



THE WORLD BANK

# Report on the Observance of Standards and Codes (ROSC)

Corporate Governance

## Corporate Governance Country Assessment

Armenia  
April 2005

# Overview of the Corporate Governance ROSC Program

## WHAT IS CORPORATE GOVERNANCE?

Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

The *OECD Principles of Corporate Governance* provide the framework for the work of the World Bank Group in this area, identifying the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibilities of the Board of Directors.

## WHY IS CORPORATE GOVERNANCE IMPORTANT?

For emerging market countries, improving corporate governance can serve a number of important public policy objectives. Good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, and leads to capital market development. Weak corporate governance frameworks reduce investor confidence, and can discourage outside investment. Also, as pension funds continue to invest more in equity markets, good corporate governance is crucial for preserving retirement savings. Over the past several years, the importance of corporate governance has been highlighted by an increasing body of academic research.

Studies have shown that good corporate governance practices have led to significant increases in economic value added (EVA) of firms, higher productivity, and lower risk of systemic financial failures for countries.

## THE CORPORATE GOVERNANCE ROSC ASSESSMENTS

Corporate governance has been adopted as one of twelve core best-practice standards by the international financial community. The World Bank is the assessor for the application of the OECD Principles of Corporate Governance. Its assessments are part of the World Bank and International Monetary Fund (IMF) program on Reports on the Observance of Standards and Codes (ROSC).

The goal of the ROSC initiative is to identify weaknesses that may contribute to a country's economic and financial vulnerability. Each Corporate Governance ROSC assessment reviews the legal and regulatory framework, as well as practices and compliance of listed firms, and assesses the framework relative to an internationally accepted benchmark.

- Corporate governance frameworks are benchmarked against the OECD Principles of Corporate Governance.
- Country participation in the assessment process, and the publication of the final report, are voluntary.
- The assessments focus on the corporate governance of companies listed on stock exchanges. At the request of policymakers, the ROSCs can also include special policy focuses on specific sectors (for example, banks, other financial institutions, or state-owned enterprises).
- The assessments are standardized and systematic, and include policy recommendations. In response, many countries have initiated legal, regulatory and institutional corporate governance reforms.
- Assessments can be updated to measure progress over time.

By the end of June 2005, 48 assessments had been completed in 40 countries around the world.

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

## Corporate governance country assessment

Armenia

April 2005

### Executive Summary

This report provides an assessment of Armenia's corporate governance framework—its laws and regulations, enforcement and common business practices. The report notes recent improvements in corporate governance regulation, makes recommendations of policy and institutional strengthening, and provides a benchmark against which to measure corporate governance in Armenia. Note that the report covers only publicly-traded companies, although many of the recommendations may also be applicable to closely-held companies and state-owned enterprises.

In recent years there have been a number of major reforms of securities markets and corporate governance issues. However, experience in other countries suggests that implementation and enforcement remain central.

The report identifies immediate and longer term steps for improvement of corporate governance in Armenia, some of which can be implemented through the PRSC process. They are:

- ❑ Provide easy public access to the documents in the company registry, notably the company charters and the lists of founders;
- ❑ Strengthen accounting and auditing practices, including training, certification, and enforcement.

Other important measures focus on implementation:

- ❑ Place a concentrated effort on raising awareness of the needs for transparency and accountability, including the creation of an Institute of Directors and a Code of Corporate Governance;
- ❑ Work to improve ownership disclosure, including by giving all shareholders the right to obtain copies of the full shareholder lists;
- ❑ Continue enforcement of reporting, with a focus on quality of information, and prevention and prosecution of self-dealing;
- ❑ Strengthen the supervising role of boards of directors by increasing their authority and accountability.

## **Acknowledgements**

This assessment of corporate governance in Armenia was conducted in December 2004 by Tatiana Nenova of the Corporate Governance Department of the World Bank, as part of the Reports on Observance of Standards and Codes Program. The ROSC was based on a corporate governance template-questionnaire completed by M/s. America CJSC. Messrs. /Mmes.: Donna Dowsett-Coirolo, Roger Robinson, Christian Petersen, Sue Rutledge, Alex Berg, Davit Karapetyan, and David Robinett provided advice and comments.

The assessment reflects technical discussions with the Securities Commission of Armenia, the Armenian Stock Exchange, the Central Depositor of Armenia, the Ministry of Finance and Economy, the Central Bank, and the Ministry of Justice, as well as commercial banks, issuers, and numerous market participants.

The ROSC assessment for Armenia was cleared for publication by the Securities Commission of Armenia and by Teresa Barger, Director of the Corporate Governance Department, in April 2005.

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## Country assessment: ARMENIA

### Market profile

The major capital markets institutions in Armenia were created in the late 90s, but much remains to be done in the area of corporate governance. The bottlenecks that risk hampering the country's pace forward in the short term relate to the availability of basic information on the more than 4000 joint-stock companies such as provided by the Company Registry, as well as the quality of their financial reporting. These areas are central to the ability of companies to obtain trade and bank financing, and would therefore be a major factor in the rate of growth of the private sector in the near term. The medium term presents a different challenge – that of ordering and prioritizing a wider range of reforms, including more sophisticated corporate governance and capital market mechanisms and fostering better enforcement and compliance.

*Liquid and narrow market, no institutional investors*

Armenia's market, created following the privatization wave in the mid-90s, has a low capitalization at US\$23 million, representing 0.8% of GDP (compared to 11% average in the countries of central and eastern Europe and central Asia). Turnover is also illiquid a turnover at less than 1%. Companies with at least 50 shareholders and capital exceeding 5 million AMD (US\$10,000) are deemed "reporting issuers" and need to register with the Securities Commission of Armenia (SCA). They also need to list for trading if they have more than 100 shareholders. There are 196 listed companies as of December 2004, out of about four thousand joint-stock companies (JSCs). No corporate bonds have been issued to date. There are also no institutional investors participating in the Armenian securities markets.

*Basic legal framework in place, more to be done*

The corporate legal framework was revised in early 2000, with the adoption of the Securities Market Regulation Law (SMRL) and the JSC Law (LJSC). While in the short term law revision is not a priority, changes and amendments would be needed going forward. Draft laws on private pension funds and investment fund are under preparation.

*Key players include the Securities Commission of Armenia, and the Armenia Stock Exchange*

Listed companies fall under the supervision of the Securities Commission of Armenia (SCA), as do broker/dealers, trust management companies, and custodians. Initial registration of companies is conducted with the State Registrar of Legal Persons which is a structural subdivision of the Ministry of Justice. The Armenian Stock Exchange and the Central Depository of Armenia (CDA) are both SROs under the supervision of the SCA. The CDA acts as registrar, depository and clearing agent. Banks and credit organizations are also regulated by the Central Bank, and insurance firms by the Ministry of Finance.

### Key issues

Several key features distinguish Armenia's corporate governance framework. The legacy of privatization, the role of the State, and poor awareness of securities markets and international corporate practices. The country is also characterized by a concentration of corporate control and absence of corporate governance traditions. In most JSCs, controlling owners carry out management directly or indirectly. This is reinforced by apathy on the part of small shareholders and the

absence of institutional foreign or domestic investors.

### Investor protection

*Shareholder rights relatively weak*

Basic shareholder rights are available by law, but relatively weak in practice. Most corporation information is available in a timely and regular manner, but is generally not requested by shareholders.

*Basic rights in place, AGM rules insufficiently clear*

Cumulative voting for directors is mandatory for companies with 500 or more shareholders, but its effect is significantly diminished by the small size of boards. The shareholder meeting approves (with  $\frac{3}{4}$  majorities of votes attending), changes to the company charter and to authorized capital. However compliance with AGM procedures, such as proper notice, is weak. Some AGM basic functions are not firmly set in the law, so that it is not illegal, for example, to eliminate annual election of directors. However one major weakness is that not all the shares of publicly-traded companies are freely transferable since closed JSCs and even limited liability companies are permitted to be traded on the stock exchange. Proxy voting is allowed, with a power of attorney. Taking the company private must be done via a tender offer at the 75% level of ownership.

*10% share capital can call EGM*

A 10% shareholder can call an EGM. The shareholders holding minimum 2% of voting shares can add items onto the AGM agenda.

*Shareholders have withdrawal rights*

Shareholders can withdraw from the company in case of merger/ reorganization, some large transactions, suspension of pre-emptive rights, and changes in charter adversely affecting the shareholder. Shareholders that voted against or did not participate in the GM can sell their shares back to the company at a market price, determined by independent valuation at the option of the board.

*Shareholders are treated equitably in the law*

Information about share classes is available from the company charter, prospectus, periodical and current reports. Within each share class, all shares carry the same rights. Approval of decisions by negatively impacted classes is regulated.

### Disclosure

*Weak requirements for ownership disclosure*

The SMRL requires that, for reporting issuers, any person who is an owner of 10% or more of the company's shares must disclose his/her ownership. In the case of tender offers, shareholder agreements must also be disclosed. However there are no requirements for public disclosure of ultimate beneficial owners.

*Weak access to company registry, and shareholders lists*

On a more fundamental issue, the law does not provide for public access to the documents held by the company registry (i.e. the lists of founders.) In addition, small shareholders with holdings of fewer than 10% do not have the right to obtain a copy of the full list of shareholders.

*Disclosure of RPTs and large transaction weak in practice*

Large transactions and RPTs are partially disclosed. By law, reporting issuers must disclose transactions among affiliated parties and all transactions exceeding 10 mln. AMD or 10% of the company's assets. In addition, the shareholder meeting must approve (by  $\frac{3}{4}$ ) large transactions of 50% of assets and share issues of more than 25% of capital, and (by  $\frac{1}{2}$ ) RPTs of 2% of assets or equity. However in practice, disclosure is often not enforced, due to the limited application of accounting standards and the feeble reliability of audits. Deals are frequently concealed or understated to avoid approval procedures. Improper RPTs or other

forms of self-dealing, especially concerning sales of property, are frequent. In addition, related loans are allowed. Directors often do not disclose conflicts of interest.

*The requirements for annual reports made for shareholders are defined poorly*

The LJSC requires publication of OJSC's annual reports and audited annual financial statements through the media. Under the SMRL, reporting issuers must file audited annual reports. These reports are publicly disclosed and are available shareholders. In addition the SCA / Armex provide public access to quarterly and current reports, prospectus, and the company charter. The specific requirements for the annual reports contents are left to accounting standards. Most key information is found in the quarterly, not annual, reports. In practice, media publications of non-financial information are rare. The reporting burden is perceived as heavy. Furthermore the information subject to disclosure is reportedly hard to obtain directly from companies.

*Lack of immediate disclosure of material events*

Material facts, including changes in board, management, large owners, auditor, equity, subsidiaries, and any changes in the prospectus information must be disclosed to SCA / Armex in "current reports" only within 10 days (and not immediately). The current reports are publicly accessible.

*Non-financial disclosure is weak*

Some of the non-financial disclosure of the OECD principles is required by law and regulation and the SCA has successfully been improving reporting compliance of listed companies. However many provisions are missing from the list of required disclosures. Most importantly, the annual report does not require an in-depth Management Discussion & Analysis (MD&A) section, company objectives, risk factors, RPTs, and directors and executives remuneration. There are also no disclosure requirements of employee or stakeholder issues under the LJSC.

### **Company oversight and the board**

*Boards of directors have insufficient authorities or accountability*

Armenian companies generally have single-tier boards (although the law does allow companies to maintain dual-tier boards.) By law, the board may have as few as three members, not including the board members who gain their positions as owners of 10% or more of the company's shares and are not subject to election by the shareholder meeting. Cumulative voting for directors is mandatory for companies with 500 or more shareholders, but its effect is significantly diminished by the small size of boards.

Under the Armenian company law, boards of directors have insufficient authorities or accountability to be fully effective. Boards of directors should be responsible for supervising company management and approving the company's strategy and internal systems of risk management and control.

Furthermore the law specifically allows shareholders to participate in company management. In practice, the executive and board chairman functions are often held within one family or are combined in one person--which is permitted for companies with less than 500 shareholders. Most boards do not play a strategic role and are dominated by the controlling owner. In many cases the role of the board is poorly understood and the boards largely perform management rather than oversight functions. Companies frequently do not hold regular board meetings.

*No rules on board*

Boards often lack independence from controlling owners and from management. There are no rules on full director independence. There is a limited definition of

<i>independence</i>	director independence, only applicable to the case of related party transactions, which further falls short of best practice independent director provisions.
<i>Statutory fiduciary duties are weak</i>	Under the SRML, the board must act in the interest of shareholders, conscientiously with the care of an owner, and carries liability to the company for damages. Liability is determined per general business practice, and is not imposed when acting in good faith. The law is not sufficiently specific in distinguishing the powers and duties of the board, the executive, and the AGM, which hampers attribution of liability. There is limited regulatory guidance on the duties of care and loyalty. Director liability is not invoked in practice.
<i>No director guidelines or training</i>	Armenia has no Corporate Governance Code and no guidelines for director duties or director training are in place.
<i>Controllers (or revision commissions) are not part of the board of directors</i>	Armenian companies have controllers (or revision commissions), which are appointed by the shareholder meeting and are not part of the board of directors. The controller assures company compliance with the law, certifies the truthfulness of the annual report, but does not nominate the external auditor. There are no financial expertise requirements for controllers and in practice, the controller is generally a company employee beholden to the owner. Note that revision commissions are not considered as “audit committees”, since the latter refers to committees within the supervising board of directors.

### Enforcement

<i>Adequate administrative SCA powers, weak Armex powers</i>	<p>SCA has fairly wide administrative enforcement powers. It can issue warnings, conduct public hearings, impose (sufficiently big) fines on issuers, conduct company inspections, suspend trading, and terminate and/or suspend issuer registration. SCA orders are detailed and substantiated. Some SCA investigative powers are weak, i.e. it cannot subpoena witnesses or obtain third party information. SCA enforcement efforts are frustrated by a slow, lacking expertise, and often partial Economic court.</p> <p>The enforcement department of Armex is small, and carries out limited disclosure and late fee enforcement. Armex suspends trading for prolonged disclosure violations.</p>
<i>Court redress ineffective, weak liability provisions</i>	Legal recourse against AGM decisions and directors or insiders rests mostly on weakly defined liability provisions. Shareholders have the right to appeal to the court regarding decisions taken by the AGM that contradict the law. The company or a 1% voting shareholder can sue the directors and executives, claiming compensation for damage caused to the company. The executive director and the chief accountant are liable for false or misleading statements in the prospectus, and transactions undertaken based on such statements are void. Most observers do not believe minority rights to have a real defense given the shortcomings of the Economic court.
<i>Limited recourse with SCA, but improving disclosure enforcement</i>	While every shareholder has the right to file a complaint with the SCA, SCA has no special powers that enable it to serve as a specialized shareholder dispute-resolution body. SCA focuses its efforts on disclosure enforcement. The most frequent infractions SCA notes are accuracy and completeness of periodic company reports, corporate asset sales at non-market prices, and improper calling, notice and conducting of AGM. Enforcement of company registration obligations is ongoing, and SCA identifies and assists companies with the registration

*Accounting and auditing standards poorly enforced*

procedure. Market participants perceive the general adherence of companies to disclosure and reporting rules, and the effectiveness of supervision, as fair.

Armenian accounting standards generally follow IFRS but are based on an outdated (2000) version of the standards. Auditing standards are based on ISA. However there are substantial gaps between official accounting standards and actual practices. In addition, the external auditor is often susceptible to pressure from the controlling owner. The auditor has no substantive interaction with the controller, board, or shareholders, and is liable only for breach of auditing law.

## Recommendations

The following recommendations are aimed at improving the Armenian Corporate Governance framework in compliance with the OECD Principles.

### Immediate priorities

*Upgrade the Company Registry*

As a first step, the law regarding the company registry should provide for public access to the documents of the company registry (including company charters and lists of company founders). Comprehensive reform is needed for the Company Registry. This should include technical upgrades to modernize its systems for filing and documentation. It should also include broader changes to refocus the Registry on providing company information, thus facilitating the implementation and enforcement of the LJC. The Registry should be able and willing to demand that delinquent companies make proper filings. It should have the resources needed for its mission. Additional support from donors will be a necessary part of this process, given the extensive and technical nature of the required reform.

*Strengthen the quality accounting and auditing*

While there has been ongoing work in this area for a number of years, the quality of accounting and auditing in Armenia still needs to be improved. As a first step, an accounting and auditing ROSC should be conducted for Armenia. Full adoption of the current versions of IFRS is needed. Familiarity with international standards should be assured via training and continuous education, as well as promoting the integrity of the audit profession. AAAA's Institute for Accountants should provide certification under the Ministry of Finance in the short term. Best practice suggests auditor independence rules. In the longer term, an independent auditor and accountant oversight body should be created, with certification and enforcement powers.

*Plan longer-term reforms*

Set up a government committee, with participation from all relevant stakeholders, to plan corporate governance priorities in the medium and long term. Increasing harmonization with EU standards would help this process along.

### Longer-term objectives

*Disclosure and reporting*

All shareholders should have the right to obtain a copy of the full shareholder list, where photocopying is at the expense of the shareholder.

Other efforts should also be made to improve corporate financial reporting. The SCA should work to improve annual report requirements, specify the annual report format precisely, and enforce that format. At a minimum, the annual report should contain ultimate beneficial ownership, RPTs and large transactions. In addition the annual reports (and audited financial statements) should be available online for public consultation. Other disclosure requirements for RPTs should

*Provide clear specification of the roles and duties of management, the board, and the AGM*

also be enforced more effectively.

One of the key weaknesses in the corporate governance system in Armenia is the lack of properly functioning boards. The Armenian legal framework, and in particular the LJSC is not adequate to assure properly functioning boards. A major weakness in the legal and regulatory framework is the absence of a clear definition of the duties of the board of directors, the executive, the controller, and the AGM. Policymakers should take steps to increase management accountability and clarify their relative powers: abolishing the concept of a collective management body in favor of a single executive manager (CEO) with clear duties; requiring a separate Chairman of the Board and CEO; and giving the board clear authority in the company, with responsibility for strategic and succession planning, financial reporting and auditor appointment, overseeing management, and overall strategy. Another area for regulatory improvement is internal control and risk management, which should be vested with the board.

The accountability of board members to shareholders should also be enhanced and clarified. The duties of care and loyalty, and the requirement that directors treat all shareholders equally should be strengthened and clearly grounded in the law. Directors should be elected every year, and for listed companies the minimum board size should be increased to allow for meaningful cumulative voting. To improve director performance, the maximal number of board memberships should be defined, as well as a maximum period of service. An Institute of Directors should be created, with a certificated director training program, and possibly with SCA requirements for director certification.

AGM procedure and notification should be also specified in detail in the law, leaving little to the charter or board or management discretion. Consideration should be given to the abolition of, the position of the controller and the board should have full responsibility for monitoring internal controls and financial systems. This may include the creation of audit committees composed primarily of independent board members.

*Improve protection of shareholder rights*

The development of an institutional investor community, including foreign investors, is vital to the promotion of corporate governance and a viable capital market. Several avenues of action should be considered: e.g. an investment fund law should be adopted. However the best way to encourage more investment and investors is better protection of shareholder rights.

Regulations and measures to prevent, detect and penalize self-dealing—tunneling—should be strengthened, this includes banning related loans to insiders and in-kind contributions to capital. Importantly, the SCA should get effective powers to enforce a truly fair market valuation for transactions in assets and stock.

More generally the powers and resources of the SCA need to be enhanced. Both the staff of the SCA and the court would benefit from relevant training.

In addition a Code of Corporate Governance should be developed and adopted by the Armex and other stakeholders, to provide a detailed framework for board members duties, legal responsibilities, and independence rules.

## Principle - By - Principle Review of Corporate Governance

This section assesses Armenia's compliance with each of the OECD Principles of Corporate Governance. Policy recommendations may be offered if a Principle is less than fully observed. Observed means that all essential criteria are met without significant deficiencies. Largely observed means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term. Partially observed means that while the legal and regulatory framework complies with the Principle, practices and enforcement diverge. Materially not observed means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. Not observed means no substantive progress toward observance has been achieved.

### SECTION I: ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK

**The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.**

**Principle IA: The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.**

**Assessment: Partially Observed**

**General statement on corporate governance.** The legal, regulatory and institutional foundation to Armenian capital markets was revised in only early 2000 with the approval of the SMRL and the legal framework is periodically being updated in improve the legal foundation. However voluntary commitments and business practices still fall short of providing an effective conduit to the overall ability of the corporate governance framework to promote ethical, responsible and transparent practices.

**Capital markets.** Armenia's capital markets are considered small, even by the standards of transition economies. Created following the privatization wave of the mid-1990s, the market still has a low capitalization of US\$23 million (0.8% of GDP), and is illiquid with a turnover of less than 1%. As of December 2004, 213 companies were registered with the SCA and 196 companies were listed having fallen from 211 at the end of 2003. Most companies remain on the exchange since the legacy of privatization created over more than the 100 shareholders beyond which companies must be listed.<sup>1</sup> However trading is light. In 2003 almost 60% of all listed companies saw no trading on Armex, and 40% of all trades were accounted for by a single issuer--the Armenian Development Bank. There have been no voluntary initial or secondary offerings. About 34% of total market capitalization and 28% of total trading volume comes from the ten largest companies. 33 firms were newly listed in 2003, and 90 in 2002, due to the increase of their size beyond the lower limit for obligatory listing or liquidation. 10 companies decreased their size sufficiently to permit their delisting in 2003, and 7 in 2002. Participation by institutional investors is weak – there are no registered private pension funds and no investment funds, though the SCA has been working on a draft law for funds for the past 2 years, and a private pension draft is also in preparation. Insurance companies are invested in government securities. The 19 commercial banks have negligible share holdings and do not act as institutional investors. There are no foreign institutional investors holding stock in Armenian companies. There is no equity market index in Armenia.<sup>2</sup> There are 19 broker-dealers as of December 2004, of which only 3-4 are active in equity market transactions.

**Ownership framework.** Mass privatization was followed by a wave of consolidation of ownership, as controlling owners secure supermajorities in their companies. The SCA estimates that large shareholders (i.e. those with 10% or more of a company's shares) on average directly hold more than two-thirds of the company shares.<sup>3</sup>

**Principle IB. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.**

**Assessment: Partially Observed**

**Corporate legal framework.** The primary governing legislation for the corporate sector consists of the Civil Code 1998, the Law on Joint-Stock Companies 2001 (LJSC), the Law on Limited Liability Companies 2001 (LLLC), and the Law on State

1 22 of the registered companies with SCA / Armex have state participation. SCA and Armex Annual Reports and interviews.

2 Armex has started preparations for an index with USAid technical assistance.

3 SCA calculations. This figure understates insider ownership, and smaller family holdings are estimated to amount to another 20%. The remaining "free float" shares are not actually available on the market. It is estimated that 80.5% of firms are directly controlled by an individual, 5% each are owned by companies, foreigners, and holdings, 3% by the state, and 1.5% by banks (company reports).

Registration of Legal Entities 2001.

**Company types.** In June 2004, there were 33,882 companies in Armenia, including 1,123 open JSCs, 3,181 closed JSCs and 28,629 limited liability companies.<sup>4</sup> Out of all open JSCs, only 196 are listed. Companies with at least 50 shareholders and capital exceeding 5 million AMD (US\$10,000) are deemed to be reporting issuers--regardless of the company form--and need to register with the SCA. As a result, firms that are not open JSCs can be traded on Armex.

**Securities legal framework.** The Securities Market Regulation Law 2000 (SMRL) and the Securities Market Rules of Regulation (SMRR) regulate the capital market, and provide the framework and supervision of the stock exchange and market intermediaries, as well as shareholder record keeping, clearing and settlement. The SCA can issue rules and regulations within its competence, which must be posted for public consultation for 30 days.<sup>5</sup> Recently, the SMRR was modified by the SCA on the order of reporting, disclosure of major acquisitions and shareholders, as well as company splits. The Law on Accounting 2000, the Law on Auditing 2002, the Law on Insurance 2004 have jurisdiction over listed companies. A draft Law On Non-State Pension Funds using the Ukraine model is being prepared, expected to be ready in early 2005. A draft on Investment Funds is in preparation.<sup>6</sup>

**Listing rules.** Armex Rules on Securities Listing and Delisting govern listed companies.<sup>7</sup> Registered companies need to list with Armex for trading if they have 100 shareholders or more. (Companies with 50-100 shareholders may list if they so choose).<sup>8</sup> Armex monitors and enforces the listing requirements set forth in its Rules. Violation of the Rules allows Armex to suspend trading, delist the security or transfer the security to a lower listing tier. There are four listing tiers. The A upper listing tier requires a capital of UDS 1 million, past operation of 3 years, 500 shareholders, 15% profitability for the past 3 years, a 5% monthly liquidity coefficient, and audited financials for the past three years. There are no companies currently listed on the A tier. The B medium tier requires a capital of USD100,000, past operation of 3 years, 100 shareholders, and positive profts for the past 3 years, and audited financials for the past three years. There are 20 companies listed on the B tier by December 2004. All other securities are listed on the C lower tier, with C2 (2nd class lower tier) reserved for issuers who are insolvent or in the process of liquidation due to bankruptcy, among other reasons (4 companies in Dec. 2004).

**Codes.** The Central Bank has drafted "New Corporate Governance Principles in the Banking System", which may provide a Corporate Governance Code for the banking sector. In addition an NGO, the Corporate Governance Center, has issued "The Guidebook for Bank Shareholders and Directors", explaining the basic corporate governance tenets for banks.<sup>9</sup> The Association for Foreign Investment and Cooperation (AFIC) has also issued a "Shareholder's Handbook" to educate the Armenian public on basic minority rights. The IFC issued a Corporate Governance Manual in 2002.

**Principle IC. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.**

**Assessment: Partially Observed**

**Securities regulator.** The SCA supervises companies admitted for trading, as well as brokerage/dealer companies, trust management companies, custodians, and SROs including Armex and CDA. (LSMR Art. 74 – 116). The SCA is an independent state authorized body responsible for securities market regulation in Armenia. The independence of the SCA is somewhat undermined by the Government review of its expenses. However the SCA's annual report is approved or disapproved by Parliament. The SCA was created by the power of the SMRL, adopted in June, 2000.<sup>10</sup> The SCA has five members: the Chairman, the Vice-Chairman and three Commissioners, each with five-year terms. While the President appoints the Commissioners, they cannot be removed without just cause. A list of grounds for removal is specified in the SMRL, including failure to perform official duties. SCA takes decisions by majority votes, and its sessions are open to the public unless the discussion pertains to confidential subjects, such as whether to begin an enforcement investigation in a specific case. The SCA mission statement includes the goal to "protect investors' rights".

**Stock exchange.** Armex, created in 2001, is a non-state non-commercial SRO under the supervision of the SCA. Its management bodies are the General Meeting of the Members, the Observer Council, the Executive Management, and the Supervisory Service.

**Central depository.** The Central Depository of Armenia (CDA) is an SRO, which performs the functions of registry maintenance, and clearing and settlement. The CDA is governed by the SMRL and supervised by SCA. CDA has exclusive

4 And 50,646 commercial legal persons. "Social-Economic Status in the Republic of Armenia" information brochure, issued by the RA National Statistic Service on January to June, 2004. State registry database.

5 LSMR Article 118, 121, 122, 132 – 136.

6 Sent to government in December, expected to be voted on by the National Assembly early in 2005.

7 Armex rules are available at [www.armex.am](http://www.armex.am) in English. CDA issued 14 rules in 2001-2, following its creation, and has only made minor modifications related to its internal functioning since.

8 LSMR Articles 20-23, SMRR Rule 4-2, 10, 18, 23.2-1, Armex Rules on Securities Listing and Delisting.

9 Funded in part by USAid, 2003.

10 LSMR Article 117, 120, 121, 122, 131.

right to maintain the registry of the holders of a publicly traded security.

**Banking and other regulators.** Listed banks and credit organizations are regulated by the Central Bank, and insurance firms by the Ministry of Finance and Economy.

**Company Registry.** The State Registrar of Legal Persons under the Ministry of Justice registers companies and keeps record of their founding documents, including the company charter.<sup>11</sup> Unlike in other transition economies (and as is required for European Union countries) the Company Registry does not provide public access to its records. The Registry has no enforcement capacity, and files the information it receives without monitoring its quality. Easy public access to the documents in the Company Registry is a cornerstone of corporate governance in European countries—and the lack of such access constitutes a major corporate governance weakness in Armenia.

**Court.** The economic and general court review securities and corporate disputes, and enforces SCA and other penalties. Most observers consider the courts to be slow, and lacking sufficient expertise in securities market issues.<sup>12</sup> The Doing Business Indicators on enforcing commercial contracts compares Armenia favorably to the region, yet unfavorably to OECD. In Armenia, contract enforcement takes 195 days and 24 procedures, and costs 17.8% of the claim value. The average for the region is 412 days, 29 procedures, and 17.7. The OECD average is 299 days, 19 procedures, and a cost of 10.8.

**Principle ID. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.**

**Assessment: Partially Observed**

**Authority, integrity and resources of regulators.** The SCA is funded through allocation from the State Budget, which is approved by the National Assembly. SCA's 2004 budget is 131 million AMD (US\$262,000). SCA's 78 employees earn one third of the level of pay of CB employees, which in turn is lower than salaries in the private sector, but higher than those at the Ministry of Finance. Armex may find itself in a difficult financial situation unless market activity is stimulated.

The Central Bank and SCA have overlapping supervision over banks and credit organizations, and the SCA and the Ministry of Finance on insurers. SR receives bank registration statements from CB, and receives from CDA information on whether shares are fully paid up.

The SCA enforcement department is composed of 11 officials, and its department is responsible for monitoring filings – of 11 staff, with a further 4 staff to tackle legal matters. SCA can issue compliance warnings and orders, conduct hearings, impose fines, suspend trading, and terminate and/or suspend issuer registration.<sup>13</sup> All hearings are open to the public except for confidential subjects, and are comprehensive and explanatory in nature providing details on the decision-making process, grounds, opinions, and the final resolution. Any interested person can obtain a copy of the ruling/resolution and statements, from the SCA staff by paying the photocopying costs. If SCA explanations are insufficient, an official request to the SCA can be submitted. LSMR Articles 122, 133. Decisions of the SCA can be appealed to the courts, but cases are rarely reversed.

The maximum fines are insufficient to deter illegal behavior. The maximum fines for individuals<sup>14</sup> are 1 million AMD (US\$2,000), and for corporations 2 million AMD (US\$4,000) per violation. The courts enforce penalties in the frequent cases of non-compliance. In cases of penalty enforcement, courts tend to re-try the case on merit as opposed to merely enforcing the SCA decision, which impedes efficiency. The SCA does not have authority under the SMRL to subpoena witnesses or take witness statements. It can conduct an on-site inspection of listed companies (except banks). The SCA has the authority to obtain information, including statements and documents, of relevance to potential violations of laws and regulations relating to securities transactions. Such information can be solicited from issuers, as well as significant shareholders, company directors and officers and other persons directly or indirectly involved in large transaction in securities markets. However the SCA cannot request information from third parties or non-registrants. The SCA does not have the power to conduct preliminary/ criminal investigations, which are done by the Prosecutor (LSMR Art. 132 – 136). The SCA would benefit from additional expertise, especially in accounting and financial statements. It should also be able to take statements from witnesses.

Armex is responsible for monitoring compliance with listing rules and may impose penalties on companies including suspension of trading, delisting, or changing the tier of a security. The Armex enforcement department is small, and carries

<sup>11</sup> The founding documents include the founding agreement; the minutes of the founding AGM; and the charter. These documents are kept with the state registrar and are disclosed only to authorized persons/representatives of the company. Nonetheless, the same documents are in the possession of the company as well and can be disclosed at the demand of shareholders (Law on State Registration of Legal Entities).

<sup>12</sup> The Economic Court is a commercial court. Private litigation generally takes 2-3 months on simpler issues, nonetheless it might take longer.

<sup>13</sup> LSMR Article 25, 28, 29, 59, 64, 132 – 149. The trading can be suspended for a maximum of 10 days. The SCA can suspend any transaction in any security for not more than 90 business days, including extensions periods (LSMR Article 28).

<sup>14</sup> SCA has the power to fine CEOs or any other board / management organ (Article 137 SMRL).

out some limited disclosure and late fee enforcement.

## SECTION II: THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

**Principle IIA: The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to:**

**Assessment: Partially Observed**

(1) Secure methods of ownership registration	CDA acts as central registry and custodian and tracks direct (but not beneficial) ownership. Registration with CDA provides legal proof of ownership. <sup>15</sup> The SMRL requires CDA registration for all companies with 50 shareholders and 5 million AMD in capital (US\$ 10,000). All registered companies are also registered at the CDA, and in total about 500 JSC are registered at CDA as of December 2004. CDA handles about 200,000 shareholder accounts. The securities are held in (non-documentary) immaterialized form, though closed JSCs may choose to hold their securities in physical form. Nominee ownership exists by law, but is not used (LSMR Article 4). There are no licensed independent custodians. A considerable number of open JSCs are not yet maintaining their shares at the CDA.
(2) Convey or transfer shares	The shares of open JSCs are freely transferable. Settlement requires blocking of actual shares, as well as pre-deposit of payment with the CBA. Once these conditions are met, the exchange is affected within the business day. The USAID Capital Markets Development Project is preparing a migration to a T+3 rolling settlement regime. <sup>16</sup>
(3) Obtain relevant and material company information on a timely and regular basis	The company must provide financial statements to shareholders at their demand within 5 days, at a cost determined by the company which covers preparation and mailing. The latest annual report is free. SCA / Armex also provide this information to the public. In practice, shareholders find it difficult to request the information anonymously. There is no public information on closed JSCs but shareholders can request basic documents from the company.
(4) Participate and vote in general shareholder meetings	Shareholders can participate and vote at AGMs. LJSC is silent as to whether preferred shareholders have the right to attend the AGM. Preferred shares do not have the right to vote unless the issues relate to liquidation or reorganization of the company or the rights of their class of shares (LJSC Art 37, 38.3). Preferred shareholders also get voting rights if they do not receive annual dividends.
(5) Elect and remove board members	<b>Process.</b> Shareholders elect members of the board of directors at the AGM. 2% shareholders can nominate directors (LJSC Article 85.2). <b>Cumulative voting/proportional representation.</b> One measure strengthening corporate governance is the requirement to use cumulative voting for electing directors in companies with more than 500 shareholders. However the absence of a minimal size board reduces the impact of mandatory cumulative voting. Any 10% shareholder has the right to appoint themselves or a representative to the board of directors.
(6) Share in profits of the corporation	Dividends are proposed by the board and approved by the AGM. The deadline for payment is in the charter or is decided by the AGM. Dividends are only paid out of net profit. Dividends for preferred shares are either stipulated in the charter or equal to common dividends. There is no mandatory dividend. Few firms actually pay dividends. <sup>17</sup>

**Principle IIB. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:**

<sup>15</sup> LSMR Articles 111 – 115. SCA undertakes a systematic effort to identify and assure the compliance of JSC subject to registration. In 2001, 207 inspections were done (2002 – 139), most involving support in registering non-registered companies. In 2003, a concerted effort by region was undertaken and 745 companies were visited. These efforts continued in 2004 as well.

<sup>16</sup> CDA Rules on Clearing and Settlement of Pre-deposited Transactions.

<sup>17</sup> LJSC Articles 38.2 and 49.4. A 2% shareholder can submit two suggestions on the AGM agenda (LJSC, Article 37g, 72). This in principle can involve a suggestion of increase in dividend payments.

<b>Assessment: Partially Observed</b>	
(1) Amendments to statutes, or articles of incorporation or similar governing company documents	Amendments to founding documents are made exclusively by the AGM with $\frac{3}{4}$ majority (LJSC Article 15).
(2) Authorization of additional shares	<p><b>Issuing share capital.</b> Authorizing share capital is an exclusive power of the AGM, with <math>\frac{3}{4}</math> of the vote. Issuing shares is an exclusive power of the AGM (<math>\frac{3}{4}</math> majority), but the board can issue shares (by unanimous decision) if this competence is delegated by the AGM and/or codified in the charter (LJSC Articles 34, 35, 67, 84.1).</p> <p><b>Pre-emptive rights.</b> Listed companies have pre-emptive rights by law—except when the shares are sold in an open subscription or are created by the conversion of other securities into equity. The AGM may also waive the pre-emptive rights of existing shareholders in cases where payment is required to be made in cash (LJSC, Article 47).</p>
(3) Extraordinary transactions, including sales of major corporate assets	<p>Major corporate transactions, such as reorganizations are decided exclusively by the AGM or EGM with <math>\frac{3}{4}</math> majority.</p> <p>Sales of major corporate assets. Company management may sell up to 25% of a company's assets. With an unanimous decision, the board may sell up to 50% of the company's assets, and larger assets, as well as 25% of shares or more, must be authorized by the AGM with a <math>\frac{3}{4}</math> majority. No tighter limits are set where assets are sold to related or affiliated parties. Such high thresholds for approval by the AGM were also part of the pre-2002 Law on Joint Stock Companies in Russia, under which substantial asset-stripping occurred. In practice, these approvals are ignored, or the size of the transaction is artificially lowered for reporting purposes. In addition the Armenian law does not require that large transactions be sold with reference to market prices—a minimum stipulation that should be place in order to discourage asset-stripping.</p>
<b>Principle IIC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:</b>	
<b>Assessment: Materially Not Observed</b>	
(1) Sufficient and timely information on date, location, agenda, and issues to be decided at the general meeting	<p><b>Meeting deadline.</b> The AGM must be held within 6 months following the completion of financial year. It is convened by the board (by law) and by management (in practice), and the law allows a 10% shareholder, the auditor, the controller, or the executive to call an extraordinary shareholder meeting (LJSC Article 66, 74).</p> <p><b>Meeting notice.</b> Open JSC shareholders are notified at least 15 days prior to the AGM. Notice for a second meeting in open JSC is given at least 10 days prior to the meeting.<sup>18</sup> Half of the infractions uncovered at SCA inspections concern improper calling, notice and conducting of AGM.</p> <p><b>Information available.</b> The meeting notice includes the agenda and location, and specifies where background information is available if not attached to the notice.<sup>19</sup> In practice, the location of AGMs is considered to be predictable.</p> <p><b>Quorum rules.</b> The AGM requires a quorum of 50% of capital. If the quorum is not met, the minimum quorum required by law for the second meeting is 30% (LJSC Art. 77).</p> <p>The AGM minutes must be compiled within 5 days and signed by the chairperson of the meeting and secretary. Shareholders have access, but minutes are not circulated.<sup>20</sup></p>

<sup>18</sup> LJSC Article 71, 77, 96. Closed JSC may publish AGM notice, but do not have to.

<sup>19</sup> LJSC Article 71. Background information must include the annual report, the opinion of the controller, information on nominated directors, draft Charter amendments, if any.

<sup>20</sup> LJSC Article 82. In practice AGM attendance represents about 80% -90% of capital. Workers usually attend, and in privatized enterprises they hold about 20% or less. Armenian shareholders living abroad, which are frequent in privatized and other firms, do not attend, and were a problem in terms of achieving quorum before the concentration of ownership in 2002-4.

(2) Opportunity to ask the board questions at the general meeting	<b>Forcing items onto the agenda.</b> Shareholders owning 2% can submit at most two proposals to the AGM agenda. Items not on the agenda are not decided on. <sup>21</sup> <b>Questions.</b> The law does not specifically provide a right to ask questions at the AGM.
(3) Effective shareholder participation in key governance decisions including board and key executive remuneration policy	Problems with AGMs constitute a major corporate governance weakness in Armenia. The SCA estimates that in 2004, one-third of the 196 registered companies failed to hold their AGM. In addition, the law allows for companies to do away with annual re-election of directors' altogether. Minority shareholders do not participate in AGMs unless they are employees, and generally show little interest in participating in the AGM, since controlling shareholders often monopolize the meeting. The voting is conducted by secret ballot. The votes are counted by the Enumerating Commission, which is elected by the AGM in open JSCs. <sup>22</sup> In theory, the AGM has exclusive power to vote on board and executive pay (LJSC, Article 67u). In practice, the AGM does not have decision power over remuneration.
(4) Ability to vote both in person or in absentia	<b>Proxy regulations.</b> Voting is allowed in person or can be delegated to a representative (LJSC Article 76). A shareholder representative must have a notarized power of attorney. Proxy voting is not used often. <b>Postal and electronic voting.</b> Postal or electronic voting is not restricted by law. <sup>23</sup>

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

**Assessment: Partially Observed**

**Classes of shares.** In principle, each share has one vote, except for preferred shares. However the nominal value of preferred shares cannot exceed 25% of company equity. The preferred shareholders do not have the right to vote in the AGM except on issues of reorganization or liquidation of the company, or changes in the charter affecting their rights, issues related to the payment of the dividends, or in case the preferred share will be converted into common share. Preferred shares may be granted some (lower) voting rights. In practice, preferred shares are rarely used and only listed companies have preferred shares. Voting caps, golden shares, or other shares that provide additional rights for specific shareholders, are not used in Armenia.

The dividend is either specified in the charter, or equal to common dividend. Cumulative preferred shares acquire voting rights if dividends are not paid in full, and non-payment of preferred dividend for three years may serve as basis for liquidation of the company.

**Ownership disclosure by companies.** Owners of 10% or more are disclosed in the prospectus, material facts, and quarterly statements. The information disclosed includes the number of shares held, management positions held, and board and management if the shareholder is a legal entity. The information also includes any individuals who directly control 20% of the capital, or control half of the board, or can impact corporate decisions, as well as their immediate family and persons acting in concert. The DCA maintains an up-to-date list of direct, but not beneficial, owners.<sup>24</sup>

**Ownership disclosure by shareholders.** Shareholders notify the company and SCA of direct holdings of 10% and above, within 10 days.<sup>25</sup> 20% shareholders, management and board file monthly statements of ownership (LSMR Art. 36). There is no requirement for indirect or beneficial ownership disclosure.

**Disclosure of shareholder agreements.** For the purposes of a tender offer, shareholder agreements are disclosed in the current reports to the SCA, and both oral and written agreements are treated as shareholder agreements (LSMR Art 35, 56). There is no general disclosure of shareholder agreements by law outside the tender offer purview.

The 10% owners are public information, obtainable from Armex in paper form, including insider ownership (LSMR, Art 38). CDA does not provide ownership information to the public. Companies can (and do) request a complete list of shareholders. A group of 10% shareholders calling a meeting can request the list from the CDA as well.

21 The board can refuse, for reasons listed in the law, and the refusal can be protested in court. LJSC, Articles 37g, 68.10, 72.

22 The Enumerating Commission has at least 3 members, who are not affiliated with the board and management of the company. The counting may be carried out by the specialized counting organization as well. LJSC, Articles 75, 79.

23 LJSC Articles 66-82. There is a remote voting procedure by mail, but it cannot be used for the AGM or EGMs.

24 SMRR Rules 10.1-a; 31.1a-1; 31.1a-2. LJSC Article 95.

25 LSMR, Articles 34-37. The information to be filed is extensive, including source of funds, shareholders acting in concert, and purpose of acquisition if that is to attain control or liquidate, among others.

<b>Principle IIE: Markets for corporate control should be allowed to function in an efficient and transparent manner.</b>	
<b>Assessment: Materially Not Observed</b>	
(1) Transparent and fair rules and procedures governing acquisition of corporate control	<p><b>Basic description of market for corporate control.</b> Although the Armenian corporate sector is actively involved in restructuring and consolidation, almost none of the acquisitions or divestitures occur through Armex. Unlike other countries such as Georgia, the securities legislation in Armenia does not require that once a company has been admitted for trading, all subsequent trading must be transacted (or at least recorded) on the stock exchange. Particularly the SMRL has no restrictions connected with off stock exchange private and securities distribution transactions. Thus virtually all changes in corporate control are negotiated bilaterally, independently of the stock exchange. SCA annual programs and companies reports. The Law on Competition Protection 2000 provides antitrust regulation. The SCA supervises merger activity and gives appropriate instructions for elimination of occurring infringements but since 2001, there has been only one on-exchange merger, one acquisition, and four spin-offs. Furthermore there is concern that corporate mergers and “partial” shares may be used to dilute targeted shareholders.</p> <p><b>Tender rules/mandatory bid rules.</b> The SMRL provides the basic rules governing tenders and changes of control (LSMR, Art 52-7) but does not require mandatory tender offers for investors acquiring more than a minimum percentage of traded companies. Acquisitions of 10% or more at higher than market price are made via a tender offer, in which all shareholders of a class are treated equally. The company acquires shares at a price determined by the board.</p> <p><b>Delisting/going private procedures.</b> A 75% supermajority is required to decide on taking the company private, and this must be done via a tender offer for companies owned at the 75% level or higher (LSMR Art. 57).</p> <p><b>Abuse to buy-backs/treasury shares.</b> Share repurchases are allowed, and AGM approval is only required if the charter does not stipulate that board approval is enough. Shares bought back cannot be re-sold within 30 days, and must be sold within a year or cancelled. There is no limitation on the amount of shares to be bought back, so long as the minimum capital level is not crossed. The company provides a 30 day notice of the buy-back to shareholders (LJSC Articles 54 and 59). The company also informs the SCA and Armex of the buy-back in its current report.</p>
(2) Anti-take-over devices	<p>Anti-takeover tools in the law are regulated indirectly, and are not frequently used in practice.</p> <p>LJSC allows voting and participation caps, to be documented in the charter (LJSC Article 32.4).</p>
<b>Principle IIF: The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.</b>	
<b>Assessment: Materially Not Observed</b>	
(1) Disclosure of corporate governance and voting policies by institutional investors	<p><b>General obligations to vote/disclosure of voting policy.</b> There is no disclosure of corporate governance and voting policies by institutional investors, and there are no institutional investors in the market.</p> <p><b>Special rules for institutional investors/pension funds.</b> Pension and investment funds do not exist – draft laws are prepared in both areas.</p> <p><b>Blocked shares/record date.</b> Shares are not blocked from trading during the period when an AGM is held. The record date is set by the board before the AGM.</p>
(2) Disclosure of management of material conflicts of interest by institutional investors	<p>There is no disclosure of management of material conflicts of interest by institutional investors, and there are no institutional investors in the market.</p>
<b>Principle IIG: Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.</b>	
<b>Assessment : Observed</b>	

**Rules on shareholder cooperation in board nomination/election.** The LJSC allows 2% shareholders to nominate and 10% shareholders to appoint a board member.

**Rules on communication among minority shareholders.** The law does not regulate the issue.

**Proxy solicitation or other formalities required.** Not applicable.

**Rules on communication among institutional investors.** The issue is not regulated.

### SECTION III: THE EQUITABLE TREATMENT OF SHAREHOLDERS

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.

**Principle IIIA: All shareholders of the same series of a class should be treated equally.**

**Assessment: Partially Observed**

(1) Equality, fairness, and disclosure of rights within and between share classes	<p><b>Availability of share class information.</b> Shareholders can obtain information about share classes from the company charter, the prospectus, and the current reports which are publicly available from Armex/SCA. (SMRR Rules 10.1-d; 31.1a-1).</p> <p><b>Equal rights within classes.</b> Within each share class, all shares carry the same rights.<sup>26</sup></p> <p><b>Approval by the negatively impacted classes of changes in the voting rights.</b></p> <p>Preferred shares, together with common shareholders, vote on issues related to the rights of their shares (LJSC Art. 38).</p>
(2) Minority protection from controlling shareholder abuse; minority redress	<p>Shareholders have several redress possibilities.</p> <p><b>Ability to call meeting.</b> The law allows a 10% shareholder to call an AGM.<sup>27</sup></p> <p>10% shareholders can request an extraordinary inspection by the controller / revision commission.</p> <p><b>Withdrawal rights.</b> In case of reorganization, large transactions, suspension of preemptive rights, and changes in charter adversely affecting the shareholder, shareholders that voted against or did not participate in the AGM can sell their shares back to the company at a market price.<sup>28</sup></p> <p><b>Ability to sue to overturn meeting decisions.</b> Shareholders have the right to appeal to the court regarding decisions taken by the AGM that contradict the law. However, most observers consider the Economic Court inefficient, and it is not used for minority redress (LJSC Articles 37.1i, 68.13). The Economic Court is a commercial court. Private litigation generally takes 2-3 months on simpler issues, nonetheless it might take longer.</p> <p><b>Regulatory Redress.</b> The SCA makes a valiant effort to enforce securities legislation but in practice, more than three-quarters of all fines are never collected. Every shareholder has the right to file a complaint with the SCA. SCA can issue warnings, conduct hearings, impose fines up to 1 million AMD (US\$2,000) for individuals and 2 million AMD (US\$4,000) for companies and request any documentation from them, conduct inspections of listed companies, suspend trading, and terminate and/or suspend issuer registration. The Economic Court enforces SCA penalties. The most frequent infractions SCA notes are accuracy and completeness of reports, and corporate asset sales at non-market prices. In 2004, the SCA received 11 shareholder complaints. In 2001, 260 instructions have been given to different companies on elimination of infringements, in 2002 - 240 instructions of which 24 penalties, in 2003 – 570 instructions of which 33 penalties, and up to Dec 1, 2004 – 226 instructions, including fines in the amount of 5,310,000 million AMD (US\$10,620). SCA has filed 4 civil cases, and referred one case for criminal prosecution over the past 3 years. Fines are not sufficient to deter illegal behavior, but even these fines are rarely paid. The SCA must almost always go to court to enforce their collection. It</p>

<sup>26</sup> LJSC Articles 31, 37, 38.

<sup>27</sup> LJSC Article 66, 74.

<sup>28</sup> Large transactions are defined as share issues above 25% of capital or transactions bigger than 50% of assets. LJSC Articles 26, 57. The market price is determined by the board, which may but does not have to, use an independent assessor (LJSC Article 59). It can be disputed in court (LJSC Article 58).

	<p>takes more than a year to collect, and as of December 2004, more than 80% of the fines imposed in 2004 had not been collected. SCA issued 226 order-decisions at its hearings in 2004. 15 inspections were carried out in Jan-Dec. 2004. Based on inspections, about 80% of infractions concern corporate matters, mainly improper calling, notice and conducting of AGM (50%), and improper director, auditor, and control committee elections (12%); 10% concern disclosure, mainly failure to publish the annual report; and 11% concern financial statements infractions, mostly non-compliance with the procedures for market valuation of assets. Over the last three years the percentage of sanctions paid partially or in full are approximately 33% and the payment is collected within 15 days to one year. Enforcement statistics are available on the SCA website (<a href="http://www.sca.am">www.sca.am</a>), which presents summarized data on securities enforcement actions, and claims on enforcement of instructions issued by the SCA.</p> <p>The enforcement department of Armex is small, and carries out some limited disclosure and late fee enforcement. In 2002, Armex issued 18 warnings, 5 severe warnings, and 7 penalties totaling 110,000 AMD (US\$220). Penalties are too small to matter. 37 issuers were suspended from trading as a disciplinary measure in 2002, and 138 in 2003, of which 120 cases eliminated the grounds for the suspension. In 2003, there were 20 warnings, 2 strict warnings, and on fine amounting to 10,000 AMD (US\$20). The penalties are listed in the Armex annual report, with an overview of prevailing causes. 26% of the penalties were related to late membership fees, and 48% were related to poor reporting. Armex pleads with the court for a faster procedure when it enforces fines, and decisions are fast.</p> <p><i>Ability to sue directors.</i> The Company or a 1% voting shareholder can sue the Board members, the Executive Director / the members of the executive body, claiming compensation for damage caused to the Company ( LJSC Article 90).</p> <p>The signatories to the prospectus are liable for false or misleading statements, and transactions based on such statements are void (LSMR Art 12-3, Criminal Code Art 204).</p> <p>Shareholders also have a general Civil Code claim for damages, and this recourse has been used with moderate frequency (Civil Code Art 14, Civil Procedure Code Art 2).</p>
(3) Custodian voting by instruction from beneficial owners.	By law, the institutions which hold shares in custody for investors are responsible for providing the shareholders with any information obtained from the company, including AGM materials and information concerning options in the use of their voting rights. In practice, there are no independent custodians in Armenia (LJSC Article 76, LSMR Article 52, 85).
(4) Obstacles to cross border voting should be eliminated.	No shares are held in ADR / GDR form. There are no foreign investors owning significant shareholdings in publicly-traded companies in Armenia.
(5) Equitable treatment of all shareholders at GMs	Preferred shares do not vote except on issues affecting their rights, reorganization, liquidation, as well as when they don't receive dividends in full (LJSC, Article 38.3). There are no significant costs to voting, and management does not make it unduly difficult for shareholders to cast their votes. However, market participants opine that there is insufficient information for shareholders to make an informed voting decision.
<b>Principle IIIB: Insider trading and abusive self-dealing should be prohibited.</b>	
<b>Assessment: Partially Observed</b>	
<p><b>Basic insider trading rules.</b> Insider trading, advising a trade based on insider information, or disclosing it to a third person is forbidden (LSMR Articles 48-51). The insider trading legislation came into force from Aug. 1 2004. Enforcement of insider trading rules is significantly hampered due to the absence of beneficial ownership disclosure requirements.</p> <p><b>Insider trading disclosure.</b> Shareholders notify the company and SCA of holdings of 10% and above, within 10 days of any trade that changed their ownership position. 20% shareholders, management and board file monthly statements of ownership (LSMR, Art 34-7). Both SCA and Armex monitor insider trading. Surveillance is not electronic.</p> <p><b>Criminal/civil/administrative penalties.</b> Enforcement is lodged with the SCA, and in criminal cases the General Prosecutor. The maximum fine is 10 million AMD (US\$20,000), and a reversal of the transaction. The party to the insider trade can seek civil recourse in court. Insider trading is not a criminal offense.<sup>29</sup> There have been no cases so far.</p>	

<sup>29</sup> LSMR Article 140. The definition of insider is in LSMR Article 49.1.

**Principle IIIC: Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.**

**Assessment: Materially Not Observed**

**RPT disclosure rules.** Insiders submit RPT information to the board, auditor, and controller<sup>30</sup> before these transactions take place. The listed companies submit the information about RPTs to SCA/ Armex in their quarterly reports. In case of breach, the RPT is not reversed,<sup>31</sup> but the insider participants are liable for damage to the company. Frequently in practice, parties try to conceal RPTs or understate their value. Further, audit standards require full auditor vigilance for RPTs; however, this is not the practice, by opinion of market participants and lawyers.<sup>32</sup> The SCA monitors and enforces RPT rules, including via on-site inspections. For example, "Yerevani Lusatexnik" JSC in its securities registration statement concealed the sale of its administrative building to insiders. "Yerevani Pahaconeri" JSC in its securities registration statement also concealed information on transactions related to sales of the company's products, where the value of transactions exceeded 10 million AMD (US\$20,000). SCA issues a warning in both cases, with a decision to correct the infraction. RPTs are defined per ISA rules.

Disclosure of indirect and third **parties' material interest.** The prospectus, current report, and quarterly statements list any individuals who control half of the board of directors, or can impact corporate decisions, as well as their immediate family and persons acting in concert with them.

**RPT approval rules/rules for approval of board/AGM.** RPTs are approved by the board by 50%, with reclusion of the related party, in companies with less than 500 shareholders, and by non-executive directors with reclusion of related parties in companies with more than 500 shareholders (LJSC Art. 62-65). Only the board, controller, and auditor are informed, and the information is filed in the quarterly report. This report is available to the public from Armex. Ex-ante AGM approval by 50% is required if the RPT amounts to 2% of assets or 2% of equity, unless the deal is a loan to the company, or is in the normal course of business. AGM approves also if all directors are related parties to the deal. In practice, deals are frequently concealed or understated to avoid approval procedures. Improper RPTs or other forms of self-dealing, especially concerning sales of property, are frequent. Related loans are allowed.

**Conflict of interest rules and use of business opportunities.** There are no specific rules on conflicts of interest or insider transactions in the same line of business beyond the general RPT rules.

#### SECTION IV: THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

**Principle IVA: The rights of stakeholders that are established by law or through mutual agreements are to be respected.**

**Assessment: Partially Observed**

**List of relevant codes for stakeholders.** The level of awareness of corporate social responsibility is weak. Labor relations fall under the Labor Code, recently reformed from its Soviet era version (the law enters into force in mid-2005). Chapter 15 of the Civil Code (the law on collateral) and the new Insolvency Law 2004 secure protection of creditors' funds.

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

**Assessment: Partially Observed**

**Redress mechanisms available to stakeholders.** Employees and creditors can seek redress in court. Employment disputes have been moderately frequent. Creditors' rights are protected under the debt collection and the bankruptcy laws.

**Principle IVC. Performance-enhancing mechanisms for employee participation should be permitted to develop.**

**Assessment: Partially Observed**

<sup>30</sup> For a description of the role of the controller, see below under Principle VC.

<sup>31</sup> The RPT can be reversed if the other party to the transaction knew or should have known about the violation of approval rules.

<sup>32</sup> LJSC Articles 62, 63, 65. SMRR Rules 10. 1a-3, 10.1a-4; LJSC Article 62-3; LSMR, Articles 34-37. The information includes the nature of the relationship between the related party and the company, and the nature and value of the transaction.

**Rules on employee stock option plans.** “Staff shares”, either common or preferred, can be given out to employees provided they are bought back from the market, and cannot exceed 25% of equity (LJSC Article 41). They may be issued at a discount no lower than ¼ of nominal value. The vesting period of a staff share may be limited for a period of time, but no longer than 3 years after allocation. The decision on allocation of staff shares, the payment for such shares, and the privileges granted to staff is adopted by the AGM. Staff shares are not frequently used.

**Principle IVD: Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.**

**Assessment: Materially Not Observed**

**Annual report discloses economic and financial prospects.** Economic and financial prospects are not discussed in the annual report, but in the prospectus, with any changes reflected in the quarterly reports, especially concerns over environment pollution (SMRR: Rule 10.1d-1, Rule 31.1a-2). Employees may find it harder to obtain the annual report if they are not shareholders.

**Annual report discloses significant facts on employees.** Beyond general discussion of the company and the total number of employees in the prospectus and the quarterly reports, there is no provision for filing employee information.

**Information is sufficient and reliable.** The required information is detailed, and SCA assures reliability.

**Information is timely and regular.** The information is filed quarterly.

**Principle IVE: Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.**

**Assessment: Largely Observed**

**Whistleblower rules.** Under the revisions to the labor code, effective in June 2005, “whistleblowers” will have protection under the law. However time will be required to see how the law is applied in practice.

**Principle IVF: The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.**

**Assessment: Materially Not Observed**

**Effectiveness of bankruptcy, security/collateral, and debt collection/enforcement codes.** Debt collection procedures are considered inadequate. Weaknesses are discussed in detail in the World Bank report on “Bank Corporate Governance and Creditors’ Rights” 2004. A recent reform in a positive direction was undertaken in the area of permissible sale of collateral by other than public auction. Creditors receive written notice of company reorganizations and capital reductions, and can demand additional guarantees or early fulfillment or termination of the loan, as well as compensation for losses. The Ministry of Justice is preparing draft laws to speed up debt collection procedures. In insolvency, power over the corporation passes to the creditors meeting, however there are major inconsistencies in the new bankruptcy legislation.<sup>33</sup> Dividend distribution can only be blocked by court order. Banks do not have access to sufficient information on borrowers, which limits severely the extent of their lending. Private credit to GDP is low for the region, at 8% in 2003.

#### SECTION V: DISCLOSURE AND TRANSPARENCY

**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 governance of the company.**

**Principle VA: Disclosure should include, but not be limited to, material information on:**

**Assessment: Partially Observed**

(1) Financial and operating results of the company

**Annual report.** Reporting issuers (with 50 or more shareholders) must file with SCA and Armex their audited annual report within 120 days after the end of the fiscal year. Mandatory financial disclosure includes the balance sheet, income, cash flow, and changes in equity statements, the external auditor’s report, notes to the financial statements (including large transactions), and information on company property, and

<sup>33</sup> LJSC Articles 18. 36. Insolvency Law Article 82, Chapter 5. AFIC report.

	<p>planning activities. Companies are required to publish their annual reports in a newspaper within 6 months of fiscal year end; however, in practice, this rule is often overlooked.<sup>34</sup> Annual reports are also available from the SCA / Armex, and for free from company headquarters. In practice, large transactions, RPTs, and a list of major shareholders is frequently not included in the annual report, though the information is public and can be obtained from quarterly reports. Shareholders do not request information due to low awareness of their rights.</p> <p><b>Semi-annual and quarterly reports, current reports.</b> According to SMRR, all listed companies file with SCA and Armex their quarterly financial statements within 45 days after the end of the fiscal year. A “current report”, or material facts, are disclosed to SCA and Armex within 10 days of their occurrence, and include changes in board, management, controller, large owners, auditor, equity, subsidiaries, and generally any changes of the information filed in the prospectus. Those are publicly available from SCA/ Armex, but rarely demanded (SMRR 31.1a-2, LJSC Art 95-6).</p> <p>Company charter contains, among other things, the size of equity, number, par value, and rights of common and preferred shares outstanding, organization and voting procedures of company governing bodies, and AGM procedures. The charter by law is to be provided by the company to any shareholder, at the cost of copying. The charter is also kept at the State Registrar, which does not make it available to the public (LJSC Article 14, 17).</p> <p>The reporting burden is perceived as heavy. The approximate annual costs of compliance with reporting rules are US\$300 and three staff-years of preparation time. Closed JSCs and limited liability firms do not disclose financials or non-financial information. Closed JSC provide certain documents to its shareholders upon request but there is no central location where they must file their financial reports.<sup>35</sup></p> <p>The SCA actively monitors compliance with disclosure, including via on-site inspections at the issuer headquarters (LSMR Art 133-4, 137-8, 142-7). SCA can issue warnings, conduct hearings, require company documents, impose fines on issuers, suspend trading, and terminate and/or suspend issuer registration. In 2004, 376 current reports were filed, and 11 companies failed to file a quarterly and 30 an annual report. In 2004, SCA uncovered 18 reporting companies that failed to register with SCA/Armex, 2 infractions related to filing of current reports, and 32 and 23 infractions respectively related to filing quarterly and annual reports. The Armex suspends trading in cases of reporting rules infringements and should de-list the shares in serious cases. The general adherence of companies to disclosure and reporting rules is perceived as a major corporate governance problem.</p>
(2) Company objectives	The information about company activity, future plans, and analysis of financial condition are included in the prospectus and the current report filed with the SCA and Armex. <sup>36</sup>
(3) Major share ownership and voting rights	Ownership information is disclosed in the prospectus, current reports, and quarterly reports (SMRR Rules 10.1-a; 31.1a-1; 31.1a-2). Compliance with ownership rules is high, but does not convey a real picture of owners because indirect ownership is not disclosed. 1651 reports of insider ownership were filed in 2004, on 154 companies.
(4) Remuneration policy for board and key executives, and information about directors	Remuneration and other information on board and management are not available in the Annual Report, but in the prospectus and the current reports, including changes in board and management, positions held; pay in the past 3 years; ownership; and kinship relations with management (SMRR Rule 31.1a-1, LJSC Art. 95). Usually pay is declared in the prospectus, and the information is not faithfully updated by current reports.
(5) Related party transactions	Disclosure of RPTs is not in the Annual Report, but in the quarterly reports (LJSC Article 62-3; SMRR Rule 31.1a-2). Enforcement is difficult, and disclosure unreliable.
(6) Foreseeable risk factors	The prospectus includes a discussion of risk factors. The annual report contains some reporting of foreseeable risks: a description of possible negative future factors that may

<sup>34</sup> Filing in an electronic format is made by brokers only, for their monthly report to SCA. All other filings are in paper form. SMRR Rule 31.1a-3, LJSC Article 96, Law on Accounting Chapter 4. LJSC Article 96, Law on Accounting Article 24.

<sup>35</sup> Those are: consolidated financials, share registers, ownership details, provided by the company within 5 days. LJSC Article 95.

<sup>36</sup> SMRR Rules 10.1-d; 31.1a-1.

	influence the marketing of the issuer's products, and a description of potential future liabilities of the issuer, which may have a negative influence on the issuer's business. <sup>37</sup>
(7) Issues regarding employees and other stakeholders	The number of employees, as well as environment issues, is discussed in the prospectus and the quarterly reports. <sup>38</sup>
(8) Governance structures and policies	Reporting issuers provide a complete description of the structure, authorities and responsibilities of management bodies, in the prospectus and current reports (SMRR 10.1a-2, 31.1a-1). There is no corporate governance component to that discussion.
<b>Principle VB: Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.</b>	
<b>Assessment: Materially Not Observed</b>	
<p><b>Compliance with IFRS.</b> Armenian accounting standards (ASRA) are based on an outdated (2000) version of IAS. ASEA is gradually doing revisions to comply with IAS but currently few companies in Armenia follow the current version of IAS/IFRS. In addition, ASRA does not have International Accounting Standards Board approval.<sup>39</sup> Due to the lack of training, in practice ASRA is not observed or implemented.</p> <p><b>Review/enforcement of compliance.</b> SCA monitors the compliance of issuers with accounting and audit standards and disclosure requirements. SCA has a staff of 11 in its corporate supervision department who monitor disclosure and accounting standards for over 200 companies. There are gaps between official accounting standards and actual practices.</p>	
<b>Principle VC: An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.</b>	
<b>Assessment: Materially Not Observed</b>	
<p><b>Compliance with ISA.</b> Armenian auditing standards (SARA) have been directly translated from ISA in 2000.</p> <p><b>Who must be audited.</b> Annual financial statements of open and closed JSCs must be audited (LJSC Article 94.2).</p> <p><b>Auditor independence.</b> The auditor must not be an insider, their family, or have property interest links with the company or its shareholders. There is no rule for periodic rotation of auditors. Auditors can engage in consulting or tax advice.<sup>40</sup></p> <p><b>Audit committee.</b> Boards of directors do not have internal audit committees. Armenian companies do have "controllers" (or auditing commissions) that are appointed by the shareholder meeting and report to the meeting. The commission may not include members of company management or officials of government bodies.</p> <p><b>Requirements for oversight of audit.</b> The AGM approves the appointment of the auditor, and in practice the approval is pro-forma. The auditor's contract is signed by the Chairman of the Board. The board sets compensation. In practice, the external auditor is susceptible to pressure from the controlling owner. The law is not specific enough in distinguishing the powers and duties of the board, the general executive, or the AGM vis-à-vis the auditor, e.g. it is unclear who receives the auditor report. The auditor has full access to company documents and may refuse to audit if such access is not provided, and reports infringements to the Ministry of Finance. The Ministry of Finance and Economy licenses and certifies functions in the field of auditing activity. There is a professional accounting and auditing body which has an NGO status, the Association of the Accountants and Auditors of Armenia. There is no independent oversight body.<sup>41</sup></p> <p><b>Audit enforcement competent/qualified.</b> The Ministry of Finance is ill equipped in terms of staff and expertise to ensure quality certification. The Association of Accountants and Auditors, in cooperation with the Scotland Institute of Chartered Accountants, has developed a three year accountant / auditor certification program financed by USAID, which is held to the highest professional standards; however, it does not have certification powers and is not recognized by the Ministry of Finance. In terms of enforcement of professional quality and standards, neither the Ministry nor the Association has adequate enforcement staff. The Ministry is working on a Code of Ethics of Professional Accountants and Auditors, and on initiatives to introduce some monitoring of auditors besides the validity of their license. The Ministry has a limited range of</p>	

<sup>37</sup> SMRR Rules 10.1-1c, 31.1a-3.

<sup>38</sup> Beyond general discussion of the company and the total number of employees in the prospectus and the quarterly reports, there is no provision for filing employee information. Economic and financial prospects are not discussed in the annual report, but in the prospectus, with any changes reflected in the quarterly reports, especially environment issues. SMRR: Rule 10.1d-1, 31.1a-2.

<sup>39</sup> Interview with the Armenian Association of Accountants and Auditors and the Scottish Institute of Chartered Accountants.

<sup>40</sup> LJSC Article 92.1, Law on Auditing, Article 12.

<sup>41</sup> LJSC Article 92. Law on Auditing Art 14, 16, 18 and Ch. 6. Charter of the Association of the Accountants and Auditors.

powers, namely to cancel or suspend the license. General recourse against auditor infractions is provided by the court.

**Auditor qualifications.** An auditor is certified / licensed by the Ministry of Finance, which in turn requires a graduate degree in economics and 3 years of professional experience.<sup>42</sup> There are 34 licensed auditors. The two international auditing firms, who are virtually the only experts in IFRS/ISA, KPMG and Grant Thornton, audit very few listed firms. CB also limits the list of acceptable auditors for banks. SCA invites auditors for hearings and has made inquiries. In a few cases, instructions were issued to auditors in response to infractions, but there have been no court cases. An auditor or accountant needs Ministry of Finance certification (Accounting Law Art. 12.5).

**Statutory auditors or similar company organs.** Similar to some early transition countries, Armenian law provides for the AGM to elect a controller, which has a mandate to assure company compliance with the law. The controller is elected by the AGM with 50% majority for a term of 3 years. The controller does not attend board of directors meetings. There are no requirements for any financial expertise or background. The controller has access to all company documents it requests, and inspects the results of the annual financial performance of the company, inspects the financial activities of the company either at any time at its sole initiative, or based upon a decision of the AGM or the board, as well as at the request of a 10% shareholder. The controller writes a yearly report on the financial situation of the company, certifying the truthfulness of the annual report, and presents this opinion to the AGM. The controller does not propose the external auditor, and is in practice composed of employees subservient to the controlling owner's interests.<sup>43</sup> Furthermore in countries where the auditing profession is well-developed, the presence of a controller/ revision committee can confuse the critical role of the external auditor.

**Principle VD: External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.**

**Assessment: Materially Not Observed**

**Auditor accountability.** The auditor has no substantive interaction with the controller, the board, and shareholders, and is in practice reports exclusively to the executive. If an external auditor finds out any involvement of board members or senior management in illegal activities, fraud or insider abuse, he should inform the company (i.e. the executive), which fails to provide the requisite checks and balances. Any shareholder can file a lawsuit against the external auditor under the Civil Code, for breach of the Auditing Law. There have been no cases. 5% shareholders can appoint their own auditor at their expense and have the financials audited (Auditing Law Art. 31, LJSC Art. 92.1).

**Auditor liability.** The auditor is liable for breach of the Auditing Law (Auditing Law Article 31).

**Auditor insurance.** Auditors are not required to purchase insurance.

**Principle VE: Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.**

**Assessment: Partially Observed**

Information is available through several channels. Armex /SCA provide access to the charter, prospectus, annual, quarterly, and current reports (material facts). Open JSCs publish their annual report (in practice, this rule is often overlooked), prospectus, and AGM announcements in a newspaper. Information is also available at company headquarters.<sup>44</sup>

**Material facts.** A "current report", or material facts, are disclosed to SCA and Armex within 10 days of their occurrence, and include changes in board, management, controller, large owners, auditor, equity, subsidiaries, and generally any changes of the information filed in the prospectus. The law defines material facts as "important in making decision on the purchase or the sale of the security"<sup>45</sup> SCA and Armex encourage the issuers to also publicize such events to their shareholders. The bodies themselves make the information available to the public in paper form, upon request.

<sup>42</sup> Auditor certification (for an individual, "license" for an audit firm), requires graduate education in economics, and 3 years of experience of last 5 years, or 5 of last 7. Auditing Law Articles 5.1, 23.

<sup>43</sup> LJSC Article 91. In a company with 50 and more shareholders (owners of voting shares), the shares that belong to the board members, as well as to the director (general director) and the members of the executive and management boards may not participate in a vote on the election or early dismissal of the controller (LJSC Article 93).

<sup>44</sup> LJSC Article 96. At company headquarters, a shareholder can request: the state registration certificate, the Charter and foundation agreement, legal proof of company property per its balance sheet, AGM minutes, by-laws of subdivisions and institutions of the company, annual reports, prospectus, financial and statistical reports submitted to public administration bodies, minutes of enumeration commission and voting ballots, reports of the controller, the company auditor, ownership of insiders and 10% shareholders, and contracts the company has entered into. These documents are to be provided to shareholders upon request within 5 days, at the cost of preparation and postage (LJSC Article 95). The above documents are only available to the extent they contain no confidential information, which is determined by the board (LJSC Article 37.3). SCA reviews board decisions on what information is confidential (LSMR Article 39).

<sup>45</sup> SMRR Rule 31.1a-1, LJSC Article 95. LSMR Article 4.

**Published information (papers, web).** Companies are required by law to publish their annual financial statements in a newspaper, and are further encouraged by SCA and Armex to publicize among their shareholders their periodic reports and material facts. So far, such practices are nevertheless rare.

**Principle VF: The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.**

**Assessment: Not Observed**

**Disclosure of conflicts of interest by analysts, brokers, rating agencies, etc.** There are no rules in Armenian legislation governing conflicts of interest or the relationship between investment companies, banks, brokers, and rating agencies. There is no market analyst so far in Armenia. Any broker has the right to advise his clients on matters related to investments, including securities prices, investments in securities, securities purchase and sale (LSMR Article 75). In 2004, the first rating company was created in Armenia – ACRA.

#### SECTION VI: THE RESPONSIBILITIES OF THE BOARD

**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.**

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

**Assessment: Partially Not Observed**

**Basic description of board.** Armenian companies have single tier boards in practice, though the charter can institute a management board. The board is assembled by the Chairman at his initiative, at the request of a Board member, the controller, the Company auditor, and the executive body. The Board may adopt decisions by means of a remote vote, unless otherwise stipulated by the charter. The board meeting is considered valid if the number of attendees is not less than half of its members. Board decisions are taken with a 50% majority unless the charter or the Board Bylaws approved by the AGM stipulate a higher percentage. In companies with more than 500 shareholders the Chairman and the Executive Director positions cannot be combined. In companies with less than 500 shareholders the functions are often combined (LJSC Art. 86, 87). 67 firms have more than 500 shareholders.

**Size requirements and typical size.** The minimum board size is three (LJSC Article 85.4). Usually, boards have 3 members, but the biggest companies can have up to 11 directors.

**Nomination and election.** The AGM elects and removes directors.

**Eligibility requirements.** Directors do not have to be shareholders unless the charter requires that. Where an executive board exists, half of the directors should be non-members of the executive board (LJSC Article 85.5).

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

**Assessment: Partially Observed**

**Adequacy of duties of loyalty and care.** The Board acts in the interest of shareholders, and within the limits of the law and company documents. Under the SMRL, the board and the executive director of traded companies must act "conscientiously and with proper attention, which under similar conditions would have been used by a person holding a similar position in managing of his/her own business, which to their opinion is first of all arising from the interests of the issuer and its securities owners." The provisions on fiduciary duties should be part of the company law and not be limited to companies whose shares are publicly traded.

Directors are liable to the Company for damage caused by their actions, unless they did not participate or voted against the decision causing damage. The Company or a 1% voting shareholder can sue directors, the Executive Director /executive body in court, claiming compensation for damage caused to the Company (LSMR Art. 40. LJSC Art. 90). There are no provisions in the law on duties owed by the board to shareholders where it makes a decision that may affect groups differently. The current legislation does not include a detailed description of the specific roles and responsibilities of directors and managers beyond the provision of official information. In the absence of such defined roles and responsibilities, it would be rather difficult to determine the extent of liability for specific individuals. Director liability is not used in practice.

**Insurance for directors.** Not required by law and not used in practice.

**Business judgment rule/board accountability.** When determining the grounds for and size of liability, business practices are taken into account. An individual shall be exempt from the liability for damage caused to the Company if he/she acted in

good faith and did not or could not know that his/her action would cause damage to the Company.	
<b>Principle VIC: The board should apply high ethical standards. It should take into account the interests of stakeholders.</b>	
<b>Assessment: Materially Not Observed</b>	
The LJSC and the Labor Code govern general issues related to unethical practices but the law provide for few details. No companies have company codes of ethics. There are no specific rules relating to Board duties to employees.	
<b>Principle VID: The board should fulfill certain key functions, including:</b>	
<b>Assessment: Materially Not Observed</b>	
(1) Board oversight of general corporate strategy and major decisions	<b>Board functionality by law and in practice.</b> The Board has an exclusive right to determine the main areas of Company activities, call AGMs, issue bonds and equity up to the level of authorized capital, and recommend to the AGM dividends and controller and auditor remuneration, among other exclusive powers. In practice, the boards of most firms do not yet play a central and strategic role, which is played instead by the controlling owner. Firms often do not hold regular board meetings. Boards do not fulfill their roles in strategic governance and executive oversight, and are involved in the daily management of company operations. One of the reasons for this is the composition of boards where members are representatives of the controlling shareholders who are at the same time top managers.  <b>Director training, IOD.</b> There is no Corporate Governance Code, no Institute of Directors, and no organized training programs for members of boards of directors. A Corporate Governance Code provides a valuable standard of business practice against which a court of law can determine if directors have complied with their fiduciary duties.
(2) Monitoring effectiveness of company governance practices	Neither directors nor the controller monitor governance practices by law.
(3) Selecting / compensating / monitoring / replacing key executives	Board functions include appointing management only if the charter so specifies. In the alternative, management is appointed and removed by the AGM.
(4) Aligning executive and board pay with long term company and shareholder interests	The AGM decides Board and Executive Director compensation. Board compensation is generally insufficient to ensure board effectiveness. In practice, the pay of the Executive Director is not determined by the AGM or the board. Only 8% of directors are paid for their services. <sup>46</sup>
(5) Transparent board nomination / election process	Board members are nominated in practice by the controlling owner, and approval by the AGM is pro-forma. The AGM has information on shareholdings of nominees for directors, but not their CV or other background material (LJSC Article 72).
(6) Oversight of insider conflicts of interest, including misuse of company assets and abuse in RPTs	Boards most often lack independence from controlling shareholders and from management. RPTs require board approval, with recusal of the related party.
(7) Oversight of accounting and financial reporting systems, including independent audit and control systems	The Executive Director is responsible for oversight of internal accounting and financial reporting systems. There is no legal provision for certification by the board of the truthfulness or otherwise of financial statements, but it provides preliminary internal approval of the annual report at least 30 days before the AGM. Though the auditor is overseen by the board and the AGM in terms of hire / removal and remuneration, his contract is signed by the Chairman of the Board who in practice is the controlling owner in companies with less than 500 shareholders. This results in practice in Executive Director oversight of the corporate audit systems. The Executive Director and the Chief Accountant

<sup>46</sup> LJSC Article 67u, 83. Survey of directors and boards, AFIC, 2004.

	sign the financial statements, and carry civil liability for false or misleading statements, or for their untimely presentation to the regulator. <sup>47</sup>
(8) Overseeing disclosure and communications processes	Boards play little role in the process of disclosure and communications.
<b>Principle VIE: The board should be able to exercise objective independent judgment on corporate affairs.</b>	
<b>Assessment: Materially Not Observed</b>	
(1) Director independence	<p><b>Director independence in law.</b> There are no rules that govern independence of the board, although in the presence of an executive board, half of board directors at least must not be members of the executive board (LJSC Art 85).</p> <p><b>Director independence in practice.</b> Boards are generally not independent, corporate power being concentrated with the controlling owner.</p>
(2) Clear and transparent rules on board committees	<p><b>Audit committees.</b> Boards of Armenian companies do not have audit committees, which would be subcommittees of the board with responsibility to report to the board.</p> <p><b>Other committees.</b> There is neither legislative requirement nor actual practice of establishing other board sub-committees.</p>
(3) Board commitment to responsibilities	<p><b>Restrictions on the number of board seats.</b> There are no restrictions on the number of companies on which a board member can serve, by law.</p> <p><b>Board meeting requirements.</b> The law does not specify any provisions for the frequency of board meetings or director attendance. Only 20% of companies have monthly board meetings (Survey of directors and boards, AFIC, 2004).</p> <p><b>Public availability of board attendance.</b> Board meeting attendance is not disclosed.</p>
<b>Principle VIF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.</b>	
<b>Assessment: Materially Not Observed</b>	
For individual board members, especially non-executive ones that are not large shareholders, it may be difficult to access confidential documentation. The board has access to professional advice at the expense of the company by a board decision only.	

47 LJSC Articles 92.2, 93, 94. Law on Accounting Articles 12, 21, 25. LJSC Article 94.1 makes the Executive Director responsible for timely filing of the annual report. The Chief Accountant is selected by and reports to the General (Executive) Director, and has no substantive contact with the controller, board, and shareholders.

## Detailed Recommendations

### Immediate Priorities

#### ***Upgrade of the Company Registry***

The law regarding the company registry should provide for public access to the documents of the company registry (including company charters and lists of company founders).

Implement technical upgrades to modernize the Registry's systems for filing and documentation.

Refocus the Registry on providing company information, thus facilitating the implementation and enforcement of the LJSC. The Registry should be able and willing to demand that companies make proper filings.

Provide the Registry with the resources needed for its mission, possibly also via international donors.

#### ***Improved quality of accounting and auditing***

An accounting and auditing ROSC should be conducted for Armenia.

AAAA should receive certification rights, or the Ministry of Finance should recognize AAAA diplomas automatically.

Effective strengthening of auditor liabilities is needed in the law.

An independent auditor and accountant oversight body should be created, with certification and enforcement powers.

The auditor's opinion should be publicly disclosed. Provide for certain rules in relation to auditor selection and require that auditors be accountable and present their report to the board (audit committee) and shareholders.

#### ***National Corporate Governance Action Plan***

Set up a government committee, with participation from all relevant stakeholders, to plan corporate governance priorities in the medium and long term. Increasing harmonization with EU standards would help this process along.

### Longer-term objectives

#### ***Disclosure: annual report content, ultimate ownership disclosure, RPT enforcement***

SCA should work to specify the annual report format precisely, and enforce that format. At a minimum, the annual report should contain ultimate beneficial ownership, RPTs and large transactions, and should be available online.

Ultimate beneficial ownership should be publicly disclosed. CDA should become an agent of ownership disclosure. Shareholders should have the right to obtain a copy of the full shareholder list.

Related loans from company to insiders should be banned, or disclosed and carried out at market prices

RPT disclosure and proper approval procedures should be enforced by SCA.

International best practice suggests real-time disclosure of material facts, as opposed to 10 days as provided by law.

Establish a system of easy access to company periodic information, eventually available online.

#### ***Clear specification of the roles and duties of corporate bodies and the AGM***

Fiduciary duties for directors should be strengthened. Liability provisions in LJSC and SMRL should be aligned.

Give directors (rather than the executive) clear responsibility for management oversight.

Directors should be elected every year, it should not be possible to avoid election of directors during the AGM.

The requirement that directors treat all shareholders equally should be clearly grounded in the law.

The maximum number of board memberships should be defined, as well as a maximum period of service.

The minimum board size of companies with 500 shareholders should be increased.

Independence rules should be introduced as to boards of directors. The SCA should develop independence criteria. The board of directors should not be dominated by managers.

An audit committee should be made mandatory for listed companies. Per best practice, other board committees, as well as a corporate secretary, significantly contribute to the board's effectiveness.

It is important to provide the board with tools to evaluate managers' performance. The board should also conduct an annual self-evaluation. These features could become requirements for listing but recommended for all open JSCs.

A director training program, possibly with SCA certificates of proficiency, should be created.

A distinction should be introduced between board chairman and the executive for all listed companies.

Abolish the controller function – give the board full responsibility for monitoring internal control and financial systems.

AGM procedure and notification should be specified in detail in the law, leaving little freedom to the charter.

### ***Effective minority rights***

In-kind contributions to capital increases of listed companies should be forbidden, or the use of independent valuations should be mandated, allowing cash always as an alternative.

SCA should get effective powers to enforce a truly fair market valuation for asset and stock transactions.

### ***Legal changes and enforcement matters***

Only open JSCs should be allowed to issue securities publicly. Once a company has been admitted for trading, all share trades should be registered on the stock exchange.

An investment fund law should be adopted.

Insurance and pension funds should be permitted to invest in domestic securities, including equity.

A Code of Corporate Governance should be adopted, when conditions are ripe.

SCA salaries should be comparable to those of similar institutions or the private sector.

SCA should strengthen accounting and auditing training for its staff.

SCA needs stronger investigative powers, and the power to exclude disreputable auditors from servicing listed firms.

Training on corporate matters for the court is needed.

## Nightex Case

*Nightex, Inc.* is a case of illegal dilution of minority shares, in the process of which pre-emptive rights were violated, there was a failure to conform to proper disclosure, appraisal of market value was not properly performed, and insider information was abused. *Nightex, Inc.* was established in 2003 as a result of a merger between *Maralik Cotton Factory open JSC* (“*Maralik*”) and *Sisakan open JSC*. Both companies were listed on Armex and had a significant number of shareholders.<sup>48</sup> Garni International, Inc. (“Garni”) – a US holding company – held 80% of the shares in both companies.<sup>49</sup>

On January 15, 2003 prior to the merger transaction, *Maralik* issued common stock in a private placement to Garni, at a price below face value, but purportedly equal to the market value of the shares.<sup>50</sup> As a result Garni's share in *Maralik* increased to 94%.

On May 14, 2003 *Maralik* and *Sisakan* merged into a new entity, *Nightex*, via a share exchange (no cash). Neither of the listed companies had filed proper disclosure of the pending merger. As a result of the merger, Garni was the owner of 92% of *Nightex*. *Nightex* filed a registration statement with SCA and with Armex. SCA reviewed the registration statement and launched an investigation, requiring additional information and suspending *Nightex* registration and trading.

The decision of SCA following the investigation was to reverse the private placement of *Maralik* shares to Garni, on the following grounds:

- issuance of shares to Garni in a *private placement transaction* violated the pre-emptive rights of the other shareholders of a JSC guaranteed by LJSC Articles 47 and 48;
- shares were issued to Garni at a price below market value determined on the basis of net assets as required by Article 59 of the JSCL, in violation of LJSC Article 44;
- shareholders were not advised on their appraisal rights in a merger transaction in violation of LJSC Art 57-8;
- such violations resulted in an inequitable dilution of shares of minority shareholders.

SCA ordered *Nightex* to re-appraise the shares by an independent appraiser in accordance with Articles 58 and 59, and advise all shareholders of their rights by ordered mail. The merger via exchange of shares was also held invalid by the SCA on the grounds of use of insider information. SCA issued a penalty on the latter grounds.

In response, Garni filed a motion to postpone the SCA hearing and proposed a settlement with restitution to *Maralik* shareholders. Following negotiations, the SCA issued a final decision specifying:

- *Nightex* would notify all shareholders of *Maralik Cotton* and *Sisakan* of their appraisal rights and the right to demand repurchase of their shares by *Nightex*. The value of the shares would be determined by an independent appraiser as of the date of merger.
- Garni would reconstitute 12% of its holdings in *Nightex* to former *Maralik* shareholders, effectively reversing the private placement transaction and re-establishing its 80% share vis-à-vis *Maralik* Minority shareholders.

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<sup>48</sup> *Maralik* had about 1000 shareholders, while *Sisakan* – 500 shareholders.

<sup>49</sup> In reality Garni acted in concert with Armenian shareholders. For simplicity, all of them are treated as one shareholder.

<sup>50</sup> Proceeds of the shares were directed at the repayment of an outstanding loan to Garni, in a debt-for-equity swap.

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## Armenia Terms/Acronyms

<b>AGM:</b> Annual General Shareholders Meeting
<b>AMD:</b> Armenian Drams
<b>Armex:</b> Armenian Stock Exchange
<b>ASRA:</b> Accounting Standards of the Republic of Armenia
<b>CDA:</b> Securities Depository of Armenia
<b>EGM:</b> Extraordinary Shareholders Meeting
<b>GDP:</b> Gross Domestic Product.
<b>ISA:</b> International Standards on Auditing
<b>IFRS / IAS:</b> International Financial Reporting Standards (previously called International Accounting Standards)
<b>JSC:</b> Joint-Stock Company
<b>LJSC:</b> Law of Joint-Stock Companies 2001
<b>SARA:</b> Standards of Audit of the Republic of Armenia
<b>SCA:</b> Securities Commission of Armenia
<b>SMRL:</b> Securities Market Regulation Law 2000
<b>SMRR:</b> Securities Market Rules of Regulation
<b>SRO:</b> Self-Regulatory Organization
<b>Cumulative voting:</b> Cumulative voting allows minority shareholders to cast all their votes for one candidate. Suppose that a publicly traded company has two shareholders, one holding 80% of the votes and another with 20%. Five directors need to be elected. Without a cumulative voting rule, each shareholder must vote separately for each director. The majority shareholder will get all five seats, as s/he will always outvote the minority shareholder by 80:20. Cumulative voting would allow the minority shareholder to cast all his/her votes (five times 20%) for one board member, thereby allowing his/her chosen candidate to win that seat.
<b>Pre-emptive rights:</b> Pre-emptive rights give existing shareholders a chance to purchase shares of a new issue before it is offered to others. These rights protect shareholders from dilution of value and control when new shares are issued.
<b>Proportional representation:</b> Proportional representation gives shareholders with a certain fixed percentage of shares the right to appoint a board member.
<b>RPT:</b> Related party transactions. The OECD Principles of Corporate Governance hold that it is important for the market to know whether a company is being operated with due regard to the interests of all its investors. It is therefore vital for the company to fully disclose material related party transactions to the market, including whether they have occurred at arms-length and on normal market terms. Related parties can include entities that control or are under common control with the company, and significant shareholders, such as relatives and key managers.
<b>Shareholder agreement:</b> An agreement between shareholders on the administration of the company, shareholder agreements typically cover rights of first refusal and other restrictions on share transfers, approval of related-party transactions, and director nominations.
<b>Squeeze-out right:</b> The squeeze-out right (sometimes called a "freeze-out") is the right of a majority shareholder in a company to compel the minority shareholders to sell their shares to him. The sell-out right is the mirror image of the squeeze-out right: a minority shareholder may compel the majority shareholder to purchase his shares.
<b>Withdrawal rights:</b> Withdrawal rights (referred to in some jurisdictions as the "oppressed minority," "appraisal" or "buy-out" remedy) give shareholders the right to have the company buy their shares upon the occurrence of certain fundamental changes in the company.

This report is one in a series of corporate governance country assessments carried out under the Reports on the Observance of Standards and Codes (ROSC) program. The corporate governance ROSC assessments examine the legal and regulatory framework, enforcement activities, and private sector business practices and compliance, and benchmark the practices and compliance of listed firms against the OECD Principles of Corporate Governance.

The assessments:

- use a consistent methodology for assessing national corporate governance practices
- provide a benchmark by which countries can evaluate themselves and gauge progress in corporate governance reforms
- strengthen the ownership of reform in the assessed countries by promoting productive interaction among issuers, investors, regulators and public decision makers
- provide the basis for a policy dialogue which will result in the implementation of policy recommendations

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Web page at: <http://rru.worldbank.org/Themes/CorporateGovernance/>

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