INVESTOR PROTECTION IN THE CIS

Legal Reform and Voluntary Harmonization

Edited by

RILKA DRAGNEVA

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Editor's Foreword

Building on the extensive interest in company law and corporate governance development in post-communist transformation, this volume examines the legal regime for protection of company investors in the Commonwealth of Independent States (CIS). We approach the subject in two principal ways. *First*, the discussion centers on the problems of domestic legal reform and the extent to which international legal standards and best practice are reflected in the process. The aim, however, is to go beyond the discourse of "compliance" which often dominates debates on legal reform in the transition economies of Eastern Europe. We offer an in-depth comparative law analysis of important aspects of investor protection, while pointing to the complex policy balance behind certain legal solutions to be made in any jurisdiction, but particularly in the post-Soviet context. More specifically, the focus is on investor protection through the provision of basic shareholder rights (*Rilka Dragneva*), cumulative voting (*Gregory Maassen* and *Rilka Dragneva)*, shareholder rights in special circumstances (*Davit Karapetyan*), and through securities markets regulation (*Hans-Joachim Schramm* and *Andrei Bushev*). The recognition of the complex socio-economic reality that domestic and foreign investors face has also led us to include a chapter on the investment climate in the CIS (*Joop de Kort*).

Second, this volume seeks to highlight the contribution of model legislation adopted within the CIS framework for legal developments in our chosen field. Model laws or other forms of "soft" harmonization have become a valuable ingredient of modern legal landscape—in the context of federal states (*e.g.*, the US), regional economic organizations (*e.g.*, the EU), or bodies pursuing international cooperation (*e.g.*, UNCITRAL). Against this background, the CIS model legislation process serves as an important example of voluntary harmonization, but also of creating an institutional medium for supporting domestic legal reform. The general assessment of the process of adopting model legislation in the CIS is the subject of the first chapter in this book (*Rilka Dragneva*). The remaining chapters take stock of legal solutions proposed particularly by the Model Legislative Provisions on Investor Protection of 14 April 2005. The volume also includes what we believe to be the first comprehensive collection of CIS model laws related to investor protection published in English.

The contributions to this book have sought to analyze legal developments in all CIS member states—Armenia, Azerbaijan, Belarus, Georgia, Moldova, Kyrgyzstan, Kazakhstan, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. We are aware that Turkmenistan changed its CIS status from a full member to an observer in August 2005. Yet, we find it

beneficial, where appropriate, to consider developments in that country too. Where a certain country has been excluded from the discussion of a particular chapter—either due to empirical difficulties, or because it does not deal with a given issue—a respective disclaimer has been made. We have aimed at reflecting the state of law as of 15 August 2006.

To paraphrase the famous sentence of John Donne, "*No book is an island, entire of itself* [...]".[1] In this sense, the preparation of this volume is related to three principal impulses. *First*, in certain ways, the book reflects thoughts developed out of the involvement of the majority of contributors in the drafting of the Model Legislative Provisions on Investor Protection for the Commonwealth of Independent States in the course of 2003-2004. This work was an exciting opportunity to delve into important issues of investor protection in the CIS, focus on the state of legal reform in the area, and gain insights into the working of the Inter-Parliamentary Assembly of the CIS. For this opportunity, a special debt is owed to Alexei Zverev from the European Bank for Reconstruction and Development, Eric Vinken of the Dutch Center for International Legal Cooperation, and the leadership of the Inter-Parliamentary Assembly of the CIS, including that of its Permanent Commission on Economy and Finance. I am particularly thankful for having been able to work—both in the drafting of the model law and in the preparation of this book—with stimulating colleagues such as Gregory Maassen, Davit Karapetyan and Hans-Joachim Schramm.

Second, at least as far as the contribution of this author is concerned, the book represents a fruition of a multi-year research project on the problems of legal harmonization and regional cooperation in the CIS. The work on this project, as well as the preparation of this book, was funded by The Netherlands Organization for Scientific Research (*Nederlandse Organisatie voor Wetenschappelijk Onderzoek*). A special debt of gratitude is owed to *NWO*, and particularly to drs. (*sic*) J.S. Voskuilen, for facilitating the publication of this book.

Third, the preparation of this volume builds upon the prior efforts and commitment of the members of the Institute of East European Law and Russian Studies (IEELRS), Faculty of Law, University of Leiden, The Netherlands, to the cause of legal development in the Commonwealth of Independent States. It has been the privilege of this author to belong to the IEELRS staff since 1999. This has been a wonderful opportunity to gain inspiration and grow in learning, but also on a more personal note, to make what I hope to be life-long friends and colleagues. In a similarly

[1] Meditation XVII in J. Donne, *Devotions Upon Emergent Occasions and Death's Duel*, New York and Toronto 1999.

personal vein, for a Bulgarian force-fed with Russian or, rather, Soviet ideology, this involvement has made it possible to reconcile myself with the world beyond the Black Sea, and get to know its cultural and human richness in new and truer ways. It is in this sense that I wish to make a personal dedication to my colleagues at the IEELRS, and particularly to those with whom I have been able to work most closely, including Joop de Kort, Hans Oversloot, Ferdinand Feldbrugge, Ruben Verheul, Wim Timmermans, and the late Ger van den Berg. My gratitude and deep appreciation go especially to William Simons for his continuous support and encouragement, vision, and friendship.

A special acknowledgement should be made of the competent and efficient contribution of Curtis Budden to the preparation of this volume. He took upon himself most of the legal language editing and, where needed, the translation of the different chapters. His contribution was critical in preparing the CIS model laws for publication by revising prior English-language drafts and/or translating from the Russian language. Similarly, many thanks to Alice Engl from the European Academy in Bozen/Bolzano, Italy, for her invaluable help with the technical preparation of this volume.

Finally, my warmest gratitude goes to my family for their support and interest in my work, and particularly to my husband, Alan Lewers, for his patience, faith in me, and readiness to help with whatever it takes.

Contents

CIS Model Legislation and its Contributions to Company-Law Reform and Harmonization

Rilka Dragneva[1]

Large-scale legal reform has been one of the defining elements of social life in Central and Eastern Europe in general, and in the Commonwealth of Independent States (CIS) in particular, over the last fifteen years. There has barely been an area of law left untouched in a process underpinning the region's move toward independent statehood, parliamentary democracy, a market economy, and the rule of law. A key place in this process was accorded to the revival of private law, particularly in relation to the legal framework for companies and other business operators. Deservedly, a great deal of attention was directed at domestic developments in the area of company-law reform by scholars and policy-makers both in the East and the West. Much of that attention focused particularly on the extent to which new laws reflected modern international legal standards and paradigms developed in the area of company law and corporate governance.[2]

What has remained insufficiently studied, however, is the contribution—actual and potential—to legal reform in the post-communist world of the process of voluntary harmonization through model laws undertaken within the CIS framework.[3] The adoption of model legislation has been considered important enough to attract the support of major international donors.[4] Yet the process has escaped the rigor of research and heat of de-

[1] The author would like to thank William Simons and Hans Oversloot for their helpful comments. The research on which this article is based was funded by The Netherlands Organisation for Scientific Research (*NWO*).

[2] The reference here is predominantly to the standards and best practices incorporated in the following documents: OECD, *Principles of Corporate Governance*, Paris 2004, available online at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>, as well as a number of CIS-related documents recently developed on the basis of the *OECD Principles*, such as OECD, *The White Paper on Corporate Governance in Russia,* Paris 2002, available online at <http://www.oecd.org/dataoecd/10/3/2789982.pdf>; EBRD, *Principles of Corporate Governance and Corporate Governance Checklist,* London 2000, available online at <http://www.ebrd.com/country/sector/law/corpgov/assess/check.pdf>; OECD, *Corporate Governance in Eurasia: A Comparative Overview,* Paris 2004, available online at <http://www.oecd.org/dataoecd/18/63/33970662.pdf>.

[3] We refer the reader to publications in this field that the present work will build on: W. Simons, "The Commonwealth of Independent States and Legal Reform: The Harmonization of Private Law", *Law in Transition* Spring 2000, 14; R. Dragneva, "The Reality of Models: Reflections on the CIS Model Law on the Limited Liability Company", 27 *Review of Central and East European Law* 2001 No.1, 113-131; Special Issue on "The Legal Regulation of Bankruptcy: Russian Legislation and Models for the CIS", 25 *Review of Central and East European Law* 1999 Nos.1-2.

[4] Such as the European Bank for Reconstruction and Development (EBRD), *GTZ*

Rilka Dragneva, ed.
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bate accorded both to legal reform as such and to similar developments in pursuit of legal harmonization internationally or in other regional settings. Much of this neglect, we believe, is not necessarily deliberate but rather the result of general attitudes to regional cooperation in the post-Soviet space and the perceived—both in the East and the West— "grand failure" of the CIS formula in promoting new-style economic integration.[5]

As with other "soft" and "hard" instruments for harmonization,[6] the use of model laws in the CIS can be discussed by reference to the advantages associated with legal uniformity, such as the creation of a regulatory level playing field, the reduction of cross-border transaction costs, predictability, and the general promotion of economic integration.[7] Another frequently mentioned purpose of harmonization is the improvement of domestic legal institutions, the presumption being that such an improvement is better done by a central legislator for a variety of reasons, such as economies of scale or the need to overcome domestic opposition to reform. We believe that CIS model legislation in the area of company law has a valuable role to play in both these directions and examine, in this work,

(*Gesellschaft für Technische Zusammenarbeit*), the USAID/Rule of Law Consortium, the Ministry of Foreign Affairs of The Netherlands, the Canadian International Development Agency, the Asian Development Bank.

5 See, for example, M. Brill Olcott, A. Aslund and S. Garnett, *Getting It Wrong: Regional Cooperation and the Commonwealth of Independent States*, Washington, DC 1999; I. Shishkov, *Integratsionnye protsessy na poroge XXI veka*, Moscow 2001. We also recognize that, for many, it has simply been difficult to follow CIS developments. This is particularly so in view of the problems in obtaining reliable information and the confused and contradictory nature of CIS integration, poignantly described as "Byzantine" and needing non-standard analytical tools—like chaos theory or another post-modern theory—to help qualify it. See K. Malfliet, "The Commonwealth of Independent States: Towards Supranationalism?", in F. Feldbrugge, ed., *Law in Transition*, The Hague 2002, 152.

6 In this work, we use "harmonization" as a generic term for efforts directed at a given level of legal uniformity. For a more specific distinction, we refer to G. Benacchio, *Diritto Privato della Comunità Europea. Fonti, modelli, regole*, Cedam 2004, 11, who defines:

> (1) "unification" as the process whereby a rule is produced by a single supranational "legislator", but is subject to interpretation and application by national courts;
> (2) "uniformization", whereby a rule is produced by a supranational "legislator" as well as interpreted and applied by a single system of supranational courts; and
> (3) "harmonization", whereby the "legislator" decides that a certain level of uniformity needs to be achieved, but single states retain some liberty in implementation.

7 For a recent summary of the advantages (and disadvantages) typically associated with harmonization, see L. Enriques, "Company Law Harmonization Reconsidered: What Role for the EC?", *ECGI Working Paper* 2005 No.53, available online at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=850005>.

the main characteristics of the process of voluntary harmonization in the CIS with a view to showing this. Yet we take a special interest in the role of model laws particularly for the improvement of domestic legislation, representing a crucial element of post-communist legal reform.[8]

Thus, we start by providing a brief summary of some general problems of legal reform observed over the last decades, intended to serve as a background against which the CIS model-law process will be discussed. We then turn to legal harmonization in the CIS: its starting point, its legal mandate, the choice of harmonizing instruments, and the organization of the process. In doing so, the focus will be on model laws dealing with the regulation of joint-stock companies rather than with all forms of business associations. In addition to limitations of time and space, this choice is related to the challenges presented by the regulation of joint-stock companies, and investor protection in particular, in the CIS context.[9] More specifically, we review five model acts adopted within the CIS framework:[10]

— Part I of the Model Civil Code of 29 October 1994 (MCC);
— The Model Law on Joint-Stock Companies of 17 February 1996 (MLJSC);
— The Model Law on Auditing of 8 June 1997 (MLA);
— The Model Law on Securities Markets of 24 November 2001 (MLSM);
— The Model Legislative Provisions on Investor Protection of 14 April 2005 (MLPIP).

We conclude by assessing the contribution of model legislation, its potential, as well as the factors that would help "unlock" or "seal" this

8 In this sense, throughout this work we use the term "legal reform" primarily with reference to adopting new, or amending old, legislation. Yet we are very aware that, especially in the context of post-communist transformation, new laws are far from being the whole answer to the need for change. Many observers have pointed out the equal importance of other legal institutions, such as judicial bodies and enforcement agencies. Further, there is the role of "the culture of law, despite its 'trickery' and other drawbacks", in the words of Professor Alekseev, particularly important in the CIS context. See S. Alekseev, "On Some Tendencies in World Legal Development and the Russian Legal System", 27 *Review of Central and East European Law* 2001 No.4, 567-580, 576.

9 For more on the importance of investor protection in the CIS context, see R. Dragneva, "Legal Regulation of Shareholder Rights in the CIS", in this book. It is because of the primary interest in investor protection that we also adopt a broad definition of joint-stock company regulation that includes auditing and securities law.

10 These documents are available online (in Russian) at <http://www.iacis.ru>. English translations are included in this book.

potential. The idea is not to provide an exhaustive list of answers but rather to share thoughts and questions in the hope of contributing to the comprehensive discussion that the CIS model-law process deserves.

A General Note on Legal Reform

The process of post-communist legal transformation has provided abundant material for debates on the theory and practice of legal reform worldwide. To start with, the question is often raised about the sources of new legal norms, and particularly about the balance between home-grown and foreign solutions. In principle, there seems to be a discrete number of sources that can be used in drafting legislation:

— Older domestic legislation;
— Organically developed, new domestic solutions—through a dialogue among the various constituencies affected by the legislation and/or through scholarly contribution;
— Foreign law solutions;
— Solutions embodied in international legal standards and best practice.

Domestic legal reform has made extensive use of the last two sources, or "legal transplants" as they are known.[11] In principle, transplants have been a part of the legal development of many countries,[12] and certainly of the Soviet Union and the Russian Empire before it.[13] At this new historical juncture, however, the reliance on foreign sources (particularly in the area of company law) is even greater than before because of, among others:

(1) The nature of the former Soviet countries' legal heritage, as will be discussed below;
(2) The context of international organizations' financial assistance and conditionality;[14] and

[11] G. Ajani, "By Chance and Prestige: Legal Transplants in Russia and Eastern Europe", *American Journal of Comparative Law* 1995 No.43, 93-117; K. Pistor, "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies", 1 *European Business Organization Law Review* 2004 No.1, 59-110.

[12] A. Watson, *Legal Transplants: An Approach to Comparative Law*, Athens and London 1993.

[13] Ajani, *op.cit.* note 11.

[14] The financial assistance of organizations such as the IMF and the World Bank is frequently conditional on the adoption of a particular legal framework. Certainly, company law and corporate-governance reform have been high on the agenda of those organizations. In addition, the quality of adopted laws is often assessed by these organizations in terms of their compliance with international legal standards, as mentioned earlier. For more on the general problems of conditionality in the practice of the IMF and the World Bank, see J. Stiglitz, *Globalization and Its Discontents*, London 2002.

(3) The desire of many CIS countries to demonstrate through law their wish to belong to the family of modern nations and to the global economy.[15]

In general, the acceptance of transplants in recipient countries is not without problems.[16] Some of these problems relate to the *contents* of the respective rules, for example, the extent to which they correspond to the needs of the recipient countries.[17] In this regard, Professor Pistor raises important questions specifically about the "transplantability" of international legal standards.[18] Other problems relate to the *process* through which foreign law and international legal standards are introduced in domestic laws. It is indeed the latter that often compromises transplants, affects their legitimacy in recipient countries, and ultimately affects the extent to which new laws are implemented.

Legal transplants can be introduced by various means. For the sake of simplicity, we note here two extreme situations. The *first* is when transplants are introduced entirely "from within" by means of reception. In this case, it is typically domestic lawyers who are placed fully in charge of the drafting process and who identify and transpose the selected legal solutions. At their best, these drafters are enlightened and very well informed about the foreign laws as such, as well as about their policy background and economic context. They have what has been described as the "knowledge of living law".[19] At the same time, they have a thorough understanding of the local legal tradition and economic relations, which helps them adapt foreign solutions, and they are able to ensure consistency with systemic legal principles and related areas of regulation. This method clearly has

[15] This is certainly most visible with regard to the CIS member states aspiring to closer relations with the European Union, such as Ukraine, but also in the context of WTO accession. All CIS countries, except Turkmenistan, have applied for membership. Kyrgyzstan, Moldova, Georgia, and Armenia have already obtained it.

[16] K. Pistor, Y. Keinan, J. Kleinheisterkamp and M. West, "The Evolution of Corporate Law: A Cross-Country Comparison", 23 *University of Pennsylvania Journal of International Economic Law* 2003 No.4, 791-871.

[17] Indeed, these are some of the questions Professor Ajani addresses in his article. Ajani, *op.cit.* note 11. An important and often debated issue in the CIS in this respect is the choice of transplants from civil-law or common-law systems. We choose not to deal with this issue not only because of a lack of space, but also out of a belief in the functional convergence of these two systems, reflected also in the fact that, in practice, CIS drafters have taken account of solutions envisaged in both. See the discussion on the sources of the Russian Civil Code further below.

[18] K. Pistor, "The Standardization of Law and Its Effect on Developing Economies", *G-24 Discussion Paper* June 2000 No.4, available online at <http://www.unctad.org/en/docs/pogdsmdpbg24d4.en.pdf>.

[19] *Ibid.*, 2

many advantages, yet it requires a type of a legal elite (and/or the time and conditions to develop one), which, for different reasons (*e.g.*, the closeness of the Soviet system, the lack of hands-on experience with market relations, or the various pressures on legal reform), has not been widely available and equally distributed in the CIS countries. Indeed, many experienced Russian civilists have been considered by foreign observers and/or pro-reform politicians as not being up to the task of drafting new, market-oriented laws because of their strong association with Soviet legal scholarship.

Second, at the other extreme,[20] laws can be drafted (and legal transplants introduced) entirely "from without" by foreign experts and rubber-stamped by local parliaments. Unfortunately, the experience of legal technical assistance over the last fifteen years has provided many examples of such transplantation in Eastern Europe.[21] This method of legal reform is certainly faster and cheaper to implement; it is also more likely (though not for certain) superior with regard to the foreign-law content of new laws. Yet practice has shown that it frequently results in a "hasty-transplant syndrome" synonymous with insufficient adaptation and lack of a systemic approach to domestic legislation, donor-driven legislative agendas, and fast output to match project and financial facility constraints.[22] With experience, adaptation to local circumstances and taking into account existing legal traditions have increasingly been recognized as crucial elements of sustainable legal reform.[23] In fact, with very few extreme exceptions, most Western legal experts, when asked, are likely to say that they have taken local conditions into account when involved in drafting. Yet even a well-informed and benevolent but external judgment cannot replace a process based on organic law- and policy-making. In this sense, we cannot agree more with Wade Channell, who notes:

> "The crux of the problem is not the origin of the law per se. [...] Rather it lies in the pursuit of law reform processes that generally do not permit users to participate in adapting the draft—whatever its origin—to local conditions. [...] Lack of local input, not transplantation is the problem."[24]

[20] Except for situations such as the automatic extension of the occupiers' legal system to occupied lands, *e.g.*, the application of German law to Poland during World War II.

[21] W. Channell, "Lessons Not Learned About Legal Reform", in T. Carothers, ed., *Promoting the Rule of Law Abroad*, Washington, DC 2006.

[22] *Ibid.*, 139.

[23] C. Gray, "Reforming Legal Systems in Developing and Transition Countries", *Finance and Development* September 1997, 14-16.

[24] Channell, *op.cit.* note 21, 140.

We recognize that there are many states between what we describe as transplantation from within and from without. Indeed, these seem to be the most interesting cases to observe. Equally applicable to all methods, however, is the need for openness and transparency of the process. The reference here is to avoiding an "ivory tower" approach to law-making, one that remains highly theoretical and abstract and largely separated from the lives of the end-users of laws: judges, businesses, interest groups, etc. As has often been stressed, laws are worth very little without reflecting a policy-making process that takes into account the different interests involved in the relationships being regulated and makes important social choices about priorities and distributions of gains and risks. The importance of such an inclusive process has been recognized as a problem area of legal reform; yet its achievement is far from becoming a reality.[25]

This brief review of issues does not at all exhaust the full range of questions and problems (many of them without black-and-white answers) of post-communist legal reform. Yet it allows us to establish the background that CIS model legislation can be placed against and to discuss its actual and potential ability to balance out many of the problems mentioned above.

Historical Background and Starting Conditions

The adoption of model legislation is an expression of the effort to promote legal uniformity in the post-Soviet space in the new conditions of independent statehood and diverging economic and legal development trajectories. As it will be discussed further below, we place the start of CIS harmonization efforts in the first half of 1992. It is essential for the subsequent analysis to provide the reader with a brief background to these efforts. Such an overview is important in order to, among other things, show the scale of the law-reform task in the area of company law, as well as the extent to which past home-grown legal solutions can be relied upon.

[25] D. Bernstein, "Process Drives Success: Key Lessons from a Decade of Legal Reform", *Law in Transition* Autumn 2002, 2-13. The author points to the reluctance of transition-country governments to open up the legislative process. Often, however, the problems are also linked to the time and money constraints of legal technical assistance projects. See Channell, *op.cit.* note 21. Bernstein also points to another important aspect of transparency, namely the fact that it reduces the possibility of particular corporate interests to "purchase" legislation in a political climate of corruption.

Unity and Diversity in the Early 1990s

Until 1990, the Soviet federative republics belonged to the unified legal space of the USSR. In the area of civil law, uniformity was maintained through the adoption of Fundamentals of Legislation (*Osnovy zakonodatel'stva*) at the federal level, which were then incorporated in republican legislation. The first Fundamentals of Civil Legislation were adopted in 1961, and were followed by the adoption of republican Civil Codes, *e.g.*, in 1964 in the RSFSR.[26] Thus, republican law-making was not made redundant,[27] yet it certainly lost much of its independent importance. As Professor Ioffe writes: "Republic civil law was subordinated to federal civil law, and the former could not contradict the latter, while the latter frequently invaded the realm of the former."[28]

In addition to formal legal unity, there was the more real unity of the Soviet economic system based on central planning and state ownership. Civil law had very little relevance to the main tenet of Soviet economic life, the state enterprise (*predpriiatie*), which by its nature departed from the principles of separate legal personality and limited liability. In fact, the separate legal personality of state enterprises was proclaimed only in the 1961 USSR Fundamentals of Civil Legislation and then envisaged in the republican Civil Codes. Even then, however, these main principles of corporate personality had very little real meaning.[29]

26 These republican Codes came to replace a first generation of Codes adopted in the aftermath of the formation of the USSR in 1923, which were very much in conformity with the Russian Civil Code of 1922.

27 The 1936 "Stalin" Constitution of the USSR attempted a tighter unification approach and provided for the drafting of a Union Code to replace the republican ones. Yet this idea did not materialize.

28 O. Ioffe, "The System of Civil Law in the New Commonwealth", in G. Ginsburgs *et al.*, eds., *The Revival of Private Law in Central and Eastern Europe*, Dordrecht 1996, 79.

29 Enterprises enjoyed a legal personality in the sense of having a name, designated property (separate balance and bank account), and distinct administration (appointed director). They did not, however, own their assets or have a right *in rem* over them. Their relation to property was defined as operative management (*operativnoe upravlenie*), within the limits of their economic purpose, defined in their charter (*ustav*). Art.50 of the 1964 RSFSR Civil Code, for example, proclaimed the invalidity of transactions concluded outside the purpose of the enterprise. It was only after the start of *perestroika* that the 1987 USSR Enterprise Law introduced "full economic ownership" and "operative management" as property rights *in rem*. Enterprises, however, still did not hold formal ownership titles.

It was also proclaimed that enterprises would be liable for their obligations with the property designated to them and that the state would not be liable for the obligations of the enterprise. See Art.8 of the 1965 USSR Statute on the Socialist State Production Enterprise. This, however, did not have any real meaning within