



THE WORLD BANK

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

Corporate Governance

## Corporate Governance Country Assessment

Azerbaijan  
September 2009

# 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 2009, 66 assessments had been completed in 55 countries around the world.

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

## Corporate governance country assessment

AZERBAIJAN

SEPTEMBER 2009

### Executive Summary

This report assesses Azerbaijan's corporate governance policy framework. It highlights recent improvements in corporate governance regulation, makes policy recommendations, and provides investors with a benchmark against which to measure corporate governance in Azerbaijan. It is an update of the 2005 Corporate Governance ROSC.

**Achievements** In recent years, Azerbaijan's economy has experienced tremendous economic growth and the substantial institutional and legal change of earlier years has continued. New laws and regulations have improved legal protection for investors and the broader business environment. These include 2007 Laws on Insurance Activity and Internal Audit, and 2008 amendments to the Civil Code and regulations that introduce board member duties and regulate related party transaction. Azerbaijan's Doing Business rankings have improved substantially since 2005. Enforcement and implementation of corporate governance has also begun to improve, especially in banks and companies with foreign investment. Foreign donors, including the IFCs Azerbaijan Corporate Governance Project, have been helpful in this area.

**Key Obstacles** While basic market infrastructure is in place, liquidity is minimal and only a few companies have turned to capital markets as a source of finance. Wider knowledge of recent legal changes is lacking, compliance with the new rules is low, and the State Commission for Securities (SCS) is required to oversee a very large number of JSCs with limited resources and penalties. Specific challenges include limited protection for small shareholders, poorly defined powers and responsibilities for supervisory and management boards and related bodies like revision commissions, a dearth of independent members of supervisory boards, and poor compliance with disclosure requirements: companies do not always publish financial statements, and audit quality is mixed.

**Next Steps** As Azerbaijan continues to reform, steps should be taken to strengthen the SCS, revive the legal framework for JSCs, and introduce a code of corporate governance. These should be supported by broad based efforts to raise awareness among board members and investors and continued efforts to improve financial and corporate disclosure. The infrastructure and wider legal framework for capital markets also needs to be revived.

Priority reforms include: clarifying the relative roles and powers of the two board tiers, better protecting small shareholders, enforcing and building on requirements to disclose ownership and related party transactions, and ensuring that more corporate information is publicly available.

## **Acknowledgements**

This assessment of corporate governance in Azerbaijan was conducted in January 2009 by Catherine Hickey and David Robinett of the World Bank Global Capital Markets Development Department, Corporate Governance Unit, as part of the Reports on Observance of Standards and Codes Program. It has been revised to reflect all relevant changes through September 2009. It is an update of a 2005 ROSC conducted by Tatiana Nenova and Sue Rutledge. The team received substantial support from the IFC Azerbaijan Corporate Governance Project, including a legal review by Anar Aliyev, a corporate governance survey conducted by the ACGP and published in 2007, background information, and due diligence coordination.

The assessment reflects technical discussions with the State Committee for Securities, Ministry of Finance, Central Bank of Azerbaijan, Ministry of Justice, Ministry of Economic Development, Baku Stock Exchange, Chamber of Auditors, and USAID, as well as commercial banks, issuers, and numerous market participants.

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## Country assessment: Azerbaijan

This update of the 2005 Azerbaijan Corporate Governance Report on Standards and Codes (ROSC) benchmarks laws and practices against the OECD Principles of Corporate Governance (Principles) and focuses on publicly traded companies.

In recent years, Azerbaijan's economy has experienced tremendous economic growth: high oil prices and increased production led to GDP growth of 25 percent in 2007 and 11 percent in 2008. Since 2005, the substantial institutional and legal change of earlier years has continued. New laws and regulations have improved legal protection for investors and the broader business environment. In recognition of these changes, in 2008 Azerbaijan's Doing Business Investor Protection rank improved from 110 to 18 and their overall ranking from 97 to 33. Enforcement and implementation of corporate governance has also begun to improve thanks to initiatives launched by the Central Bank of Azerbaijan and support from the IFC, EBRD, and other international donors and investors. This should continue as the State Committee for Securities (SCS) brings forward efforts to revitalize its own enforcement efforts.

However, substantial challenges remain. While basic capital market infrastructure is in place, trading and liquidity are minimal and only a few companies have turned to the stock market as a source of finance. The legal framework for corporate governance and investor protection has been strengthened, but wider knowledge of these changes in the public is lacking, and compliance with the new rules is low. Critically, the SCS has limited resources and penalties given the large number of entities it is supposed to oversee. Specific challenges include limited protection for small shareholders, poorly defined powers and responsibilities for supervisory and management boards and related bodies like revision commissions, a dearth of independent members of supervisory boards, and poor compliance with disclosure requirements: many companies do not publish financial statements on a regular basis; ownership is often not disclosed; and audit quality is mixed.

### Market profile

*Trading on the BSE limited*

The Baku Stock Exchange is Azerbaijan's only stock exchange. 234 joint stock companies (JSCs) with more than 100 shareholders are required to have shares available for trading on the exchange. However, none meet listing requirements and their shares may also be traded off exchange, where much trading occurs. Turnover for 2008 was about 9.5 billion manats, up from 5.5 billion in 2007, according to the BSE. Turnover was made up mostly of government fixed-income securities. The BSE does not maintain statistics on market capitalization, which has limited meaning giving the infrequency of trading. Nine companies have issued bonds through the exchange, almost all banks.

*Most JSCs created through privatization*

The great majority of companies were created through privatization. Employee ownership is widespread, and after privatization, ownership concentration has been steadily on the increase. There are no mutual funds or pension funds.

*Institutional investors are starting to appear*

In 2006, the government launched the Azerbaijan Investment Company (AIC), a 90 million manat (\$100 million) fund that invests in companies outside the oil sector. AIC considers corporate governance factors when making its investment decisions.. Kazimir Partners is a privately-held investment firm with investments in two Azerbaijani banks.

*State ownership remains extensive*

Although the size of the private sector has expanded dramatically, state ownership remains extensive. Estimates of GDP produced by state owned enterprises (SOEs) range between 15 and 25 percent. Major entities such as the oil company SOCAR and Azerbaijan Airlines are owned by the Azerbaijani government, which also has holding in over 200 smaller JSCs.

*Azerbaijan's legal framework is deepening*

Azerbaijan is a civil law country. It is practically unique in not having a dedicated law or act for companies. Such an act was in force until 2004, when it was repealed and relevant provisions on companies added to the 2000 Civil Code; which is the country's main legislation for corporate and commercial matters. Other major legislation includes the 2004 Law on Accounting (which introduced International Financial Reporting Standards (IFRS) for large and financial companies) and the 1994 Law on Auditor Services.

In 2004, the Law on Banks and the Central Bank of Azerbaijan (CBA) Regulation on Implementation of Corporate Governance Standards in Banks introduced advanced corporate governance regulations for banks. The 2007 Law on Internal Audit requires companies to establish an internal audit function. In 2008 Regulations on Related Party Transactions (RPTs) were issued and 2008 amendments to the Civil Code introduced fiduciary duties for directors<sup>1</sup>. The Annex provides a summary of changes since the 2005 ROSC.

*Enforcement is limited*

While legislative efforts are successful and ongoing, enforcement still lags. Right now, the SCS cannot penalize companies with more than a nominal fine and must spread its regulatory resources across hundreds of JSCs, not just those that issue securities or are open companies that are quoted on the BSE. Other than the BSE, the main institutions for capital markets are the State Committee for Securities (SCS) and the National Depository Center (NDC). A new chairman took over the SCS in 2008 and is trying to improve compliance with securities laws.

*Corporate governance for banks is fairly advanced*

Banks have a regulatory regime that incorporates advanced corporate governance practices. The Central Bank of Azerbaijan (CBA) coordinates regular ongoing training for bank managers. Since February 2007, bank audits must be conducted in accordance with International Standards on Auditing (ISA).

*Development of a corporate governance code is underway*

Currently, there is no corporate governance code for JSCs. A corporate governance code is being developed by a corporate governance task force led by the Ministry of Economic Development. It is expected to be finalized by mid- to late-2009.

## Key findings

The following sections highlight the principle-by-principle assessment of Azerbaijan's compliance with the OECD Principles of Corporate Governance (page 23). A summary of changes since the 2005 Corporate Governance ROSC is provided at the end of this section (page 13). While there has been improvement

<sup>1</sup> As the ROSC was being finalized, new listing rules had been introduced for the BSE.

since 2005, overall implementation is limited, and Azerbaijan significantly lags behind some other countries in Europe and Central Asia, including those in the Balkans and, especially, the recent EU member states.

### Investor protection

*Many basic shareholder rights are in place...*

Shareholders have a general right to attend GMSs, trade and transfer their shares, receive basic information from the company, elect board members, and approve major transactions. Approval by 66 percent majority of attending shareholders at the GMS is required for changes in the company charter, issuing new share capital, and initiating restructuring or liquidation. Shareholders can dispute a GMS decision in court and new fiduciary duties mean shareholders can, in theory, sue directors and company officers for damages.

*...but compliance is low*

GMSs are not always held, and when they are held, shareholders may not approve major transactions or receive all required information. Shareholders do not have an explicit right to ask questions during the GMS. The decision to issue capital can be delegated to the board, and minority shareholders do not have preemptive rights when new shares are issued. Accessing corporate information is difficult.

*Market infrastructure inadequate*

Outdated securities market infrastructure and norms and limited liquidity also effectively limit shareholder rights by making it more difficult to trade shares. Clearing of all securities traded on the BSE is conducted by the exchange, not the NDC, which handles share settlement on the basis of instructions received from the BSE. DVP (delivery-versus-payment) is not fully attained: settlement is real time on a gross basis. Most trades are executed off exchange. The lack of companies meeting listing requirements also effectively limits shareholder rights.

*Market for corporate control is underdeveloped*

Currently there is no takeover law or regulation, and no requirement for investors seeking to take control of a company to make a tender offer to other shareholders. In practice, there have been few changes in control. Changing from an open to closed JSC requires a 2/3<sup>rd</sup> GMS majority; however, there are few other protections for minority shareholders during such a change. This is a serious concern due to the large number of open JSCs and small shareholders created by privatization.

*Insider trading rules exist but enforcement is low*

Insiders are defined in the law, and insiders cannot trade on inside information or disclose it to third parties. Insiders should file with the SCS their trades within one day. The SCS and BSE are also supposed to monitor trading to detect abuse, but criminal sanctions are not allowed and civil sanction amounts are low. In practice, enforcement in this area has been minimal.

*Dividends are rare*

Dividends are proposed by the supervisory board and approved by the GMS. In practice, shareholders do not always approve dividends and only 18 percent of the companies surveyed by IFC in 2007 declared and paid dividends.

*New rule on RPTs introduced*

A new SCS regulation on related-party transactions defines who a related party is and requires that related parties notify the supervisory board in writing about the nature and scope of their interest in a transaction. The regulation also requires that related-party transactions exceeding 5 percent of company assets shall be approved by the GMS, and that these transactions should be disclosed publicly. While the new rules are a significant improvement, many market participants are not aware of them.

## Disclosure

*Law requires companies to issue audited financial statement, but many do not*

All companies are required to produce audited financial statements that include a balance sheet and income statement. A cash flow statement and information on controlling or beneficial owners is not required for many JSCs. Until recently, the majority of companies did not produce annual reports or financial statements, or did not provide them to shareholders. The SCS has begun actively penalizing non-compliance, and more companies are now issuing financial statements. Many still do not, though, and quality is often poor.

*More banks and other companies using IFRS*

Banks and (as of January 2008) companies which are considered public interest entities<sup>2</sup> are required to use International Financial Reporting Standards (IFRS) to prepare their consolidated financial statements. Other companies may use National Accounting Standards (NAS). NAS are being revised to be closer to IFRS, but simpler and hence easier for medium and smaller companies to comply with. Larger banks and some other companies, usually with foreign investment or control, have made progress in implementing IFRS, but other companies have not. Many companies still do not comply with NAS and use tax accounting for their reports.

*Audit quality slowly improving*

While all JSCs are required to use an external auditor, until recently many did not. The quality of audits has also been questioned by some market participants; however, the growing presence of foreign audit firms and gradually improved accounting and audit education may be increasing audit quality, at least for banks and some companies.

*Few requirements for auditor independence*

Auditors cannot be directly connected to the company and are required to comply with a professional code of ethics. Otherwise, provisions on auditor accountability to shareholders were actually removed from the law and have not been replaced. There are no requirements for rotation for audit firms or partners and other independence requirements are minimal. Auditors often do other non-audit work for their clients. In some cases they may, effectively, both prepare and audit accounts.

*Chamber of Auditors regulates the profession*

The Chamber of Auditors regulates the profession, and licenses auditors and audit firms. It sets local audit standards, and will require compliance with International Standards of Audit (ISA) starting in 2009. The Chamber can resolve disputes between auditors and clients, and reviews audit quality. It can revoke licenses for low quality of audits, and has done so a few times. It requires licensed auditors to undergo ongoing education and organizes training. The Chamber became a full member of IFAC in 2008. Market participants had mixed views of the Chamber, many were positive, but some felt that they could be more effective in improving quality of accounting and auditing.

*Information still hard to access*

While improvements have been made since the 2005 ROSC, shareholders and investors continue to report problems in accessing company information. The BSE posts some information, including prospectuses and a small number of annual reports, and the Registrar in the Ministry of Taxes also has basic information for companies. Some banks and a few companies also have websites with information for the public.

<sup>2</sup> Under the law, public interest entities include insurance companies, banks, other JSCs with shares traded on the exchange, and other commercial organizations that meet certain thresholds set by the government. In practice, outside of banks, insurance companies, and some large SOEs, there is little oversight or awareness of public interest entity requirements.

## Company oversight and the board

*Division of responsibilities between boards is often unclear*

Azerbaijani companies have a two-tier board structure: a supervisory board and a management board<sup>3</sup>. The supervisory board is supposed to oversee the work of the management board, while the management board carries out the day-to-day operations of the company. Practice however varies greatly across companies, with supervisory boards playing little role in some companies, and working full time in others, engaged in day to day management. Overall, the supervisory boards in many JSCs do not supervise key functions, including corporate strategy, financial reporting and risk management and policy.

*Election of management board members often made by GMS instead of supervisory board*

Under the Civil Code, the management boards of JSCs may be selected either through the GMS or by the supervisory board. In many countries with two-tier board structures, only supervisory boards have the ability to select the management boards. Electing management board members by GMS limits the ability of the supervisory board to oversee management and hold them accountable.

*Revision commissions remain a fixture of the corporate structure*

Revision commissions are elected by the GMS and their members are not members of either board. They serve varying purposes, from approving financial statements to advising on tax issues. It is often unclear how their work differs from that of the audit committee and the external auditor. These sorts of bodies have been reformed or removed in other countries in Eastern and Central Europe, and some experts have recommended the same for Azerbaijan<sup>4</sup>.

The Law on Internal Audit now requires certain companies to have audit committees of the supervisory board to do some of the same things revision commissions do. Furthering the confusion, banks have mandatory auditor commissions, which serve similar functions to the revision commission for JSCs, and insurance companies have “revision commissions” that are similar to board audit committees. Other committees of the supervisory board are not widely used.

*Fiduciary duties are introduced*

Fiduciary duties for supervisory board directors were introduced in the Civil Code in 2007. According to these duties, directors and key company officers must act reasonably and in good faith toward the company. Directors can be held liable for losses caused to the company for wrongful behavior, but no known cases of director liability have been brought yet<sup>5</sup>.

*Independent board members are rare*

Except in insurance companies, there are no independence requirements for supervisory boards by law. Banks and JSCs that want to improve corporate governance to attract outside investment have introduced independent supervisory board members, though many complain that it is difficult to find a truly independent person in Azerbaijan who is well-versed enough in business to serve. The percentage of independent members on supervisory boards is still fairly low. 28 percent of companies in the 2007 IFC survey claimed any independent supervisory board members, using their own definition of independence.

<sup>3</sup> JSCs with 50 or fewer shareholders do not have to have a supervisory board, and JSCs, except banks and insurance companies, can choose to have a single director instead of a management board. The great majority of companies with 100 or more shareholders have both boards.

<sup>4</sup> These include Charles Canfield and Vusal Eynullayev, *Elimination of the Revision Commission from Azerbaijani Legislation and Establishment of the Audit Committee*, Azerbaijan Corporate Governance Review (Sep. 2007) and OECD *Policy Brief On Corporate Governance Of Banks In Eurasia* (Apr. 2008)

<sup>5</sup> No cases have been confirmed from court records or by market participants.

*New rules against conflicts of interest*

For JSCs, there are few specific rules on conflicts of interest, though a new SCS regulation on related party transactions applies to supervisory board members. Bank management and supervisory board members have more specific conflict of interest rules.

*Some training for supervisory board members*

The IFC Azerbaijan Corporate Governance Project coordinates ongoing training for companies. However, training for supervisory board members of JSCs is still relatively uncommon. A corporate governance code that will give guidance to supervisory board members on their duties is in development but has not yet been released. There is more training available for banks. Board performance evaluations are also rare.

*Some improvements have been made in SOE corporate governance...*

The great majority of SOEs have been corporatized and come under the Civil Code. International standards of accounting and auditing have been introduced for significant SOEs, and the World Bank is supporting these enterprises in improving their financial reporting. Other recent reforms, including the CBA's standards of corporate governance, which apply to state-owned banks, the introduction of director duties and rules on related party transactions, and ongoing training for board members and awareness raising by the IFC, have also improved the governance of some SOEs.

*...but challenges persist*

However, better SOE governance also faces a number of challenges and obstacles. Some of the most important SOEs are not corporatized and have an ambiguous legal form<sup>6</sup>. Many SOEs still rely on indirect and direct financing from the state and sometimes carry out various policy and other non-commercial functions, without clear financial arrangements. A range of executive authorities carry out the state's ownership rights in an essentially ad-hoc manner. While there have been some improvements in terms of disclosure for larger SOEs, most remain opaque. Board practices, mandates, and independence are not well established, and many SOEs do not have supervisory boards.

### **Enforcement**

*The SCS has broad powers, but fines low*

The SCS regulates securities issuers, brokers and other market intermediaries, the BSE and NDC, and both commercial and securities related issues for all 1,914 JSCs. The SCS has powers to issue new regulations, investigate complaints, initiate civil suits and impose fines, and grant and suspend licenses. It has recently stepped up its enforcement activities, and investigated over 200 investor complaints in 2008.

However, its fines are limited—maximum 300 manats or 400USD for even the most serious violations. The SCS is unable to pay competitive salaries and has no real budgetary or administrative independence. The need to oversee all JSCs also strains its limited resources.

*The CBA is a major proponent of good governance*

Since the 2005 ROSC the CBA has become a major proponent of corporate governance, both in overseeing compliance with relevant laws and regulations and in promoting training and raising awareness. The court system has also seen major reform since the previous ROSC, with broad measures of performance, such as time to resolve a commercial case, improving significantly. However, some market participants still question the capabilities of the courts vis-à-vis

<sup>6</sup> These include the State Oil Company (SOCAR), the Caspian Shipping Company (CASPAR), and the Baku Metro.

complicated corporate cases.

## Recommendations

*The reform process should continue*

Azerbaijan has undergone significant and broad based reform, introducing the legal and institutional framework for capital markets and corporate governance, much of it in the last few years. However, fully tapping the potential of capital markets and professionalizing boards and management will require that reform continues.

Good corporate governance ensures that companies use their resources more efficiently and leads to better relations with employees, creditors, and other stakeholders. It is an important prerequisite for attracting the patient capital needed for sustained long-term economic growth.

### ***Strengthen the SCS and enforcement***

*The SCS needs greater legal power and resources*

The law should be changed to give the SCS the right to initiate criminal cases and carry out on-site inspections. The fines that the SCS may charge also need to be made larger to have a preventative effect against legal infractions.

Because its resources are currently limited, SCS should focus its enforcement efforts on “public interest entities” and larger JSCs with 100 or more shareholders. As noted below, smaller JSCs should be encouraged to become closed or limited liability companies, a process the SCS should facilitate. This renewed focus should include compliance with filing and other disclosure requirements as well as other elements of shareholder protection.

For it to carry out its duties more effectively, greater resources for the SCS are necessary. The SCS should be allowed to increase salaries for its employees in order to retain a critical number of skilled staff and to recruit qualified people from the private sector. It should seek out training for its staff, including in corporate governance, and should work with donors and other international partners to upgrade its capabilities. Part of this should include an IOSCO assessment, which would also review the SCSs governance and independence.

*The CBA should expand good practice to more banks*

The Central Bank of Azerbaijan should continue its efforts in enforcement and training for financial institutions and their board members. It should seek to ensure good practice in a wider range of banks, including compliance with reporting requirements to the public as well as other corporate governance and prudential requirements, and encourage those banks to seek help from the IFC Corporate Governance Project and EBRD.

### ***Substantially revise the law for companies and consider a new companies act***

*New or revised legislation should clarify board powers...*

Either through a revision of the Civil Code, or, preferably the introduction of a focused Act for companies, the legal framework for JSCs should be strengthened and clarified. As noted below, this should be complemented by broader legal reform for capital markets that facilitates the establishment of new market participants and protects investors during ongoing ownership consolidation.

The revised Civil Code or new Act should make explicit the relative powers of the supervisory board and management board. The supervisory board should have exclusive power to select and replace the management board and in turn the management board should clear authority for the day to day operations of the JSC. Supervisory boards should also have explicit power to approve the compensation of management board members and oversee management

performance, corporate strategy, and the process for preparing financial statements and disclosing information to the public.

*...encourage JSCs to have audit committees instead of revision commissions...*

The new or revised legislation should limit the number of large shareholders and former management board members that can sit on the supervisory board. The legislation should also explicitly note the possibility of JSCs forming audit committees composed of supervisory board members, and require a majority of members on such a committee to be independent of major shareholders and management board members. JSCs that have such a committee and an external auditor should not have a revision commission.

Related legislation for public interest entities, banks, and insurance companies should be revised and harmonized to universally call for audit committees made up of independent supervisory board members.

*...and better protect shareholders*

The new or revised legislation should give the GMS exclusive power to approve compensation for supervisory board members and include procedures on conflicts of interest consistent with the SCS regulations on RPTs and related requirements for banks. Shareholders should have preemptive rights, allowing them to buy shares first when the JSC issues new shares, and approval to issue new shares should be an exclusive power of the GMS, and not be delegated to the board.

The right of shareholders to attend the GMS and ask questions should be clear in the new law, with appropriate penalties for violation of this right. The new or revised legislation should make it easier to use proxies, and require proxies to follow written instructions from the shareholder when power of attorney is not given.

The new Act or revised Civil Code should also have stronger requirements for companies converting to a closed form, with the possibility of dissenting shareholders selling their shares back to the company or controlling shareholder for a fair price. As noted below, other kinds of “buy out/squeeze out” provisions should also be considered.

*Exempt smaller JSCs from certain requirements*

To allow for more effective enforcement and lower costs, certain provisions, including requirements to produce audited financial statements, should not apply to the smallest JSCs. Through time, all closed JSCs could be exempted from such requirements, but only after their small shareholders have the chance to sell their shares, as noted above. Alternately, closed JSCs could be phased out, with smaller JSCs becoming limited liability companies.

### ***Introduce a corporate governance code and encourage greater awareness of corporate governance***

*The code should provide practical guidance and build on current requirements for banks*

A Code of Corporate Governance should be introduced that builds on the existing rules for banks and the *OECD Principles of Corporate Governance*. It should elaborate on the duties and responsibilities of the supervisory board; emphasize equal rights for all shareholders and provide guidance on the GMS; encourage better disclosure and lead to the introduction of sound risk management policies. A more detailed list of recommendations for the code is given at the end of this section.

*Raise awareness of the importance of corporate governance*

The development and release of the code creates a great opportunity to raise awareness of the importance of good corporate governance. It should be developed through consultation with a variety of stakeholders across Azerbaijan. The Global Corporate Governance Forum’s “Developing Codes of Best Practice” toolkit provides good models of such a consultative process. The IFC Azerbaijan

<i>Expand opportunities for board member training</i>	<p>Corporate Governance Project (ACGP) and Global Corporate Governance Forum are in a strong position going forward to support the development of the code and support related work, such as seminars on corporate governance for the media.</p> <p>Developing board member independence and objectivity will require expanded training for board members and companies. IFC ACGP and the Global Corporate Governance Forum can play an important role in facilitating development of board training. Consideration should also be given to establishing a domestic institute of corporate governance. The toolkit produced by the Forum on “Building Director Training Organizations” provides useful guidance in creating such an institute.</p>
<b><i>Continue to improve disclosure</i></b>	
<i>Expand efforts to implement IFRS</i>	<p>Current efforts to implement IFRS in public interest entities, and other banks and JSCs with foreign investment should continue and expand to improve the quality of accounting more generally. This will require expanded training and awareness raising, and ensuring that companies have qualified accountants on staff.</p>
<i>Enforce disclosure requirements more vigorously</i>	<p>It will also require greater oversight of accounting and auditing. The SCS should continue its efforts to ensure that JSCs meeting filing requirements and issue annual reports, especially those open JSCs with 100 or more shareholders. It should also begin a program to selectively review the contents of these reports for JSCs that meet the definition of public interest entity.</p> <p>The Chamber of Auditors should also play a more active role in quality assurance, and expand on efforts to review compliance with audit standards. It should seek to ensure high quality audits by local firms as well as the affiliates of the major international auditors.</p>
<i>Require disclosure of ultimate ownership</i>	<p>More aggressive enforcement should include current requirements for ownership disclosure by companies. This should be supported by two legal changes:</p> <ul style="list-style-type: none"> <li>• Require disclosure of ultimate and controlling ownership, with these concepts defined in the law;</li> <li>• Require individual shareholders to disclose their ultimate and controlling ownership when they cross the 10 percent ownership threshold.</li> </ul>
<i>Make information available to the public</i>	<p>Improved enforcement, the new code, and or legal changes should also lead to more companies making their companies widely available to the public. Larger JSCs and banks should post reports on their own websites and make them available to the BSE for posting on its website.</p> <p>Companies should also report material facts, as required by law, and regulation should require that this information is passed on to the public, for example by posting on the BSE or SCS website.</p>
<i>Strengthen auditor independence</i>	<p>Current requirements in the law for auditor independence should be strengthened. Provisions removed from the Civil Code on auditors should be restored (or placed in the new companies act), empowering the GMS to choose auditors and confirming their liability to shareholders and the company.</p> <p>Rotation of the audit partner should be required after a reasonable period of time, for example 5 years, and the fees for various and all services performed by the audit firm should be disclosed the GMS and in the annual report. Moving forward, additional restrictions should be put in place to limit the non audit-work the audit firm may perform.</p>

*Protect  
whistleblowers*

Both at the company level and in national legislation, efforts should be made to protect employees that report legitimate concerns to the supervisory board or, when appropriate, regulators or the press. Receiving serious concerns from employees in confidence should be a core function of the audit committee.

*Implement 2006 A&A  
ROSC*

The 2006 Accounting and Auditing ROSC has more recommendations to improve transparency and disclosure, and these should continue to be implemented by the SCS, Chamber, and other authorities.

***Enhance the broader framework for capital markets***

*Upgrade market  
infrastructure and  
consider new listing  
rules that include a  
corporate governance  
tier*

Fully protecting investors will also require significant enhancement of market infrastructure and the broader legal framework for capital markets. Current initiatives of the SCS and BSE in this area should move forward and seek to ensure that:

- Settlement moves to DVP (delivery versus payment) and is t+3 or faster;
- Costs of trading on the exchange are competitive with off-market trading;
- Listing rules are clear and facilitate the listing of leading banks and JSCs.

To support these changes, the SCS should consider additional restrictions on off-market trading and reviewing the governance of the BSE as well as ways of enhancing the NDC and its role with the BSE.

The BSE and SCS should also consider developing a two tier listing regime. A bottom tier with basic disclosure and other requirements, and a more advanced tier for companies willing to adopt more stringent corporate governance. This would allow those companies willing to make more substantial reforms to signal to investors, which, based on experience in other countries, can lead to higher share prices and better access to capital.

*Facilitate market  
consolidation*

Given the large number of small JSCs and small shareholders resulting from privatization, consolidation of ownership will be a natural part of market development going forward. In the longer term, a law on takeovers should be introduced that protects shareholders during changes in control by making such transactions more transparent and requiring those seeking to take control of a company make public tenders to all shareholders at a fair price. Rules that allow, or require, an owner with more than 90 or 95 percent of shares to buy out other shareholders at a fair price should also be considered.

In addition, the Registry should be cleared of non-functioning JSCs and other entities.

*Develop a legal  
framework for  
institutional investors*

Long term market development will also require a greater role for institutional investors and a more effective legal framework for these investors as well as other market intermediaries. This framework should address investor and fund governance, offer basic protections to beneficiaries, and seek to limit conflicts of interest involving funds, brokers, and others. These sorts of rules would be especially important for pension funds, the introduction of which could prove a key catalyst for the market as well as a necessary savings vehicle.

### Code of Corporate Governance: Detailed Recommendations

The corporate governance code should apply to all public-interest entities as well as JSCs with 100 or more shareholders. It should be required for supervisory boards of such companies to report on compliance with the code to shareholders.

- Duties and responsibilities of the supervisory board should be an important piece of the code. The code should:
  - Lay out independence requirements for the supervisory board;
  - Include guidance on the board's role in providing strategic guidance and managerial oversight;
  - Detail board election and meeting procedures;
  - Advise on board size and profile;
  - Elaborate on board member duties, including equal treatment for all shareholders, the fiduciary duties of care and loyalty, and the duty to take into account the legitimate interests of stakeholders;
  - Encourage board member training and evaluation;
  - Hold the supervisory board for reporting on code compliance;
  - Encourage effective board composition and skills.
- The code should encourage equal rights for all shareholders. To this end, the code should:
  - Reiterate all shareholders' right to participate in the GMS and give guidance on GMS notification;
  - Advise companies to allow proportional representation or cumulative voting;
  - Encourage all board members and a representative from the external auditor to be present at the GMS;
  - Advise companies on valuing and presenting transactions that require shareholder approval;
  - Strongly encourage the adoption of codes of ethics and whistle-blowing policies.
- The code can be a key tool for encouraging better disclosure. It should:
  - Require companies to produce annual reports which should be made publicly available on the company website and elsewhere;
  - Require large companies to comply with IFRS (NAS compliance should be required for smaller firms) and their auditors ISA;
  - Encourage companies to disclose non-financial items such as beneficial ownership, all material events, and reiterate the need for disclosure of related-party transactions.
- The code should encourage the introduction of sound risk management policies. It should:
  - Encourage the introduction of sound internal controls;
  - Advise on the internal audit department and require that it reports to the audit committee of the board;
  - Advise companies to employ a reputable external auditor who will give an objective assessment of the company's overall financial situation;
  - Provide additional guidance on the audit committee, and encourage that it be composed of independent members who have financial expertise.

## Summary of Key Recommendations

Recommendation	How to be Introduced	Priority/Status
<b><i>Strengthen the SCS and enforcement</i></b>		
Increase SCS fines and powers	Changes in relevant legislation	Immediate
Increase SCS pay and resources	Changes in relevant legislation Donor assistance	Medium-Term
Improve governance at more banks	Current CBA efforts	Medium-Term
<b><i>Substantially revive the law for companies</i></b>		
Clear board powers and duties	New CA/ amend Civil Code	Medium-Term
Replace revision com. with audit com.	New CA/ amend Civil Code	Medium-Term
Clearer powers for shareholders	New CA/ amend Civil Code	Medium-Term
Stronger right to participate in GMS	New CA/ amend Civil Code	Medium-Term
Protection when going to closed or llc	New CA/ amend Civil Code	Medium-Term
Lighter rules for small companies	New CA/ amend Civil Code	Long-Term
<b><i>Introduce a corporate governance code and raise awareness</i></b>		
Finalize the CG code	Broad-based consultation Donor assistance	Immediate
Raise awareness on CG	Donor assistance	Medium-Term
Expand board training	Current efforts/donor assistance	Medium-Term
Establish a local CG institute	Donor assistance	Long-Term
<b><i>Continue to improve disclosure</i></b>		
Accelerate implementation of IFRS	Current efforts/donor assistance	Immediate
Enhance enforcement	SCS and Chamber	Immediate
Better disclosure of corporate control	Changes in relevant legislation New law on takeovers	Medium-Term
Limit auditor conflicts of interest	Changes in relevant legislation	Medium-Term
Extend diffusion of information online	New Code New legislation	Medium-Term
Formal protection for whistleblowers	New Code New law on whistleblowers	Long-Term
<b><i>Enhance the broader framework for capital markets</i></b>		
New listing regime	Current efforts/donor assistance	Immediate
New market infrastructure	Current efforts/donor assistance	Medium-Term
Facilitate market consolidation	New law on takeovers	Long-Term
Legal framework for inst. Investors	New law on investors	Long-Term

## Summary of Improvements since the 2005 CG ROSC

Since 2004, when the first Corporate Governance ROSC for Azerbaijan was conducted, Azerbaijan has undertaken a number of legal and regulatory changes that have led to improvements in the corporate governance framework. These are summarized below.

### LEGAL CHANGES

#### 2007 Law on Insurance Activity

- Requires all insurance companies to be open joint stock companies (JSCs);
- Requires insurance companies to have both supervisory boards and management boards (like banks);
- Requires insurance company supervisory boards to have revision commissions;
- Requires supervisory and management boards and other key executives to undergo fit and proper tests; administered by the Ministry of Finance;
- Requires at least one supervisory board member to be independent;
- Defines related party transactions and approval process for RPTs.

#### 2007 Law on Internal Audit

- Requires that companies establish an internal audit function that is consistent with international best practices set forth by the Institute of Internal Auditors;
- Requires creation of audit committees in all “public interest entities”.

#### 2008 Civil Code Amendment on Fiduciary Duties of the Directors

- Introduces fiduciary duties for members of supervisory and management boards;
- States that supervisory board directors can be held liable for losses caused to the company resulting from wrongful behavior.

### STATE COMMISSION ON SECURITIES REGULATION CHANGE

#### 2008 SCS Regulation on the Conclusion and the Disclosure of RPTs

- Defines related parties and the types of companies to which the regulation applies.
- Requires related parties to immediately notify the supervisory board about the nature and scope of their interest in a transaction.
- Requires that if the RPT exceeds 5 percent of the company's assets it must be executed with the approval of the GMS.
- Requires companies to disclose information on transactions exceeding 5 percent of a company's assets to the mass media and through the company's official website within five business days after the execution of the transaction.
- Requires that related parties can be held liable for losses caused to the company because of a transaction that is determined to be in violation of procedural requirements.

## Summary of Observance of OECD Corporate Governance Principles

Countries	Observed	Largely Observed	Partially / Materially Not Observed	Not Observed
<b>Azerbaijan (2009)*</b>	<b>0</b>	<b>2</b>	<b>21</b>	<b>9</b>
<b>Azerbaijan (2005)</b>	<b>0</b>	<b>0</b>	<b>25</b>	<b>7</b>
Armenia (2005)	1	1	29	1
Bosnia & Herzegovina (2006)	0	4	28	0
Bulgaria (2008)*	3	13	15	1
Croatia (2008)*	2	10	19	1
FYR Macedonia (2005)	0	9	22	1
Poland (2005)	7	12	12	1
Ukraine (2006)	0	1	28	3
<b>Average ECA (05-09)</b>	<b>1.4</b>	<b>5.8</b>	<b>22.2</b>	<b>2.6</b>

\*The ratings in these ROSCs have been converted to be comparable to the format used before 2008

Principle		FI	BI	PI	NI	NA
<b>I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK</b>						
IA	Overall corporate governance framework			X		
IB	Legal framework enforceable /transparent			X		
IC	Clear division of regulatory responsibilities		X			
ID	Regulatory authority, integrity, resources			X		
<b>II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS</b>						
IIA	Basic shareholder rights					
IIA 1	Secure methods of ownership registration			X		
IIA 2	Convey or transfer shares			X		
IIA 3	Obtain relevant and material company information			X		
IIA 4	Participate and vote in general shareholder meetings			X		
IIA 5	Elect and remove board members of the board		X			
IIA 6	Share in profits of the corporation			X		
IIB	Rights to part in fundamental decisions					
IIB 1	Amendments to statutes, or articles of incorporation		X			
IIB 2	Authorization of additional shares			X		
IIB 3	Extraordinary transactions, including sales of major corporate assets		X			
IIC	Shareholders GMS rights					
IIC 1	Sufficient and timely information at the general meeting			X		
IIC 2	Opportunity to ask the board questions at the general meeting			X		
IIC 3	Effective shareholder participation in key governance decisions			X		
IIC 4	Availability to vote both in person or in absentia			X		
IID	Disproportionate control disclosure				X	
IIE	Control arrangements allowed to function					
IIE 1	Transparent and fair rules governing acquisition of corporate control				X	
IIE 2	Anti-take-over devices				X	
IIF	Exercise of ownership rights facilitated					
IIF 1	Disclosure of corporate governance and voting policies by inst. investors				X	
IIF 2	Disclosure of management of material conflicts of interest by inst. investors				X	
IIG	Shareholders allowed to consult each other			X		
<b>III. EQUITABLE TREATMENT OF SHAREHOLDERS</b>						
IIIA	All shareholders should be treated equally					
IIIA 1	Equality, fairness and disclosure of rights within and between share classes		X			
IIIA 2	Minority protection from controlling shareholder abuse; minority redress			X		
IIIA 3	Custodian voting by instruction from beneficial owners			X		

	Principle	FI	BI	PI	NI	NA
IIIA 4	Obstacles to cross border voting should be eliminated		X			
IIIA 5	Equitable treatment of all shareholders at GMs			X		
IIIB	Prohibit insider trading			X		
IIIC	Board/Mgrs. disclose interests			X		
<b>IV. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE</b>						
IVA	Legal rights of stakeholders respected			X		
IVB	Redress for violation of rights			X		
IVC	Performance-enhancing mechanisms			X		
IVD	Access to information				X	
IVE	"Whistleblower" protection				X	
IVF	Creditor rights law and enforcement			X		
<b>V. DISCLOSURE AND TRANSPARENCY</b>						
VA	Disclosure standards					
VA 1	Financial and operating results of the company			X		
VA 2	Company objectives				X	
VA 3	Major share ownership and voting rights				X	
VA 4	Remuneration policy for board and key executives			X		
VA 5	Related party transactions			X		
VA 6	Foreseeable risk factors			X		
VA 7	Issues regarding employees and other stakeholders				X	
VA 8	Governance structures and policies				X	
VB	Standards of accounting & audit			X		
VC	Independent audit annually			X		
VD	External auditors should be accountable				X	
VE	Fair & timely dissemination				X	
VF	Research conflicts of interests				X	
<b>VI. RESPONSIBILITIES OF THE BOARD</b>						
VIA	Acts with due diligence, care			X		
VIB	Treat all shareholders fairly			X		
VIC	Apply high ethical standards			X		
VID	The board should fulfill certain key functions					
VID 1	Board oversight of general corporate strategy and major decisions			X		
VID 2	Monitoring effectiveness of company governance practices				X	
VID 3	Selecting/compensating/monitoring/replacing key executives				X	
VID 4	Aligning executive and board pay				X	
VID 5	Transparent board nomination/election process				X	
VID 6	Oversight of insider conflicts of interest			X		
VID 7	Oversight of accounting and financial reporting systems			X		
VID 8	Overseeing disclosure and communications processes				X	
VIE	Exercise objective judgment					
VIE 1	Independent judgment			X		
VIE 2	Clear and transparent rules on board committees				X	
VIE 3	Board commitment to responsibilities			X		
VIF	Access to information			X		

Note: FI=Fully Implemented; BI=Broadly Implemented; PI=Partially Implemented; NI=Not Implemented; NA=Not Applicable

## Corporate Governance Landscape

### CAPITAL MARKETS

The capital market in Azerbaijan is at an early stage of development. There are no listed companies on the Baku Stock Exchange (BSE). There are 234 companies with more than 100 shareholders, whose shares are quoted and available to trade on the stock exchange by law.<sup>7</sup> A large portion of the trades occur off exchange, mostly via notary sales contracts. According to BSE, 2008 was the first year in the exchange's history when the number of on-exchange trades surpassed those that occurred off-exchange. Though trading is still low, it has significantly increased from 2001-2, when 50-100 trades occurred annually. Total turnover on the BSE for 2008 was about 10 billion manats, which is double the turnover for the previous year. This figure compares with the volume of trades for 2004, which was \$113 million. In the first quarter of 2009, 94 percent of all transactions on the BSE were for government securities. Given no listed companies, low turnover and large and opaque off market trading, market capitalization figures are essentially meaningless in the case of the BSE. The bonds of nine companies were being traded as of April 2009. There are 12 licensed broker/dealers.

The shares of many companies are not traded on a regular basis. In the 2007 IFC survey, only seven of the companies surveyed (7.0 percent) said that their shares were traded. Within the previous year, the shares of fifty-seven of the companies surveyed (57.0 percent) had not circulated on the secondary market and thirty-six respondents (36.0 percent) did not know whether their companies' shares had been traded on the secondary market.

### OWNERSHIP FRAMEWORK

Most JSCs were formed via privatization with 15 percent employee participation. After privatization, ownership concentration has been steadily on the increase, as cash-constrained employees sold their privatization shares to controlling owners, typically at artificially low prices due to lack of a market and liquidity. The dominant owners are believed to be local business leaders, along with a few institutional investors. The state remains a significant owner. Foreign ownership restrictions on portfolio investment and in the banking sector have been recently lifted.

The concentration of ownership was confirmed in the 2007 IFC survey. In eighty-one of surveyed companies (81.0 percent), a single shareholder had controlling interest. More specifically, in fifty-six companies (56.0 percent), a single shareholder owned more than 66.7 percent of the shares and in twenty-five of them (25.0 percent), a single shareholder owned 50.0 percent to 66.7 percent of the shares.

Generally, in the few companies where one shareholder did not have a controlling interest, a small number of shareholders controlled the company. Most of the companies surveyed (76.0 percent) had minority shareholders (holding 2.0 percent or less of the shares). Within the survey sample, there was one exception to highly concentrated ownership. In that company, all of the shareholders held 2.0 percent or less of the outstanding shares.

The 2007 survey of corporate governance in Azerbaijan<sup>8</sup> also found little separation of ownership and governance in the companies surveyed. Management and supervisory board members owned in aggregate 55 percent of shareholdings in all companies surveyed. In many of the companies surveyed, the major shareholders also participated in management (36 percent) or as members of supervisory board (31 percent). Foreign investors held shares in nine of the companies surveyed (9 percent); accounting for only 4 percent of the aggregate charter capital of 99 percent of the respondents. The survey showed that, in five of the fifteen companies where management consisted of a single individual, the general directorate owned more than 20 percent of the shares. This is in violation of the Civil Code, which prohibits holders of more than 20 percent of a company's share capital from being a member of the executive body of that company.<sup>9</sup>

The survey found that ownership in non-bank JSCs was not as concentrated through family relationships as it was in the bank sector.<sup>17</sup> Seventy-seven respondents (77.0 percent) reported that their major or controlling shareholders had no outside relationships with one another. Further, eighty (80.0 percent) reported that no relatives of the controlling shareholders were members of the supervisory board or management. The major shareholders were related in fifteen companies (15.0 percent). In eight (8.0 percent), the major shareholders were affiliated through partnerships in other businesses.

**Institutional Investors:** Portfolio investment funds and private pension funds do not exist.<sup>10</sup> There are 46 banks and 30 insurance companies, which rarely, if ever, invest in companies.<sup>11</sup> A large part of the banks and insurance companies belong to an industrial-financial group, and operate and invest largely within the group. There was one foreign institutional investor active in the market as of April 2009.

In 2006, the government launched the Azerbaijan Investment Company (AIC), a fund that invests in companies outside the oil sector. AIC considers corporate governance factors when making its investment decisions. Caspian Investment

<sup>7</sup> Outside of directly negotiated trades with a specifically identified counterpart via a notary.

<sup>8</sup> Survey of Company Corporate Governance in Azerbaijan, p.16.

<sup>9</sup> Survey, p.17

<sup>10</sup> The 1997 privatization experience of both local and foreign investment funds has been negative, with the result of closure and exit of funds from the market.

<sup>11</sup> By law banks are allowed to invest up to 10% of their shares in equity. The new 2007 Law on Insurance has no such requirement.

Company is a subsidiary investment fund of AIC aimed at investing in Shari'ah compliant businesses, but it has not made any investments yet. Kazimir Partners is a privately-held investment firm with investments in two Azerbaijani banks.

Azerbaijan Investment Company (AIC): Current Investment Projects*			
Company Name	Sector	Amount Invested	Co-Investors
Milk-Pro	Agriculture (milk processing)	4.6 million manats	EBRD
Gardagh Cement	Cement/construction	13.7 million euro (10% stake)	EBRD, Holcim Group (construction services firm)
Azersun	Salt production	1.9 million manats (25% stake)	
Sangachal Garadagh Oil and Gas Terminal	Terminal for oil tankers	7.6 million manats (25% stake)	currently negotiating
Davachi Brovler	Agriculture (farming)	12 million manats (25% stake)	
Caspian International Investment Company	Investment company seeking to invest in businesses operating in non-oil sectors of the Azerbaijan economy, except for those prohibited under Shari'ah (Islamic) Law	14 million US dollars (20% stake)	Islamic Corporation for the Development of the Private Sector (ICD)
Kuwait Azerbaijan Investment	Investment company targeting non-oil sectors of Azerbaijani economy	5 million US dollars (25% stake)	Kuwait Finance House subsidiary Turkapital

\*Portfolio information from AIC website: [www.aic.az](http://www.aic.az)

## LEGAL FRAMEWORK

**Corporate legal framework.** The main laws governing JSCs are the Civil Code articles 98-108 on JSCs, and the Law on State Registration and State Registry of Legal Entities.

**Company types.** There are about 1700 open JSCs and about 200 closed JSCs. Of those, only about 200 may trade in a given year. Only open JSCs can issue shares, make a public subscription, and trade shares freely (CC §98.2, 99.1). Companies with 100 or more shareholders must trade their shares on exchange, barring directly negotiated trades via a notary. The law does not, however, preclude even limited liability companies to issue bonds traded on exchange.<sup>12</sup> Currently, there are no limited liability companies trading on the exchange, but two closed JSCs do offer bonds. All JSC fall under SCS oversight. There is no body with express oversight functions for other company forms. The minimum limit of charter capital for open JSCs (excluding banks) is 4,000 manats (approximately \$5,000) for closed JSCs – 2,000 manats (approximately \$2,500).<sup>13</sup> Closed JSCs can restrict free transfer of shares, may not issue shares publicly, and may have no more than 50 shareholders (CC §100). Banks must be established as open JCSs.

**Securities legal framework.** Articles 987-997 and 1078 of the Civil Code regulate the securities market and trading. In addition, the Law on Protection of Investor Rights on the Stock Market 2000 (amended 2002), and SCS regulations have been instrumental in providing a legal framework in the area of securities.<sup>14</sup> BSE and NDC regulations, as well as regulations on public share registers, provide the framework for the stock exchange, depository, and registry services.

**Listing rules.** The listing and trading rules of the BSE regulate operations on the stock exchange.<sup>15</sup> The BSE trading department is responsible for enforcement of listing and trading rules. BSE can de-list companies or suspend trading, but cannot impose fines. There are two listing tiers. Any legal entity may issue securities on the second tier of the BSE. Rules for the top tier were revised just as the ROSC were being finalized. As of September 2009, no companies were listed on that tier.

**Codes.** A code of corporate governance for JSCs is currently under development. A task force led by the Ministry of Economic Development has undertaken the code drafting process, and the final version should be completed by the end of 2009. The CBA has issued corporate governance banking regulation in 2004.<sup>16</sup> The Azerbaijan Bank Training Center provides valuable awareness raising and coaching services to bank administrators. International donors have actively

<sup>12</sup> There are about 8000 limited liability companies.

<sup>13</sup> Decision #224 of the Government of Azerbaijan, December 23, 2000.

<sup>14</sup> The more noteworthy SCS regulations from a corporate governance perspective are:

- SCS rules on preparation and disclosure of annual reports of investment securities issuers 2004,
- SCS rules on preventing security manipulation on the security market 2004,
- SCS rules on storing, using, and presenting overhead information on the stock market 2004,
- SCS rules on stock issue with the purpose to increase authorized capital 2004,
- SCS regulation on decreasing of authorized capital of JSC by means of stock redemption and dividends payment 2004.

<sup>15</sup> Specifically, those are: BSE rules of membership, BSE rules of security admittance to auction, BSE rules of trading, BSE clearance and settlement rules, BSE listing and delisting rules.

<sup>16</sup> CBA Regulation on Implementation of Corporate Governance Standards in Banks.

supported numerous training and technical assistance projects in the area of corporate governance and related areas. Examples include IFC's company and board engagement; work by KfW and USAID on development and implementation of corporate governance standards of banks and the associated training and implementation; and IFC and others' work with BSE and CBA on legislative initiatives, such as the CBA audit regulations. EBRD investments in banks are also helping raise the corporate governance level.

**Charters.** Some significant provisions are commonly included in the companies' charters. For example, 82 percent of the companies surveyed included in their charters such fundamental provisions as defining responsibility and authority as between management board and its chairperson or responsibilities of individual general directorate. General principles of shareholders' rights were included in the charters of seventy-three (73.0 percent) and sixty-seven (67.0 percent) had procedures for the AGM. Additionally, the charters of forty-two companies (42.0 percent) had provisions with respect to the treatment of minority shareholders in the event of a takeover or merger. On the other hand, only eighteen of the companies surveyed (18.0 percent) included in their charters a provision regarding the appointment of independent supervisory board members. Notably, even though both the law and good corporate governance practice preclude any restriction on the transfer of shares, fourteen of the companies surveyed (14.0 percent) included such restrictions in their charters. Some significant provisions were commonly included in the companies' charters.

## REGULATORY FRAMEWORK

**Securities regulator.** The SCS regulates securities and securities markets, including implementation of state legislation, creation and enforcement of regulations, control over activities of BSE, NDC, issuers and other market participants, and licensing of professional market participants and investment funds. SCS is financed by state budget.<sup>17</sup> SCS can issue regulations and rules which it makes available to the public. SCS is responsible for enforcement of all commercial legislation for JSCs, as well as on securities.

**Stock exchange.** BSE was established in 2000 as a closed JSC with 18 owners, mostly brokers. It is supervised by the SCS.<sup>18</sup> BSE can act as a depository for securities, and is the only provider of clearing and settlement services.

**Central depository.** The National Depository Center (NDC) acts as a depository and can act as a share registrar. In 2009, more than 2000 companies are using NDC as a registry, and about 300 JSCs who should be using NDC by law are not.

**Banking and other regulators.** Banks and credit companies are regulated by the Central Bank of Azerbaijan (CBA), and insurance firms by the Ministry of Finance.

**Company Registry.** In 2007, the state registry of legal entities moved from the Ministry of Justice to the Ministry of Taxation. The Ministry of Taxation is responsible for maintaining the registry, of which there are over 70,000 in Azerbaijan. JSC must file their charters, a list of initial board members, and the holdings of shareholders, at the Ministry of Taxation. In theory, companies can be stricken from the register for failing to comply with these regulations.<sup>19</sup> Since the 2005 ROSC the Registry has begun computerizing its record and is working to improve access, However getting information on most JSCs remains difficult and the Registry has limited capacity to ensure that all information is filed correctly,.

**Court.** Courts are divided into civil and economic courts. The economic court only tries disputes between legal entities and enterprises; cases where one side is an individual (not representing an enterprise) go to the general courts, even if the case concerns securities (Civil Procedures Code, §25, 26). Courts are rarely used for corporate and securities disputes. Training of judges on corporate and securities issues is also limited, though EU assistance has been planned to improve training

<sup>17</sup> Regulations of the SCS, §8, 9; Decree on ensuring operations of SCS, §4.

<sup>18</sup> Regulations of the SCS, §11.5; Civil Code, §1078-35

<sup>19</sup> Law on State Registration and State Registry of Legal Entities 2003, §5, 6, 7, 8; Civil Code, §130, 134.

## Principle - By - Principle Review of Corporate Governance

This section assesses compliance with each of the OECD Principles of Corporate Governance. Please see Methodology for Assessing the Implementation of the OECD Principles on Corporate Governance for full details.<sup>20</sup>

### 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 Implemented**

In recent years the legal framework for banks, companies, and capital markets has developed rapidly with the 1999 Civil Code—amended to include the legal norms for JSCs in 2004, the 2004 Law on Accounting, the 2004 Law on Banks, 2007 Law on Insurance Activity, 2007 Law on Internal Audit, 2008 Regulations on Related Party Transactions (RPTs) and 2008 amendments to the Civil Code on fiduciary duties for directors. These have increased legal protection for investors and, combined with other legal changes, have led to a substantial increase in Azerbaijan's Doing Business Ranking, from 97 to 33.

Whereas legislative efforts have been dynamic, enforcement has lagged behind. Poor corporate governance, transparency, and accountability conditions have stunted securities market development, curtailed foreign investor interest, precluded the formation of strong local institutional investors, and permitted the stock exchange to remain illiquid and lacking in breadth and depth. Such enforcement deficiencies can be explained by several factors. First, the legislation is relatively recent. Second, enforcement is to a large extent dependent on an eventual need for an effective state registry, court, a parallel continued privatization program, and functioning accounting and audit institutions. Finally, the markets are short of qualified and trained practitioners.

The overall environment for transparency and governance is also weak. Azerbaijan ranks in the lowest 25 percent in Transparency International and World Bank indicators in these areas.

While the overall environment remains challenging, there have been some improvements in practice since the 2005 ROSC. The CBA has improved corporate governance in banks, and the IFC, EBRD, and foreign investors have spurred better corporate governance in a small number of JSCs. A domestic institutional investor has been established, and trading on the BSE has increased, albeit primarily in fixed income government securities.

**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 Implemented**

**Legal clarity.** Discrepancies exist between the Civil Code, which applies to all commercial entities in Azerbaijan, and the Law on Banks and Law on Insurance Activity. The Civil Code should provide the broader framework for banks and insurance companies, but in practice they tend to follow the sector specific laws and the place of the Civil Code is unclear.

Legal clarity is also limited by the many different requirements for different kinds of companies. Beyond the distinct requirements for banks, insurance companies, and open and closed JSCs, there are also distinct rules for Public interest Entities and JSCs with assets of more than US\$1,000,000 and revenue over US\$500,000 (see section V). More generally the rapid pace of legal change has created a substantial gap between law and practice, with poor understanding of newer changes and ambiguity on key corporate functions and bodies, for example the roles of the revision commission, audit committee, and auditor commission.

<sup>20</sup> Principles are Fully Implemented if the OECD Principle is fully implemented in all material respects with respect to all of the applicable Essential Criteria. Where the Essential Criteria refer to standards (i.e. practices that should be required, encouraged or, conversely, prohibited or discouraged), all material aspects of the standards are present. Where the Essential Criteria refer to corporate governance practices, the relevant practices are widespread. Where the Essential Criteria refer to enforcement mechanisms, there are adequate, effective enforcement mechanisms. Where the Essential Criteria refer to remedies, there are adequate, effective and accessible remedies. A Broadly Implemented assessment is likely appropriate where one or more of the applicable Essential Criteria are less than fully implemented in all material respects. A Partly Implemented assessment is appropriate when (1) one or more core elements of the standards described in a minority of the applicable Essential Criteria are missing, but the other applicable Essential Criteria are fully or broadly implemented in all material respects (including those aspects of the Essential Criteria relating to corporate governance practices, enforcement mechanisms and remedies); and (2) the core elements of the standards described in all of the applicable Essential Criteria are present, but incentives and/or disciplinary forces are not operating effectively to encourage at least a significant minority of market participants to adopt the recommended practices; or the core elements of the standards described in all of the applicable Essential Criteria are present, but implementation levels are low because some or all of the standards are new, it is too early to expect high levels of implementation and it appears that the reason for low implementation levels is the newness of the standards (rather than other factors, such as low incentives to adopt the standards). A Not Implemented assessment likely is appropriate where there are major shortcomings. A Not Applicable assessment is appropriate where an OECD Principle (or one of the Essential Criteria) does not apply due to structural, legal or institutional features (e.g. institutional investors acting in a fiduciary capacity may not exist).

**Consistency of application.** Banks face the strongest regulation, while the SCS is challenged to enforce relevant laws and regulations for the hundreds of JSCs. Both are seen as reasonably fair and impartial. Recent reforms have improved court performance, but market participants still question their consistency and depth of knowledge on these issues.

**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: Broadly Implemented**

**Regulatory Overlap.** SCS regulations in the area of capital markets are binding to other executive bodies.<sup>21</sup> CBA and SCS both need to consult the other on regulations in areas of overlap of jurisdiction.<sup>22</sup> In practice, there is little overlap.

**Regulatory cooperation.** The CBA and SCS have a cooperation agreement in which the CBA and SCS agree to exchange information on banks and conduct mutual consultations when drafting legal acts applicable to bank activity in securities markets. Responsibility for market surveillance lies with both BSE and SCS, with BSE daily reporting to SCS.

**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 Implemented**

**Authority, integrity and resources of regulators.** SCS is funded through state budget allocations, and all collections return to the state budget. Its 2005 budget was US\$2,774,300.<sup>23</sup> SCS currently has 95 employees. The salary level of SCS is half of that of the private sector, and significantly less than the BSE or CBA. The President appoints the SCS Chairman and his deputies.<sup>24</sup> The SCS is legally subordinated to cabinet, like most other government bodies.

The authority of the SCS extends to securities issuers, brokers and other market intermediaries, the BSE and NDC. They are responsible for overseeing both securities market and corporate law for all 1,914 JSCs. Substantial resources are needed to oversee even basic legal requirements for such a large number of JSCs.

The SCS can issue regulations and rules which it makes available to the public, but the practice of public consultation on proposed regulations still needs to be developed (CC §1078-40.1).

SCS can obtain information from market participants, conduct inspections, summon witnesses, impose sanctions, participate in civil suits against violators, and suspend and terminate licenses and trading.<sup>25</sup> The SCS does not have power under the law to institute civil or criminal cases and the SCS does not carry out on-site inspections. SCS's legal department (staff of 7 in 2005) is mainly responsible for enforcement, though other departments participate as well. 226 complaints were investigated by the SCS in 2008 and 163 administrative proceedings were carried out, versus 104 carried out in 2004. SCS administrative proceedings are adjudicated by the Chairman of the SCS, and can be appealed administratively and in court.<sup>26</sup> In 2008, 96 penalties were issued against JSCs for non-presentation of annual reports and 57 JSCs were penalized for non-presentation of information and documents to SCS, and two JSCs were penalized for violation of shareholder rights. Eight JSCs were found to violate rules on execution of professional securities market activity and for violation of legislation on lotteries.

BSE can delist for breach of listing rules, and can suspend trading, but has never done so. The trading department is responsible for surveillance. BSE can issue fines only to members (brokers).<sup>27</sup>

**Courts.** The court system's enforcement of shareholder rights is impeded by lack of familiarity by judges of the issues presented in certain commercial and corporate cases, as well as the low level of shareholder awareness of their rights. However measures of court performance have improved significantly since the 2005 ROSC.

Indicators developed by the World Bank imply that the time required to enforce a standard contract in Azerbaijan is better than the region and OECD average and procedures and cost of recovery is similar to the region average. Only number of procedures is worse than the OECD average. (See Doing Business 2008 at [www.doingbusiness.org](http://www.doingbusiness.org)).

21 Regulations of the SCS, §7.1; Decree on ensuring operations of SCS, §2, 5.

22 Regulations of the SCS, §15; Civil Code, §1078-43.5.

23 Presidential Decree on Implementation of the Azerbaijan Republic Law on State Budget for 2005, of December 29, 2004.

24 Regulations of the SCS, §1, 10, 12.

25 SCS Rules on removal of violations in the securities market and conducting of supervision over the protection of the rights of investors, §3; Regulations of the SCS, §7.20, 11.16; Law on protection of investor rights on the stock market, §6, 7, 8.

26 Code on administrative offences.

27 Law on protection of rights of investors on stock market, §11.

Contract Enforcement Indicator	Azerbaijan	Eastern Europe Central Asia Average	OECD Average
Number of Procedures	39	36.4	30.8
Time (days)	237	425.2	462.7
Cost (% of debt)	18.5	23.4	18.9

## 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:**

**Principle IIA 1: Secure methods of ownership registration**

**Assessment: Partially Implemented**

**Secure share registration.** Shares can be bearer and registered, and registered shares can be certificated or dematerialized (CC§989, 990). Banks must issue shares in registered form (Law on Banks §19.3). Companies with registered shares and 20 or more shareholders must keep their shares at a private registry or at the National Depository Center (NDC), while those with less than 20 shareholders also have the option of maintaining their own share registers (CC §106-2.2, 1078-34.6). NDC acts as a depository and registry.<sup>28</sup>

In the 2007 IFC survey, 93 percent of the companies used an external registrar and only three maintained the share register internally. The NDC maintained the share registers of 58 percent of the companies surveyed. There are about 300 firms who have not registered with NDC and have more than 20 shareholders. Legal proof of ownership rights is provided by the NDC (for immaterialized shares) or a company-issued share certificate (for companies who keep their shares in physical form) (CC §1078-20.3, 1078-21). NDC keeps record of direct ownership only. Nominee ownership is recognized by law. NDC, brokers, and private registries can keep shares in the name of the nominee (CC§992-1.6, 1078-34.10, 1078-12-16). In practice, only brokers act as nominees. The concept of custodian is not defined in the law.

**Principle IIA 2: Convey or transfer shares**

**Assessment: Partially Implemented**

There are no restrictions on the transfer of shares of open JSCs. Clearing and settlement of all securities traded on the BSE is conducted by the BSE, not NDC. DVP (delivery-versus-payment) is not fully attained. Settlement is real time on a gross basis. NDC handles all share settlement, on the basis of instructions received from the BSE. Most trades are executed off-exchange. Liquidity on the exchange is extremely limited. Notably, even though both the law and good corporate governance practice preclude any restriction on the transfer of shares, fourteen of the companies surveyed (14.0 percent) included such restrictions in their charters.

**Principle IIA 3: Obtain relevant and material company information on a timely and regular basis**

**Assessment: Partially Implemented**

Access to corporate information is generally limited in Azerbaijan. By law, shareholders have the right to request from the company the register of shareholders once a year, the charter, and the annual report (CC §101-3.2, 106-2.3, 1078-43). In practice, many companies consider this information confidential, and do not share it publicly, and in some cases may not file it with the relevant regulator. Though more companies are publishing financial statements on a regular basis, according to the 2007 IFC survey, only 37 percent of respondents reported that they disclosed their annual reports and only 33 percent reported that they disclosed their balance sheets.

**Principle IIA 4: Participate and vote in general shareholder meetings**

**Assessment: Partially Implemented**

Shareholders have a general right to attend AGMs. Whether preferred shareholders are allowed to attend the AGM is left up to the company charter. Preferred shares vote on liquidation, reorganization, and issues concerning their rights, but they don't vote by law in case of non-payment of dividends (CC §106.1.3.5, 106-1.4, 106-1.5).

In JSCs with more than 100 shareholders, the law provides for a counting commission of at least 3 members. The procedures of the counting commission are left to the charter. In practice, shareholders vote by show of hands. Minutes of

<sup>28</sup> Presidential Decree #580, "About the National Depository System", of May 14, 1997.

the counting commission are added to the AGM minutes (CC §107-4).

Based on the past ROSC and 2007 IFC survey, AGMs are not always held, even in banks. It is difficult to provide a statistic on how many companies hold their AGMs, but SCS estimates at least a 30 percent failure rate. Only companies with a very large number of shareholders appear to hold AGMs regularly.

In the companies surveyed by IFC in 2007, the AGM did not commonly perform many of its conventional functions. For example, only around one-quarter of the respondents indicated that the AGM approved the annual report or appointed the external auditor.

#### Principle IIA 5: Elect and remove members of the board

##### **Assessment: Broadly Implemented**

**Process.** Supervisory boards are required in open JSCs with more than 50 shareholders. They are optional in closed JSCs. The AGM has the exclusive right to elect and can remove the supervisory board by simple majority for JSCs and 75 percent majority for banks (CC §106-1.3.1, 107). The procedures for electing supervisory board members are left to the charter.

**Cumulative voting/proportional representation.** The law does not provide for cumulative voting or proportional representation. In the 2007 IFC survey, only six percent of companies surveyed allowed cumulative voting.

#### Principle IIA 6: Share in profits of the corporation

##### **Assessment: Partially Implemented**

Dividends are proposed by the supervisory board and approved (but cannot be increased) by the AGM, and cannot exceed corporate profits (CC §106-3). There is no mandatory minimum dividend. A greater problem is the lack of profitability on the books, for a vast majority of JSCs, which are therefore not paying dividends.

18 percent of the companies surveyed by IFC in 2007 declared and paid dividends for the fiscal years 2002 through 2004. These companies had a good record of timely payment: twelve of them paid the dividends in less than fifteen days and the other six paid within two months.

Less than half of those in the 2007 IFC survey (45 percent) said that the AGM approved the declaration and distribution of dividends.

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

##### Principle IIB 1: Amendments to statutes, or articles of incorporation or similar governing company documents

##### **Assessment: Broadly Implemented**

Amendments of the company charter require 2/3<sup>rd</sup>s AGM majority in enterprises, and 75 percent majority for banks. This is an exclusive AGM right by law (CC §107.1).

##### Principle IIB 2: Authorization of additional shares

##### **Assessment: Partially Implemented**

**Issuing share capital.** The AGM authorizes changes in share capital with 2/3<sup>rd</sup>s in JSCs and 75 percent in banks (CC §107.1.1). Issuing share capital can be delegated to the supervisory board.

**Pre-emptive rights.** Pre-emptive rights exist for closed JSCs. There are no provisions for mandatory preemptive rights for open JSCs, though the company charter may specify those rights (CC §101.1, 104.2). Thus, there have been cases of share issues solely to the controlling shareholder, excluding smaller shareholders and in some cases not even informing them of the capital increase.

##### Principle IIB 3: Extraordinary transactions, including sales of major corporate assets

##### **Assessment: Broadly Implemented**

AGM decisions on reorganization and liquidation require 2/3<sup>rd</sup>s majority for enterprises and 75 percent for banks (CC §107.1.5).

**Sales of major corporate assets.** The AGM approves transactions of more than 25 percent of net assets. The information on such transactions must be disclosed, according to procedures provided in the company charter (CC §99.3). There are no provisions for external assessment of such transactions to assure that they occur at market prices.

#### 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:

**Principle IIC 1: Sufficient and timely information on date, location, agenda and issues to be decided at the general meeting****Assessment: Partially Implemented**

**Meeting deadline.** The AGM must be held annually. It is called by the supervisory board within 6 months of the financial year end (for companies without supervisory boards, by the executive body). There is no requirement by law fixing the location of the AGM, so theoretically the AGM could be held outside of the country. 10 percent of voting shares can call an EGM (CC §107-1).

**Meeting notice.** Notice must be published in the mass media 45 days before the AGM, and mailed to shareholders and nominees who assure the transmission of the information to the beneficial owners. In the 2007 IFC survey, less than half of the companies surveyed (46 percent) did comply with this requirement. According to the company survey, notices were most commonly sent to shareholders by registered mail (69.0 percent). Other methods included an announcement in the press (51.0 percent) and (less effective) an announcement at the company's office (42.0 percent).

**Information available.** The notice includes the date, time, venue, and agenda, but does not provide background information on newly nominated directors, or auditor details. In the IFC survey, the materials to accompany the notice included the agenda (92.0 percent), a description of each agenda item (49.0 percent), the annual report (47.0 percent), the financial report (43.0 percent) and supporting documents related to agenda items (33.0 percent). Most frequently (44.0 percent), the agenda was prepared by management.

**Quorum rules.** The AGM quorum is 60 percent of voting shares on first call, 40 percent on second call, and 25 percent on third and fourth call.<sup>29</sup> If four attempts to achieve a quorum in a year are not successful, the SCS may initiate court proceedings to liquidate the company.

For banks, the AGM has an exclusive right to decide on changes of charter and of capital, election and dismissal of supervisory board, sale, reorganization and liquidation of bank (decisions taken by 75 percent majority), as well as election and dismissal of auditor commission and approval of audited financials (decisions taken by 50 percent). Approval of bank investments in other entities, appointment of external auditor, and appointment / dismissal of management board can be delegated to the supervisory board. The AGM is held within 2 months of the preparation of the audited annual report. The Controller's Board, Auditor Commission, the Supervisory Board, and 5 percent voting shareholders can call an EGM (Law on Banks, §24.1, 24.3, 24.5).

**Principle IIC 2: Opportunity to ask the board questions at the general meeting****Assessment: Partially Implemented**

**Forcing items onto the agenda.** The law allows shareholders in principle to seek amendments to the agenda, but does not provide specific procedures for adding agenda items. Issues not on the agenda cannot be decided at the AGM (CC §106-1.3, 107-5.2).

In the 2007 IFC survey, shareholders of companies surveyed proposed agenda items routinely (51 percent), rarely (25 percent), or never (9 percent). Notably, 56 percent of respondents said that changes to the agenda were permitted during the meeting, if deemed necessary.

**Questions.** The law is silent on the right of shareholders to ask questions and be answered at the AGM.

**Principle IIC 3: Effective shareholder participation in key governance decisions including board and key executive remuneration policy****Assessment: Partially Implemented**

Pay for bank management and supervisory board members is approved by the AGM. In other companies, such approvals may be allowed for in the charter.

**Principle IIC 4: Availability to vote both in person or in absentia****Assessment: Partially Implemented**

**Proxy regulations.** Proxies are provided for by law and require a notarized power of attorney (CC §107-3, 362). They are sometimes used in practice. There are no requirements that shareholders must instruct proxy-holders on voting preferences of the shareholder.

**Postal and electronic voting.** The company charter can provide for voting by mail based on specific written voting

<sup>29</sup> Civil Code §107-1, 107-2. The second call is decided by the board and the information is published in the mass-media in 3 days and notice is sent about the second meeting to all shareholders or their nominees in 5 days. The second meeting should be announced during 3 days after the first one and held in period of not earlier than 30 and not later than 45 days after.

institutions for each item on the agenda (CC §107-3).

The companies in the 2007 IFC survey showed a lack of awareness of appropriate mechanisms to protect the rights of minority shareholders, including with respect to voting procedures. For example, only thirty percent of them applied proxy voting.

**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: Not Implemented**

**Classes of shares.** A JSC can issue common and preferred shares. Preferred shares cannot make up more than 25 percent of company capital. Preferred shares do not convey the right to participate in company management, but the law allows them to vote on reorganizations, liquidations, and charter amendments which change preferred share rights. Other rights of preferred shares are left to the company charter (CC §106.2, 106-1). There are no minimum dividends for preferred shares by law, though the law provides that “as a general rule, a preferred share dividend [is a]... fixed percentage of the nominal value of those shares regardless of outcomes of economic activity of a joint-stock company” (CC §106.3-4). Preferred shares are rarely used in practice.

**Ownership disclosure by companies.** Companies must disclose their shareholders with 10 percent or more holdings, in the annual report.<sup>30</sup> There is no requirement to disclose indirect and ultimate owners. The disclosure must contain the number of shares held, executive / board positions held, and (in case the owner is a legal entity), the members of its boards. Companies must disclose their holdings in related companies in the notes to their annual report (CC §124.4). SCS is responsible for monitoring and enforcement of ownership disclosure.<sup>31</sup> NDC, the State Registrar (Ministry of Taxation), private registers, and companies themselves also by law must keep ownership information.

In practice, official information on share ownership is unusually difficult to obtain in Azerbaijan. Enterprise registries are not yet publicly accessible, largely due to the absence of implementing regulations for public access—and lack of public awareness of the right to access to the information in the commercial registries. There have been no penalties by SCS on non-disclosure of ownership so far.

Fit and proper provisions for banks provide for CBA sanction of large bank owners. Specifically, banks inform CBA upon notification of any changes in the holdings of their direct and indirect 10 percent shareholders, including shareholders with “significant influence”, and enclose extensive information on the shareholder.<sup>32</sup> Banks further have investment limits by law – they cannot own entities where their equity investment is more than 10 percent of the bank capital, or total equity investment in all owned entities is more than 40 percent of bank capital (Law of Banks, §30.1, 30.2).

**Ownership disclosure by shareholders.** Ownership disclosure by shareholders is not required by law. There is no requirement that disproportionate share structures be specifically disclosed, although some of those issues may be discussed in the company charter.

**Disclosure of shareholder agreements.** Shareholder agreements disclosure is not required. Institutional investors such as AIC and Kazimir conclude written shareholders’ agreements in open JSCs, though informal agreements are common elsewhere.

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

**Principle IIE 1: Transparent and fair rules and procedures governing acquisition of corporate control**

**Assessment: Not Implemented**

**Basic description of market for corporate control.** Currently there is no takeover law or regulation that would require an investor to offer to buy all the shares of a company after buying a minimum percentage, such as 25 percent or 50 percent, and the legislation does not envisage tender offers. To date, there has been only limited trading on the Baku Stock Exchange and none included tender offers. The market for corporate control in Azerbaijan is also limited by the substantial presence of business groups, as well as by concentrated ownership. In the 2007 IFC survey, the charters of forty-two companies (42.0 percent) had provisions with respect to the treatment of minority shareholders in the event of a takeover or merger.

Control transactions of banks are carried out with CBA permission (Law of Banks, §29).

**Tender rules/mandatory bid rules.** Tender rules, mandatory tender offers, squeeze-out rules and associated fair pricing provisions are not currently mandated by law.

**Delisting procedures.** Decisions on JSC conversion from open to closed are taken by the AGM with 2/3<sup>rd</sup> majority. There

<sup>30</sup> Regulation on preparation and disclosure of annual reports of issuers of investment securities §2.2.8; Civil Code §1078-47.1.4.

<sup>31</sup> Code on administrative offences, §206, 220, 324.

<sup>32</sup> Law on Banks, §22.2, 22.3, 22.4, 22.8 & 22.9. The information includes, for a legal entity, audited financial reports for the last 3 years, auditor opinions, the list of board members, and the list of 10% stakes of banks or other legal entities in their capital; for an individual, the information filed includes a list of legal entities owned and controlled; and for both legal entities and individuals, a list of their 10% stakes in banks or other legal entities.

are no rules (beyond those for any stock exchange transaction) governing the process of buying out shares on- exchange in order to take the company private. Terms (price) of going-private transactions off-exchange are to be decided by the AGM (CC §105-1.3). In a past case, an open JSC attempted to transform itself into a closed JSC in order to eliminate a large part of its minority shareholders. SCS requested the Ministry of Justice to stay the company's registration as a closed JSC, due to the illegality of the company's actions.<sup>33</sup>

**Abuse to buy-backs/treasury shares.** Price, quantity, and disclosure of transactions where companies buy back their own shares on-exchange are not regulated (beyond those for any stock exchange transaction). Off-exchange, the price of the transaction must be approved by the AGM. There are no limits on the amount of bought-back shares, except in consideration of minimum capital requirements. Treasury shares cannot be voted and need to be either re-sold or canceled within a year (CC §105-1.5).

#### Principle IIE 2: Anti-take-over devices

**Assessment: Not Implemented**

There are no provisions on anti-takeover devices in the law. Voting caps are allowed (CC §103.6).

**Principle IIF: The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.**

#### Principle IIF 1: Disclosure of corporate governance and voting policies by institutional investors

**Assessment: Not Implemented**

Since 2005 a limited number of institutional investors have entered the market. The Azerbaijan Investment Company (AIC) has been established by the Azerbaijani government to foster development of the non-oil industry. AIC is a state-owned investment company and can do business only by directly investing in businesses. In November 2007, AIC launched a subsidiary investment fund, Caspian International Investment Company, but thus far Caspian has not invested in any projects. Kazimir Partners is a regional investor with two investments in Azeri banks.

**General obligations to vote/disclosure of voting policy.** There are no requirements and little practice.

**Special rules for institutional investors/pension funds.** There are no regulations. There are no private pension funds and mutual funds in Azerbaijan so far.

#### Principle IIF 2: Disclosure of management of material conflicts of interest by institutional investors

**Assessment: Not Implemented**

There is no disclosure of management of material conflicts of interest by institutional investors, and there are few if any institutional investors on the market.

**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.**

**Assessment: Partially Implemented**

There are no restrictions on consultation. There are no rules on acting in concert.

### 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.**

#### Principle IIIA 1: Equality, fairness and disclosure of rights within and between share classes

**Assessment: Broadly Implemented**

**Availability of share class information.** By law, information about the voting rights attached to all classes of shares should be included in the prospectus, as well as the charter. In practice, only common stock is used.

<sup>33</sup> March, 2005, "Janubtikintiservis" JSC.

**Equal rights within classes.** All shares within one class have the same rights by law.

**Approval by the negatively impacted classes of changes in the voting rights.** Preferred shares have the right to vote, together with common shares (not as a class), on any changes in preferred share rights (CC §106-1.5).

### Principle IIIA 2: Minority protection from controlling shareholder abuse; minority redress

#### Assessment: Partially Implemented

Shareholders have few effective redress possibilities.

**Ability to call meeting.** 10 percent of voting shares can call an EGM for JSCs, and 5 percent in the case of banks (CC §107-1), Law on Banks §24.5).

In the 2007 IFC survey, 16 percent of the companies surveyed had held an EGM in the last two years. Of those, six (37.5 percent) convened the meeting to seek approval of amendments to the charter, three (18.8 percent) to seek approval for the issue of new shares, two (12.5 percent) to elect board members, one (6.3 percent) to seek approval of significant transactions and one (6.3 percent) because the AGM did not meet expectations/requirements.

**Withdrawal rights.** There are no shareholder redemption rights that would allow a shareholder to demand that the company redeem his shares if he/she did not vote in favor of, for example, a charter amendment that substantially violates his/her rights or mergers, divisions or transformations or the purchase, disposal or exchange of real estate at less than book value. The Civil Code contains a very general provision that allows shareholders to request withdrawal of shares if allowed by law or company charter, but no specific procedures or conditions have been outlined (CC §105-1.1).

**Independent audit.** 10 percent of shareholders can request an inspection of the company by the revision committee and can also request a company audit (CC §106.6).

**Ability to sue to overturn meeting decisions.** A shareholder has the right to dispute an AGM decision in court, though the law does not specify the grounds for dispute (CC §107-5.4). Given the inefficiency of the court system, this right has little value to shareholders.

**Regulatory Redress.** Shareholders can turn to the SCS for protection of their rights, and instances of that have occurred. The SCS may investigate violations of laws and regulations related to companies issuing shares. Decisions by the SCS may be appealed to the court. SCS can conduct administrative hearings and impose direct penalties as a result but cannot assess damages that a company would pay to shareholders without a court decision.

The SCS fines by law are US\$28-99 for individuals and US\$99-330 for legal entities, which is relatively low for serious prevention. In 2008, 150 companies were penalized for not filing financial statements on time, and another 100 companies were penalized for other infractions. Collections are carried out via the bailiff service and this can lead to a delay in collection.

**Ability to sue directors.** Shareholders have a general blanket civil law right to a lawsuit, which in theory would apply also to supervisory board and management board members.

Signatories of disclosure documentation are responsible for the false disclosure (CC §1078-11.7). Fiduciary duties for directors and managers were introduced in 2008 (CC 49.3). Directors and company officers can be held responsible for their actions or inaction, and shareholders of the legal entity have a right to demand reimbursement of damages caused to the company by virtue of such a violation (CC 49.3). These duties are not well-defined in the law, though. Awareness is limited among management and board members.

**General court redress.** In theory, shareholders can turn to the court for redress. Disputes among legal entities are tried at the Economic Court; those where one party is an individual are tried at the general court.<sup>34</sup> Court proceedings can be prolonged and are reputed to be partial. The enforcement of shareholder rights appears to be difficult given the weaknesses in the court system, i.e., lack of familiarity by judges of the issues presented in shareholder rights cases, as well as the low level of shareholder awareness of their rights. The legislation allows direct and derivative suits, but provides no thresholds thereto (class action suits are not provided for).

### Principle IIIA 3: Custodian voting by instruction from beneficial owners

#### Assessment: Partially Implemented

The law does not provide for custodians. Nominees whose name appears in the shareholder register are required to forward the AGM agenda to beneficiary owners. Nominees must receive voting instructions from beneficiaries.<sup>35</sup> In the 2007 IFC survey, only 12.0 percent of companies included proxy voting instructions.

<sup>34</sup> Civil Procedure Code, Section 3.

<sup>35</sup> Civil Code, §107-1.4, 1078-34. Nominees must be instructed by the beneficiary owner in order to exercise any rights over the nominee shares. Nominees inform the registry within 3 days of trades they have concluded, and submit a list of beneficiary owners within 7 days of registry's request.

<b>Principle IIIA 4: Obstacles to cross border voting should be eliminated</b>
<b>Assessment: Broadly Implemented</b>
There are no shares held in depositary receipt form. Few foreign investors make portfolio investments.
<b>Principle IIIA 5: Equitable treatment of all shareholders at GMs</b>
<b>Assessment: Partially Implemented</b>
It appears that company procedures do not generally make it unduly difficult or expensive to cast votes. <b>Disclosure of voting results.</b> AGM minutes must be prepared within 3 days, signed by the Chairperson and secretary of the meeting, and disclosed to shareholders within 15 days. A copy of the minutes must be provided to a shareholder upon request (CC §107-5.3, 107-6.1, 107-6.3). The majority of the companies surveyed by IFC in 2007 (77 percent) announced AGM results to shareholders before the meeting adjourned, 12 percent sent a report to shareholders by regular mail, 5 percent sent it by registered mail and 6.0 percent used other means. Three-quarters of the respondents (75 percent) did not make the results of the AGM available to the public. Of those that did, all disclosed the results through the media.
<b>Principle IIIB: Insider trading and abusive self-dealing should be prohibited.</b>
<b>Assessment: Partially Implemented</b>
<b>Basic insider trading rules.</b> Insiders are defined as persons who currently or in the past 6 months have been members of the supervisory and management board, or are 10 percent shareholders. Also considered as insiders are others in position to obtain non-public information (including via contracts or via insiders), and persons under the influence of the management or the supervisory board. Family members of insiders are specifically designated as insiders by law. Insiders cannot trade on inside information or disclose it to third parties. <sup>36</sup> Blackout periods are not specified in the legislation. Disclosure of wrong or misinterpreted information in the equity market, and carrying out unfair advertisements is forbidden, as is instigating other persons to trade providing wrong, misinterpreted or insider information. Price manipulation, churning and similar activities are banned. <sup>37</sup> The 2004 insider trading rules may not be perfectly aligned with existing Civil Code legislation. <sup>38</sup> <b>Insider trading disclosure.</b> Insiders should file with the SCS their trades within one day. SCS may request additional information, and if such information is not provided, penalize the insider, interrupt the trade or apply to court to reverse it, as well as publish the transaction in the media. <sup>39</sup> The law is too new to foresee how it would function in practice. <b>Criminal/civil/administrative penalties.</b> SCS is charged by law with monitoring the market in order to prevent insider trading abuse. The BSE trading department prepares daily reports to SCS on trading activities, and also monitors insider trading. NDC ownership information is also used in insider trading monitoring. The law provides administrative, but not criminal, sanctions for insider trading. Professional participants should stop insider transactions after they have been cleared, and inform SCS (CC §1078-47.3, 1078-47.4).
<b>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.</b>
<b>Assessment: Partially Implemented</b>
<b>RPT disclosure rules.</b> RPT regulations are incomplete but improving. In the civil code RPTs of executive board members are disclosed to and approved by the supervisory board (CC §107-10.5). SCS Regulation approved in May 2008 outlines the requirements on RPTs applicable to companies which are neither banks or insurance companies. <sup>40</sup> Related parties can be held liable for losses caused to the company because of a transaction that was concluded in violation of procedural requirements. The liability of members of the supervisory board, members of the executive body and the heads of the structural units of the company occurs if they were or should have been aware of their interest or the interest of close relatives in the transaction but fail to disclose it. The company's executive body, supervisory board members or shareholders may apply to the court and demand the compensation of damages by the related party which did not disclose its interest in the transaction.

<sup>36</sup> Regulations on storage, use and presentation of service information in the equity market, §2.2, 3; Civil Code, §1078-47.

<sup>37</sup> Regulations on prevention of manipulations with prices in the equity market, §2.1.

<sup>38</sup> For example, Civil Code §107-10.6 requires, in a somewhat unprecedentedly strict rule per international practice, that supervisory and management board members disclose their intention to trade shares prior to the insider trade, in the media.

<sup>39</sup> Regulations on storage, use and presentation of service information in the equity market, §2.4, 2.5, 4. The additional information includes: date and venue of insider trade; whether it was a buy or sell; the identity of the sides to the trade; name of the issuer; type of the security traded, its nominal value and state registration number; and amount and price of the trade.

<sup>40</sup> SCS Regulation on the Conclusion and the Disclosure of the RPTs (May 2008).

The CBA has a detailed RPT regulation on banks, but enforcement has been limited so far to warnings and some transaction reversals upon discovery of infraction. Members of the supervisory and management boards and the auditor commission disclose to the supervisory and management boards their and their family members' major commercial interests, at a frequency and per procedures specified internally by the bank. RPTs are approved by the supervisory board, with reclusion (Law of Banks, §28). The supervisory board notifies CBA of reported or discovered conflict of interest, and calls an EGM where it presents its decisions on the issue. Related parties are defined as members of the supervisory and management board, as well as all committees, employees, their families, 10 percent shareholders in the bank and in any entities controlled by the bank. The rules also limit related loans of banks to 10 percent for loans to legal entities, and 3 percent to individuals, with the provision of full collateral coverage, on market terms (Law of Banks, §34.2.5).

Azerbaijan's Law on Insurance Activity defines related parties, and states that RPTs can be made upon approval of the supervisory board. Total volume of the transactions with all related parties cannot exceed 10 percent of the company's assets. The supervisory board may also require an opinion of the revision commission on the fairness of the transaction prior to making its decision.

Market participants opine that RPTs are prevalent especially in context of financial-industrial groups with "pocket" banks.

**RPT approval rules/rules for approval of board/AGM.** SCS Regulation (SCS Regulation art. 1.3.2) requires related parties to immediately notify the supervisory board in writing about the fact, the nature and the scope of their interest in a transaction. This includes members of the supervisory board, executive body and heads of the structural units of the company as well as their close relatives.

RPTs not exceeding 5 percent of the company's assets are executed with the approval of the supervisory board. SCS regulation does not require a director to abstain from voting if the director is interested in the transaction. If the RPT exceeds 5 percent of the company's assets, such transactions should be executed with the approval of the AGM. The AGM also approves the RPTs if half of the members of the company's supervisory board have an interest or the related party is the company's sole executive body (General Director). The AGM is to be supplied with sufficient information on the RPT submitted for approval, including names of the related parties, nature of their interest and key terms of the transaction. Decisions of the AGM are adopted by a simple majority of votes.

In the companies surveyed by IFC in 2007, the authority to approve related party transactions seemed to be shared among governing bodies: management (72 percent), followed by the AGM (32 percent) and the supervisory board (27 percent).

**Conflict of interest rules and use of business opportunities.** For JSCs, there are no specific rules on insiders using company business opportunities for personal gain, or involvement of company insiders in the ownership or governance of competitor companies. Related loans are allowed. In the case of banks, management and supervisory board members have a duty to never use a business opportunity which they learn of in their capacity as members of their bank's boards without first fully describing such opportunity to the supervisory board and offering it exclusively to their bank.<sup>41</sup>

#### 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 Implemented**

**List of relevant codes for stakeholders.** The level of awareness of corporate social responsibility is weak. There are no specific legal provisions that require that the company recognize the rights of stakeholders or encourage active cooperation with the stakeholders.

During the privatization program, employees<sup>42</sup> were entitled to obtain company shares, and many small shareholders are current or former company employees. They face the same problems that other shareholders do in exercising their rights.

Labor relations are governed by the Labor Code. An employee can join trade unions or other representative bodies or public organizations, and take part in strikes, meetings, gatherings and other mass actions.<sup>43</sup> Creditor rights are regulated by the Civil Code and the Law on insolvency and bankruptcy.<sup>44</sup> Corporate duties related to consumers are provided in the Civil Code and the Law on Consumer Protection.<sup>45</sup> Corporate duties related to the environment are outlined in the Law on Protection of the Environment and the Law on Underground Oil Exploitation.<sup>46</sup> There are no voluntary codes on stakeholder

<sup>41</sup> Regulation on implementation of corporate governance standards in banks, §7.4.2.

<sup>42</sup> State Program II of privatization; State Program on Poverty Reduction and Economic Development.

<sup>43</sup> Labor Code, §9.

<sup>44</sup> Briefly, they are, to call on and execute the debt of individual and legal entities; to claim their dues from relevant third parties; and to request the bankruptcy of the debtor.

<sup>45</sup> Briefly, those are the right to goods and services consistent with government standards; and the right to information on origin, brand name, production date, "use by" date, and other relevant information.

<sup>46</sup> Briefly, those are: to undertake measures on environmental protection; to obey limits on hazardous waste; to develop internal regulations on ecology norms (eco audit, eco passport etc); and to report periodically to the

rights.																				
<b>Principle IVB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.</b>																				
<b>Assessment: Partially Implemented</b>																				
The court and relevant Ministries are empowered to conduct enforcement and may provide redress.																				
<b>Principle IVC: Performance-enhancing mechanisms for employee participation should be permitted to develop.</b>																				
<b>Assessment: Partially Implemented</b>																				
Employees own shares through privatization, and many controlling shareholders are involved in the supervision or management of companies they have shares in. However, given the illiquidity in the market and minimal legal framework, share based compensation is not used and would be difficult to develop. There is no code and little practice regarding other kinds of performance-based pay outside of a small number of banks and other companies with foreign investment.																				
<b>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.</b>																				
<b>Assessment: Not Implemented</b>																				
Employee shareholders and the general public have the same problems accessing corporate information as do other shareholders and investors.																				
<b>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.</b>																				
<b>Assessment: Not Implemented</b>																				
<b>Whistleblower rules.</b> There are no whistleblower regulations by law and few companies have policies in this area.																				
<b>Principle IVF: The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.</b>																				
<b>Assessment: Partially Implemented</b>																				
<b>Effectiveness of bankruptcy, security/collateral, and debt collection/enforcement codes.</b> Until recently, bankruptcy and collection procedures were notoriously slow and ineffective. Some recent reforms have been introduced in the area of credit registries, leasing, and improving recovery of unpaid debts and collateral. Creditors cannot block a dividend distribution by law. Creditors have the right to call in their debt upon reduction of the charter capital of a debtor (CC §105.2). There are no early warning mechanisms for financially distressed debtors. The legal regime does not restrict trading in the company's stock when it is effectively insolvent. Standard measures developed by the World Bank confirm that since the 2005 ROSC creditor legal rights and information have improved significantly and compare favorably to other countries in the region. However, these indicators focus primarily on laws on the books and do not fully incorporate practice. (See Doing Business 2008 at <a href="http://www.doingbusiness.org">www.doingbusiness.org</a> ).																				
<table border="1"> <thead> <tr> <th>Creditor Rights Indicator</th> <th>Azerbaijan</th> <th>Eastern Europe &amp; Central Asia Average</th> <th>OECD Average</th> </tr> </thead> <tbody> <tr> <td>Legal Rights Index (out of a possible 10)</td> <td>8</td> <td>6.3</td> <td>6.8</td> </tr> <tr> <td>Credit Information Index</td> <td>5</td> <td>4.1</td> <td>4.8</td> </tr> <tr> <td>Public credit registry coverage (percent)</td> <td>3.1</td> <td>4.6</td> <td>8.4</td> </tr> <tr> <td>Private bureau coverage (percent)</td> <td>0</td> <td>17.6</td> <td>58.4</td> </tr> </tbody> </table>	Creditor Rights Indicator	Azerbaijan	Eastern Europe & Central Asia Average	OECD Average	Legal Rights Index (out of a possible 10)	8	6.3	6.8	Credit Information Index	5	4.1	4.8	Public credit registry coverage (percent)	3.1	4.6	8.4	Private bureau coverage (percent)	0	17.6	58.4
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relevant authority.

## 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:**

**Principle VA 1: Financial and operating results of the company**

**Assessment: Partially Implemented**

**Annual report.** All JSC must publish (in summary form) and submit to SCS their annual report which includes audited financial statements (§1078-43.1). The annual report must contain a balance sheet, income statement, auditor's report, the number of shareholders, a list of 10 percent shareholders (name, number of shares held, percent of capital held), 10 percent or higher holdings of the company in other legal entities; name of share register that the company uses or a note confirming that the register is being kept by the company, and information on the AGM (date, place, minutes).

There is no requirement for the annual report to include a cash-flow statement, and no rule to publish the annual accounts notes in the media.

The annual report must be filed with the SCS within 15 days of the AGM, and published in the mass media within 30 days (i.e., within 7 months of the end of the financial year).<sup>47</sup>

In practice only some non-bank JSCs publish and file full annual reports, but few larger firms may publish key figures in the press.<sup>48</sup> In the 2007 IFC survey thirty-seven respondents (37.0 percent) reported that they disclosed their annual reports and only thirty-three (33.0 percent) reported that they disclosed their balance sheets.

Banks must prepare and file with the CBA, publish in the mass media and on their webpage, and provide to shareholders as well as clients (upon request), audited consolidated financials prepared in accordance with IFRS, within 5 months of the end of the financial year. The disclosed financial information must be signed by the Chairman of the Management Board and the Chief Accountant (Law of Banks, §12, 45.1). In practice, 15-20 banks do publish annual reports.

**Consolidation.** Public interest entities and banks are required to file consolidated statements.

**Management Discussion and Analysis.** A provision requiring that companies with assets of more than US\$1,000,000 and revenue over US\$500,000 must present a report of the "state of affairs", containing plans for the following financial year, was deleted from the law 41 percent of the companies in the IFC 2007 Survey included a management discussion and analysis in their annual reports.

**Oversight, Sanctions, and Remedies.** SCS monitors compliance via inspections based on complaints received. SCS can issue notices, warnings, and fines, suspend trading, void transactions and limit company operations causing the infraction.<sup>49</sup> Last year the SCS fined over 150 JSCs for violating reporting requirements. The CBA actively monitors compliance in banks.

**Principle VA 2: Company objectives**

**Assessment: Not Implemented**

Again, the provision that companies with assets of more than US\$1,000,000 and revenue over US\$500,000 must present a report of the "state of affairs", containing plans for the following financial year was removed from the law.<sup>50</sup>

Bank supervisory or management boards must develop a strategic plan and mission statement of the bank, confirmed by the AGM, and planning for at least the following 3 years, which must be regularly reviewed.<sup>51</sup>

**Principle VA 3: Major share ownership and voting rights**

**Assessment: Not Implemented**

Companies must disclose their shareholders with 10 percent or more holdings in the annual report. There is no requirement to disclose indirect and ultimate owners. There is little compliance with these provisions currently.<sup>52</sup>

47 Regulations on preparation and disclosure of issuers' annual reports, §2.2, 3; Civil Code §107.6, 121.1, 124, 1078-43.3.

48 Market participants estimate that about 100-200 of the 1700 JSCs do so, while the SCS estimate is 25% of JSCs.

49 Code on administrative offices, §206.0.1, 206.0.5, 214, 324; Law on protection of the rights of investors, §6, 8, 9, 11.

50 Civil Code, §122.1, 125, Resolution #77 of the Cabinet of Ministers of 5 April, 2001; Decree #386 on approval, enforcement of the Civil Code and legal regulation of problems arising from them, 2000.

51 Regulation on implementation of corporate governance standards in banks, §3.

52 Regulation on preparation and disclosure of annual reports of issuers of investment securities, §2.2.8; Civil Code, §124.4, 1078-47.1.4. The disclosure contains the number of shares held, executive / board positions held, and (in case the owner is a legal entity), the members of its boards. Companies disclose their holdings in related companies in the notes to their annual report.

<p>In the 2007 IFC Survey 27 percent of the companies surveyed disclosed significant shareholders. Only four disclosed the shareholdings of the supervisory board and management. The identities of beneficial controlling shareholders (those owning more than 50 percent of the shares) were disclosed by only two of the companies surveyed.</p>
<p><b>Principle VA 4: Remuneration policy for board and key executives, and information about directors</b></p>
<p><b>Assessment: Partially Implemented</b></p>
<p>The names of the members of the supervisory board must be filed with the company register, as well as reflected in the annual report. The notes to the financial statements must contain information on salary, profit shares, reimbursements, insurance costs, commissions and other payments to supervisory and management board members. Payment for services rendered to the company other than as a board member must be reported separately. In practice, easy public access to the company register or the annual report is not yet in place and such information may be difficult for shareholders to obtain.</p> <p>In the 2007 IFC Survey only two percent of companies disclosed biographical information or remuneration details with respect to members of the supervisory board, either individually or collectively, and only three percent disclosed this information with respect to management.</p>
<p><b>Principle VA 5: Related party transactions</b></p>
<p><b>Assessment: Partially Implemented</b></p>
<p>New SCS regulation requires that companies disclose information on related party transactions exceeding 5 percent of the company's assets. These transactions must be disclosed to the SCS, the mass media and through the company's official website (if available) within five business days after the transaction is executed. The following information should be included: date of transaction; the parties of the transaction, including related parties and nature of their interest; the scope of transaction (percentage of sold or purchased goods compared to the company's net assets); and the amount and other principal terms of the transaction.</p> <p>Disclosure of RPTs are also to be made in the annual report. The National Audit Standard 33 on Related Parties (2003) introduces some rules in this regard by law, and IAS 24 (for companies filling under IFRS) also requires RPT disclosure. In practice awareness of these requirements is limited, and these transactions are not transparent.</p> <p>In the 2007 IFC survey, disclosure of related party transactions was minimal. Five percent of the companies surveyed disclosed related party transactions and four percent disclosed significant transactions. Only eighteen percent disclosed both. Seventy-three percent disclosed neither.</p>
<p><b>Principle VA 6: Foreseeable risk factors</b></p>
<p><b>Assessment: Partially Implemented</b></p>
<p>The state of affairs reports that larger JSCs are required to file should cover risk factors. Banks must address risk factors in the notes to the financial statements under IFRS 7, though the CBA reports that IFRS 7 has been difficult for banks to adapt to. The CBA plans to offer training in this area.</p>
<p><b>Principle VA 7: Issues regarding employees and other stakeholders</b></p>
<p><b>Assessment: Not Implemented</b></p>
<p>There are no specific requirements for disclosure of issues regarding employees and other stakeholders.</p>
<p><b>Principle VA 8: Governance structures and policies</b></p>
<p><b>Assessment: Not Implemented</b></p>
<p>There is no legal requirement for disclosure of a company's governance structures and policies.</p> <p>In the 2007 IFC survey, corporate governance policies and principles were disclosed to the public by only five percent of the companies surveyed, and only six percent disclosed the charters and bylaws.</p>
<p><b>Principle VB: Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.</b></p>
<p><b>Assessment: Partially Implemented</b></p>
<p><b>Compliance with IFRS.</b> The Law on Accounting 2004 requires all public interest entities to prepare their consolidated financial statements in accordance with IFRS starting January 1, 2008. These include insurance companies, investment</p>

funds, JSCs with securities traded on the stock exchange, and other commercial organizations that meet minimum thresholds for annual revenue, number of employees and or assets.<sup>53</sup> Other JSCs are free to implement IFRS or revised National Accounting Standards (NAS). The new NAS have been prepared by the Ministry of Finance and are based on IFRS, but simplified for use by local companies. Differences with IFRS are disclosed in NAS.

The Law on Accounting also requires public interest entities to post their financials on their websites, including the auditor report, publish those in the press, and provide them upon request.

Banks are required to prepare consolidated IFRS statements (Law on Banks, §43.1, 43.2, and 44.1).

In practice, Azeri financial reporting is moving slowly towards international standards. The IFC Corporate Governance Project, World Bank, and, in the banking sector, CBA are all helping some banks and JSCs implement IFRS. However IFRS are utilized minimally in the non-banking sector, usually in firms with some foreign participation. Some JSCs still use tax accounting standards. In those banks and companies that do use IFRS, the auditor may have to provide substantial guidance to facilitate IFRS compliance, and few JSCs have the internal capacity to implement IFRS on their own. It is unclear how many JSCs even know they are considered public interest entities and required to comply with IFRS.

In the 2007 IFC survey, 45 percent of the respondents reported that they prepared financial statements in accordance with IFRS, but only 15 percent of the companies surveyed disclosed a cash flow statement, which is an obligatory component in a complete set of financial statements under IFRS.

**Review/enforcement of compliance.** The SCS oversees compliance with reporting requirements by JSCs and the CBA oversees bank reporting.

**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.**

**Assessment: Partially Implemented**

**Compliance with ISA.** Azeri Auditing standards have been in the process of converging with ISA, and full ISA is to be adopted starting later in 2009, when a translated ISA become available. A 2007 regulation requires banks to comply with ISA.

**Who must be audited.** JSCs and banks must have their financial statements externally audited.<sup>54</sup> According to the 2005 ROSC “the absence of a well-developed auditing sector may hinder the effective implementation of the Law. By estimates of market participants, only 20 percent of open JSCs actually undergo an external audit.” Since that time compliance has improved, but it is not clear that all JSCs comply.

**Auditor independence.** A licensed auditor cannot be connected with the company or its shareholders / managers through property interests, or through being a prior employee of that company.<sup>55</sup> There is no mandatory auditor rotation. Auditors are not generally barred from performing other services.<sup>56</sup> Auditor fees for other services are not disclosed. In practice, audit independence is not high; some auditors help clients prepare their accounts.

**Audit committee.** Public interest entities are required to have audit committees (Law on Internal Audit 4.2). The responsibilities of the audit committee under the law include oversight of external auditor reports, the internal audit and control systems, and of risk management. However, the law is unclear on whether the audit committee reports to the GMS or to the supervisory board. The law also does not specify a required number of audit committee members, frequency of meetings, or independence criteria.

Banks have a mandatory auditor banking commission, and all JSCs have a revision commission. These are not board committees, and are discussed below.

**Requirements for oversight of audit.** Audit services are regulated by the Chamber of Auditors, a body that includes both industry representatives and members chosen by Parliament and the government. The Chamber also updates existing legal documents and drafts standards of audit, as well as ensures monitoring and enforcement. The Chamber has the disciplinary powers of warning, inspection, and de-licensing of auditors. The Chamber also resolves disputes between auditors and clients (and failing that, the conflict would proceed to the court). The Chamber can revoke an audit license only in extreme cases, namely for low quality of audit occurring at least three times in a year, for obtaining a license under false pretenses, or for gross infraction of the law.<sup>57</sup> In practice, the chamber does occasionally revoke auditor licenses and carries out inspections of audit companies. However, market participants and the 2006 Accounting and Auditing ROSC question the extent to which it effectively oversees audit quality and its capacity in these areas is limited. The CBA also oversees auditors and audits for banks.

<sup>53</sup> Azerbaijan Accounting Law 2004 2.9

<sup>54</sup> Code, §99.2, 107.6.; Law on Banks, §44; Rules on preparation and disclosure of annual reports of issuers.

<sup>55</sup> Civil Code §107.6, Law on Auditor Services §18, Code of Professional Ethics of Auditors, section 8.

<sup>56</sup> Except broker/dealer, investment adviser, or investment banking services. Civil Code §1078-28.4, Code of Professional Ethics of Auditors, sections 9 and 10.

<sup>57</sup> Law on Auditor Services, §9, 15, 19, 20; Charter of the Chamber of Auditors 1995, §1, 8.

**Audit enforcement competent/qualified.** There are a number of local audit firms, independent auditors, and a growing number of international firms: both the “big 4” and some second tier international firms. A number of banks are audited by foreign affiliates, as are other financial companies, the oil sector, and companies involved with foreign capital, use foreign firms as well. The recent growth in the activity of the foreign firms is believed to have raised audit quality, as has various efforts to train accountants and auditors. However, many market participants remain skeptical of audit quality, especially by local firms.

For banks, in addition to a standard audit report as provided by law, the auditor also prepares a statement on completeness and truthfulness and informs CBA on infractions and deficiencies. CBA may demand the replacement of a bank’s auditor and a repeat audit at the bank’s expense. CBA also inspects banks itself or via an external auditor at least once a year, and can request accounting books, documentation and other records, clarifications, as well as require from the supervisory and management board, large shareholders, employees and others all necessary information (Law on Banks, §44, 46). SCS is not involved in auditor oversight.

**Auditor qualifications.** Auditors are licensed by the Chamber of Auditors. For licensing, they must have a higher education in accounting, finance, economics or law and a minimum of 3 years of professional experience, and must have passed the professional licensing exam of the Chamber of Auditors (Law on Auditor Services, §6). Continuing education is required to maintain their license.

**Statutory auditors or similar company organs.** Companies with more than 50 shareholders must have revision committees, elected by the AGM, and functioning per provisions in the company charter. There are no rules on the number of members, but they cannot be shareholders, or members of the supervisory or management board. The revision committee does not attend supervisory or management board meetings, and there are no expertise requirements. It reports on the annual financial statements to the AGM, and can require the needed documentation from management (§107-11). It also conducts a company inspection upon the request of 10 percent of shareholders. In practice, the functions of the revision committee vary by company, and overlap with those of the external auditor. The revision committee is not an adequate replacement for a fully independent audit committee.

Banks are required to maintain an auditor commission, elected and compensated by the AGM.<sup>58</sup> The commission is composed of at least 3 members.<sup>59</sup> Meetings must occur at least quarterly, and members are under certain independence and eligibility restrictions.<sup>60</sup> The duties of the auditor commission include oversight of the external auditor reports, the internal audit and control systems, and/or risk management system (Law on Banks, §27). The auditor committee does not recommend the appointment / dismissal / compensation of the external auditor, nor review / approve RPTs or large transactions. With similar functions this committee and the audit committee of the supervisory board overlap substantially, and good practice suggest that an independent audit committee of the board would be more effective.

**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: Not Implemented**

Key provisions in the law on auditor accountability were deleted after the past ROSC and not replaced.

**Auditor accountability.** Appointment and dismissal of the external auditor is not specified for JSCs, except for banks and insurance companies, where it is to be decided by the GMS and can be delegated to the supervisory board. (The auditor in practice generally interacts with, and reports all findings to, the controlling owner, which fails to provide adequate checks and balances. Civil law allows lawsuits against auditors in principle (via a generic provision allowing general lawsuits), but there have been no cases.

**Auditor liability.** Auditors have voluntary obligations under the Code of Professional Ethics of Auditors developed by the Chamber of Auditors. Liability provisions are vaguely defined and do not realistically permit auditor lawsuits by shareholders.

**Auditor insurance.** Auditors are not required to, and typically do not, purchase auditor liability insurance.

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

**Assessment: Not Implemented**

In the recent past, corporate information was rarely available. Few companies filed their annual reports with SCS or published them. More companies are known filing and publishing (summary) reports. Full annual reports are still hard for

<sup>58</sup> Regulation on implementation of corporate governance standards in banks §5.5.7; Law on Banks §24, 27.

<sup>59</sup> For up to 4 years, and re-election is permitted.

<sup>60</sup> Members of the committee cannot be members of other governance bodies of the bank (with the exception of the AGM); cannot take other employment positions at the bank; cannot be relatives to members of the supervisory board, auditor commission and management board, or the chief accountant; and cannot be government employees (Law on Banks, §10). The committee members must have higher education in economics or law, or work experience.

most investors to obtain.

According to the 2007 IFC survey, information on company management, operations and financial condition was not readily available to potential investors. Only a little more than a half of the respondents (63 percent) indicated that this information was available to the public. Only thirteen percent published interim reports and only ten percent made such information available on their websites. Most of the companies surveyed (86 percent) reportedly did make this information available upon request. Thus, the only practical way for investors to get information was to approach the company itself.

**Material facts.** Information on main events and actions exerting an influence on the financial-economic activity of the issuer must be disclosed within 15 days of occurrence to the SCS, by law (CC §1078-43.4). There is no detailed definition of materiality or examples to guide companies in their disclosure. There is little disclosure of material facts in practice.

**Published information (papers, web).** Some banks publish their annual reports in the media and on their website and the website of the BSE. Some JSCs also publish basic annual figures in the press.

**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 Implemented**

**Disclosure of conflicts of interest by analysts, brokers, rating agencies.** Conflicts of interest or the relationship between brokers, investment management companies, and banks are not regulated. There are no analysis or rating agencies in the market. Recent regulation with a grandfather clause forbids banks to possess broker licenses necessitating the brokerage business to be operated via a subsidiary.

#### 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 Implemented**

**Basic description of board.** The executive body of a company can be collective (called "managing board" or "directorate") or individual (referred to as a "director" or "general director") (CC §107.4). The responsibilities of the management board may be contractually delegated to a third party, e.g., a commercial entity or an individual entrepreneur (CC §107.4). JSCs with 50 or more shareholders also have a supervisory board which oversees management, and members of the management board cannot sit on the supervisory board. In the 2007 IFC survey, 96 percent of the companies surveyed had a supervisory board.

By law, management powers are vested with the management board; however, in practice members of the supervisory board, usually the controlling owner or a closely related party, may micro-manage the company out of their permanent offices on company premises. The specific authorities and functioning of the supervisory board, including frequency of meetings, size, and decision-making procedures, are left to the company charter (CC §107).

The supervisory board of banks is elected and compensated by the AGM (CC §107).

The supervisory board of a bank oversees management and reports to the AGM. The board is also responsible for reporting internal violations to the AGM and the CBA, management of internal conflicts of interest, and approval of RPTs and of large transactions.

**Size requirements and typical size.** For JSCs, limits on supervisory board size are not fixed by law, but are determined by the charter. According to the 2007 IFC survey, the highest number of supervisory board members recorded was five; the average number of members was 3.4.

For banks, the minimum supervisory and management board size is 3 (CC §107, Law on Banks §25.2, 26.2). In practice, boards can have 5-7 members in larger companies and banks, and about 3 members in smaller firms.

**Eligibility requirements.** There are no foreign nationality restrictions. Members of supervisory boards of banks are subject to fit and proper criteria administered by CBA, and whose enforcement is un-assessed so far. Legal entities cannot serve as board members. Members need not hold shares to sit on the board, unless the charter so requires (CC §107-7).

Shareholders with 20 percent or more cannot sit on the management board.

For banks, members of the management and supervisory boards must have higher education in economics or law, and work experience in banking. Members of the supervisory and management board, the auditor commission and the chief accountant of the bank, cannot be members of other governance bodies of the bank (with the exception of the AGM); cannot take other employment positions at the bank; cannot be relatives to other members of the supervisory and management board, the auditor commission or the chief accountant of the bank; and cannot be government employees. In addition, supervisory board members cannot own, manage, or supervise more than three legal entities. Finally, management board

members and the chief accountant cannot be employed elsewhere (Law on Banks, §10, 25.3, 26.3).

**Adequacy of duties of loyalty and care.** Recent amendments to the Civil Code introduced fiduciary duties of care and loyalty for members of both management and supervisory boards. Board members should “act in good faith, professional and reasonable manner, be loyal to the company and all its participants, hold the interests of the company and its shareholders above his/her personal ones and have the duty of care while fulfilling their obligations for the benefit of the company he/she is representing.” Directors can be held liable for losses caused to the company resulting from wrongful behavior. (CC 49-3) Shareholders have a right to demand reimbursement of the damages caused to the company. There have been no court cases on director liability.

Fiduciary duties for supervisory board members of banks include the: duty to keep oneself informed, devote sufficient time and attention (diligence), be “prudent, circumspect and conservative”, independence (which includes not acting principally in the interest of a given shareholder group), duty of good faith, loyalty, and confidentiality and acting in the bank’s best interests. They also include the responsibility for monitoring and assessing the financial performance of the bank and ensuring that the bank is in compliance with all applicable laws and regulations including the prevention of conflicts of interest by the supervisory and management board, The sanctions for fiduciary duties in banks are in the process of being legislated – conflicts between the concept of fiduciary duties and the structure and functioning of the penal code and criminal law may render implementation difficult.<sup>61</sup> The Law on Insurance Activity does not provide for the fiduciary duties of directors. The current individual duties do not comply even with the fiduciary requirements under the CBA’s relevant regulations.

**Insurance for directors.** There is no requirement for board insurance, and it is not usually used.

**Business judgment rule/board accountability.** The Civil Code states that directors and company officers can be held responsible for their actions or inaction unless such action or inaction was made in good faith, on an informed basis and in the best interest of the company.

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

**Assessment: Partially Implemented**

There is no provision in the law requiring that supervisory board members treat all shareholders fairly. For banks, the supervisory board is mandated not to “make decisions or vote as directed by or principally in the interests of any shareholder or group of shareholders” (Regulation on implementation of corporate governance standards in banks §7.3.2)

**Principle VIC: The board should apply high ethical standards. It should take into account the interests of stakeholders.**

**Assessment: Partially Implemented**

The current framework does not provide a code or law on ethical standards for JSCs, or on protection of the interest of stakeholders. The Civil Code and the Law on Banks contain provisions, enforced by the respective regulators, on illegal activities. The regulation on implementation corporate governance standards in banks contains provisions for the creation of a Code of Ethics for bank employees.<sup>62</sup>

**Principle VID: The board should fulfill certain key functions, including:**

**Principle VID 1: Board oversight of general corporate strategy and major decisions**

**Assessment: Partially Implemented**

**Board functionality by law and in practice.** There are no detailed guidelines for the roles, responsibilities, operation, qualifications or structure of JSC supervisory boards. In practice, boards have not assumed an independent oversight function, and are considered to play a relatively minor role in providing strategic guidance for corporations. According to the 2007 IFC survey, certain key functions may be performed by the management board, including declaring and paying dividends (41 percent) and issuing shares (34 percent). Boards tend to be dominated by the controlling shareholder(s), who typically head the board. While more companies are holding regular supervisory board meetings, such meetings are still not held in a sizeable number of companies. The management board, on the other hand, tends to be stripped of some of its daily management responsibilities, instead being obliged in practice to consult on a daily basis with controlling owners, who tend to hold a permanent office at company premises.

For banks, the supervisory board by law manages strategic corporate planning, oversees management and reports to the AGM. Its other notable duties include management of conflicts of interest, and approval of RPTs and large transactions.<sup>63</sup> In

<sup>61</sup> Regulation on implementation of corporate governance standards in banks, definitions, and §7.

<sup>62</sup> Regulation on implementation of corporate governance standards in banks, §15.2.

<sup>63</sup> Law on Banks, §25; Regulation on implementation of corporate governance standards in banks, §3, 5.

practice, the effective dominance of the controlling shareholder(s) over the functioning of the governance bodies is a factor in the case of banks as well. For insurance companies, the scopes of responsibilities resemble the requirements under banking legislation.

**Principle VID 2: Monitoring effectiveness of company governance practices**

**Assessment: Not Implemented**

There are no provisions for supervisory boards to monitor corporate governance practices. Some major corporate governance practices are monitored by law in the case of banks, as part of the functional and structural requirements of bank management and governance.

**Principle VID 3: Selecting/compensating/monitoring/replacing key executives**

**Assessment: Not Implemented**

Under the Civil Code, management must be elected or dismissed by the AGM, unless the authority to do so has been reserved for the supervisory board in the company's charter.

In practice management sometimes exercises authority and responsibility generally assigned to either the supervisory board or the AGM. For example, under the Civil Code the AGM has the exclusive authority to appoint the chairperson and members of the supervisory board; however, market participants have reported cases where the management board performs this function. Moreover, thirty respondents in the 2007 IFC survey indicated that management approved its own compensation.

In the case of banks, the AGM is responsible for the hiring, compensation and replacement of management, but the power can be delegated to the supervisory board. The supervisory board reviews management performance annually by law.

**Principle VID 4: Aligning executive and board pay with long term company and shareholder interests**

**Assessment: Not Implemented**

There are no relevant provisions for JSCs as a whole. In the case of banks, one of the duties of the supervisory board by law is to assure that the company (including management) compensation system focuses on long-term corporate results, and avoids short-term profit goals.<sup>64</sup>

Only ten of the companies surveyed by IFC in 2007 had a remuneration system for supervisory board members in place.

**Principle VID 5: Transparent board nomination/election process**

**Assessment: Not Implemented**

The AGM does not play an effective role in the nomination or election of the supervisory or management boards in practice, though by law the AGM has the right to elect and remove both boards. The law does not require any background information on newly nominated directors to be provided to the AGM to facilitate their decision.

**Principle VID 6: Oversight of insider conflicts of interest, including misuse of company assets and abuse in RPTs**

**Assessment: Partially Implemented**

By law, oversight of insider conflicts of interest is only mandated for banks, not for JSCs generally. In practice, boards may lack sufficient independence from the controlling owners to effectively monitor conflicts of interest, even for banks.

**Principle VID 7: Oversight of accounting and financial reporting systems, including independent audit and control systems**

**Assessment: Partially Implemented**

For JSCs, the charter specifies the persons responsible for signing off the financial statements, and they carry liability for false information.<sup>65</sup> Criminal liability is added, in the case of false information in the prospectus.<sup>66</sup> The supervisory board does not have to certify the truthfulness or otherwise of the information within the financial statements.

In the case of banks, the management board as a whole is responsible for financial reporting systems and the chairman of

<sup>64</sup> Regulation on implementation of corporate governance standards in banks, §15.1.

<sup>65</sup> Civil Code, §1078-11.7; Rules on preparation and disclosure of annual reports of issuers of investment securities, §2.4.

<sup>66</sup> Criminal Code, §203, 211, 212, 213.

the management board and the chief accountant certify the veracity of the financial statements. It is required to establish systems that clearly allocate responsibility and accountability.<sup>67</sup> The supervisory board is responsible for the oversight of financial reporting and audit systems. The auditor commission bears independent responsibility on those, as well.

Management, not the supervisory board, in a significant proportion of the companies surveyed by IFC in 2007 had the authority to select the external auditor (57 percent) and approve the annual report and financial statements (54.0 percent).

#### Principle VID 8: Overseeing disclosure and communications processes

##### Assessment: Not Implemented

The process of disclosure and communications is not included by law among the duties of the JSC supervisory board. In practice, there is little disclosure and communication that companies engages in.

#### Principle VIE: The board should be able to exercise objective independent judgment on corporate affairs.

**Principle VIE 1: Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.**

##### Assessment: Partially Implemented

**Director independence in law.** There are no independence provisions for the supervisory board members by law. Members of the management board cannot sit on the supervisory board. Shareholders with 20 percent or more cannot sit on the management board. In the case of banks, members of the supervisory board, auditor commission and management board, as well as the chief accountant, cannot be members of other governance bodies of the bank (with the exception of the AGM); cannot take other employment positions at the bank; cannot be relatives to members of the supervisory board, auditor commission or management board, as well as chief accountant; and cannot be government employees.

The Law on Insurance Activity states that for insurance companies, at least one member of the supervisory board has to be independent. The independence criteria, however, do not require an absence of any employment links to the company, association with the auditor, or status as a significant customer of the insurance company.

**Director independence in practice.** In practice, supervisory boards tend to be beholden to controlling owners. A few companies have introduced independent supervisory board members, but the practice is not widespread. Companies complain that the country still lacks viable candidates for independent directorships.

In seventy-eight percent of the companies surveyed by IFC in 2007, major shareholders and persons affiliated with them were members of the supervisory board. Notably, the supervisory boards of eighteen of the companies surveyed (18 percent) were comprised entirely of major shareholders and affiliated persons. As a group, major shareholders and persons affiliated with them represented 48 percent of all supervisory board members. Minority shareholders were represented on the supervisory boards of 53 percent companies surveyed, comprising 27 percent of all supervisory board members in the companies surveyed. The next largest group among all supervisory board members in the companies surveyed was representatives of state or regional authorities (two percent).

Independent members served on the supervisory boards of twenty-eight percent of the companies surveyed and five percent respondents claimed that the supervisory board was comprised entirely of independent members.

#### Principle VIE 2: Clear and transparent rules on board committees

##### Assessment: Not Implemented

**Audit committees.** The Law on Internal Audit requires creation of audit committees in “public interest entities”, but not for other companies. Most JSCs do not have audit committees but do have revision commissions, which are chosen by shareholders and made up of people with no connection to the company but who review financial statements. In practice, revision commission duties tend to overlap with those of the external auditor.

Auditor commissions composed of members independent of the supervisory board elected by shareholders are required for banks only, though they share some functions with the revision commission. Auditor and revision commissions are described in detail in section VC.

**Other committees.** In JSCs, the law does not require other committees, and there is no practice establishing such committees. Some of companies in the IFC survey reported that they had established committees. The most prevalent existing committee was the ethics committee (28 percent), followed by the conflict resolution committee (24 percent), the corporate governance committee (18 percent) and the strategic planning committee (12 percent). Only 10 percent had established an audit committee, but, 26 percent planned to do so.

<sup>67</sup> Regulation on implementation of corporate governance standards in banks, §8.3.

For banks, several committees are required at the level of the management, not supervisory, board. Specifically, the law mandates that the supervisory board, in consultation with the management board, establishes the following committees: for the purpose of effective implementation of credit risk management processes Credit Committee, for the purpose of effective management of liquidity and funds Assets and Liabilities Management Committee, for the purpose of secure and effective functioning of Information Technologies of the bank, Information Technologies Committee may be appointed (Regulation on implementation of corporate governance standards in banks, §5, 10). In banks with total assets above US\$6 million or having a branch network of more than three branches, a Risk Management Committee is established to coordinate the activities of internal committees and manage other risks. 10-12 banks have already started implementing these legal requirements.

### Principle VIE 3: Board commitment to responsibilities

#### Assessment: Partially Implemented

**Restrictions on the number of board seats.** There are no legal restrictions on the number of board seats held by supervisory board members. For banks, a supervisory board member cannot be an owner, manager, or supervisor in more than 3 companies.

**Board meeting requirements.** The Civil Code requires a minimum of quarterly supervisory board meetings. (Civil Code 107-9.1) Quorum is at 50 percent of members. JSCs as a rule do not hold frequent regular supervisory board meetings. For banks, supervisory boards must hold at least quarterly meetings. It is difficult to estimate the frequency of board meetings in banks in practice.

In the 2007 IFC survey, supervisory board meetings were most frequently held two to three times a year (31.0 percent), followed by once a year (29.0 percent). Only 26 percent of the companies surveyed met the minimum requirement for number of supervisory board meetings, and 8 percent indicated that the supervisory board met monthly. Nearly half of the respondents (48 percent) indicated that supervisory board meetings lasted one hour; the average duration was sixty-two minutes.

In the companies surveyed by IFC in 2007, the number of management meetings per year reportedly ranged from one to fifty. This wide range can be attributed partly to the lack of any minimum legal requirement with respect to the number of meetings and partly to each respondent's definition of a formal meeting. Roughly a quarter of the companies surveyed (22 percent) indicated that management met only once per year. Fifteen (15 percent) reported that management met quarterly and thirteen (13 percent) held meetings monthly.

**Performance Evaluation.** Only 36 percent of respondents to the 2007 IFC survey claimed that their supervisory boards had conducted a self-evaluation in the last two years. The concept is quite new in Azerbaijan and therefore, the 36 percent figure may be inflated.

**Director training, IOD.** No code of corporate conduct has been developed to assist supervisory board members in their duties and there are no institutions responsible for formal training of supervisory board members for JSCs. In the banking sector, such tools are actively used. The corporate governance regulations of the CBA have the force of law over banks, and the Azerbaijan Bank Training Center provides valuable awareness raising and coaching services to bank administrators.

**Public availability of board attendance.** Supervisory board members are not required to disclose their attendance at board meetings. Minutes of board meetings and board attendance are not available publicly.

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

#### Assessment: Partially Implemented

For JSCs, there are no special provisions in the law on supervisory board access to information or professional advice.

Less than half of the companies that responded to the IFC survey provided supervisory board members with adequate information within a reasonable time prior to board meetings. Only 41 percent furnished notice of meetings and related materials more than two weeks in advance. Roughly one-third (28 percent) usually provided notice and materials one week in advance, and 13 percent did so one to two weeks before meetings. Some distributed the materials one day in advance (6 percent) or at the meetings (2 percent); others had no established practice for distributing materials in advance (6 percent). The materials most commonly provided to supervisory board members in advance of meetings were an agenda (82 percent), minutes of the last meeting (63 percent), financial statements for the last reporting period (59 percent) and an explanation of each agenda item (36 percent). Only 29 percent included draft resolutions for items subject to approval at the meeting.

In the case of banks, supervisory boards (but not individual members) have access to all requisite information from the management board. The Regulation on implementation of corporate governance standards in banks provides a detailed list of information that the management board and various committees distribute at supervisory board meetings (§5.2).

## Azerbaijan Terms/Acronyms

<b>ACGP:</b> IFC Azerbaijan Corporate Governance Project
<b>AIC:</b> Azerbaijan Investment Company
<b>BSE:</b> Baku Stock Exchange
<b>CBA:</b> Central Bank of Azerbaijan
<b>CC:</b> Civil Code
<b>CEO:</b> Chief executive officer
<b>CSR:</b> Corporate Social Responsibility
<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 percent of the votes and another with 20 percent. 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 percent) for one board member, thereby allowing his/her chosen candidate to win that seat.
<b>EBRD:</b> European Bank for Reconstruction and Development
<b>EGM:</b> Exceptional General Meeting
<b>ESOP:</b> Employee Stock Ownership Program
<b>GMS:</b> General meeting of shareholders
<b>GDP:</b> Gross Domestic Product
<b>IFC:</b> International Finance Corporation
<b>IFRS:</b> International Financial Reporting Standards
<b>IOSCO:</b> International Organization of Securities Commissions
<b>IPO:</b> Initial Public Offering
<b>ISA:</b> International Standards on Auditing
<b>JSC:</b> Joint Stock Company
<b>LR:</b> Listing Rules
<b>NAS:</b> National Accounting Standards
<b>NDC:</b> National Depository Center
<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>PS:</b> Permanent Secretary
<b>Pyramid Structures:</b> Pyramid structures are structures of holdings and sub holdings by which ownership and control are built up in layers. They enable certain shareholders to maintain control through multiple layers of ownership, while at the same time they share the investment and the risk with other shareholders at each intermediate ownership tier.
<b>RPT:</b> Related party transaction.
<b>SCS:</b> State Commission for Securities
<b>Shareholder agreement:</b> An agreement between shareholders on the administration of the company, shareholder agreements typically covers rights of first refusal and other restrictions on share transfers, approval of related-party transactions, and director nominations.
<b>SOE:</b> State owned enterprise
<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
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Contact us at [CG-ROSC@worldbank.org](mailto:CG-ROSC@worldbank.org)