



THE WORLD BANK

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

Corporate Governance

## Corporate Governance Country Assessment

Croatia

March 2008

# Overview of the Corporate Governance ROSC Program

## WHAT IS CORPORATE GOVERNANCE?

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

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

## WHY IS CORPORATE GOVERNANCE IMPORTANT?

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

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

## THE CORPORATE GOVERNANCE ROSC ASSESSMENTS

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

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

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

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

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

## Corporate governance country assessment

Croatia

March 2008

### Executive Summary

This report assesses Croatia's corporate governance policy framework for publicly traded companies. It highlights recent improvements in corporate governance regulation, makes policy recommendations, and provides investors with a benchmark against which to measure corporate governance in Croatia. It is an update of the 2001 Corporate Governance ROSC.

**Achievements:** Since 2001, Croatia has undertaken substantial legal and regulatory change that has led to a number of improvements in the framework for corporate governance. This includes, the introduction of Acts on Takeovers and the Securities Markets, substantial amendments to the Companies Act, and the creation of a single supervisory agency for capital markets, insurance, and private pensions (HANFA). The two stock exchanges were recently merged and a Code of Corporate Governance introduced. Reform continues as Croatia works towards joining the European Union. The real economy has also performed well, valuations have risen rapidly, and investment fund assets are growing strongly.

**Key Obstacles:** Substantial challenges still remain. The legal framework contains some critical gaps, especially with regard to conflicts of interest. Too many companies are not meeting legal requirements for disclosing financial and other information, including related party transactions and ultimate (beneficial) ownership. Supervisory boards play a secondary role in the companies they are supposed to supervise. The rise of financial conglomerates and a trend towards ownership consolidation in privatized companies present substantial long run corporate governance challenges.

**Next Steps:** As Croatia continues its aggressive pace of reforms, it will need to close remaining legal gaps, strengthen HANFA, and ensure that companies meet their current statutory requirements and begin to apply the new Code. In addition to improving the corporate governance framework, many of these reforms are necessary for Croatia to fully implement EU Directives on companies and financial markets.

Priority reforms include: changing company law to address conflicts of interest and protect small shareholders during delisting; effectively enforcing requirements for disclosure of related party transactions and indirect ownership; ensuring that annual reports are publicly available; encouraging investment funds to become proponents of good governance; and providing donor support to strengthen HANFA.

## **Acknowledgements**

This assessment of corporate governance in Croatia was conducted in May 2007 by David Robinett and Vidhi Chhaochharia of the Corporate Governance Department with Sue Rutledge and M. Can Atacik of Private and Financial Sector Development, Europe and Central Asia Region, as part of the Reports on Observance of Standards and Codes Program. It has been revised to reflect legal changes that were enacted later in 2007.

The ROSC was based on a corporate governance template-questionnaire completed by Divjak, Topic, & Bahtijarevic. Myla Taylor Williams, Richard Symonds, Marie-Laurence Guy, Sanja Madzarevic-Sujster, David Nagy, Alex Berg, Michael Edwards, and Eric van der Plaats provided advice and comments.

The assessment reflects technical discussions with the Ministry of Finance, Croatian Financial Services Supervisory Agency, Croatian National Bank, Commercial Court—Zagreb, Delegation of the European Commission, Zagreb Stock Exchange, Central Depository Agency, FINA, Croatian Privatization Fund; legal experts, and representatives of companies, banks, and market participants.

# Table of Contents

<b>Market profile</b> .....	1
<b>Key issues</b> .....	3
<i>Investor protection</i> .....	3
<i>Disclosure</i> .....	4
<i>Company oversight and the board</i> .....	6
<i>Enforcement</i> .....	7
<b>Recommendations</b> .....	8
<b>Summary of Key Recommendations</b> .....	12
<b>Summary of Observance of OECD Corporate Governance Principles</b> .....	13
<b>Corporate Governance Landscape</b> .....	15
<i>Capital markets</i> .....	15
<i>Ownership framework</i> .....	15
<i>Legal Framework</i> .....	17
<i>Regulatory Framework</i> .....	18
<b>Principle - By - Principle Review of Corporate Governance</b> .....	19
<i>Section I: Ensuring The Basis For An Effective Corporate Governance Framework</i> .....	19
<i>Section II: The Rights of Shareholders and Key Ownership Functions</i> .....	21
<i>Section III: The Equitable treatment of Shareholders</i> .....	27
<i>Section IV: The Role of Stakeholders in Corporate Governance</i> .....	29
<i>Section V: Disclosure and Transparency</i> .....	31
<i>Section VI: The Responsibilities of the Board</i> .....	35
<b>ANNEX: Summary of Improvements since the 2001 CG ROSC</b> .....	41



## Country assessment: Croatia

This update of the 2001 Croatia 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. Related recommendations are presented in the 2007 Accounting and Auditing ROSC for Croatia.

Croatia has experienced rapid and substantial reform over the last decade. New institutions have been created and the roles of private ownership and market forces have expanded. This rapid pace of reform has continued to meet the various requirements for membership in the European Union (EU). Since the 2001 ROSC there have been substantial legal and regulatory changes, many of which address shortcomings identified in the 2001 assessment<sup>1</sup>.

However, substantial challenges remain. The legal framework contains critical gaps on potential conflicts of interest. Not enough companies provide full financial statements to their shareholders or the public, and there is insufficient disclosure of related party transactions and ultimate ownership. Supervisory boards take a secondary role in the companies they are supposed to supervise. Looking forward, the rise of financial conglomerates and a trend towards ownership consolidation in privatized companies will present substantial corporate governance challenges.

### Market profile

*The merger of Croatia's two stock exchanges coincided with a bull market and surge of popular interest in buying stocks*

Until recently Croatia had two stock exchanges: the Varaždin Stock Exchange and the Zagreb Stock Exchange (ZSE). In March 2007 the exchanges merged, retaining the name of the ZSE. Following the merger, the ZSE had 454 securities worth a total of 343 billion Kuna (HRK) (~65.17 billion US dollars).

Croatia experienced a bull market in 2007: market capitalization on the ZSE increased 78 percent, turnover 57 percent, and the CROBEX index of stock prices 63 percent. The market peaked in early 2008, with prices giving up some of their earlier gains.

2007 market capitalization approached 100 percent of GDP, one of the highest ratios in the region. Other measures of equity market development, including turnover, are relatively low. There were seven IPOs in 2007, but many companies are still somewhat reluctant to tap capital markets, despite the high valuations implied by current equity prices.

*The exchange has four tiers, only 9 companies meet the requirements of the top two*

The stock market comprises four segments: the Official Market, the Regular Market, and the JDD Market, and the Parallel (or Free) market. The law defines public companies and requires all public companies to list on one of the top three tiers. This includes all companies with more than 100 shareholders and paid-in capital above 30 million HRK (~5.5 million US dollars).

The Official Market is considered the top-tier and has eight issuers. The Regular Market has one. Issuers on both tiers are required to meet a range of requirements, including a free float of at least 15 percent of shares. They are the only issuers

<sup>1</sup> The Annex reviews the changes made since the 2001 Corporate Governance ROSC.

	willing and able to meet such requirements.
<i>Most companies on the exchange are “JDDs”, listed by legal requirement and meeting basic standards for disclosure</i>	<p>The JDD market is comprised of those public companies that do not meet the requirements of the Official or Regular market. There are 248 companies on the JDD, including some larger companies that have a free float below 15 percent. Trading of JDD stocks is limited.</p> <p>Parallel or Free Market segment allows for trading in securities issued by companies that are not considered public, not required to list, and that do not meet any sort of listing requirements. Since the merger of the two exchanges the number of issuers on the parallel market has declined from 223 to 112. This report focuses on public companies listed on the other tiers.</p>
<i>There are hundreds of thousands of small shareholders, but control remains concentrated</i>	<p>Many public companies are fully or partly privatized (former) state owned enterprises (SOEs). Privatization has been carried out through employee and management buy outs, vouchers granted to veterans and others affected by the war, sale of direct stakes to strategic investors, and more recently, sales of discounted shares to the general public. INA, the former national oil company, alone has over 45,000 shareholders. There are approximately 500,000 shareholders across Croatia.</p>
<i>The state retains significant stakes in over 200 companies, including some of the largest</i>	<p>State ownership remains extensive. There are over 100 companies that have majority government ownership, and approximately 100 companies that still have 25 to 50 percent government ownership. This includes some of the largest listed companies. Estimates of GDP produced by SOEs range as high as 40 percent.</p> <p>The Privatization Fund represents the state as shareholder in most of these companies, though in some of the larger strategic enterprises influence is exerted directly by the relevant ministries.</p>
<i>Foreign controlled companies hold 90 percent of banking assets</i>	<p>Foreign investment plays a significant role in the corporate sector. Foreign strategic investors control INA, Pliva (a major producer of pharmaceuticals) and a number of other companies. They dominate the banking sector: foreign controlled banks hold over 90 percent of banking assets. Foreign investors are also an important source of portfolio investment, facing no legal restrictions on investing in Croatian shares.</p>
<i>Investment funds are growing rapidly in number and assets</i>	<p>Croatia has a rapidly growing pension and investment fund industry. This includes the four mandatory pension funds (OMFs) to which all employees must contribute, sixteen voluntary pension funds that remain relatively small, and over eighty open and closed end investment funds. The latter have been growing rapidly, by some estimates 200 percent a year, and now have more assets under management than the OMFs. The OMFs have tight restrictions regarding their investments and potential conflicts of interest. The investment funds face much lighter regulation. Both types of funds have been increasing their holdings of equities, both directly and through investments in other funds.</p>
<i>Financial conglomerates dominate banking and other financial services</i>	<p>Banking and financial intermediation are dominated by financial conglomerates that generally combine traditional banking with brokerage and custody services, investment banking, and investment fund management. They hold stakes in the OMFs (which must be organized as separate companies) and have long-term marketing agreements with insurers. They also trade on their own account.</p>
<i>The legal framework is rooted in the continental tradition</i>	<p>Croatia is a civil law country strongly influenced by the German and Austrian legal traditions. More recently it has been adapting its legislation to the norms of the EU. Key legislation includes the Companies Act (CA) and Securities Market</p>

*and experiencing rapid change to meet EU requirements*

Act (SMA). Changes to the legal framework are frequent: the CA was amended extensively in 2003 and again in 2007, the SMA in 2006. Over the last few years, essentially new acts on Accounting, Auditing, and Bankruptcy have been introduced. Additional legal changes are planned as negotiations with the EU continue<sup>2</sup>.

*HANFA is the combined non-bank financial regulator*

The Croatian Financial Services Supervisory Agency (HANFA) was formed in 2006 from various regulatory agencies as the non-bank financial regulator, and has authority over issuers, financial intermediaries, pension and investment funds, and insurance companies. The Croatian National Bank (HNB) regulates banks.

*A “comply or explain” corporate governance code has been introduced*

2003 amendments to the CA require public companies to note their compliance with a code of corporate governance. HANFA and ZSE jointly issued the Code in April 2007. The Code focuses on disclosure, the general meeting of shareholders, the management board and the supervisory board and covers many aspects of good corporate governance consistent with OECD Principles. It includes a questionnaire in the back to facilitate companies meeting the “comply or explain” requirement.

HNB is also in the process of preparing a corporate governance code for banks not listed on the ZSE. It remains to be seen what impact these codes will have in terms of informing investors or encouraging better corporate governance.

## Key issues

The following sections highlight the principle-by-principle assessment of Croatia’s compliance with the OECD Principles of Corporate Governance. Incomplete compliance with relevant EU Directives is also noted, and discussed more extensively in the following corporate governance landscape (pg 19). The Annex provides a summary of changes since the 2001 Corporate Governance ROSC.

### Investor protection

*Basic shareholder rights are in place...*

Basic shareholder rights are in place in Croatia. Registration is secure and dematerialized through the Central Depository Agency (SDA). The ability of the management board to block share transfers under the CA (*vinkulation*)—a major violation of shareholder rights identified in the 2001 Corporate Governance ROSC—is no longer allowed for public companies, and shares are freely transferable. Shareholders can demand a variety of information directly from the company and have a clear right to participate in the general meeting of shareholders (GMS) either in person or by proxy and to nominate, vote for, and remove supervisory board members. Changes to the company articles, increasing authorized capital, payment of dividends, and major transactions all require shareholder approval at the GMS.

*...but are limited by legal loopholes and certain company*

However, shareholders also face legal and practical limitations on their rights. Shareholders have pre-emptive rights to capital increases, but these may be waived by  $\frac{3}{4}$  of shareholders at the GMS or by the articles of the company.

<sup>2</sup> Some of these changes occurred after the initial draft of this report, and included some recommendations made at that time. The report has been updated to reflect all relevant legal revisions on or before March 31, 2008. However compliance cannot be fully assessed, as many of these changes were too recent for implementation by the private sector

*practices*

Shareholders also need a ¾ majority to remove board members, and again this can be limited by the company's articles. They cannot participate in the GMS by mail or electronically. Companies have also been able to use subterfuge to impair shareholders rights, for example hindering shareholder participation in the GMS or using treasury shares (i.e. shares bought back by the company) to increase the voting power of the largest shareholders.

*Provisions on conflicts of interest in the Companies Act are minimal*

The most serious threat to shareholder rights comes from related party transactions and other conflicts of interest involving board members or other corporate insiders. Provisions in the CA regulating conflicts of interest are minimal. This in turn undermines disclosure requirements for related party transactions, which are not implemented in many companies. Critically, ultimate ownership or mechanisms of control are also not fully disclosed, obscuring who may benefit from the company's actions and providing potential concealment conflicted decisions.

The new Code does address conflicts of interest and related party transactions, but does not address them in sufficient detail, is voluntary, and remains untested in practice.

*Conflicts of interest are also a potentially serious problem in banks and other market intermediaries*

Another weakness is potential conflicts of interest involving funds and financial intermediaries. While regulation has been adequate to date, the rapid growth of the investment fund industry combined with the dominant position of the financial conglomerates raises potential for serious conflicts of interest between the interests of beneficiaries and other clients of the typical bank. Similarly, the rules in the SMA on "privileged information" and insider trading by company insiders or financial intermediaries are unclear to many market participants and not fully implemented.

The lack of legal provisions on conflicts of interest, and incomplete implementation of rules on privileged information and insider trading, is not consistent with the EU Directives on Market Abuse and Annual Accounts. They will need to be addressed as negotiations move forward.

*Shareholders have benefited from an active market in corporate control*

One law that has benefited shareholders is the Law on Takeovers of Joint Stock Companies. Control has changed in a number of companies in recent years, and the would-be acquirers have disclosed their intentions and made equitable bids to other shareholders under that law. Small shareholders have also benefited from the requirement that public companies, including those with more than 100 shareholders and 30 million HRK, in assets be listed and meet basic disclosure requirements.

*But future changes in ownership and listing may be to their detriment*

However, many companies currently listed do not plan on staying that way forever and will seek to reduce the number of their shareholders. It is also anticipated that mandatory listing will ultimately be phased out. This coming consolidation in ownership raises critical corporate governance challenges.

Currently, a single shareholder with 95 percent of shares may squeeze out other shareholders by offering them an "adequate" price. This price is regularly disputed in court. There is no comparable sell out right for shareholders and no practice with protecting shareholders during delisting.

## Disclosure

*Summary financial statements are*

Public companies in Croatia have a number of disclosure requirements they are supposed to comply with. In practice, most companies do produce summary

*available online, full statements are much harder to access*

statements that are available online. These are missing a range of relevant non-financial information, including company objectives, foreseeable risk factors, stakeholder issues, and information related to conflicts of interest, related-party transactions, and beneficial (ultimate) ownership. Many banks and some other large companies do produce full financial statements that are available to the public.

*IFRS was introduced in 2000 and is still not fully implemented*

International Financial Reporting Standards (IFRS) were mandated for Croatian companies in 2000. However, IFRS have never been widely implemented in Croatia. This stemmed from substantial delays in translation, a lack of professional capability, the range of inconsistent disclosure requirements companies were supposed to comply with, and an unrealistic mandate that all companies, large and small, comply with full IFRS. Critically, the legal and regulatory capacity was not in place to ensure IFRS compliance, even by listed companies.

*New acts on Accounting and Audit fix some problems, but lack credible enforcement*

Over the last two years new acts on Accounting and Audit have been introduced to ensure that companies do produce quality financial statements audited in compliance with international standards. The acts address some key weaknesses, for example requiring the development of less demanding standards for smaller, non-listed, companies. However, they lack a strong enforcer. Only recently was HANFA given explicit authority to ensure that public companies produce full IFRS statements, however, their capacity to do so remains limited. For a more detailed review of legal requirements and practice, see the 2007 Accounting and Auditing ROSC.

*Disclosure of related party transactions and beneficial ownership is poor*

Full compliance with IFRS requires disclosure of the company's ultimate ownership and related-party transactions. Neither is disclosed sufficiently, and the lack of disclosure increases shareholder vulnerability to conflicted decision involving board members and other corporate insiders.

Information on the top ten direct shareholders is available online for all listed companies. However, this includes custodians who do not have to report the holdings of their various clients, and does not include the ultimate owners of foreign or domestic legal persons. The acquisition of direct or indirect control of 10 percent, 25 percent, 50 percent or 75 percent of capital is supposed to be disclosed, but in practice only direct ownership is disclosed. Confidential shareholder agreements are also employed that may further obscure corporate control.

In addition to the general problems of IFRS compliance, reporting of related party transactions is undermined by a lack of basic requirements on conflicts of interest in the CA, which in turn limits the ability of companies to know when a related party transaction is taking place.

Poor reporting of related party transactions and ultimate ownership is not consistent with EU directives on Transparency and Annual Accounts. Both will need to be addressed as Croatia moves closer to membership.

*Company information must be accessed from a range of sources*

With some difficulty, shareholders can access company data from a range of sources. In addition to the summary statements provided to HANFA and ZSE, somewhat different summary data can be accessed from FINA, which collects it for statistical purposes. Basic company documents are filed with the Commercial Courts, which act as the company registry. Some information can be accessed electronically, but full documents require visiting the Court where the company is

incorporated. Certain information, including insider transactions in shares and the announcement of the GMS, are to be published in specialty journals. Finally, the shareholder should be able to access full financial statements and other documents deemed relevant by the management directly from the company.

Recent legal changes require companies to provide annual reports and other documents to the Courts and to FINA to make available online in a free database. Companies are also required to make more information available on their website. These requirements had not been implemented at the time of this report.

### Company oversight and the board

*Supervisory boards oversee the company, but most power lies with the management board*

Croatian companies have a two-tier board structure: a supervisory board and a management board. The supervisory board hires and fires the management board, and oversees their ongoing work. The management board oversees the day to day operations of the company and has a number of specific powers and responsibilities specified in the CA. In practice, the management board is the more powerful of the two. Major shareholders who wish to have a direct role in running the company serve as the head of the management board, not the supervisory board.

Recent amendments to the CA allow for companies to opt for a single board of directors. There is very little practical experience with this board structure.

*Board members are to act as “good businessmen”, but have no duty to the company or shareholders*

Board members have a clear duty of care. Under the CA they have the duty to act “as good businessmen”. According to the new, non-binding Code, they should “discharge their duties with the diligence of fair and conscientious professionals”. The Code also notes that management board members should act in the sole interest of the company and its shareholders. Until recently, there was no equivalent duty of loyalty to shareholders or the company for supervisory board members, though the CA has now been amended to include one.

In practice management board members can be held liable for damages to shareholders or stakeholders, though shareholders cannot sue on behalf of the company (the derivative suit is unknown). It is much harder to hold supervisory board members liable due in large part to their limited responsibility.

*Board members are not obliged to disclose conflicts of interest under the CA*

This lack of responsibility extends to conflicts of interest. The CA does not require that management or supervisory board members reveal such conflicts to other board members, or require supervisory board members to oversee such conflicts. Similarly, the CA does not require any special approvals or reporting requirements for related party transactions.

The new Code does address conflicts of interest and related party transactions, but does not address them in sufficient detail, is voluntary, and remains untested in practice.

*While non-executive, supervisory board members are not always independent*

Independence requirements for supervisory board members have been recently introduced with the new Code. In practice, objectivity may be weakened by the fact that board members are shareholders, employees, customer or supplier. It is common practice to have at least one banker for the company on the supervisory board. In companies owned by a multinational, the supervisory board members are normally executives in other parts of the group.

In a number of “strategic” companies with state ownership, ministers serve on the board. There have been some controversies with these board members. It is not clear if they can devote sufficient time to their duties, retain full objectivity, or be held liable for any damage they may cause.

*Employees are represented on some boards and through worker councils, but cannot easily report bad behavior by the company*

Some supervisory boards also have employee representatives, which are required in boards of companies with significant state ownership at the national, regional or local level. Employees may also be represented by worker councils, which must be consulted on relevant issues.

Employees also have certain protection when acting as “whistle-blowers”, but this protection is not considered to be adequate in practice, and employees rarely report wrong-doing. More generally, companies do not have codes of ethics and the two boards have limited responsibility to ensure ethical behavior on the part of the company.

*Supervisory board members do not always have the time or training they need, and make limited use of committees*

In practice, supervisory boards normally have 5 to 8 members. The law allows large companies to have up to 21. Individuals are “limited” to serving on up to 10 supervisory boards at a time. The Audit Act and Code require an audit committee made up of supervisory board members or those chosen by the board. It is not clear how many companies actually have this committee or what it does in practice. The Code recommends other committees, but these do not seem to be used. Training for supervisory board members has only recently been introduced by a Zagreb university, and few supervisory board members have had training.

### **Enforcement**

*HANFA has broad powers, but cannot issue fines or take cases to court*

HANFA has broad authority over non-bank financial intermediaries, including brokers, investment banks, pension and investment funds, and insurance companies. HANFA can issue regulations, reverse unlawful actions, and grant, suspend, and revoke licenses and permissions. For issuers they oversee certain disclosure requirements, the use and abuse of privileged information by company insiders, and application of the Takeover Act. However HANFA does not have authority over the CA and cannot fine or bring cases directly against issuers or board members on behalf of shareholders.

*HANFA is not known to consult with or recruit from the private sector*

HANFA is still building its reputation with market participants. It has taken some strong and high profile enforcement actions, but is not always seen as applying the law consistently. HANFA has developed substantial regulation and helped issue the new Code, but is not known for consulting with industry or the public, including on the Code, missing an opportunity to raise awareness among market participants. While its overall funds are adequate, HANFA has difficulty in retaining staff or recruiting those with industry expertise. It does not always do a good job of communicating its decisions, and charges high fees to answer questions. This is particularly problematic given the ambiguous nature of key provisions in the SMA.

*Commercial Courts oversee Company Act enforcement*

The Commercial Courts are responsible for overseeing enforcement of the CA. In addition to acting as the Registry for company documents, the Commercial Courts hear both criminal cases brought by the State Prosecutor and civil cases brought by shareholders or other private parties. Market participants find them to be slow and, outside the Zagreb court, sometimes lacking adequate expertise in corporate matters. However, they are actually more efficient by some measures than their peers in the region, and have been working to improve access to basic corporate documents.

## Recommendations

*The reform process should continue*

Croatia 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. Continued reform to corporate governance and disclosure will also be critical to fully implement the Directives of the European Union, many of which have only recently been included in Croatia's regulatory and legal framework.

### *Address conflicts of interest and better protect shareholders*

*The CA must be amended to address conflicts of interest*

Current plans to revise or replace the CA must address conflicts of interest. The following changes should be incorporated, both to protect shareholders and allow full compliance with EU Directives on Annual Accounts and Transparency.

If a board member is conflicted about a potential and material action by the company, they should be required to inform other board members and recuse themselves from relevant decisions. If either board approves a transaction where a board member is conflicted, or is considered a related party transaction by the Code or IAS 24, shareholders should be informed. If it is a major transaction requiring shareholders approval, they should be informed before the general meeting of shareholders (GMS) as part of the meeting announcement. Requiring shareholder approval for smaller related party-transactions should also be considered.

Through the Audit Act and Code (and building on existing language), the audit committee should be given responsibility for vetting such transactions. They should have the power to bring in outside experts, and confirm that transaction will be conducted based on market-based prices.

*Conflicts of interest involving financial intermediaries should also be addressed*

Going forward it will also be critical to address conflicts of interest involving financial intermediaries and financial conglomerates, as required by the Market Abuse Directive. Current plans for a law on financial conglomerates should advance, and address the conflicts that can arise from trying to serve different kinds of customers, i.e. issuers, retail investors, fund beneficiaries, and so on. This should include requirements that these intermediaries disclose how they manage such conflicts. Efforts to revise the capital market legislation to implement other EU Directives, particularly MiFID (on financial instruments), will also be helpful.

*Investment funds should become active proponents of good governance*

Investment and pension funds should also become vehicles for improving governance. Following international good practice, they should regularly vote their shares and provide a clear rationale on how and why they vote the way they do. They should limit their investments to issuers that comply with HANFA regulations and make a good-faith effort to comply with the new Code as certified by HANFA.

In addition, HANFA should also continue its current efforts to crack down on misleading information and market manipulation. It should provide additional guidance to market participants on what constitutes these abuses, abuse of privileged information, and proper procedures for when insiders trade in the company's shares.

Given the critical role played by the big banks and funds in the Croatian capital markets, additional analysis in this area should be considered. To facilitate this, additional diagnostics of banking and fund governance should be considered.

*Protect small shareholders during delisting*

Another fundamental challenge going forward will be treatment of small shareholders during delisting, both from ownership consolidation and the eventual phase out of mandatory listing. Language on squeeze-outs should be strengthened in the CA, and note that shareholders should receive a market based price. Shareholders should also be given a "sell-out" right at the 90 or 95 percent threshold, requiring the main shareholder or company to buy back their shares at a market based price. Finally, de-listing rules should only allow for delisting with approval by a qualified majority of shareholders and with sell-out right for those that object.

*Encourage participation in the shareholders' meeting*

The CA should be amended, or regulatory guidance provided by HANFA, to explicitly allow for electronic / postal voting, in the GMS. It should also be made clear that shareholder have a right to ask relevant questions, and that preventing shareholders from participation is a violation of the law.

*Preemptive rights should be difficult to waive, board members not so difficult to remove*

Additional changes should also be considered to better protect shareholders. The CA should specify that the articles may be changed to *lower* (but not increase) the threshold and requirements for the GMS to remove board members and the Articles may be changed to *increase* (but not lower) the threshold to waive preemptive rights. In the latter case, the supervisory board should also be required to provide a clear rational for the waiver, confirming that it is in shareholder interest and allowing it to be contested in court. Company articles that make it harder to remove board members or easier to waive preemptive rights should be invalidated.

*Improve disclosure*

*Enforce existing requirements to disclose related party transactions and indirect ownership*

To fully address conflicts of interest and fully implement EU Directives on Market Abuse, Annual Accounts, and Transparency, reporting of related party transactions and disclosure of ultimate ownership will need to improve. Both are essentially required under current law. For related party transactions, this necessitates full implementation of IAS 24 in addition to the changes to the CA as noted above.

For ultimate ownership, Article 115 and related articles of the SMA requiring disclosure of significant direct or indirect ownership should be fully enforced. Regulatory guidance should be provided by HANFA that holdings via custody accounts or other indirect arrangements, or shareholder agreements that give

additional voting power, can in fact cross the relevant thresholds and require disclosure. The relevant language in the Transparency Directive should be incorporated into this regulation.

*All companies should file statements with the Courts; listed ones should make full financial statements available to HANFA and online*

The paucity of financial statements must be addressed as part of any reform to improve company disclosure. *All* companies—joint stock and limited liability—should provide their statements to the Court Registry, where they should be available electronically. Current initiatives in this area should move forward, and recent legal amendments fully implemented.

HANFA's authority over company reporting has recently been clarified, and HANFA should use this authority to ensure that full-financial statements and annual reports are made available online. The summary annual reports currently available should be phased out. HANFA should also devote reasonable resources to ensure that statements are audited and comply with other Accounting requirements. HANFA should also oversee compliance with other Accounting and Audit Act provisions for issuers, such as the audit committee requirement.

*Shareholders should be able to find all relevant information on one website*

More generally, financial reporting requirements should be streamlined, and information should be gathered together on one website for issuers. Current requirements regarding reporting certain things in the daily press, to HANFA, and so on should be interpreted as requiring this information to be passed on to HANFA and ZSE, where it will be made available to the public online. Ultimately this should be linked to the system provided by FINA and the Court Registry to ensure that all company information is available in one place.

*A&A ROSC has more on improving disclosure*

The 2007 Accounting and Auditing ROSC for Croatia contain additional recommendations on disclosure, oversight of accounting and auditing, and strengthening the profession.

### ***Enhance company oversight***

*Hold board members liable if they do not disclose potential conflicts of interest*

The CA should be amended to address potential conflicts of interest involving board members. It should be clear that board members, including supervisors, are liable for damages and may face criminal charges when acting while conflicted and not disclosing such information or recusing themselves.

*Companies should have codes of ethics*

More generally, board members should be encouraged to behave in an ethical and lawful manner. The current relevant language in the CA should be supplemented to make clear that board members are obliged to act lawfully and respect mutually agreed contracts. They should have a responsibility to ensure that others in the company do likewise. This should be supported by requirements in the Code for companies to have codes of ethics.

Employees who report improper behavior should be protected. Current provisions in the Labor Act protecting employees that reveal improper conduct should be enforced more effectively.

*Boards should have more independent members, and make greater use of training*

Boards and companies should also take voluntary actions to improve their performance. They should embrace the Code's provisions on independence and audit committees, which will make it easier to avoid potential conflicts of interest and may bring new skill and points of view to the board. Board members should also seek training on their duties and responsibilities. Donors should consider supporting efforts to expand training opportunities for board members.

In addition, it may be necessary to go beyond voluntary efforts. A requirement may be added to the Audit Act to mandate that audit committees are composed primarily of independent, supervisory board members. Training may also be mandated for audit committee members, or for issuers under the SMA, all supervisory board members. Finally, changes to the Code or CA may be considered that make it easier for minority shareholders to appoint a certain number of supervisory board members.

*Improve the oversight of state owned enterprises*

One area where improved board oversight is particularly urgent is in state owned enterprises (SOEs). Current plans to privatize remaining state holdings through IPOs on the ZSE should advance. In addition, reforms based on the OECD Guidelines on Corporate Governance of State Owned Enterprises should be implemented, including the replacement of ministers on the supervisory boards of SOEs where they currently serve. To facilitate reform in this area, a diagnostic based on the Guidelines should be considered.

### **Strengthen enforcement**

*Donors should support initiatives to strengthen HANFA*

Many of the reforms needed to improve corporate governance will place greater demands on HANFA. Donors should support a broad based program to strengthen the regulator. This should include expanded training for staff, including “twinning” exercises with regulators in other countries. The financial viability of reducing attrition to and recruiting more from the private sector should be reviewed. Other forms of financial assistance should also be considered.

*HANFA should establish a dialogue with the market*

HANFA should also begin to enhance its relationship with the market. While the need to build up credibility is understandable, the regulator should now engage in greater consultation on its initiatives. It should also seek greater dialogue with industry through other channels, and make greater effort to explain its rulings. At the same time, it should apply the law in an evenhanded manner and maintain its reputation as a professional and effective regulator.

This dialogue should extend to the Code. HANFA, working with the ZSE, should do more to popularize the Code and ensure that companies understand the need to complete their compliance statement. They should also be open to periodic revisions that would consider feedback from issuers and the financial community. Donor support could also be useful in continuing to “roll-out” the code.

## Summary of Key Recommendations

Principle	Recommendation	How to be Introduced	Responsible party	Priority/Status
<b>Better Protect Investors</b>				
IIIA(2), IIC, VID (6)	Disclose and manage board member conflicts of interest	Amend the Companies Act Provide additional guidance in the Code	M. Justice & Fac. of Law HANFA & ZSE	Immediate
IIIB	Address conflicts of interest involving financial conglomerates	New act on financial conglomerates Regulation	M. Finance, HNB, HANFA HANFA	Medium-Term
IIF	Make investment funds vehicles of good corporate governance	Regulation and enforcement Possible amendments to fund acts	HANFA HANFA & M. Finance	Immediate
IIIA	Protect small shareholders via sell-outs and squeeze outs	Amend the Companies Act Possibly amend the SMA (or new securities act)	M. Justice & Fac. of Law HANFA & M. Finance	Medium-Term
IIA(5), IIB(3)	Reinforce preemptive rights and the possibility of shareholders to remove board members	Amend the Companies Act	M. Justice & Fac. of Law	Medium-Term
<b>Improve Disclosure</b>				
IID, VA	Implement requirements to disclose related party transactions and indirect (ultimate) ownership	Regulation and enforcement Possibly amend the SMA (or new securities act)	HANFA HANFA & M. Finance	Immediate
IIA, VA	All financial statements filed with Court Registry	Development of capacity by Court Registry Implement current legal requirements	Commercial Courts M. Finance & M. Justice & Fac. of Law	Immediate
IIA, VA, VB	Full financial statements issued to public by listed companies	Regulatory clarification and enforcement	HANFA	Immediate
IIA, VA	One website with links to all investor information	With donor support	HANFA & ZSE	Medium-Term
<b>Improve Company Oversight</b>				
VIB, VID	Address board member conflicts of interest	Amend the Companies Act Provide additional guidance in the Code	M. Justice & Fac. of Law HANFA & ZSE	Immediate
IVE, VIC	Ensure lawful behavior and encourage codes of ethics	Code requirements Possible changes to Companies Act	HANFA & ZSE M. Justice & Fac. of Law	Medium-Term
VIE(1)	Encourage independent members of boards and increase training for supervisors	Private initiatives with donor support Possible changes in the Audit Act regarding audit committees	HANFA or ZSE M. Finance	Medium-Term
IA, VIE	Improve the oversight of state owned enterprises (SOEs)	Diagnostic of SOE corporate governance based on OECD Guidelines	M. Finance	Medium-Term
<b>Strengthen HANFA</b>				
ID	Increase surveillance and enforcement capabilities	Donors working closely with HANFA	HANFA	Immediate
IA, VA8	Consult with private sector	HANFA initiatives	HANFA	Immediate

## Summary of Observance of OECD Corporate Governance Principles

	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		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			
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		

	Principle	FI	BI	PI	NI	NA
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

As of February 2008, the market capitalization of the Zagreb Stock Exchange was 343 billion Kunas (US \$65.17 billion). The market has been expanding rapidly and has increased from 177.35 billion Kunas in December, 2006 representing a 111% increase. Turnover also grew rapidly in 2007, increasing 57 percent, before slowing in 2008. Trading is concentrated in the largest companies. The top ten stocks in the market account for 43.8 percent of turnover and 53.8 percent of market capitalization.

#### Market Profile

Country Name	Market capitalization of listed companies (% of GDP) as of 2006	Market capitalization of listed companies (current US\$) as of 2007	Total Listed domestic companies as of 2007	Stocks traded, total value (% of GDP) as of 2006	Stocks traded, total value (current US\$) as of 2007	Stocks traded, turnover ratio (%) as of 2007
Croatia	67.6	66.0	353	4.2	4.1	7.2
Bulgaria	32.8	21.8	369	4.8	5.5	34.1
Czech Republic	34	73.4	32	23	41.9	73.4
Hungary	37.1	47.7	41	27.6	47.5	102.6
Poland	44	207.3	328	16.2	84.6	44.1
Romania	27	44.9	2096	3.5	8.1	19.2
Slovak Republic	10.1	7.0	153	0.2	.03	0.5
Slovenia	40.7	29.0	87	2.7	2.7	10.7
<b>ECA Average</b>	<b>72.70</b>	<b>172.7</b>	<b>320.07</b>	<b>53.60</b>	<b>89.8</b>	<b>0</b>
<b>OECD Average</b>	<b>113.48</b>	<b>598.5</b>	<b>899.5</b>	<b>111.56</b>	<b>1008.01</b>	<b>132.5</b>

Source: Financial Structure Database and EMDB

In March 2007 the Varaždin Stock Exchange and the Zagreb Stock Exchange merged. At the time of the merger, the newly combined Exchange had a total of 295 Billion Kuna in market capitalization (of which 251 billion in shares and almost 43 billion in bonds) and 426 listed securities. The ZSE uses an electronic system, MOST, to trade securities. The stock market comprises four segments: The Official Market, the Regular Market, the JDD Market, and the Parallel (or Free) market. At the end of 2007 there were 14 stocks listed on the official market, 248 on the JDD market and 112 on the parallel market.

CROBEX is the official Zagreb Stock Exchange share index and has been published since September, 1997. CROBEX is weighted by free float adjusted market capitalization. The weight of any individual issuer in CROBEX is limited to 20% of the index capitalization. The CROBEX index had been growing rapidly and increased 63 percent in 2007 falling again in early 2008.

The price-to-earnings (P/E) ratios for companies have significantly increased, in particular during the past two years, creating concerns for market participants and regulators that the market was over-heated. Market participants report that the current conditions are favorable for new listings, and some IPOs are also planned.

### OWNERSHIP FRAMEWORK

Ownership is concentrated and free float limited. The top 10 shareholders own 80 percent or more of the shares in most companies.

As a result of privatization, hundreds of thousands of small shareholders acquired shares through vouchers and employee share purchase programs. In many cases company managers either initially secured or eventually accumulated a significant portion of the shares.

**State Ownership:** State ownership remains extensive, and state owned enterprises (SOEs) are estimated to produce up to 40 percent of GDP. The Croatian Privatization Fund has stakes in 1,112 companies. The total equity of these companies is HRK 177.6 billion, the state's share amounts to HRK 21.8 billion. At the time of this report, the Fund had majority ownership in 178 companies, and 25-50 percent ownership in 164. Some of these companies have golden shares giving the state control rights beyond their ownership. Local governments are also significant owners of productive assets.

The Fund has significant holdings in the processing, trade, tourism, agriculture, transport and communications sectors (see the following table). The Privatization Fund hopes to privatize the majority government owned companies by end of 2008.

Portfolio of the Croatian Privatization Fund				
No.	ACTIVITY	No. of companies	Equity (million HRK)	State Portfolio (million HRK)
1	AGRICULTURE, HUNTING AND FORESTRY	83	4,154	2,512
2	FISHING	5	41	9.
3	MINING AND EXTRACTION	4	52	5.61
4	PROCESSING INDUSTRY	374	28,625	9,570
5	ELECTRICITY, GAS AND WATER SUPPLY	1	.5	1,101
6	CONSTRUCTION	101	1,774	196
7	TRADE	179	4,067	329
8	TOURISM	153	14,156	3,876
9	TRANSPORT, WAREHOUSING AND COMMUNICATIONS	65	6,303	2,792
10	FINANCIAL MEDIATION	15	115,085	1,151
11	REAL ESTATE, RENTAL AND BUSINESS SERVICES	86	3,054	1,298
12	EDUCATION	3	4.5	.2
13	HEALTH PROTECTION AND SOCIAL WELFARE	9	15	.5
14	OTHER PUBLIC, SOCIAL AND INDIVIDUAL SERVICE ACTIVITES	32	2393	35
<b>Total:</b>		<b>1112</b>	<b>177.602</b>	<b>21.803.172.733</b>

Source: Croatian Privatization Fund, 2007

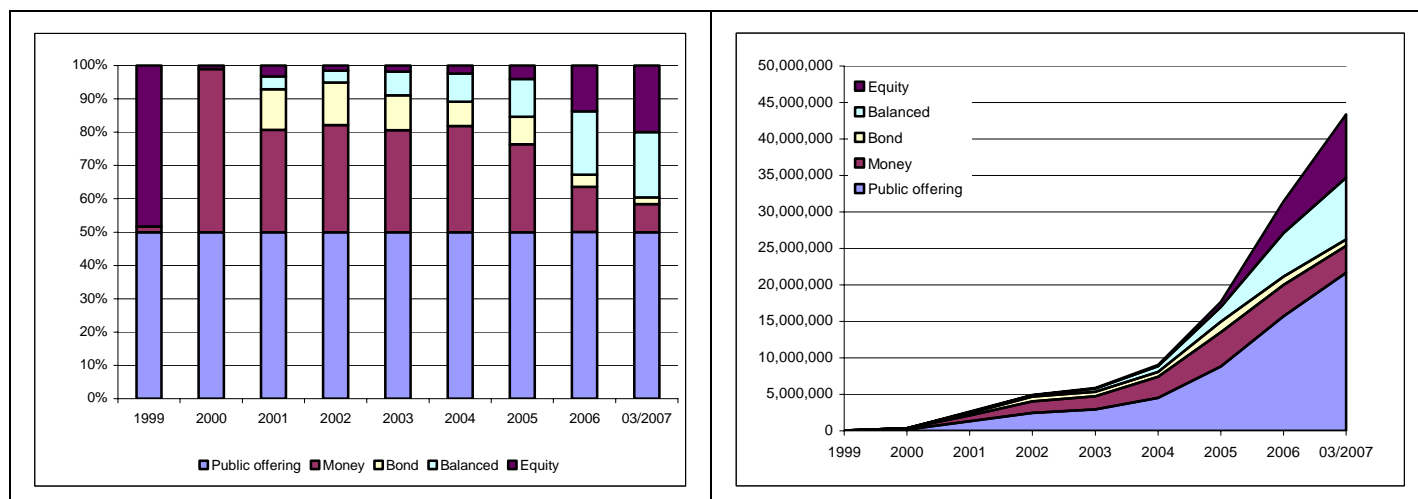
**Institutional investors:** Croatia has four mandatory pension funds (OMFs), sixteen voluntary pension funds (OMFDs) and at least eighty investment funds. Until recently, the OMFs—to which all employees are required to contribute—held more assets, but they have been overtaken by the fast growing investment funds. OMFDs remain relatively small.

Composition of the Croatian Non-bank Financial Sector				Assets of Voluntary and Mandatory Pension Funds (March 2007)	
Type of entity	Number	Assets (in million HRK)	Assets/G DP	OMFs	OMFDs
Insurance companies	22	19662	7.85	68.59%	48.81%
Pension fund management companies	8			9.93%	19.10%
Mandatory funds	4	15919	6.35	8.20%	10.50%
Voluntary funds	16	458	0.18	6.17%	11.92%
Investment fund management companies	26			2.29%	3.09%
Open-end funds	72	16038	6.4	2.07%	1.28%
Closed-end funds	7	2505	1	1.28%	5.00%
Leasing companies	58	27075	10.8	1.04%	0.15%
Factoring companies	8	1687	0.67	0.35%	0.14%
Brokerage companies	48	n/a	n/a	0.07%	0.00%
Venture Capital Funds	1	n/a	n/a	0.00%	0.00%

Source: HANFA

Growth in local investment funds has approached 200 percent per year. The funds have been shifting their investments from short term monetary instruments into composite funds and equity investments.

## Assets of Investment Funds: Portfolio Distribution and Cumulative Assets (in thousand HRKs)



Source: HANFA

## LEGAL FRAMEWORK

**Corporate Legal Framework.** The 1993 Companies Act (CA) provides the legal framework governing companies and is based on German and Austrian company law. The CA was revised in 2003 and again in 2007 in preparation for joining the EU. Changes in corporate control are regulated by the 2007 Act on Takeovers of Joint Stock Companies, which replaced a 2002 act.

**Company types.** The CA recognizes four types of enterprises: general partnerships, limited partnerships, joint stock companies, and limited liability companies. Sole proprietors are governed by their own act.

A joint stock company, "d.d.", is a company whose shareholders participate in the company's capital, which is divided into shares. A joint stock company has its own legal personality, fixed share capital, and an incorporated organization which consists of three levels: shareholders' meetings, a supervisory board and a management board. Shareholders are not legally responsible for a joint stock company's liabilities. The minimum share capital required for establishing a joint stock company is HRK 200,000 (approximately EUR 27,000 or US\$ 37,000).

A limited liability company, "d.o.o.", implies a limited personal liability of the shareholder up to the amount of the invested capital. The limited liability company must have a management board of one or more directors, but is only required to have a supervisory board under certain conditions, e.g. 300 or more employees. The minimum founding capital required for establishing a limited liability company is HRK 20,000.

At the beginning of 2007, there were 1,511 joint stock companies and 60,951 limited liability companies in Croatia.

The SMA defines a public joint stock company as a joint stock company that has either issued shares in a public offering and/or has 100 shareholders, and initial capital of at least HRK 30 million. All public companies are required to be listed on an exchange (in practice the Official, Regular, or JDD, tier of the ZSE), their shares must be freely transferable, they must produce periodic summary financial statements and they must meet other requirements of the SMA and HANFA regulation. There are about 250 public joint stock companies.

**Securities law framework.** The 2002 Securities Market Act (SMA) governs the stock exchange, brokers, investment advisors, and issuers, including public joint stock companies. Investment funds and pension funds are regulated by additional acts. The SMA includes provisions on insider trading and the use, and abuse, of privileged information. The SMA was amended in 2006 and may be further amended as part of negotiations with the EU.

**Listing rules.** The stock market comprises four segments: The Official Market, the Regular Market, the JDD Market, and the Parallel (or Free) market. Companies listed in the Official Market are required to have paid-in capital or the expected market capitalization of least 100 million HRK. They must also comply with the requirements of the regular market, which are (a) financial reports for no less than the last 2 financial years, (b) 50 or more shareholders, (c) more than 15% shares in free float and (d) expected market capitalization of at least 10 million HRK<sup>3</sup>.

The JDD market includes all public joint stock companies not on the Official or Regular tier: companies (a) with more than 100 shareholders and paid-in capital above 30 million HRK or (b) which have issued shares to the public. Listing requirements on the JDD are moderate and the ZSE is not allowed to terminate a listing on the JDD in case when it does not fulfill its obligations regarding disclosure or other duties required by exchange rules or law.

<sup>3</sup> Zagreb Stock Exchange Rules, <http://www.zse.hr/docs/PravilaZSE-2003-ENG.pdf>

Parallel or Free Market segment allows for trading in the shares of companies that are not considered public, but have multiple shareholders due to privatization. These companies have not entered into contract or agreement with the exchange regarding listing or trading their securities and are not under any obligation imposed by ZSE Rules. There is virtually no transparency or disclosure provided by issuers of securities traded within Parallel or Free Market segment.

Companies listed in the first three tiers are required to comply with SMA and HANFA regulations. They are expected to implement the newly adopted corporate governance code on a "comply or explain" basis. Parallel market members are not required to follow the newly adopted corporate governance code, the SMA, or HANFA regulation.

**Banking Law.** Banks are regulated by the 2003 Banking Act, which is administered by the HNB. The Banking Act supplements the requirements in the CA for boards and disclosure, in addition to its other prudential requirements for banks. The HNB is preparing a new law as part of negotiations with the EU.

**Codes.** 2003 amendments to the CA require companies to note their compliance with a code of corporate governance. HANFA and ZSE jointly issued a Code in April 2007. The Code focuses on disclosure and the functioning of the general meeting of shareholders (GMS), supervisory board, and management board. It contains a number of provisions consistent with good practice and the OECD Principles. The Code is applicable to all public joint stock companies, which must answer a questionnaire on their compliance with the Code, and include the completed questionnaire in their annual report and on their website.

Market participants reported that there was very limited public consultation during the preparation of the Code. It is unclear if there will be any attempt to verify the answers provided by companies, or the ways in which market participants will use the Code.

HNB is also in the process of preparing a corporate governance code for banks not listed on the ZSE. The draft code has been recently published on HNB's website for public comment. The Croatian Employers Association and the Chamber of Economy have each issued a Code of Ethics for their members.

## REGULATORY FRAMEWORK

**Securities Regulator.** The Croatian Financial Services Supervisory Agency (HANFA) is the non-bank financial regulator. HANFA was created in 2006 by the merger of the Croatian Securities Commission, Insurance Companies Supervisory Authority, and Agency for Supervision of Pension Funds and Insurance. HANFA regulates non-banking financial intermediaries including insurance undertakings, leasing companies, pension fund management companies, and investment fund management companies; as well as brokerages, investment consultants, the stock market, and insurance underwriters. It has authority over public joint stock companies and other issuers.

The 2005 Act that created HANFA lists a number of legal acts it is to enforce and gives it broad powers, though it cannot issue fines or bring criminal or civil cases to court. HANFA is governed by a board of five members, each of whom serves a six year term. The agency must submit a report to parliament each year, but is largely independent.

**Banking Regulator.** The Croatian National Bank (HNB) supervises banks. It has a strong reputation with market participants and has overseen extensive restructuring in the sector, which has included heavy foreign investment. The Bank enjoys operational autonomy and independence but is responsible to the Croatian Parliament. It was established in 1990 under the Constitution and is currently governed by the 2001 HNB Act. In response to the high level of foreign bank ownership, HNB has either signed or is in the process of signing Memorandums of Understanding (MOU) with their supervisor counterparts from Austria, Bosnia & Herzegovina, France Hungary, and Italy.

**Stock Exchange.** The Zagreb Stock Exchange (ZSE) was founded in 1991, and is a successor to an exchange of the same name that operated from 1918-1946. In March 2007 it merged with the Varaždin Stock Exchange, and is now Croatia's only stock exchange. Traded securities include corporate bonds and commercial paper as well as common and preferred stock. The securities of all public joint stock companies must be listed on the exchange.

The ZSE is a self-regulatory organization owned by its member-brokers. It sets listing requirement, and supervises its members and trading, but in practice its regulatory role is limited. The ZSE is overseen by HANFA.

**Depository.** Shares for public companies have to be registered and dematerialized with the Central Depository Agency (SDA). The SDA maintains share ownership records, provides the register of shareholders used for the GMS, and lists of the ten largest direct shareholders in public companies on its website. About 900 companies register their shares with the SDA. The SDA also provides clearing and settlement services.

**Registries.** Croatia has about 70,000 legal entities, all of which are registered with the Commercial Court Registry under the supervision of the Ministry of Justice. Access to basic company information, such as the name of the company and its form of legal incorporation, is available online from the Ministry's website. However, to obtain detailed information, such as the company's articles of incorporation, shareholders are obliged to visit one of the 13 regional commercial courts. The law on company registrations is being revised to follow the *acquis communautaire* that provides for a single location for company information. Under current plans, with an upgrade of the courts' IT capacity, starting in January 2009, users will be able to obtain copies of companies' full financial statements as well as companies' articles of association and lists of founders with percentage of ownership at the time of the company's formation. It is anticipated that the Croatian court registry will also be connected to the European Business Register, which links the business registries of EU countries.

## Principle - By - Principle Review of Corporate Governance

This section assesses compliance with each of the OECD Principles of Corporate Governance.<sup>4</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).

### 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**

Legal reform and institutional development in Croatia have had three strong and significant driving forces: 1) The breakup of Yugoslavia and the need to create an essentially new legal and institutional framework; 2) Economic transition to allow greater scope for private ownership and market forces; and 3) The need to meet the various requirements for membership in the European Union (EU). Rapid and substantial reform has resulted, including in those areas related to corporate governance. Since the 2001 Corporate Governance ROSC there have been substantial amendments to the Companies Act (CA) and Securities Market Act (SMA), essentially new acts on Accounting, Auditing, and Bankruptcy, the issuing of a large number of related regulations, the creation of a new combined regulator for the non-bank financial sector (HANFA), and recently the merger of the two stock exchanges and issuance of a new code of corporate governance<sup>5</sup>.

However, legal change has sometimes outpaced institutional capabilities. For example, Croatia was an early adaptor of International Accounting Standards/International Financial Reporting Standards (IFRS), requiring them for essentially all companies in 2000. Yet according to the 2007 Accounting and Auditing ROSC, many companies are not IFRS compliant, and the needed framework for enforcement and education is still being developed. Another example: in 2003 the CA was amended to require all companies to note their compliance with a code of corporate governance. The code was introduced in 2007.

The need to strengthen institutional capabilities is widely accepted. The government has also launched a new initiative to simplify and streamline existing regulation. "HITROREZ" has been established as a "regulatory guillotine" to review existing business regulation and provide recommendations on making regulation more efficient and eliminating unnecessary regulation when possible.

**Overall capital market transparency.** The requirement that all companies with more than 100 shareholders and 30 million HRK in assets list (forming the "JDD" segment of the market) combined with more vigorous enforcement by HANFA of basic filing requirements, has increased transparency and investor confidence. The largest companies, especially those with foreign parents, generally do comply with international good practice. HANFA, supported by recent changes to the SMA, is hoping to reduce potential market manipulation and the spreading of false or misleading information. On the other hand,

<sup>4</sup> Please see [Methodology for Assessing the Implementation of the OECD Principles on Corporate Governance](#) for full details.

<sup>5</sup> The Annex summarizes in more detail corporate governance relevant changes since 2001.

while information on direct ownership is available, ultimate ownership is not always transparent. The dominance of financial market intermediation by financial conglomerates also raises potential for conflict of interest that the current regulatory framework may not be able to address fully.

**Regulatory consultation process.** The Croatian National Bank (HNB) regularly consults the banking industry and public on potential regulations or guidelines. HANFA does not consult as consistently and many market participants feel that its decisions sometimes suffer as a result.

**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: Broadly Implemented**

**Legal clarity.** The CA, SMA, and other relevant legislation provide detailed and clear guidance on a number of issues and are supported by regulatory guidance. However, these acts also have omission and lack clarity in key areas, including conflicts of interest in the CA and “privileged information” in the SMA. More generally, the rapid pace of legal change has sometimes surpassed the ability of market participants to absorb it or regulators to implement it.

**Consistency of application.** HNB has developed a reputation as a strong and consistent regulator. The newer HANFA is still developing such a reputation. The commercial courts are not considered to be entirely consistent in applying relevant legislation, especially those outside of Zagreb.

**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**

**Clear division of regulatory responsibility.** HNB and HANFA have clear and distinct areas of authority under their founding acts. However, neither has explicit authority to enforce key legislation: the CA, Accounting Act, or Audit Act.

**Regulatory cooperation.** HANFA and CNB have formed a joint operation board to coordinate the overall regulation of the financial sector. They regularly conduct joint inspections of financial conglomerates and provide each other relevant data when requested. They expect to prepare a joint law on financial conglomerates which is anticipated for parliament vote in the first quarter of 2008.

**Legal harmonization.** Like other countries in the region, the CA has been heavily influenced by the legal tradition in Central Europe, especially German and Austrian legal tradition, and the SMA by securities regulation in the US, UK, and other Common Law countries. All laws have been or are being revised to implement the Directives of the EU. In practice, contradictions or inconsistencies between or within various laws is not considered a serious problem. However, there may be a gap regarding enforcement of the Accounting Act and companies do face a wide range of reporting requirements that require producing a number of somewhat different reports.

**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**

**Supervisory authority.** The Croatian Financial Services Supervisory Agency (HANFA) has authority related to a number of laws, including the following:

- Croatian Financial Services Supervisory Agency Act
- Securities Market Act
- Investment Funds Act
- Privatization Investment Funds Act
- Act on Takeover of Joint Stock Companies
- Act on Pension Funds
- Insurance Act

They do not have responsibility for the Accounting Act, Audit Act or Companies Act, which limits their authority over issuers.

HANFA may issue regulations, exercise supervision over financial market participants (except banks), annul unlawful or irregular actions, issue and withdraw permissions and licenses, keep books and registries, launch initiatives for the adoption and amendment of laws, and report to other authorities and judicial bodies on relevant matters. They cannot impose fines or criminal penalties and must refer such cases to the relevant commercial court. They cannot bring civil suits or sue on behalf of investors. Proposed changes to securities legislation would allow HANFA to impose fines.

**Supervisory resources.** HANFA is governed by a board of 5 members who serve six years terms. While it is encouraged to

work with other parts of the government when relevant, it is an independent agency and does not have to consult others regarding its decisions. HANFA is ultimately accountable to parliament, and must submit to parliament and the government an annual report on its affairs and the state of financial markets.

HANFA receives the bulk of its funding from fees, and thanks to the recent bull market, has more than adequate financial resources. It has 104 employees. Salaries are comparable to the HNB, and, for lower level positions, the private sector. Pay for more senior employees is lower than equivalent work in the private sector. Employees will leave for the private sector, and HANFA, in turn, has a hard time recruiting from the private sector. HANFA considers the lack of enough qualified people to be one of its main constraints.

**Reputation of supervisory bodies.** HANFA is still new, and working hard to establish its credibility. Market participants feel that it sometimes lacks a private sector perspective, in part because it rarely consults with the private sector on new regulation. HANFA has taken some high profile enforcement action, but some market participants feel that it is not always consistent in its application of the law.

**Regulatory efficiency.** HANFA is relatively timely in making its decisions. However, it is not always clear on why it makes the ruling it does, and charges substantial fees to answer queries regarding relevant law or regulation. One of the biggest challenges in the market is the uncertainty caused by the rapid pace of legal change, and ambiguities in some legal provisions. This lack of clarification by HANFA does not ameliorate the situation.

**Courts.** Corporate governance related cases are heard in commercial courts. This allows for a certain degree of specialization; however market participants feel that the competence of the courts in corporate disputes remains limited, and cases take too long. Indicators developed by the World Bank imply that the procedures and cost of recovery to enforce a standard contract in Croatia is better than the region average, and comparable to the OECD average. Time required is only slightly better than the region and worse than the OECD average, indicating that the courts are relatively efficient, but more time consuming to use than in more developed economies (See Doing Business 2007 at [www.doingbusiness.org](http://www.doingbusiness.org)).

Contract Enforcement Indicator	Croatia	SEE Average <sup>6</sup>	OECD Average
Number of procedures	22	35	22
Time (days)	561	606	351
Cost (% of debt)	10	15	11

## 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: Fully Implemented**

**Secure share registration.** Shares for public companies have to be registered and dematerialized with the Central Depository Agency (SDA). The SDA maintains share ownership records and provides the lists used for the GMS.

In practice about 900 JSE register their shares with the SDA. These include all listed companies as well as other joint stock companies. There are a few firms that maintain a separate registry. It is estimated that around 10-15 firms still have bearer shares.

Companies	Ownership by Custodian
INA	24.53%
Podravka	7.44%
Zagrebacka	0.27%
Adris Grupa	73.76%
Viadukt	21.71%
Ericcson Nikola	59.81%
Pliva	2.88%

**Secure custody system.** It is common for shareholders to hold shares through custodians; which is the only form of

<sup>6</sup> Average for South East Europe: Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia, and Slovenia.

nominee ownership recognized in the law. Custodians are normally banks. PBZ has 40 percent of the custodian market. Under the law, securities in a custodian account are the shareholders property and cannot be included either in custodian's property, its assets if in liquidation, or in its bankruptcy estate.

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

**Assessment: Fully Implemented**

**Restrictions on share transfer.** The shares of public companies are freely transferable (SMA § 90). Under the CA, share transfer (*vinkulacija*) could be restricted by management, and can still be in non-listed companies.

**Clearing and settlement framework.** The SDA is responsible for clearing and settlement. Transactions are settled on a net basis, DVP on T+3.

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

**Assessment: Partially Implemented**

**Availability of information (charter, financial statements, minutes, capital structure).** Company data is available from a number of different sources. At the GMS, shareholders can request information on company business, legal and business relations, change or acquisition in share holdings. Company management may refuse to provide information on taxes paid and differences in book value and market value of assets. In that case, the court decides whether shareholders' requests as to whether the management board is obliged to provide them with relevant information. (CA § 287,288).

Summary reports can be obtained from the ZSE, HANFA, and FINA. Information on the articles of association and historical data can be obtained from the Court Registry. Full financial statements can be obtained from the company directly. Some banks and large companies have full financial statements that are easily available to shareholders. Information on ownership of the top 10 shareholders and direct ownership is available from the SDA. Relevant information regarding indirect ownership, related party transactions, risk factors and company objectives is not always available. There is no single source where the public can obtain all relevant information regarding a company. Recent legal changes require companies to provide their annual reports to FINA and the Court Registry, which is then to make them available online. This system was not operational at the time of this report.

The new Code encourages public companies to disclose all material information on their website. It notes that the annual, semi-annual and quarterly statements include management discussions, analysis of company risk, strategies etc. Moreover, such information should be easily accessible to shareholders. Regarding ownership data the Code recommends disclosure of the list of shareholders, cross holdings and holdings of the management and supervisory board. The Code also recommends adoption of good dissemination policies. The CA was recently amended to increase disclosure requirements for companies.

Based on a study of websites of leading Croatian companies, only 47 percent reveal ownership structure information and only 51 percent of these companies have annual reports online.

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

**Assessment: Partially Implemented**

**Voting rights.** Ordinary shareholders have the right to attend, participate and vote at meetings (CA § 167,291). Shareholders can alter the agenda using counter proposals (CA § 282). They can enter into agreements for voting and other purposes and be represented by proxies and custodians. The CA has been amended to remove possible limits on the number of shares that can be voted (voting caps). Votes are generally counted by the chairman and certified by the notary.

The Code notes that the company should encourage participation in the GMS and not use conditions such as advanced registration or certification of power of attorney to discourage participation.

In practice, shareholder participation at meetings is not high. Retail investors have a limited awareness of their rights. There have also been cases of abuses at shareholder meetings<sup>7</sup>.

**Redress.** Any actions against shareholders can be set aside if any decision is adopted which is contrary to corporate law and the articles of association (CA § 360).

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

**Assessment: Broadly Implemented**

<sup>7</sup> Wrong information regarding the meeting was provided and all voting took place within the first 15 minutes of the shareholder meeting. There also has been a case where employees were physically prevented from attending a shareholder meeting. In another case shareholders confirmed their attendance to a shareholder meeting for INA assuming that it is a party.

**Election.** Members of the management board and its chairman are appointed by the supervisory board (CA § 244). Members of the supervisory board are elected at the annual general meeting (CA § 256). The articles of association might require that some members of the supervisory board be appointed directly by certain shareholders and the employees (CA § 256).<sup>8</sup> Up to one third of supervisors may be chosen in this way. All shareholders can nominate board members through the counter proposal mechanism.

Supervisory board members may be removed by  $\frac{3}{4}$  of shares at the GMS (CA § 259, 260). Management board members can be removed by the supervisory board (CA § 245). The articles can limit shareholders right in this area.

The Code requires complete disclosure on the candidates prior to the election.

Under the CA voting is done on the basis of a simple majority rule. However, prior agreements may result in *de-facto* proportional representation.

**Redress.** Supervisory board members appointed by shareholders or employees can be removed by them. Shareholders who hold  $\frac{1}{10}$ <sup>th</sup> of share capital can file a motion with court to remove an appointed supervisory board member (CA. § 260).

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

##### Assessment: Broadly Implemented

**Clear legal framework.** The management board presents its proposals for distributing profits to the supervisory board. The proposal must be based on audited financial statements. Shareholders may alter this proposal at the GMS. The profits of the company shall not be paid to the shareholders until the reserves reach 5 percent of the share capital. The company law is silent on the schedule of dividend payments.

The Code recommends that dividend announcements include a schedule of payments.

In the last few years companies have been making profits and hence paying dividends. There have been cases where the dividend payments have been delayed. Information on the dividend payment schedule is often not provided to shareholders.

**Equitable treatment.** Shareholders are entitled to dividends proportional to their holdings. (CA. § 167)

The Code recommends that dividend announcements include a schedule of payments and noted that dividends cannot be paid in such a way as to favor individual shareholders.

#### 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

**Changes to basic governing documents.** The GMS have sole authority to amend company statutes and business objectives (CA § 301). The GMS may authorize the supervisory board to amend the articles of association if the amendments relate to changing the wording of the text. Amendments require a  $\frac{3}{4}$  majority of share capital at the meeting (CA § 208). The bylaws can require a greater majority or impose additional requirements.

**Shareholder Challenges.** Shareholders generally have limited redress mechanisms available. Unless there are procedural violation shareholders cannot take the matter to court.

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

##### Assessment: Partially Implemented

**Issuing share capital.** Registered increases in share capital can be made by the GMS (CA § 301). It requires a  $\frac{3}{4}$  majority approval. For issuance of non voting preferred shares the bylaws and statutes might set different requirements and a higher requirement for approval. If several classes of shares are issued then they require the approval of each class of shareholders.

If the share capital is not immediate and there is a need for additional shares the bylaws allow the board to increase the shares not exceeding  $\frac{1}{2}$  of share capital at the meeting (CA § 306). As of 2001 firms could issue 50% of authorized share capital with  $\frac{3}{4}$  shareholder approval for a period of 5 years. That has been reduced to 3 months.

**Preemptive rights.** Shareholders have preemptive rights in case of new share issues. There is a limit of 14 days to exercise authority on the new shares (CA § 308). The right to subscribe new shares may be assigned to another person only if the shareholder's subscription rights have been preserved. To waive preemptive rights, approval by  $\frac{3}{4}$  of shareholders in

<sup>8</sup> If the number of members on the supervisory board are not sufficient then the court can appoint additional members on the request of the management board (CA § 257).

the GMS is required (CA § 308). The law allows company statutes to waive preemptive rights on new issues. The new Code requires that the announcement for issuance of new shares be made 10 days prior to the date set for establishing shareholder status in the register. Pre-emptive rights are also prescribed by the Code.

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

**Assessment: Partially Implemented**

**Sales of major corporate assets.** Major corporate transactions require shareholder approval. Transfer of assets or sale of more than ¼ of founding capital requires ¾ majority at the GMS. (CA § 301). A similar majority is required for mergers (CA § 516).

There are no general requirements for shareholder approval of related party transactions.

**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: Broadly Implemented**

**Meeting deadline.** The annual general meeting must be held within the first 8 months of the financial year (CA § 301a).

**Meeting notice content.** Shareholders are notified 30 days in advance for an annual general meeting by a meeting invitation in a company designated journal. (CA § 277) For any other meeting, shareholders are notified 14 days in advance. Unless the articles provide otherwise, shareholders holding at least 1/20<sup>th</sup> of share capital can convene a GMS. (CA § 278)

The meeting notice must include the agenda and location and invitation to the meeting, nominations for the supervisory board, and proposed amendments to the articles of association if any. (CA § 280). The GMS does not have the authority to decide on items on the agenda which have not been properly published.

At the GMS, shareholders can request information on company business, legal and business relations, change or acquisition in share holdings. Management also presents all relevant financial and other information on subsidiaries (CA § 287). Company management may refuse to provide information on taxes paid and differences in book value and market value of assets. (CA § 287) In that case the court decides shareholders' requests as to whether the management board is obliged to provide them with relevant information. (CA § 287,288).

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

**Assessment: Partially Implemented**

**Forcing items onto the agenda.** Shareholders may send proposals, countermotions to the management board within 7 days of the invitation to the GMS (CA § 282)<sup>9</sup>.

**Shareholder questions.** In practice, shareholders do ask questions at the meeting, though the legal basis for discussion of items not on the agenda is limited.

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

**Assessment: Partially Implemented**

**Facilitation of shareholder participation.** Shareholder participation is facilitated via various means, including appointment of directors, various rights to decision making at the GMS level (approval of mergers, issuing new capital, change to bylaws

<sup>9</sup> Countermotions may not be communicated to shareholders if :- (i) countermotion represents a criminal offense, (ii) the countermotion would lead to a decision of the general meeting which would be contrary to law or the articles of association of the company, (iii) statement of reasons for the countermotion includes certain material aspects data which are manifestly incorrect, or data which might mislead shareholders, (iv) if a shareholder's countermotion, based on identical facts, has already been communicated to the general meeting, (v) an identical countermotion of a shareholder, with essentially the same explanation, was communicated to the general meeting at least twice in the past five years and was endorsed by shareholders whose aggregate shareholding equals less than one-twentieth of the contribution capital of the company, (vi) it is clearly evident that the shareholder will not take part nor be represented in the general meeting, (vii) at two sessions of the general meeting held during the past two years the shareholder did not, either in person or through his representative, present any countermotion which he has communicated.

and charter, major transactions) and rights to information.

**Cumulative Voting / Proportional Representation.** Under CA, voting is done on the basis of a simple majority rule. However, in practice prior agreements may result in proportional representation. The articles may also allow for some shareholders with a certain proportion of votes to be able to appoint supervisory board members directly.

**Approval of board and key executive remuneration.** The GMS or the articles determine the remuneration for the supervisors, though in the later case the GMS can change the articles with a majority vote. The supervisory board determines the remuneration for management board members.

#### Principle IIC 4: Availability to vote both in person or in absentia

##### Assessment: Partially Implemented

**Proxy regulations.** Shareholders may vote either in person or by proxy (CA § 291). Shareholders can nominate another person as his proxy to attend and vote instead of him. There are no restrictions on appointments as proxies. Company articles can require that proxy appointments be notarized. Proxy voting through custodians is common.

The new Code requires that the process of voting through proxies be simplified and made cost effective.

**Postal and electronic voting.** The option of electronic voting or voting by post/mail is not available. The Code encourages companies to use electronic voting, it is not clear if this is possible under the law.

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

##### Assessment: Partially Implemented

Article 115 of the Securities Law and related articles of the SMA require disclosure of significant direct or indirect ownership. The SDA lists the top ten direct shareholders on its website and provides the complete list of shareholders to a shareholder in that company. The new corporate governance code recommends that a company disclose a complete list of shareholders and details to the public. Such information should be updated twice every month. The CA has also been amended to require more comprehensive disclosure of ownership information.

In practice, information on ultimate ownership—including the holders of shares in custody accounts—is not readily available in Croatia. Ownership can be obscured through custody and offshore accounts.

**Classes of shares.** Two kinds of shares are used, ordinary shares, each of which has one vote, and preferred shares, which may not have voting rights. Multivoting shares are not allowed.

**Disclosure of disproportionate control.** The provision of the SMA requiring indirect disclosure by significant shareholders is not effectively implemented.

**Disclosure of shareholder agreements.** Shareholder agreements are common and not required to be disclosed.

#### 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: Broadly implemented

**Basic description of market for corporate control.** The market for corporate control is relatively active in Croatia. Foreign companies have been buying large stakes in Croatian firms. The privatization wave continues and recently an oil company had its IPO.

Target	Acquirer	Nature of Deal	Amount	Year
Dukat	Lactalis	Friendly	€ 300 mil	2007
INA		Privatization	\$455 mil	2006
Pliva d.d.	Barr	Friendly	\$2.2 bn	2006
Splitska Banka	Societe Generale	Friendly	€ 900 mil	2006

These transactions took place on and off the stock exchange. All takeover bids must be approved by the Croatian Competition Agency. The regulations governing takeovers and mergers (henceforth "Takeover Rules") in Croatia are clearly laid out in the Securities Law and Law on Takeovers in Joint Stock Companies. HANFA is responsible for ensuring that the

requirements of the law are complied with. The general authority for merger oversight is the Croatian Competition Agency. In addition to the Agency's authority, the merger control of banks is exercised by the Croatian National Bank.

Shareholders seeking redress can go to the HANFA or Commercial Courts for disputing decisions and contracts for shares acquisitions.

**Disclosure of substantial acquisition of shares.** The law requires disclosure of large stakes and acting in concert in the context of a takeover.

**Tender rules/mandatory bid rules.** A bidder that acquires 25 percent of the total number of votes has to publish a takeover bid. The bidder continues to publish bids when he/she acquires up to 75 percent of voting shares. After which he/she has to publish a bid in 5 percent increments. The price given in the takeover bid cannot be lower than the highest price that the bidder acquired the shares.

**Squeeze out provisions.** The CA allows a single shareholder that controls 95 percent of another company to buy out the remaining 5 percent of shareholders.

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

**Assessment: Partially implemented**

**Description of anti-takeover devices in use in the market.** Firms do have anti takeover devices. While the Takeover Act limits the ability of the management board to issue authorized shares or make extraordinary decisions that could have a significant impact on the assets or liabilities of the company; poison pills and shareholder agreements are known anti-takeover devices used in Croatia.

Golden parachutes are also used. Upon request they are disclosed to investors. Their adoption or rescission does not require GMS approval.

**Duty of loyalty in the event of a takeover.** The Takeover Act requires the supervisory board to provide an opinion on a takeover bid, but otherwise "may not act in any way that may lead to any influence on the takeover bid". There is no requirement or equivalent for board members to "act in the interest of the company" or advise shareholders regarding potential changes in control.

**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**

**Blocked shares/record date.** Companies can set the date for which shares are registered for the meeting. The new corporate governance code requires that shareholders register their status at most 7 days before the GMS.

**General obligations to vote.** Institutional investors have no general obligation to vote by law.

**Disclosure of voting policy.** Institutional investors have no specific rules on disclosure of voting policies and activities.

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

**Assessment: Partially Implemented**

**Institutional investor policies on conflicts of interests.** Institutional investors are not required to disclose management of conflicts of interest. To mitigate conflicts of interests custodians are required to maintain separate custodian and client accounts. Pension funds are also required to be incorporated separately and limit contact with their parent company(ies). Other investment funds are not as closely regulated.

**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: Broadly Implemented**

**Rules on shareholder consultation and acting in concert.** There appear to be no rules that obstruct the ability of

shareholders to consult with each other on the execution of their basic shareholder rights. There is an acting in concert rule in takeover law (§ 8)<sup>10</sup>.

### 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**

**Equality within share classes.** Under the law, a class of shares must provide the same rights to all holders of those shares (CA § 168) and notes that "Under the same conditions, shareholders shall be equal in the company" (CA § 211).

**Availability of share class information.** The summary information disclosed by public companies through HANFA and the ZSE include the number of ordinary shares and preferred shares. The description of the security on the ZSE website also notes "votes per share" (1 for ordinary shares and 0 for preferred shares) and includes a link to the prospectus, which should include any special rights for preferred shares. This information should also be available at the court registry.

The new Code recommends that if companies issue non-voting shares then they should disclose all relevant information regarding these shares. The CA has been recently amended to require the company to disclose any classes of shares with special rights.

**Approval by the negatively impacted classes of changes in the voting rights.** A ¾ majority of preferred shareholders can remove the rights provided by their shares, at which point they become ordinary, voting, shares. Preferred shareholders must also approve new issues of preferred shares and have preemptive rights. Preferred shareholders also gain voting rights if obligatory dividends are not paid. (CA § 296-297).

**Principle III A 2: Minority protection from controlling shareholder abuse; minority redress**

**Assessment: Partially Implemented**

#### EX ANTE PROTECTIONS

**Pre-emptive rights.** Shareholders have preemptive rights. These may be waived by company articles or by a ¾ majority at the GMS.

**Ability to call meeting.** Shareholders holding at least one twentieth of the share capital may call for the GMS. If the management board does not accede to their request, they may go to court and receive authorization to convene the meeting themselves (CA § 278).

#### EX POST PROTECTION

**Ability to sue to overturn meeting decisions.** A shareholder may go to the commercial court to set aside a decision of the GMS if the decision was adopted contrary to the provisions of law or of the articles of association. They may also contest the

<sup>10</sup> Natural persons and/or legal entities shall act in concert:(a)if they have agreed to harmonise their actions with respect to the acquisition of the issuer's shares or with respect to exercising their right to vote towards the issuer; or (b)if one of them holds shares for the account of another.(2) Legal entities, as well as natural persons and legal entities, shall act in concert when one of them directly or indirectly controls another or other legal entities.(3) Pursuant to paragraph 2 of this Article, a natural person or legal entity is deemed to be controlling a legal entity if(a) it holds, directly or indirectly, a share of 25% and larger of the initial capital of the legal entity;(b) it has, directly or indirectly, 25% and more voting rights at the general assembly of the legal entity;(c) it has the right to manage business and financial policies of the legal entity on the basis of statutory authorisations or authorisations arising from agreements;(d)it exerts, directly or indirectly, the prevailing influence on the management of business operations and the decision-making process.(4) Companies shall act in concert if they are interrelated pursuant to the provisions of the Companies Act.(5) Natural persons are considered to be acting in concert if they are consanguineously related lineal kin or collateral kin of the first degree, and if they are spouses.(6) The establishment of acting in concert by an agreement referred to in paragraph 1, item (a) above shall be equal to the acquisition of shares carrying voting rights.(7) The votes of persons that act in concert with the offeree shall be added to the offeree's votes.(8) When the obligation to publish a takeover bid results from the establishment of acting in concert based on an agreement referred to in paragraph 1, item (a) above, or if one of the persons that act in concert acquires shares so that such acquisition results in the obligation to publish a takeover bid, every such person shall be obliged to publish a takeover bid in accordance with the terms and conditions defined by this Law. The obligation to publish a takeover bid shall be deemed fulfilled if the bid has been published by any of the persons who act in concert.

decision if it 1) benefited another shareholder who approved of the decision at the GMS; 2) the decision was to the detriment of the company or other shareholders; and 3) other shareholders were not adequately compensated for the damage incurred (CA § 360). The contesting shareholder must be on record as opposing the decision, or must have somehow been prevented from participating in the GMS (CA § 362). Affected shareholder can also attempt to set aside decisions that prevented the proper payment of dividends or exercise of preemptive rights (CA § 365 & § 366).

The CA also specifies decisions that are void if correct procedures are not followed.

**Redress from regulators.** In disputes between shareholders and issuers, HANFA may refer cases to the State Prosecutor or other relevant bodies, and staff members may testify in court as expert witnesses; however HANFA cannot issue fines or suspend or overturn decisions directly.

**Ability to sue directors (and major shareholders).** Shareholders, either individually or as a group, may sue board members, the company, or other shareholders, for damages incurred. They may also sue individuals that have an “undue influence” in the company (CA § 273), and may, albeit under restrictive circumstances, have a company hire a special representative to bring the suit directly against the person exercising undue influence, or a court do so on their behalf<sup>11</sup>. In practice, liability falls primarily on management board members, not supervisory board members. Shareholders cannot sue on behalf of the company (i.e. cannot file derivative suits). Suits by shareholders are not common, and generally require clear procedural violations to be successful.

**Withdrawal rights.** Shareholders have no special rights to sell their shares back to the company. Under the CA (CA § 301) a shareholder with 95 percent or more can buy out remaining shareholders at an “adequate” price. This price is frequently disputed in court.

**Inspection Rights.** Under CA article 287 “the management board shall provide each shareholder, at his request, with relevant information regarding the company business, where necessary, for proper evaluation of the items on the agenda.” However, the act also notes a number of exceptions (see IIC1). If a shareholder acquires information outside the GMS, then that information must be offered to all shareholders. Dissenting shareholders may go to court to demand information on a decision of the management board.

The GMS can request the appointment of special auditors for the company that can inspect the company’s records and demand information from the company’s boards. Special auditors can also be “appointed by the court upon request of shareholders whose aggregate shareholding equals to at least one-tenth of the share capital of the company, provided there is a reasonable doubt that there have been irregularities in the process of the establishment of the company or that the law or the articles of association have been violated”. The court can also change the special auditor if there is some doubt about their ability or competence. The cost of the auditors must be born by the company (CA § 298-300). The CA was recently amended, requiring those demanding the inspection to pay for it under certain circumstances.

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

#### Assessment: Broadly Implemented

**Rights of beneficial owners.** The custodian must inform the shareholder of the GMS and the issues to be decided, request voting instructions from the shareholders, and propose to the shareholder how they plan to vote the shares held in custody if they do not receive instructions (CA § 284). The CA requires that custodian shall “take the shareholder’s interest into account and shall take his best effort to prevent the custodians interest...from affecting this”. This article was amended in 2003 to also require the custodian to declare certain potential conflicts of interest, such as their board member serving on the board of the company in which the shares are held, or if the custodian is a member of a consortium that has acquired shares in the respective company.

**Depository receipts.** Holders of depository receipts have the same rights as other shareholders whose shares are held by a custodian or other financial institution.

### Principle IIIA 4: Obstacles to cross border voting should be eliminated

#### Assessment: Partially Implemented

**Clarity of right to exercise voting rights.** Custodians are supposed to inform shareholders, including foreign shareholders, of the GMS and request instructions as noted above.

**Meeting notice requirements.** The management board of the company has up to twelve days after publishing the invitation to the general meeting to contact custodians directly.

**Procedures to facilitate voting by foreign investors.** There are no restrictions on foreigners holding shares and foreign shareholders may vote by proxy or through their custodian in the same manner as domestic shareholders. However, the lack of postal or electronic voting, and the requirements by some companies for notarization of proxies may limit foreign

<sup>11</sup> Under article 273a, the shareholders must have at least 8,000,000 HRK in registered capital, or must go to court, and have at least one twentieth of capital, or 4,000,000 HRK worth.

participation.

The Code encourages the company to treat foreign shareholders the same as other shareholders.

#### Principle IIIA 5: Equitable treatment of all shareholders at GMs

**Assessment: Partially Implemented**

**Procedures to facilitate voting (electronic and postal voting systems).** Neither postal nor electronic voting are currently possible. However, the Code notes “Shareholder participation and especially voting at the [GMS] should be enabled by the use of modern communication technology”.

**Equitable treatment of shareholders at meetings.** Shareholders can make counter motions regarding the agenda and can, in most cases, make proposals or ask questions at the meeting. However, the chairman of the supervisory board does have ultimate authority over the conduct of the meeting. A shareholder who is prevented from participating fully in the meeting has standing to petition to set aside its decisions (CA § 362). In practice, shareholders have been prevented from participating through a range of tactics, ranging from employees blocking the meeting to providing inadequate or misleading information on the meetings location.

**Disclosure of voting results.** Results of the decisions are to be confirmed by a notary and recorded in the minutes.

**Cumulative Voting / Proportional Representation.** Under the CA voting is done on the basis of simple majority rule. However, in practice prior agreements may result in proportional representation. The articles may also allow for some shareholders with a certain proportion of votes to be able to appoint supervisory board members directly.

#### Principle IIIB: Insider trading and abusive self-dealing should be prohibited.

**Assessment: Partially Implemented**

**Basic insider trading rules.** The SMA defines privileged information as information that is not known to the public and that might “influence the price of securities” (§ 103). The act contains general provisions on not disclosing this information or taking advantage of such information when trading in securities. It specifies that board members, along with their parents, spouses, and children, shall be considered to possess privileged information (§ 105). Market participants have expressed some uncertainty on the implications of these provisions and what sort of actions they prohibit in practice.

The Code also notes that company should ban the use of inside information (price sensitive information that is not known to the public) by shareholders, members of either board, or external advisors. It encourages the company to establish mechanisms to supervise the flow and use of such information.

**Insider trading disclosure.** Under the SMA, board members are to disclose to the company if they trade in the company’s securities, and in turn the company is to disclose that information in the “daily press” within seven days of receiving the information.

The Code notes that board members should regularly disclose their holdings of the company’s shares.

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

**Assessment: Not Implemented**

With some narrow exceptions, there are essentially no requirements in the CA for members of either board to inform the supervisory board, shareholders, or public, of any interest they may have in a transaction being considered or undertaken by the company. The broad language on “privileged information” in the SMA may be interpreted to require such disclosure under certain circumstances, but it rarely occurs, or is interpreted that way, in practice.

The new Code notes that Board members should disclose potential conflicts to other board members. It also notes that related party transactions should be based on market principles, stated clearly in the company’s reports, and confirmed by a neutral assessment.

**Conflict of interest rules and use of business opportunities.** The supervisory board must approve loans to supervisory and management board members (CA § 249, 271), contracts between the company and supervisory board members (CA § 270), and positions or activities of management board members that may compete with the company (CA § 248).

There are no provisions on abuse of potential business opportunities or other conflicts of interest.

### 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

<b>respected.</b>
<b>Assessment: Broadly Implemented</b>
<p><b>Stakeholder participation in corporate governance.</b> Employees in Croatian companies have the right to be represented by unions and participate in collective bargaining. They may also participate in the governance of the company through workers councils, board representation, and/or by holding shares in their employer.</p> <p>The Code encourages management board members to take into account the interest of stakeholders, ensure transparent and quality relations with them, and notes that management board members are responsible for ensuring their rights are respected.</p> <p><u>Employee board representation:</u> According to the Labor Act, a worker's representative must sit on the supervisory board in a company with more than 200 employees and which is more than 25 percent owned by the Republic of Croatia or by a unit of local and regional self-government, as well as in public institutions, regardless of the number of workers employed in the enterprise or institution concerned.</p> <p><u>Worker Councils:</u> Under the Labor Act, employees may form a workers' council if their employer has at least 20 employees. Workers' councils are not compulsory, and may be established by a trade union motion or by at least 10% of the employees. Employers are obliged to consult the council regarding decisions that will affect the employees. This includes reassignment and dismissal plans; health and safety measures; the introduction of new technology; changes to the organization and methods of work; and the adoption of redundancy and social security plans. Employers must have the consent of the council to dismiss older employees or those with (imminent) disabilities.</p> <p><u>Employee share ownership:</u> As noted under IV C, employee share ownership is relatively common. However, employees have been known to come under pressure to use their shares to support management.</p> <p><u>Creditors:</u> Creditors have certain rights under the CA, as noted under IVF. In practice, some companies do have representatives of banks on their supervisory boards, and banks can exert influence on companies through their direct, and, via funds and custodian accounts, indirect share holdings.</p> <p><b>Corporate social responsibility and codes for stakeholders.</b> Some of the larger companies in Croatia support charities and report on issues like the environment and community impact. The Croatian Employers Federation and the Croatian Association of Management Consultants, working with UNDP, have introduced CSR training aimed primarily at middle management, but have also done some events for board members. The Croatian Chamber of Commerce has introduced a Code of Business Ethics that addresses CSR issues, including the environment, corruption, and employee and community relations. Over 500 companies have signed up to it. However, some market participants feel that these efforts are mostly for show, and have limited substance behind them.</p>
<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: Broadly Implemented</b>
<p>Employees, creditors, and other stakeholders, either individually or as a group, can take companies to court for violation of relevant legislation or contracts. In some cases they can sue management board members and other relevant employees, who may also have criminal liability for serious violations of stakeholder rights. Stakeholders face the same delays and procedural burdens in court that shareholders do (see ID).</p> <p>Croatia is a signatory to the New York convention and other international conventions on arbitration. By mutual agreement, parties to a contractual dispute may seek resolution through the Arbitration Court attached to the Croatian Chamber of Commerce.</p>
<b>Principle IVC: Performance-enhancing mechanisms for employee participation should be permitted to develop.</b>
<b>Assessment: Broadly Implemented</b>
<p>The CA allows the members of the management board to share in the profits of the company and requires the supervisory board to ensure that management board members' remuneration "bears a reasonable relationship to the work done by that management board member and with the condition of the company". It also allows for a reduction in pay to management board members if "financial circumstances...deteriorate to such an extent that further payment of remuneration...would result in gross injustice to the company" (246, 247).</p> <p>Employee and management ownership of their companies' shares is relatively common due to privatization. The CA also allows for companies to issue shares to employees. Share options are not widely used.</p>
<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: Partially Implemented</b>

In most cases, stakeholders have access to the same limited information that shareholders do (see section V).

In companies that have workers councils, the Labor Act obliges employers to inform the council about the company's business performance, development plans that affect employees, changes in salaries, industrial safety measures and general issues affecting the workers' economic and social circumstances.

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

**Assessment: Partially Implemented**

**Whistleblower rules.** Under the Labor Act, an employer cannot fire an employee that report wrongdoing. In practice, this protection is not considered to be effective, and "whistle blowing" by employees is rare.

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

**Assessment: Broadly Implemented**

Over the last eight years, the banking sector in Croatia has experienced large-scale restructuring and rapid growth. Foreign investment has been extensive and foreign controlled banks now hold 91 percent of all banking assets. Credit to the private sector has increased to 58 percent of GDP—high by the standards of the region or other transition economies—and the HNB has recently resorted to administrative controls to slow the growth of bank lending.

The HNB is generally considered an effective regulator and has a strong reputation amongst market participants. Thanks in part to its regulatory oversight, banks, at least the larger ones, meet relatively high standards for disclosure. The HNB is preparing a code of corporate governance for banks that are not listed on the ZSE.

**Effectiveness of bankruptcy, security/collateral, and debt collection/enforcement codes.** The CA allows creditors to hold board members liable for damages, requires the voiding of decisions of the GMS that are against the interest of creditors, allow creditors to demand security for their claims if the company engages in a share buy back (reduces share capital) and provides creditors additional rights in the event of bankruptcy and liquidation. Other protections for creditors are provided in the Law on Obligations and the Bankruptcy Act. Bankruptcy proceedings are overseen by the relevant commercial court and allow for reorganization as well as liquidation. Securitized lending is well established.

Standard measures developed by the World Bank indicate that legal rights for creditors are not as extensive compared to other countries in the region or the OECD. Access to information is particularly poor. (See Doing Business 2007 at [www.doingbusiness.org](http://www.doingbusiness.org)). However, these ratings may not fully reflect the revision of the Bankruptcy Act in 2006 to comply with EU requirements and the introduction of a Creditors' Registry.

Creditor Rights Indicator	Croatia	SEE Average <sup>12</sup>	OECD Average
Legal Rights Index (out of a possible 10)	5.0	6.2	6.3
Credit Information Index	0.0	2.7	5.0
Public credit registry coverage (percent)	0.0	3.1	8.4
Private bureau coverage (percent)	0.0	7.0	60.8

## 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: Broadly Implemented**

**Overview of Financial Reporting.** Public companies provide summary financial information to HANFA and ZSE, which is

<sup>12</sup> Average for South East Europe: Albania, Bosnia & Herzegovina, Bulgaria, Macedonia, Montenegro, Romania, Serbia, and Slovenia.

then made available online. These statements include: shares & issues, share price & earnings, 10 major shareholders (direct only), balance sheet, income statement, cash flow, changes in equity, and limited management comments. Shareholders should be able to receive full financial statements at the headquarters of the company, and under the Accounting Act, they are also to publish their full financial statements, but this rarely happens in practice.

The Code encourages companies to prepare statements in compliance with IFRS and post them on their websites. It also encourages them to make their annual reports available in English.

**Consolidation.** The CA and SMA imply and IAS 27 requires companies to produce consolidated financial statements and the requirements in the CA were recently strengthened. However, according to the 2007 Accounting and Auditing ROSC, the Accounting Act does not provide enough guidance on how to produce consolidated statements.

**Management discussion and analysis.** The Accounting Act does not require a management discussion or directors report in the annual report. The CA refers to a Supervisor Report and report on standing of a company or group, and has recently been amended to require a more detailed management report. The Code encourages the management board to report on business operations and the supervisory board to present a report to shareholders on the “overall efficiency of the company’s operations and performance of the company’s management”.

**Oversight, Sanctions and Remedies.** HANFA monitors compliance with the issuance of summary reports, and, under recent changes to the law, full annual reports. However, it has limited capacity to verify their quality. The HNB oversees compliance by banks. The larger banks do produce full statements that are accessible online.

#### Principle VA 2: Company objectives

##### Assessment: Partially Implemented

Company objectives are not required to be disclosed, except in the articles, which are available at the Court Registry. The Code encourages the management board to explain “any significant discrepancies between planned results and strategic objectives”.

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

##### Assessment: Partially Implemented

**Periodic disclosure of significant ownership.** Information on the 10 largest direct shareholders is available in summary statements posted online and from the SDA. The SMA (§115) requires that “a natural or legal person directly or indirectly” whose ownership crosses the 10 percent, 25 percent, 50 percent or 75 percent threshold notify in writing HANFA and the issuer within 15 days. The issuer in turn is required to inform the public. The Takeover Act has similar thresholds and requires reporting on parties “acting in concert” (see IIG). Information on shares issued and whether or not they are voting is also disclosed.

The Code encourages companies to make their full list of shareholders available to the public, and update it twice monthly. The CA has been recently amended to require companies to disclose more on indirect owners.

In practice, the level of ultimate ownership is not always disclosed. Custodian accounts and foreign holdings can be used to conceal ultimate ownership.

**Regulatory agency access to ownership information.** HANFA receives ownership reports directly. They can demand that banks provide information on the holders of custodian accounts.

**Disclosure of company group structures.** The CA defines groups and affiliated companies and requires reporting on groups to the GMS.

The Code encourages companies to disclose information on cross-shareholdings.

#### Principle VA 4: Remuneration policy for board and key executives, and information about directors

##### Assessment: Partially Implemented

**Material information about directors (qualification, selection, independence).** The name, age, and address of directors are reported in summary statements filed online. Minutes of the GMS, available from the Court Registry, record the process of selecting the supervisory board.

**Board member disclosure of holdings and transactions in company securities.** The SMA requires that board members report transactions in the company’s shares, and that these reports are made available to the public. Understanding of and compliance with these provisions is limited.

The Code encourages companies to report board member shareholdings in the annual report and regularly report changes on the company website.

**Full disclosure of remuneration and remuneration policy.** Information on remuneration is supposed to be disclosed in accordance with the IAS 19 and 24. It is unclear that this happens in practice.

The Code encourages detailed reporting on the remuneration of management and supervisory board members.

<b>Principle VA 5: Related party transactions</b>
<b>Assessment: Partially Implemented</b>
<p><b>Ex-ante disclosure of material related party transactions.</b> There are no requirements to disclose such transactions in advance.</p> <p><b>Periodic disclosure of related party transactions.</b> Relevant information on related party transactions are supposed to be disclosed according to IAS 24. However, the lack of supporting provisions in the CA (see VI D 6) and limited implementation of IFRS greatly limit compliance.</p> <p>The Code encourages companies to disclose transactions and potential conflicts of interest involving board members.</p>
<b>Principle VA 6: Foreseeable risk factors</b>
<b>Assessment: Partially Implemented</b>
<p><b>Disclosure of material risks.</b> Disclosure requirements related to material risks are based on IFRS requirements (IAS 32). The CA has been recently amended to require disclosure of policies regarding risk and internal controls.</p> <p>The Code encourages the management board to disclose, in a timely manner, current and probable risks for the company, such as political risk, economic risk, and operational risk.</p>
<b>Principle VA 7: Issues regarding employees and other stakeholders</b>
<b>Assessment: Not Implemented</b>
<p><b>Disclosure of stakeholder issues.</b> There is no requirement for public disclosure of material issues related to stakeholders per se.</p>
<b>Principle VA 8: Governance structures and policies</b>
<b>Assessment: Partially Implemented</b>
<p><b>Disclosure of corporate governance report (including structure and operation of board).</b> The Articles are available at the Court Registry, and board composition is available online.</p> <p>The CA requires disclosure on compliance with a Code of Corporate Governance. The Code was released in April, and includes a questionnaire public companies are supposed to fill in to track compliance.</p> <p><b>Comply-or-explain in force.</b> The Code is comply-or-explain.</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>
<b>Assessment: Partially Implemented</b>
<p><b>Compliance with IFRS.</b> Listed companies have been required to comply with IFRS since 2000. The translation process of IFRS was disrupted between 2000 and 2004, and the formal adoption of IFRS in the Official Gazette in December 2006 is from 2004. As a result, even those companies that use available IFRS guidelines are not in full compliance with the latest standards.</p> <p>Although the Accounting Act requires public companies to publish their full financial statements, in practice many companies do not make their statements publicly available<sup>13</sup>. Companies do file the summary statements required by HANFA, and these are available online.</p> <p>The Banking Act has financial reporting requirements for banks. There is some overlap and contradiction between IFRS and the different requirements of HNB (see the 2007 Auditing and Accounting ROSC). In practice, the major banks do comply with IFRS.</p> <p>The Financial Reporting Council (FRC) is in the process of drafting local accounting standards for SMEs, which will be based on IFRS as of 2000 and EU Fourth Company Law Directive. The FRC intends to apply all the exemption options for smaller companies available in the <i>acquis communautaire</i> regarding the preparation, presentation, publication and audit of financial statements.</p> <p><b>Review/enforcement of compliance.</b> Article 21 of the Accounting Act stipulates that representatives of companies can be fined up to HRK 50,000 and entities up to HRK 500,000 for the preparation of financial statements that do not give a true</p>

<sup>13</sup> A survey by USAID of the 10 largest Croatian companies found that full financial statements were only available from 4 of these companies in 2004 and 5 in 2006 ([http://www.pfsprogram.org/activities\\_pfs\\_see\\_croatia.php](http://www.pfsprogram.org/activities_pfs_see_croatia.php)).

and fair view with the intent to obtain financial advantage. Entities can be fined up to HRK 500,000 for the preparation of financial statements based on invalid documentation. However, HANFA has no authority to enforce the provisions of the Accounting Act, and there is no other regulator dedicated to its enforcement.

**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**

**Audit Requirements and Auditor Independence.** All listed, regulated and firms with a turnover higher than 30 million HRK are required to have consolidated financial statements that are externally audited. The law also requires all connected companies whose controlling company is subject to audit to have externally audited annual financial statements. (Audit Act § 6). Financial institutions are required to have semi annual or quarterly audits. Audits must be undertaken by audit firms or auditors licensed by the Croatian Chamber of Auditors.

**Auditor independence.** Auditors and audit firms are prohibited from providing additional services to the audited entity, and may not have business or other relationships with audited entities (Audit Law §11, 21,22).

It is mandatory for auditors to purchase insurance which ranges from HRK 100,000 to 3 million for financial companies. The Banking Act requires the rotation of bank auditors every four years.

**Auditor qualifications.** External auditors need to have a university degree, 3 years of experience, and a certificate from the Audit Chamber (Audit Law § 7). They must provide evidence of no prior conviction for criminal acts involving payment transactions and operations. They must be registered with the Chamber of Auditors.

Currently, Croatia has approximately 960 certified auditors and 250 audit firms, including local member firms of major international networks. The 2007 Auditing and Accounting ROSC finds that continued education of accountants and auditors is a major problem and the current content of qualification exams is outdated.

**Audit quality assurance / enforcement.** All auditors are required to follow International Standards of Auditing (Audit Law §17). However ISA are still being translated into Croatian. The audit profession is regulated by Chamber of Auditors, a self-regulatory organization established in 2006. The Chamber has a governing board with 11 members including one member appointed by the MoF, the rest are members of the profession. The body is essentially a self-regulatory one, though MoF does have formal oversight powers.

There is currently no systematic quality assurance to detect and correct poor audit quality. According to the Audit Act, the Chamber of Auditors is responsible for audit quality control and disciplining members of the profession. All auditors and audit companies should fully comply with the audit regulations by March 18, 2007. However, the Chamber has limited institutional capacity and an adequate monitoring system has yet to be implemented. Self-regulatory organizations in other countries have been criticized for a lack of enforcement actions and power.

**Audit standards development.** The Chamber's Code of Ethics is based on the 2005 IFAC handbook, but plans to update it. The Chamber is also working to complete the translation of ISA, and hoping to publish it in the Official Gazette in 2007.

**Board reporting of the audit relationship.** There are no requirements for either board to report on its relations with auditors.

**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: Partially Observed**

**Auditor accountability to shareholders.** The external auditor must be appointed by the GMS (CA § 275) and shareholders can request an independent audit at the company's expense (CA § 300). The auditors report to the management board, supervisory board and audit committee (Audit Act and CA).

Auditors have a general contractual obligation to the company. They may be fined or imprisoned for either not disclosing relevant circumstances or for disclosing business secrets (CA § 628, 629) and may be fined for violating the requirements of the Audit Act.

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

**Assessment: Partially Implemented**

**Material facts.** All information and facts influencing price and securities is regarded as material information (SMA). This information is supposed to be disclosed to HANFA and normally posted on the ZSE website.

**Easy accessibility of disclosed information.** Shareholders have access to summary statements, 10 main direct owners, and material reports by public companies online. Shareholders can request for additional information from the company (CA § 287) and should have access to the articles, board meeting minutes, board attendance information and GMS minutes

through the Court Registry. Some large companies do publish their financial statements and other information on their websites. Many do not.

**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: Partially Implemented**

2006 amendments to the SMA increase the penalties for market manipulation: journalist as well as market participants can be held liable for passing on information designed to manipulate stock prices.

**Disclosure of conflicts of interest by analysts, brokers, rating agencies.** This information is currently not disclosed.

**Regulation of sell-side analyst conflicts of interest.** There is little regulation in this area outside of the general provisions on market manipulation noted above.

#### 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**

Croatia has a two tier board system with a management and a supervisory board. One of the members of the management board is appointed the chairman (CA § 239). The number of directors on the management board is determined by the company's articles of association. The supervisory board is required to have a minimum of 3 members (CA § 254). The maximum number of members on the supervisory board is dependent on the share capital of the company<sup>14</sup>.

Firm	Management Board	Supervisory Board
INA	7	6
Podravka	6	11
Zagrebacka Banka	8	9
Adris Grupa	5	8
Viadukt	3	7
Tisak	1	11
Jadranski Naftovod	1	5
Eriksson Nikola Tesla	1	5
Pliva	5	5
Atlanska Plovidba	5	7

The table provides the average board size and division across the supervisory board and management board for the 10 largest companies in Croatia. On average firms have 3-5 members on the management board and 5-7 members on the supervisory board.

The CA was recently amended to allow for one tier board structures, i.e. a single board of directors. There is little experience with this board structure in practice.

**"Duty of care" and "Duty of loyalty".** Directors on the management board and supervisory board have the duty to act "as good businessmen (CA § 252, 272). The new Code suggests that the supervisory board members should "discharge their

<sup>14</sup> For companies with a share value of DM 3,000,000 the supervisory board can have up to 9 members. Companies with counter value above DM 3,000,000 can have up to 15 members. Lastly for companies with share capital exceeding DM 20,000,000 the supervisory board can have 21 members.

duties with diligence of fair and conscientious professionals and keep the company's business secrets". Until recent revisions to the CA, there was no duty of loyalty to the company or the shareholders for supervisors.

The Code does recommend that the management board "act in the sole interest of the company and its shareholders, while also taking into account the interest of the employees and wider community, with a view to increasing the value of the company". This is a duty of loyalty, albeit one that only applies to directors (not supervisors) and has no legal liability attached to it.

**Effective enforcement.** The management and supervisory board members who violate their duties are jointly and severally liable for the damage inflicted on the company (CA § 252, 272). There is no liability to compensate if the actions of the management board members were based on a decision of the GMS<sup>15</sup>. Shareholders cannot file derivative suits on behalf of the company: such suits must be initiated by the boards. Shareholders can sue for damage they incur due to board member behavior. In practice, management board members are sometimes sued successfully; supervisory board members almost never are, in large part due to their limited responsibility.

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

**Assessment: Partially Implemented**

**Board "duty of loyalty" / duty to treat all shareholders fairly.** There is no explicit requirement for board members to treat shareholders equitably. The CA has a general provision that "Under the same conditions, shareholders shall be equal in the company" (CA § 211). It also notes that board members will be liable if they assist someone, including a shareholder, to have "undue influence in the company" that causes damage to shareholders (CA § 272). However, they face no such liability if the decision is made by the GMS.

The new Code recommends that the management board act in the sole interest of the company and its shareholders.

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

**Assessment: Partially Implemented**

**Development of company codes of ethics.** Neither the CA nor the Code require boards or companies to have codes of ethics. The Code does require that the supervisory board have an "internal code of conduct" and that no document "shall prevent any member in acting in accordance with the law".

Some of the larger companies have codes of ethics which are published on their websites. There is no specific statute applicable to boards regarding corruption, which falls under general criminal acts. The Chamber of Commerce has introduced a code of ethics for its members. Over 500 businesses have signed up to support it.

**Board and interest of stakeholders.** Employees of companies and bank representatives participate in the governance of some companies through board representations. The management board can be sued for violations of stakeholder rights. The Code recommends that managers "tak(e) into account the interest of the employees and wider community".

**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**

**Central and strategic role played by boards.** The management board is responsible for the management of the day to day business of the company. The management board also prepares and enforces decisions, bylaws and contracts as requested by the GM (CA § 243). The CA requires the management board to submit reports on business policy, future business strategy, profitability, revenues, financial condition of the company, material business activities to the supervisory board at least once a year (§ 250). The articles of association might provide for a different method of management (CA § 240). In case of a disagreement among board members the final decisions is made by the minority of members or in the case of a tie in voting, the chairman is the pivotal voter.

Supervisory boards are required to supervise the management of the company's business, and control and inspect business books and documents of the company (CA § 263). Written reports on compliance to laws, bylaws, and 'true' financial position have to be submitted by the supervisory board to the GM. The supervisory board can also convene sessions of the

<sup>15</sup> The company may waive its claim for compensation of the damage or negotiate a settlement of the claim only upon the expiry of 3 years after the claim was first made but with the consent of the general meeting (CA § 252), and if there is no objection from the minority owning at least 1/10th of the share capital of the company. The time limit does not apply if the person is declared insolvent. However, in cases other than those mentioned above, the foregoing shall apply only if the management board member has grossly violated his duty to act as a prudent businessman.

GM. The supervisory board might be required to manage the company. This decision requires a ¾ majority of the GM. The new Code, in addition to what company law requires, specifies that supervisory board should report on all supervision activities performed.

The Code suggests that the supervisory board and the management board should cooperate and discuss strategic guidelines of the company's business.

**Director training, IOD.** Training of supervisory board members is a relatively new concept, and there are no organizations focused on director training. There is also no formal process of director accreditation.

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

**Assessment: Broadly Implemented**

**Board oversight of legal compliance.** The supervisory board is required to report to the GMS on the companies' compliance with relevant laws.

**Board oversight of code compliance.** The CA requires the management and supervisory board to act in accordance with the Code or explain any deviations from it (§ 272a).

**Board self evaluation.** The Code recommends that the supervisory board do a self evaluation. The evaluation should include an evaluation of each member and committees as well as an evaluation of the performance of the board compared to its targets.

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

**Assessment: Broadly Implemented**

**Board oversight of selecting and replacing key executives.** The supervisory board is responsible for appointing and determining the compensation of management board members. However, the management board might appoint (other) key employees. The management board may influence the decision with the help of reports and notices.

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

**Assessment: Broadly Implemented**

**Develop and disclose remuneration policy.** The remuneration for the board and the CEO is set by the supervisory board (CA § 247). The supervisory board sets the aggregate income of a management board member based on some kind of performance evaluation. The supervisory board, or the court at the request of the supervisory board, is entitled to reduce management board member compensation in response to worsening financial performance.

Members of the supervisory board may receive remuneration for their services based on a decision of the GMS(CA § 268). The articles of association also might provide directives on compensation for supervisory board members, though a majority of votes at the GMS may alter the articles in this case.

The new Code specifies that the remuneration of the supervisory board should be commensurate with the time, effort and experience. The remuneration should include a fixed component, a variable component based on operating performance. Detailed information on remuneration should be publicly disclosed. The Code requires that a remuneration committee be created which would propose the policy of remuneration, remuneration of individual members and monitor the amount paid to senior management.

For the management board, the company should provide a statement of policy on director compensation. The statement should include the relative portions, information on pay performance sensitivity and detailed information on the compensation contracts provided to the directors. The compensation for directors should be determined based on the performance of the director and the company.

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

**Assessment: Broadly Implemented**

**Clear and transparent board nomination process.** The supervisory board appoints the management board and its chairman for a maximum period of 5 years. Persons guilty of a criminal offense cannot be appointed to the management board (CA § 239). Such appointments are renewable (CA § 244). The renewable appointment cannot be made earlier than 1 year prior to the expiration of their mandate. The supervisory board has the power to revoke its decision on the appointment of board members provided there has been a violation of duty, or a no confidence vote has been passed at the GM. The decision can be contested in court. The removal is considered valid till its nullity is established by a court decision.

The members of the supervisory board are elected by the GMS (CA § 256). The articles of association may prescribe that certain shareholders and employees appoint a certain number of supervisory board members. However, not more than 1/3<sup>rd</sup> of the board can be appointed. Persons who are member of the management board, a member of supervisory boards in 10 companies, member of management board controlled by a JSE and member of the management board of another company

of capital in whose supervisory board there is one of the members of the company management board cannot be appointed to the supervisory board (CA § 255). Deputies of the supervisory board cannot be appointed.

The supervisory board members can be appointed for a maximum of a 4 year term which is renewable (CA § 258). The supervisory board elects a chairman and at least 1 deputy chairman among its members (CA § 264). The GMS can remove a member of the supervisory board even before his term expires (CA § 259). A  $\frac{3}{4}$  majority is required to remove a supervisory board member (this threshold can be changed in the articles). An appointed supervisory board member can be removed at any time by the shareholder who made the appointment.

**Effective shareholder participation in board nomination process.** Shareholders can participate in the nomination process with the help of counterproposals (CA § 283, 294). Nomination proposals made by shareholders who hold at least 1/10<sup>th</sup> of share capital have to be considered before the proposals of the supervisory board.

The supervisory board has the power to revoke its decision on the appointment of board members provided there has been a violation of duty, or a no confidence vote has been passed at the GM. The removal is considered valid till its nullity is established by a court decision.

**Disclosure of nomination procedures.** The nomination process is recorded in the supervisory board minutes and can be reviewed. The articles of association of a company might specify further requirements for disclosure of the nomination procedures.

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

**Assessment: Not Implemented**

**Board oversight of internal controls.** There are no requirements for mechanisms to put in place that reduce conflict of interests. Company law only requires management to act as prudent business persons and in the best interest of the company (CA § 252).

**Board oversight of related party transactions.** In the CA there are no rules regarding related party transactions. However, a member of the management board cannot engage in activities of a company with similar business without approval from the supervisory board (CA § 248)<sup>16</sup>. The company can also grant loans to management board after approval from the supervisory board (CA § 249). The loan agreement has to be concluded not later than 3 months after the date on which the decision on granting the loan has been adopted. The decision specifies the interest rate and installment payments<sup>17</sup>.

Companies are allowed to make loans to the supervisory board members upon the approval of the board (CA § 271).

The new Code proposes general rules for related party transactions. In particular the transactions should be based on market principles. The transactions should be ratified by qualified experts. Any contracts between the member of the supervisory board and the company should be approved by the supervisory board and any material facts should be disclosed in the annual report.

For insurance companies, the Insurance Act requires the board members to inform the supervisory board and the HANFA of any significant stock ownership as well as information regarding potential conflicts of interest. (Insurance Act § 32).

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

**Assessment: Partially Implemented**

**Board oversight of external auditors.** All firms are supposed to have internal audit functions. The head of the internal audit can attend audit committees but there are no specific provisions in Audit Law. The by laws of the company specify who the internal auditors report to. The Audit committee consists of members from the supervisory board and members nominated by the supervisory board (Audit Act § 27). One member should be an expert in the field of accounting. The audit committee oversees internal controls, audits, provides recommendations to the GMS and oversees other material reporting. They also comment on business plans, and oversee independence of auditors (Audit Act § 28).

The Code recommends that the audit committee provide recommendations regarding the appointment and reappointment of the external auditor, supervise their independence and objectivity, and analyze the effectiveness and causes of dismissal of the external auditor.

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

<sup>16</sup> If a management board member is engaged in the business of a competitor then the company can claim compensation. The company can ask for earnings made by the management board member to be transferred to the company.

<sup>17</sup> Other legal transactions which can be classified as a loan shall go through the same process of approval except in the case that the loan exceeds the monthly salary of the management board members.

**Assessment: Partially Implemented**

**Board oversight of disclosure process.** The supervisory board is required to examine financial statements and present the results to the GMS (CA § 300c-d).

**Board responsibility for communications strategy.** Under the Code, the management board should have a strategy on investor relations. The management board is encouraged to provide balanced and complete information on the status and position of the company. Investors should also be able to request information on the company from managers at any time. The management is also required to hold special conferences if investors request it.

**Principle VI E: The board should be able to exercise objective independent judgment on corporate affairs.**

**Principle VI E 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 requirements.** A member of the supervisory board cannot be a member of the management board (CA § 261). However, the supervisory board may appoint some of its members as deputies of missing management board members, but the appointment cannot last longer than 1 year.

The new Code adopted in April 2007 requires the supervisory board to be composed of independent directors. A well defined concept of independence is also specified<sup>18</sup>. Members of the management board should have financial expertise and business management experience.

**Separation of Chairman / CEO.** The two tier board system ensures the separation of the chairman and the CEO. The CEO is the head of the management board and the chairman oversees the supervisory board.

**Independent oversight of key board tasks including:**

**Financial Reporting.** The management board compiles financial statements which are approved by the supervisory board and the AGM. The audit committee which is composed of members of the supervisory board analyzes financial statements and oversee the external auditor.

**Related Party Transactions.** There are no requirements on oversight of related party transactions except in insurance companies. The Code proposes general rules for related party transactions. The transactions should be ratified by qualified experts. Any contracts between the member of the supervisory board and the company should be approved by the supervisory board.

**Board and executive nomination.** Supervisory board members are elected by the shareholders. Management board members are appointed by the supervisory board members who are by definition independent. The Code that has been adopted in April 2007 requires that the supervisory board set up an appointment committee. The appointment committee

<sup>18</sup> A supervisory board member is considered independent if:-

- 1) is not related to the company in any way, with the possible exception of holding a certain minor number of shares in the company; is not a majority shareholder or a group of majority shareholders, and is not a member of a group of majority shareholders, or a spouse, bloodline relative or in-law up to the second degree of any person from the aforementioned groups, or has any connection with the companies related to the majority shareholder.
- 2) is not a current or former member of the management board or the company or any of its subsidiaries or related companies for at least 5 years
- 3) is not a current or former employee of the company or any of its subsidiaries or related companies for at least 3 years.
- 4) does not currently receive and has not received other significant payment from the company except the remuneration for activities on the supervisory board, excluding a possible dividend
- 5) does not currently have and has not for at least one year had a significant business relationship with the company or with its related companies, directly or indirectly as a partner, shareholder, member of the management board or the supervisory board or of top management of an organization that has a significant business relationship with the company such as important indirect or direct suppliers and/or buyers of goods and/or services of the company (including financial, legal, advisory and consulting services) and organizations
- 6) is not currently nor has in the last 3 years been a partner or an employee of an audit company which provides or has provided audit services to the company or its related companies,
- 7) is not a member of the management board of another company in which some members of the company's management board serve as members of the supervisory board, nor has significant relations with members of the company's management board through participation in other organizations, bodies or companies.
- 8) has not been a member of the supervisory board for more than 12 years.
- 9) is not a spouse or is bloodline relative or an in-law up to the second degree to any members of the management board or physical persons holding positions stated in the above items

is responsible for appointments to the supervisory boards as well as providing evaluations for supervisory board members.

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

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

**Requirements and experience with committees of the board.** All listed firms are required to have an audit committee (Audit Act § 27-29). The audit committee consists of supervisory board members and at least one financial or accounting expert. The audit committee is responsible for monitoring the financial reporting, supervise the audit, monitor independence of the auditor, and give recommendations. The independent auditor is required to report to the audit committee on key issues and internal weaknesses.

The new Code requires that the supervisory board set up appointment, remuneration and audit committees. The appointment committee is responsible for suggesting candidates for both boards. The remuneration committee is required to propose the remuneration of board members and senior management. The audit committee is required to analyze financial statements, maintain sound internal control and risk management. The audit committee is also required to oversee the external auditor.

Most public companies have audit committees, as required by the Audit Act. However, their purpose, functions, and links to the supervisory board are not always well understood or consistently applied. Most companies do not have other types of committees.

#### Principle VIE 3: Board commitment to responsibilities

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

The CA does limit the number of boards a supervisor may serve on. The maximum number of boards that a supervisory board member can serve on is 10. (CA § 255).

**Company disclosure of board member activity.** There are no requirements for company disclosure of board member activity.

**Requirements for initial and on-going training.** There are no legal requirements for board training. The Code recommends that the company should “enable continuous professional training and education of management and supervisory board members.”

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

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

**Board access to information.** Directors, auditors and members of the supervisory board have access to any corporate information. Members of the supervisory board can request management to provide information on any business activities at any time ( CA §250).

**Free access to qualified advisors.** Board members may employ qualified experts.

## ANNEX: Summary of Improvements since the 2001 CG ROSC

Since 2001, when the first Corporate Governance ROSC for Croatia was conducted, Croatia has undertaken substantial legal and regulatory change that has led to a number of improvements in the corporate governance framework. These are summarized below with Acts of Parliament followed by other institutional changes, including the 2007 Code of Corporate Governance.

### ACTS OF PARLIAMENT

#### 2002 Securities Market Act (SMA)

- Defines public joint stock companies and requires them to be listed and regulated.
- Requires that shares be paid for in full and freely transferable.
- Requires disclosure of significant direct and indirect share ownership.
- Introduces rules for use and misuse of privileged information and insider trading.
- Requires public companies to disclose material events.

#### 2002 Act on Takeovers of Joint Stock Companies

- Requires tender offers during potential changes in corporate control.
- Includes a definition of acting in concert for determining control thresholds.
- Requires the target supervisory board to provide an opinion on an offer.
- Restricts activities by the target's boards that could influence or impact an offer.

#### 2003 Amendments to the Companies Act (CA)

- Requires listed companies to note compliance with a code of corporate governance.
- Allows a 95 percent shareholder to "squeeze out" remaining shareholders.
- Removed the possibility of "voting caps" on shareholders in listed companies.
- Requires custodians to act in the interest of their client and avoid conflicts of interest.
- Clarifies responsibility of the supervisory board for financial reports.
- Strengthens other shareholder rights.

#### 2005 Croatian Financial Services Supervisory Agency Act

- Creates a combined regulator for non-bank financial services (HANFA).
- Gives HANFA broad powers and independence from governmental interference.

#### 2005 Accounting Act

- Reaffirms that listed companies use IFRS and publish full IFRS statements.
- Allows smaller companies to use simpler standards.
- Creates a Financial Reporting Council to update IFRS translation on a periodic basis.
- Requires listed companies to publish full IFRS statements.

#### 2006 Audit Act

- Requires listed companies to have audit committees.
- Includes provisions to reduce potential conflicts of interest involving auditors.
- Creates a Chamber of Auditors to oversee the profession and audit standards.

#### 2006 Amendment to the Securities Market Act

- Strengthens provisions on market manipulation and misleading information.

#### 2007 Amendments to the Companies Act

- Requires companies to issue a management report.
- Incorporates EU requirements on mergers and acquisitions.
- Introduces an explicit duty of loyalty for supervisory board members.
- Allows for a one tier-boards.

#### 2007 Accounting Act

- Establishes online database of company information, including annual reports.

## INSTITUTIONAL CHANGE

### 2006 Croatian Financial Services Supervisory Agency (HANFA)

- Begins operations, issuing regulations and taking enforcement actions.

### 2006 Central Depository Agency (SDA)

- Lists on its website top ten shareholders for all public companies.

### 2007 Zagreb Stock Exchange (ZSE)

- Merges with Varaždin Stock Exchange, creating one marketplace for securities.

### 2007 Code of Corporate Governance

- Issued by HANFA and ZSE.
- All public companies must comply, or explain areas of non-compliance.
- To protect **shareholder rights** the Code recommends:
  - How to manage related party transactions and conflicts of interest.
  - Facilitating participation in the GMS.
  - Simplifying voting through proxies.
  - Making use of electronic voting.
  - Treating foreign shareholders the same as other shareholders.
  - Establishing mechanisms to supervise the flow and use of privileged information.
- To respect **stakeholders** the Code recommends:
  - Management board members consider stakeholder interest.
- To improve **disclosure** the Code recommends:
  - Disclosing material information on the company website.
  - Disclosing list of shareholders, cross shareholdings and shareholdings of board members.
  - Disclosing board member remuneration.
  - Making annual reports available in English.
  - Reports by both boards should report on company performance and risk.
- To improve the performance of **boards** the code recommends:
  - Supervisory board and management members should act diligently.
  - Management board members should “act in the sole interest of the company”.
  - The supervisory board should be composed of independent directors.
    - A well defined concept of independence is specified.
  - Remuneration of the supervisory board should be performance based.
  - The supervisory board should have remuneration, audit, and appointment committees.
  - The management board should have a strategy on investor relations.
  - Board members should participate in ongoing training.
  - The supervisory board should perform a periodic self-evaluation.

## Croatia Terms/Acronyms

<b>Acquis Communautaire:</b> The body of legislation of the European Communities and the European Union. Applicant countries must accept the <i>acquis</i> before they can join the EU
<b>CA:</b> Companies Act
<b>CEO:</b> Chief executive officer
<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>EU:</b> European Union
<b>GMS:</b> General meeting of shareholders
<b>GDP:</b> Gross Domestic Product
<b>HANFA:</b> Croatian Financial Services Supervisory Agency ( <i>Hrvatska Agencija za Nadzor Financijskih Usluga</i> )
<b>HNB:</b> Croatian National Bank ( <i>Hrvatska Narodna Banka</i> )
<b>HRK:</b> Croatian Kruna, the local currency. At the time of the report, there were approximately 5.5 HRK per US dollar.
<b>IFRS:</b> International Financial Reporting Standards
<b>ISA:</b> International Standards on Auditing
<b>JSC:</b> Joint Stock Company
<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>Public companies:</b> Public joint stock companies that meet the requirements specified in the SMA.
<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>SDA:</b> Central Depository Agency ( <i>Središnja Depozitarna Agencija</i> )
<b>Shareholder agreement:</b> An agreement between shareholders on the administration of the company, shareholder agreements typically cover rights of first refusal and other restrictions on share transfers, approval of related-party transactions, and director nominations.
<b>SOE:</b> State owned enterprise
<b>SMA:</b> Security Market Act
<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.
<b>ZSE:</b> Zagreb Stock Exchange

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

The assessments:

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

To see the complete list of published ROSCs, please visit  
[http://www.worldbank.org/ifa/rosc\\_cg.html](http://www.worldbank.org/ifa/rosc_cg.html)

To learn more about corporate governance, please visit the IFC/World Bank's corporate governance resource Web page at: <http://rru.worldbank.org/Themes/CorporateGovernance/>

---

Contact us at [CG-ROSC@worldbank.org](mailto:CG-ROSC@worldbank.org)