may sue a director for losses caused by the director, if the losses are the direct result of the director's actions. However there are no provisions for class actions lawsuits.

The courts are generally considered slow in decision-making, and the lack of accepted industry practices make such cases difficult to adjudicate. Arbitration is not commonly used in Bulgaria. However, the BNSC can initiate investigation of its own accord or upon the request of third parties. In cases of non-compliance or violation of the LPOS by market participants, the Commission may give warnings, halt trading, publicize cases of abusive practices and may apply fines. The 2002 amendments to the LPOS raised the maximum penalty that the BNSC can impose to BL 200,000 (USD 100,000).² Decisions by the BNSC regarding fines can be appealed to the regional civil courts. All others can be appealed to the Supreme Administrative Court under the Law on Administrative Proceedings. Unlike other jurisdictions, the Bulgarian BNSC has been successful in maintaining its sanctions. Of the 19 broker-dealers whose licenses have been revoked, only one was able to successfully appeal and have the revocation cancelled. In addition, the license of one investment company was revoked (and has not been appealed.)

Although ownership by nominees or custodians is rarely used in Bulgaria, there are no specific requirements to ensure that votes by custodians or nominees are cast in a manner agreed upon with the beneficial owner of the shares and there are no requirements for broker-dealers (acting as nominees and custodians of their customers' shares) to request that the beneficial shareholders send voting instructions.

Policy recommendations: Also the LPOS should regulate voting by nominees and custodians to ensure that ultimate beneficial owners can, if they so wish, provide their custodians or nominees with voting instructions.

Principle IIB: Largely observed

Description of practice: The LPOS provides for extensive prohibitions of insider trading and market manipulation, including prohibition against entering into transactions, spreading false rumors and forecasts or other acts with the intent of creating of false perception of the prices or volume of traded securities. An insider is defined to include members of management and boards of directors, persons holding ten percent of the shares of a company (directly or through related parties) or someone who due to his profession, activities, duties or relations of connection with a traded company has access to privileged information. Insider trading and market manipulation are subject only to civil sanctions and do not carry criminal liability. However market participants complain that information regarding tender offers is distributed very slowly, allowing for the potential for insider trading.

The rules of the BSE include prohibitions of insider trading. In 2000, the BSE investigated three cases of potential insider trading and market manipulation, of which one was referred to the

² This is for a second offense. The maximum penalty for a first offense is BL 100,000 (USD 50,000). Art. 221, LPOS.

BNSC and fines were imposed. While the LPOS provides for clear prohibition of insider trading and abusive self-dealing, the absence of decisions on a large number of cases makes it difficult to determine if the BNSC will prove successful in enforcing the provisions of the LPOS. In addition, investigations are generally initiated only by the BSE, which has authority to control only its member broker-dealers and market participants suggest that investigations would be more effective if initiated by the BNSC. In addition, it should be noted that in a tightly-knit financial and business community, such as Bulgaria, with low levels of liquidity and turnover, it is difficult to identify clear cases of insider trading or market manipulation.

Policy recommendations: As a first step, consideration should be given to strengthening the authority and capability of the BNSC to investigate possible cases of insider trading. Once the market becomes more active, consideration might also be given to establishing insider trading and abusive self-dealing as criminal (as well as civil) offenses.

Principle IIC: *Not observed*

Description of practice: Neither the CL nor the LPOS requires that company management or members of the supervisory board disclose any material interests they have in transactions or matters affecting the corporation. Anecdotal evidence suggests that it is not uncommon for members of the board of directors to hold the position of executive management of the company's suppliers. Proposed changes to the LPOS would provide that all transactions between the company and "interested persons" (defined as a company's directors, major shareholders, and connected persons to either directors or major shareholders) be executed at "fair" prices and that such transactions must be approved by the (supervisory) board. Shareholder approval would be required for transactions over two percent of the company's assets.

Policy recommendation: Implement amended LPOS, once approval has been obtained.

Section III: Role of Stakeholders in Corporate Governance

Principle IIIA: *Partially observed*

Description of practice: Under the legislation, trade unions have a limited role in Bulgaria, and employees have limited rights with regard to protection against unfair dismissals, disclosure of information regarding unlawful or irregular conduct. Nor are there legal requirements that employees or their representatives be consulted prior to a corporate merger or restructuring. However the CL requires that members of the board of directors perform their functions in the interest of the company, including the interests of stakeholders, thus requiring that the company recognize any stakeholder interests established by law.

Policy recommendation: Modernize labor legislation in line with practices in the region and with the view to comply with European standards.

Principle IIIB: *Partially observed*

Description of practice: Any stakeholder whose constitutional rights have been violated may appeal to the court for redress. However, as noted above the labor legislation provides for limited rights for employees and the judiciary system is generally considered to be slow in resolving commercial disputes.

Policy recommendation: Modernize labor legislation in line with practices in the region and with the view to comply with European standards.

Principle III C: Partially observed

Description of practice: Bulgarian companies seldom provide share option or other performance enhancing mechanisms. However, in 1999 the Belgian company Interbrew allowed employees to buy shares from the company's initial public offering on the Brussels Stock BSE. In addition employees were generally offered discounted prices on shares for companies undergoing privatization.

Policy recommendation: It would be helpful if the use of performance-enhancing mechanisms for company employees could be encouraged. It may also be useful to conduct a study of the costs and benefits of various performance-enhancing mechanisms including stock options for managers and employees.

Policy III D: Largely observed

Description of practice: Stakeholders generally have access to the same company information as shareholders, for example, access to the information in the commercial court register and in the register of the BNSC.

Policy recommendation: It may also be helpful for the BSE to encourage public companies to include disclosure of relationships with stakeholders in the companies' annual reports and, where available, websites.

Section IV: Disclosure and Transparency

Principle IV A: Partially observed

Description of practice: The LPOS sets out the disclosure requirements for public companies. The latter must provide to the BNSC and the Chamber of Commerce audited financial statements within 90 days of the end of the year. In addition, companies must file with the BNSC any material changes. In addition, the company must present its semi-annual report within 30 days of the end of the period. Bulgarian accounting standards require that in their annual reports, companies disclose their current activities and future prospects. In practice, large corporations (and particularly those with foreign shareholders) make such disclosures but most public companies do not.

For traded securities on the Official Market, the LPOS requires that all shareholders with five percent or more of the voting shares must notify the company, the BNSC and the BSE. (Note that this level is higher than the minimum of ten percent set by EU Directives.) The LPOS provides a comprehensive list of criteria for determining indirect and beneficial ownership. It states that in counting the percentage of voting shares, shareholders must include shares held by: (a) spouses and minor children of the shareholder, (b) a company over which the shareholder has control, (c) a third party on behalf of the shareholder, (d) a person with which the shareholder has a common policy with regard to management of the company through the voting of shares, (e) deposited as collateral (unless the secured creditor exercises the right to vote), and (f)

deposited with a person under Art. 145, Para 1, Item 1, transferring the rights to vote without special instructions from the shareholders. For all traded companies, shareholders who acquire 50 percent of the voting shares or more are obliged to notify the BNSC and the company within 14 days of acquisition of the shares.

Despite such requirements, information on indirect shareholding is often difficult to obtain. An estimated half of the annual USD 900 million in foreign investment is made by companies incorporated in Cyprus, (for which the regulatory authorities provide little information on shareholder structures.) Proposed changes to the LPOS would provide that when a legal entity (including an off-shore company) owns five percent (or a multiple of five percent) of the company's shares, the legal entity must disclose the persons that control it and the ways in which such control is exercised.

The CL allows either a two-tiered board structure or a single-tier structure. However, neither the CL nor company by-laws provides detail on the authority of the board of directors. Some companies fill the vacuum by negotiating "director contracts," in which the roles and responsibilities (and remuneration) of the directors are laid out. In addition, director contracts generally stipulate that the director provide collateral equal to three months' salary. However, director contracts are generally confidential and not made available to shareholders and other stakeholders, as would company by-laws. It is estimated that about 1/3 of the companies on the Official Market in director contracts. In addition, many companies also adopt rules of procedures for the board.

Under the Ordinance on the Prospectuses for Public Offering of Securities and Disclosure by Public Companies and other Issuers of Securities, the names of the members of the board, their professional qualifications and individual remuneration are disclosed in the prospectus. Under the Ordinance, the company must disclose material risk factors in the prospectus, which would include material issues regarding employees and other stakeholders but not the company's corporate objectives. In addition the prospectus must disclose the remuneration of board members (both in aggregate and individually), the shares held by each board member, and the professional qualifications of the board members and their activities outside the company for the prior three years. The LPOS also requires that the information not be false, misleading or incomplete and that it allow the investor to make an accurate assessment of the economic and financial status of the issuer and the securities offered. However, the failure to require annual disclosure of the same factors presents a corporate governance weakness.

Policy recommendations: Once the amended LPOS is approved, the BSNC should implement measures to ensure compliance with disclosure of indirect ownership interests. In addition, in their annual report, companies should be: (1) required to provide disclosure of material financial and non-financial factors, including the main risks faced by the company and (2) encouraged to discuss governance structures and policies.

Principle IVB: *Partially observed*

Description of practice: All enterprises are currently obliged to prepare their financial statements in accordance with Bulgarian National Accounting Standards, which are considered to be close to International Accounting Standards (IAS). Bulgarian National

Accounting Standards include a requirement for consolidation of accounts, but have no requirements for segment reporting, accounting for inflation or disclosure of contingent liabilities. Under the Accounting Law (effective January 2002), by 2003 all banks, insurance companies and companies issuing publicly traded shares or debt will be obliged to prepare their statements in accordance with IAS.

The Institute of Certified Public Accountants is responsible for auditing standards and practices and has the authority to impose fines or other economic sanctions. There is no statutory limit to the liability of auditors. According to the LPOS, the company's chief accountant is jointly liable with company management, board of directors and the investment intermediary for damages caused by false, incomplete or inaccurate information in the prospectus. Also, the chartered accountant or specialized audit firm is responsible for damages caused by the accounting statements audited by them. The Institute supervises auditors' activities. Every year, certified public accountants must report to the Institute: the number of companies audited and the number of companies for which the certified public accountant has refused to certify.

Policy recommendations: Included as part of the Accounting and Auditing ROSC.

Principle IVC: *Partially observed*

Description of practice: The Law on Audit requires that an independent audit be prepared for all medium and large enterprises, i.e., companies with over 50 employees and revenues and net assets over certain limits. Under the CL, the shareholders' meeting may not approve the company's financial statements unless they have been audited by a certified public accountant. Under the Law on Accountancy, a specialized auditing company or a certified accountant may not, directly or indirectly through related persons perform an audit and verification, if the company performs the accounting of those enterprises. "Independence" is not specifically defined, although the Audit Law specifies that an audit firm is not allowed to perform an audit of a company with whom it is related in terms of capital. For publicly traded companies, the BNSC monitors the annual and semi-annual financial statements with regard to their compliance with the Law on Accounting. However, to date there have been no lawsuits brought against companies, their board members or accountants or auditors. Despite the move towards the introduction of international standards on both accounting and auditing, auditing practices are generally considered weak and audited opinions less than fully reliable. In addition, most companies do not have internal audit departments, necessary to facilitate the external audit.

Policy recommendations: Included as part of the Accounting and Auditing ROSC.

Principle IVD: *Partially observed*

Description of practice: Under the LPOS, public companies must submit their annual financial statements to the BNSC within 90 days of year-end and 30 days of the close of the semi-annual period. The information is available to shareholders and other stakeholders from the BNSC. However, the information is not available online from the BNSC, and most companies do not maintain websites. Also, companies are not required to update information originally provided in the prospectus.

Policy recommendation: Use BNSC website for online access to company information.

Section V: Responsibilities of the Board

Principle VA: *Materially not observed*

Description of practice: One of the major weaknesses in the corporate governance framework in Bulgaria is the minimally defined level of responsibility for members of the supervisory body. Under the CL, companies may choose to have either a two-tiered or a unitary board of directors; under a two-tiered structure, all (supervisory) board members are chosen from outside company management. However, under both a two-tiered and a single-tiered structure, Bulgarian companies tend to be run by company management with little supervisory review by the board of directors.

A key weakness is the limited definition of the role and responsibilities of (supervisory) boards of directors. The CL only notes that either prior approval of the supervisory board is needed for certain decisions: (a) closing down or transfer of enterprises, (b) substantially altering a company's business, (c) substantial organizational changes, (d) long-term agreements material to the company, and (e) establishment of branches. Some definition may be given in the company by-laws but is not always present. Also some companies have adopted "rules of procedure" for the (supervisory) board of directors, but they are generally not publicly available.

In addition, the accountability of the (supervisory) board of directors is limited. The CL states that directors are obliged to perform their functions in the interest of the company and not disclose confidential information after they leave their positions as directors. The LPOS also stipulates that it is the duty of each director to treat all shareholders in a fair and equitable manner. The Law on Contracts and Obligations requires that parties to a contract fulfill their obligations accurately and in good faith, in accordance with the law and that they not obstruct the other party in fulfilling its obligations. However, under the current securities and commercial legislation, there is no requirement that the actions of the directors be conducted with due care and diligence. Some companies require provisions as part of director contracts that the directors must set aside as collateral funds equal to three months' salary. However, according to market participants, directors are generally (though not always) absolved of further liability by the decision of the shareholders' meeting. In addition, there is no corporate governance code or other form of accepted industry practice giving detailed guidance on the structure, operation and conduct of (supervisory) boards of directors. For example, there are no guidelines on the creation of internal board committees on such important issues as finance and audit, risk management or management succession. Although discussions with market participants suggest that asset-stripping and below market transfer pricing are not-unheard-of, to date, no lawsuits have been initiated against directors who may not have acted in the interest of the company, and it is unclear how the courts would make such decisions. Proposed amendments to the LPOS would specifically provide that directors' duties include duties of care and loyalty and the obligation to act in good faith and in accordance with the law.

Policy recommendations: Strengthening (supervisory) boards of directors will require: (a) amending the CL to clearly define the duties of due care and diligence for board members and (b) developing a voluntary code of best practice in corporate governance providing recommendations on the operation, structure and functioning of (supervisory) boards of

directors. In addition, consideration should be given to establishing an institute of directors to provide training and disseminate best practice approaches.

Principle VB: Materially not observed

Description of practice: The requirements of the LPOS to act in the interest of the company would encourage (supervisory) boards of directors to treat fairly all shareholder groups. However, as noted in the assessment, practice may not always follow.

Policy recommendations: Amend the CL to further define the roles and responsibilities of boards of directors. Establish a corporate governance code to provide guidance on the operation, structure and functioning of boards of directors. Create an Institute of Directors to ensure that directors receive adequate training in their legal responsibilities and international practices regarding the operations of boards of directors.

Principle VC: Materially not observed

Description of practice: The requirements of the LPOS to act in the interests of the company would encourage boards of directors to ensure that company complies with applicable laws. In addition, the Law on Contracts and Obligations specifically requires compliance with the law. However, as noted above, practice may not always follow.

Policy recommendations: See recommendations above.

Principle VD: Materially not observed

Description of practice: The definition of the roles and responsibilities of boards of directors is limited. While it covers monitoring mergers and acquisition and selecting company management it does not provide for boards to monitor and manage potential conflicts of interest, oversee disclosure and communications or ensure the integrity of the company's accounting and financial reporting systems or governance practices.

Policy recommendations: See recommendations above.

Principle VE: Materially not observed

Description of practice: Under two-tiered boards, all the members of the supervisory board would be independent of the management board but for unitary boards, there are no requirements (or guidelines) on the nomination of non-executive board members. In addition, there are no effective mechanisms to ensure that boards exercise objective judgment independent of company management. Boards generally meet regularly but there are no guidelines on the amount of time devoted to board responsibilities.

Policy recommendations: See recommendations above.

Principle VF: Materially not observed

Description of practice: Directors have no specific right to inspect the accounting records of the company and may have limited access to company information.

Policy recommendations: The board should have broad access to company information, records, documents and property where needed to make informed decisions on matters within the authority of the supervisory board. Directors should also be able also obtain independent professional advice at the company's expense.

IV. SUMMARY OF POLICY RECOMMENDATIONS

This section sets out policy recommendations to improve the compliance of listed companies with the OECD Principles of Corporate Governance. The next step is the development of a detailed action plan. The action plan should be formulated in close cooperation with the Bulgarian authorities and in consultation with the private sector and other stakeholders. Also, in order to be most effective, corporate governance reforms should be coordinated with the action plans resulting from the Accounting/Auditing and the Insolvency/Creditor Rights ROSCs conducted in 2001/02.

The detailed policy recommendations made in the principle by principle review for the less than fully observed Principles can be grouped under the following broad categories: legislative reform and private sector initiatives.

Legislative reform: Proposed amendments to the legislative framework dealing with corporate governance issues are already underway and will provide greater clarity, responsibility, accountability, and transparency for traded companies. Detailed legislative issues are proposed in the policy recommendations of the principle by principle review section above. *Priority: high*

Voluntary/private sector initiatives: The next important step will be in strengthening the practices of (supervisory) boards of directors. This should be done through the development of a corporate governance code, developed under the leadership of the corporate sector in collaboration with the BSE. In addition, consideration should be given to establishing an Institute of Directors that could provide valuable training for board members. *Priority: medium*

The World Bank would be pleased to play the role of a facilitator to convene the Bulgarian stakeholders to discuss the findings of this report so that a broad consensus of ownership and a detailed action plan can be derived.

ANNEX A: OECD PRINCIPLES OF CORPORATE GOVERNANCE

Section I: The Rights of Shareholders

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

Principle IB. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes, such as: (a) amendments to the governing documents of the company; (b) the authorization of additional shares; and (c) extraordinary transactions that in effect result in the sale of the company.

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

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

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

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

Section II: The Equitable Treatment of Shareholders

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

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

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

Section III: Role of Stakeholders in Corporate Governance

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

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

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

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

Section IV: Disclosure and Transparency

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

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

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

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

Section V: Responsibilities of the Board

Principle VA. The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability

to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

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

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

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

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

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

ANNEX B: OECD Principles-Assessment Matrix

Section I: The Rights of Shareholders

Principle IA. Basic shareholders rights:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IB. The right to participate in decisions on fundamental corporate changes:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input checked="" type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IC. The right to be adequately informed about, participate and vote in general shareholder meetings (AGM):

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle ID. Disclosure of capital structures and arrangements enabling control disproportionate to equity ownership:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IE. Efficient and transparent functioning of market for corporate control:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IF. Requirement to weigh costs/benefits of exercising voting rights

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input checked="" type="checkbox"/>		

Section II: Equitable Treatment of Shareholders

Principle IIA. Equal treatment of shareholders within same class

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IIB. Prohibition of insider-trading and self-dealing

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IIC. Disclosure by directors and managers of material interests in transactions or matters affecting the company.

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input checked="" type="checkbox"/>		

Section III: Role of Stakeholders in Corporate Governance

Principle IIIA. Respect of legal stakeholder rights as established by law

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IIIB. Redress for violation of rights

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IIIC. Performance-enhancing mechanisms for stakeholder participation

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IIID. Access to relevant information

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Section IV: Disclosure and Transparency

Principle IVA. Timely and accurate disclosure of material information

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IVB. Preparation of information, audit, and disclosure in accordance with high standards of accounting, disclosure and audit.

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IVC. Annual audit by independent auditor

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

Principle IVD. Channels for disseminating information allow for fair, timely, and cost-efficient access to information by users

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

Section V: Responsibilities of the Board

Principle VA. Act on an informed basis, in good faith, with due diligence and care, in the best interest of the company and shareholders

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

Principle VB. Fair treatment of each class of shareholders

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

Principle VC. Compliance with law and taking into account stakeholders' interests

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

Principle VD. Fulfillment of key functions, including corporate strategy, selection and monitoring of management, remuneration, board nomination, monitoring of conflict of interest including misuse of corporate assets and abuse in related party transactions, integrity of accounting, audit, governance practices and overseeing disclosure and communication.

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

Principle VE. Objective judgement on corporate affairs independent from management; devotion of independent time.

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

Principle VF. Access to accurate, relevant, and timely information

(a) Observed (b) Largely observed (c) Partially observed
(d) Materially not observed (e) Not observed

*This table attempts to summarize the current provisions in the country, benchmarked against the items set out in the **OECD Principles of Corporate Governance**.*

***Observed** means that all essential criteria are generally met without any significant deficiencies*

***Largely observed** means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the OECD Principles, practices and enforcement diverge. **Materially not observed** means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means that no substantive progress toward observance has been achieved.*

Any comments are welcome