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.
## Executive summary

This report provides an assessment of Nepal’s corporate governance policy framework, enforcement, and compliance practices. It highlights recent improvements in corporate governance regulation, makes policy recommendations, and provides investors with a benchmark against which to measure corporate governance in Nepal.

Awareness of the importance of corporate governance is growing. The central bank has introduced higher corporate governance standards for banks and other financial companies as part of a wider program of financial sector reform. Accounting and auditing standards are being developed. And a number of draft laws have been prepared that if passed and implemented should deepen and accelerate the reform process.

The legal framework contains large and significant gaps. Critical institutions, including the securities board and company registrar, have little resources or authority. Most importantly, political uncertainty and the current security situation have weakened the economy and delayed the passage of draft legislation.

Passing the current draft legislation is the critical next step. Overall, reform should seek to enhance key institutions, better protect shareholder rights, enhance transparency, and increase the effectiveness of boards. This will require a combination of legislative change, action by regulators and the public sector, and can be aided by targeted technical assistance.
Acknowledgements

This assessment of corporate governance in Nepal was conducted in April 2005 by Alexander Berg and David Robinett of the Corporate Governance Department of the World Bank, as part of the Reports on Observance of Standards and Codes Program. The ROSC was based on a corporate governance template-questionnaire completed by Pioneer Law Associates. Messrs./Mmes.: Christopher Juan Costain, Richard Symonds, Sabin Raj Shrestha and Tatiana Nenova provided advice and comments.


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Country assessment: NEPAL

This ROSC assessment of corporate governance in Nepal benchmarks law and practice against the OECD Principles of Corporate Governance, and focuses on listed companies.

Nepal has a small but active capital market, with hundreds of thousands of retail investors. New issuers continue to come to market, and new issues are often oversubscribed. However, the overall framework for investor protection and corporate governance has a number of important weaknesses that have hindered capital market development.

Awareness of the importance of corporate governance is growing. The central bank has introduced higher corporate governance standards for banks and other financial companies as part of a wider program of financial sector reform. Accounting and auditing standards are being developed. And a number of draft laws have been prepared that should deepen and accelerate the reform process if passed and implemented. While political uncertainty and security problems have weakened the economy and delayed the passage of the draft legislation, interest remains strong, and further reform seems likely, given that the security situation does not deteriorate dramatically.

Market profile

Nepal has a small but active equity market

Market capitalization at the end of 2004 was 4.68 billion rupees, or USD 656 million, a significant increase over 2003 but still below the level of 2000. Nepal’s equity market was the smallest in the region in absolute terms, and second smallest as a percent of GDP. Market capitalization amounted to 8.7 percent of GDP at the end of 2003. Market turnover was average for the region, if low by OECD standards. At the end of April 2005 there were 124 companies listed on the Nepal Stock Exchange (NEPSE).

Companies are listed for both regulatory reasons and to raise capital

The bulk of market capitalization and trading volume is made up of banks or other finance companies, which are required to list by the Nepal Rasta Bank (NRB). Some companies originally listed for tax advantages that have since been phased out. However, companies also continue to list to raise funds.

Family ownership predominates

Nepal’s business houses continue to play an important role as corporate owners. The State holds shares in some banks and other financial institutions, and some subsidiaries of foreign multinationals incorporated in Nepal are also listed. Nepal also has an active class of retail investors. While control is concentrated, based on available information, ownership structures are relatively straight-forward compared to other Asian countries. Nepal has two domestic institutional investors—an investment trust and a closed end mutual fund. Between them they hold a small fraction of outstanding equity. No foreign investors are currently licensed to invest in the market.

The current law has important deficiencies

Important legislation for the capital markets includes the Company Act 1997 (CA) and the Securities and Exchange Act 1983. Both are based on common law. Market participants consider each to have significant deficiencies, and new drafts...
of each wait the endorsement of His Majesty, the King. The Securities and Exchange Board (SEBO) is the capital market regulator. Enforcement of the Company Act falls to the Office of the Company Registrar (OCR); disputes are heard by the related Company Board. The state owned NEPSE is largely autonomous.

The Central Bank has emerged as an important leader in corporate governance reform

As part of a broader reform of the financial sector, the NRB has been given the authority to oversee corporate governance standards for banks and other financial companies—the bulk of listed companies by market capitalization. It is represented on SEBO and the governing board of NEPSE. With its superior resources and independence, it has emerged as a key corporate governance regulator.

Key issues

The following sections highlight the principle-by-principle assessment of Nepal’s compliance with the OECD Principles of Corporate Governance.

Investor protection

Equity is considered by many to be a relatively good investment in Nepal, and new issues are regularly oversubscribed. Shareholders are also not as “passive” as in some other countries. Nonetheless, there are a number of weaknesses in the corporate governance framework that limit investor confidence.

Corporate governance weaknesses limit shareholder confidence

Shareholders can and do participate in the general meeting. They have standard powers to approve changes to company’s articles, and authorize dividends, capital increases, and mergers as well as appoint the company’s auditor. They can choose directors using a combination of proportional and cumulative voting that generally allows non-controlling shareholders to choose at least a few directors. Significant shareholders can place items on the agenda.

However, for some shareholders participation involves demanding money and in kind benefits at the AGM

However, many shareholders attend shareholder meetings not to participate in fundamental corporate decisions but instead to receive food money or other gifts from the company. Due to shareholders spreading their shares over a number of family members, the amount paid out in kind or cash can become significant. There is also a cadre of “VIP” shareholders that demand additional special treatment, such as dinner the night before the general meeting. These shareholder “activists” will disrupt the meeting if these benefits—which are ultimately paid for by other shareholders—are not provided. In response, some companies—especially those not making a profit—are not holding the general meeting of shareholders. Other companies hold the AGM at the same time and a few companies have their headquarters outside the Katmandu Valley to limit participation by shareholders.

Share registration is cumbersome and prone to abuse

Companies maintain their own share registries and issue share certificates. The board must approve any transfer of shares. While there have been few cases of abuse, the system is cumbersome: it can take 45 days for shares certificates to reach their new owners. Companies also normally close the register for 15 days...
Information on listed companies can be hard to access. Information on listed companies is often difficult to obtain. This reflects both poor compliance with filing requirements, but also the limitations of the OCR. Certain information provided to NEPSE is not shared with the public.

Major and related party transactions are potential areas of abuse. The regimes for changes in control and other major and related party transactions (RPTs) are minimal. In practice control changes are not common. Market participants report that RPTs are common, to the potential detriment of minority shareholders.

Disclosure

Disclosure is poor, especially for non-financial companies. Until recently, Nepal essentially had no standards for accounting and auditing. Other elements of disclosure are also weak. While NRB directives now ensure reporting requirements are generally met by banks and other financial companies, many other companies do not make required filings or issue the annual report.

Ownership disclosure is limited. Banks and other financial companies are supposed to disclose direct ownership. However, there is at least one listed bank whose ultimate controlling shareholder is unknown. Listed companies are required to report to NEPSE if there is a change in ownership such that a single person has 5 percent or more of shares: this is not disclosed to the public. Shareholders have no obligation to report their holdings, and there are no provisions in the law regarding indirect ownership.

Standards for auditing and accounting are still being developed. Since 2003 the Institute of Chartered Accountants Nepal (ICAN), through the affiliated Accounting Standards Board and Audit Standards Board, began issuing accounting and auditing standards. The issued standards are based on International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS), but a number of standards remain to be issued. While ICAN has legal sanction, both sets of standards remain voluntary for listed companies, and are not referred to in the law.

Company oversight and the board

Boards and management under family control. Nepal has a single tier board system. Boards normally contain some members not affiliated with the controlling family and most companies have separate chairman and managing directors. In practice however the controlling family remains in charge of both the board and company management.

Directors have limited guidance on their duties or powers. The law contains little on the specific duties and powers of directors. There are no duties of loyalty and care or equivalent. Unsurprisingly, directors are not sued. Bank directors, under NRB Directive 6, are required to have a duty of care and ensure that the bank remains within the law.

Basic rules on conflicts of interest are in place, but enforcement is limited. Directive 6 also requires that boards follow a code of ethics developed by the NRB. Directors of all companies are prohibited from offering bribes, engaging in corruption, trading in the shares of the company, or having any conflicts of interest on appointment—though shareholders can waive the latter requirement. Banks and other financial companies cannot make loans to their directors. The draft company law would extend this limit to all companies.

Formal independence requirements are novel, and limited. While boards may have a minority of directors seen as representing smaller shareholders, there are no formal independence requirements in the law for listed companies. Starting in 2005 banks and other financial companies are required to
appoint a “professional director” from a list approved by the NRB. The draft company law would also require that all companies have one or two independent directors.

“Blacklisting” directors has weakened the concept of limited liability

To strengthen the banking system and prevent “willful default”, the NRB has directed that the board members and significant shareholders of companies in default can be “blacklisted” by the affected bank. Those blacklisted, and companies they control, cannot borrow, and cannot serve as bank directors. While blacklisting has encouraged the recovery of distressed loans and appears to be contributing to building a culture of repayment, some market participants feel—especially given the current political and economic environment—that the list has unfairly penalized the directors and significant shareholders of companies under legitimate distress, while weakening the concept of limited liability. Recently the NRB has revised the relevant directive to provide “non-willful” defaulters with a grace period.

Enforcement

Key corporate governance institutions lack resources and authority...

Key institutions that are mandated to oversee companies and capital markets in Nepal are limited and play a secondary enforcement role. SEBO has limited authority, resources and independence and undertakes few enforcement actions. The OCR, which has certain powers under the CA, also has limited resources and a mediocre reputation with market participants. The affiliated Company Board, a part time court like body, hears a steady stream of cases, but these are regularly appealed. The standards developed by ICAN and the Accounting and Auditing Standards Boards remain voluntary, and only a fraction of registered accountants and auditors have been licensed by the body.

...enforcement is largely left to the NEPSE, Katmandu District Court, and the Central Bank

On the other hand the NEPSE can license its members, oversees suspicious trading, and can suspend trading and de-list companies. It requires reporting price sensitive and ownership information not shared with the public. The Katmandu district court and the Court of Appeals, which hears the appeals from the Company Board, have a relatively positive reputation. However the current law effectively limits the range of cases that will go to court. Overall, it is the NRB that has become the driving force for corporate governance reform in Nepal.

Recommendations

Nepal should continue the reform process, passing the draft company and securities legislation

Nepal has initiated corporate governance reform in the financial sector and draft legislation has been prepared to spread reform to other companies. Fully tapping the potential of capital markets and professionalizing boards and management will require this legislation be passed and implemented and overall reform efforts continue. Good corporate governance ensures that companies use their resources more efficiently and leads to better relations with workers, creditors, and other stakeholders. It is an important prerequisite for attracting the patient capital needed for sustained long-term economic growth.

Strengthen Capital Market Institutions

Overhaul the OCR

In conjunction with the new legislation, priority must be given to strengthening those institutions charged with enforcing it. Comprehensive reform is needed for
the OCR. This should include technical upgrades to modernize its systems for filling and documentation. It should also include broader changes to refocus the OCR on providing company information and facilitating the implementation and enforcement of the Company Act. The OCR should be able and willing to demand that delinquent companies hold the AGM and make proper fillings. It should have the resources and political independence needed for its mission. Additional support from donors will be a necessary part of this process, given the extensive and technical nature of the required reform.

**Increase authority and resources for SEBO**

Additional resources and authority are also essential for SEBO to become a serious capital markets regulator. This authority should include sole power to approve the prospectus and license brokers. SEBO should be capable of taking the lead when working with the NEPSE, the OCR and ICAN to enforce relevant requirements regarding insider trading, major and related party transactions, disclosure of ownership, and financial reporting. It should be able to issue fines and reverse abusive or incorrect corporate actions. To take on these new responsibilities, an increased and secure source of funding will be needed, as will greater autonomy that does not sacrifice accountability. The IOSCO assessment currently proposed will provide additional guidance on this transition.

**Privatize NEPSE and consider the creation of a central share registry**

Other institutional changes that should be considered include the privatization of NEPSE to allow greater focus on market development as certain authority is shifted to SEBO. As a longer term goal, the current system of company based share registration should be replaced with a central share registry to reduce potential conflicts of interest, facilitate settlement, and limit market abuses.

**Better Protect Shareholders’ Rights**

**Ensure the AGM is about the governance of the company, not getting gifts**

The first step that should be taken to bolster shareholder rights: ban outright all gifts, in cash or in kind (including catered meals), at the AGM. While some shareholders benefit from these gifts it is the company, and hence all shareholders, that bear the costs. The focus on gift getting also distracts the AGM from its critical corporate governance role, and has discouraged companies from holding productive meetings.

**Establish transparent procedures for major and related party transactions**

Another critical step to better protect shareholder rights is the creation of transparent procedures for the approval of major and related party transactions. These procedures should include adequate notice, equitable means of valuation, and direct shareholder approval for the most significant transactions. Equitable and transparent procedures should also be developed for other significant corporate actions, including delisting and changes in control.

**Enhance Transparency**

**Mandate that all listed companies follow national standards for accounting and auditing**

To ensure transparency, the national standards for accounting and auditing being developed by ICAN should become mandatory for all listed companies. A significant increase in the number of licensed accountants and auditors will be needed to implement these standards, and ultimately all lead auditors and accountants for listed companies should have a license issued by ICAN. Adequate training should be available to facilitate this transition, and could be supported by donor assistance.

**Ensure that high standards are ICAN in turn must ensure that the standards it issues conform closely to International Financial Reporting Standards (IFRS) and International Audit
introduced and implemented Standards (IAS). To maintain the reputation of the accounting and auditing professions, it must demand a high level of professionalism from its members. Through time, SEBO, the NRB, and perhaps ultimately a specialized oversight body, will need to support ICAN in maintaining high standards for accounting and auditing. An Accounting and Auditing ROSC should also be conducted to facilitate the introduction of superior standards.

Improve disclosure of ownership and control One element of disclosure that needs particular attention is ownership and control. The current regime is minimal, and without improved ownership disclosure, other important reforms, including improved procedures for related party transactions, will prove less effective. Important steps include requiring shareholders to disclose significant ownership, and companies to provide ownership information in the annual report. The concept of indirect ownership and control needs to be introduced into the legal framework. These efforts will be facilitated by complimentary reforms to the OCR and share registration.

Increase the Effectiveness and Objectivity of Boards

Increase the effectiveness of boards The board has a central role to play in ensuring transparency and vetting major transactions as part of its broader mandate to oversee the governance and strategy of the company. In the process it must strive to act with loyalty and care and treat all shareholders fairly. In Nepal this will require changes to existing legislation, and may also be facilitated by the introduction of a voluntary code of corporate governance, which should be developed in a broad consultative process in co-operation with NEPSE and SEBO.

Specify the directors’ duties of loyalty and care The most basic reform is to enumerate director duties and powers, with explicit duties of care and loyalty to all shareholders placed in the law. The need for directors to behave ethically and be responsible to legitimate stakeholders should also be introduced in the law or a new code.

Establish the role of the board in major and related party transactions The law must also make clear that the board has authority over major and related party transactions, with directors declaring their interest and abstaining from voting if conflicted. Where present, audit committees should provide informed opinions on proposed transactions, as well as overseeing the overall disclosure of the company. Over the longer term, the requirements for audit committees should gradually extend beyond banks. Perhaps first to Group A companies, then to all listed companies.

Encourage the development of independent directors To be effective and capable of objective judgment, boards and especially audit committees need a minimum number of independent directors. Requirements for these directors should be formalized and expanded beyond the one “professional” directors required by the NRB for financial companies. To develop independent directors, and ease understanding of their new duties, current training for board members should be expanded and augmented. NEPSE, SEBO, the NRB, and/or local universities could play a role, as could the creation of a new body—such as an institute of directors or corporate governance. This is an area where donor assistance could be helpful.

Focus efforts to penalize willful defaulter as part of broader creditor rights Efforts to improve boards should build on recent reforms, seeking to curb the problem of willful defaulters, while not unduly penalizing the directors of companies facing legitimate distress or weakening the concept of limited liability. Protecting creditors rights will require broader reforms to the insolvency framework that allow for appropriate restructuring and liquidation, and penalize
reform fraudulent conveyance. The Credit Information Centre should also be encouraged to develop a more balanced profile of companies and directors. The ongoing Insolvency and Creditor Rights ROSC should facilitate this process. As these reforms progress, narrower use can be made of the blacklist to prevent unwarranted harm to companies and board members.
## Summary of Observance of OECD Corporate Governance Principles

<table>
<thead>
<tr>
<th>Principle</th>
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<th>LO</th>
<th>PO</th>
<th>MO</th>
<th>NO</th>
<th>Comment</th>
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<tbody>
<tr>
<td>I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK</td>
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<tr>
<td>IA Overall corporate governance framework</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Small but active capital market</td>
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<tr>
<td>IB Legal framework enforceable / transparent.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Law has substantial gaps</td>
</tr>
<tr>
<td>IC Clear division of regulatory responsibilities.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>NRB has emerged as the main regulator</td>
</tr>
<tr>
<td>ID Regulatory authority, integrity, resources.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>SEBO has little resources or authority</td>
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<tr>
<td>II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS</td>
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<tr>
<td>IIA Basic shareholder rights</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Share registries kept by companies</td>
</tr>
<tr>
<td>IIB Rights to part. in fundamental decisions.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Fundamental decisions decided by 75% majority</td>
</tr>
<tr>
<td>IIC Shareholders AGM rights</td>
<td>X</td>
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<td></td>
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<td>Meetings disrupted by vocal minority</td>
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<td>IID Disproportionate control disclosure</td>
<td>X</td>
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<td></td>
<td></td>
<td></td>
<td>Ownership disclosure minimal</td>
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<td>IIE Control arrangements allowed to function.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Little in the law or in practice</td>
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<tr>
<td>IIF Exercise of ownership rights facilitated.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Little regulation of institutional investors</td>
</tr>
<tr>
<td>IIG Shareholders allowed to consult each other.</td>
<td>X</td>
<td></td>
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<td>Not facilitated in the law</td>
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<td>III. Equitable Treatment of Shareholders</td>
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<tr>
<td>IIIA All shareholders should be treated equally</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Little redress in practice</td>
</tr>
<tr>
<td>IIIB Prohibit insider trading</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Rigid laws, limited enforcement</td>
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<tr>
<td>IIIC Board/Mgrs. disclose interests</td>
<td>X</td>
<td></td>
<td></td>
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<td></td>
<td>No explicit disclosure requirements</td>
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<tr>
<td>IV. Role of Stakeholders in Corporate Governance</td>
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<tr>
<td>IVA Legal rights of stakeholders respected.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Awareness of CSR is growing</td>
</tr>
<tr>
<td>IVB Stakeholder redress</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Stakeholders have certain options for redress</td>
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<tr>
<td>IVC Performance-enhancing mechanisms</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mandatory profit sharing with no link to performance</td>
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<tr>
<td>IVD Stakeholder disclosure</td>
<td>X</td>
<td></td>
<td></td>
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<td>Access through public disclosure</td>
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<tr>
<td>IVD “Whistleblower” protection</td>
<td>X</td>
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<td>No formal whistle blower protection</td>
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<td>IVD Creditor rights law and enforcement</td>
<td>X</td>
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<td></td>
<td>Secured creditors have some protection</td>
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<td>V. Disclosure and Transparency</td>
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<tr>
<td>VA Disclosure standards</td>
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<td></td>
<td>Limited disclosure standards and compliance</td>
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<tr>
<td>VB Standards of accounting &amp; audit</td>
<td>X</td>
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<td></td>
<td></td>
<td>Accounting standards still being introduced</td>
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<tr>
<td>VC Independent audit annually</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Audit standards still being introduced</td>
</tr>
<tr>
<td>VD External auditors should be accountable</td>
<td>X</td>
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<td></td>
<td>Auditors chosen directly by shareholders</td>
</tr>
<tr>
<td>VE Fair &amp; timely dissemination</td>
<td>X</td>
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<td></td>
<td></td>
<td>Certain dissemination channels (OCR) not functional</td>
</tr>
<tr>
<td>VF Research conflicts of interests</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Basic regulation of brokers</td>
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<tr>
<td>VI. Responsibilities of the board</td>
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<tr>
<td>VIA Acts with due diligence, care</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Limited requirements in the law</td>
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<td>VIB Treat all shareholders fairly</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Certain conflicts of interest regulated</td>
</tr>
<tr>
<td>VIC Apply high ethical standards</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Bank boards must have a code of ethics</td>
</tr>
<tr>
<td>VID The board should fulfill certain key functions</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Little guidance in the law</td>
</tr>
<tr>
<td>VIE Exercise objective judgment</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Smaller shareholders have limited “representation”</td>
</tr>
<tr>
<td>VF Access to information</td>
<td>X</td>
<td></td>
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<td>Directors normally have access to basic information</td>
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### PRINCIPLE - BY - PRINCIPLE REVIEW OF CORPORATE GOVERNANCE

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

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

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

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

**Assessment:** Partially Observed

**Capital Markets.** Market capitalization at the end of 2004 was 4.68 billion rupees, or USD 656 million, a significant increase over 2003 but still below the level of 2000. Market capitalization amounted to 8.7 percent of GDP at the end of 2003. Nepal’s equity market was the smallest in the region in absolute terms, and second smallest as a percent of GDP. At the end of 2004 the top 10 companies in the market represented 64 percent of total market capitalization. They also accounted for 91% of trading volume. The turnover ratio was a low 9.64 percent in 2004 vs. an average of 26 percent earlier in the decade. Nepal has an estimated 200,000 active shareholders.

By April 2005 there were 124 companies listed on the Nepal Stock Exchange (NEPSE). Over the 2004 fiscal year 7 companies came to market, all but one where banks or other finance companies that are required to list by the NRB. Banks and other financial companies also make up the bulk of market capitalization and trading volume. The NEPSE has an A group and a B group. To be listed on the A group a company has to meet certain asset and profitability requirements as well as submitting its financial statements on time. 43 companies are in the A group, all but one—Nepal Lever—is a financial company. A company must be listed for its shares to be traded: there is no over the counter or secondary markets. The NEPSE occasionally de-lists companies for not paying their dues: there is no legal avenue for voluntary delisting. Last year one company was de-listed, a large state controlled bank with 7000 small shareholders.

**Institutional Investors.** Nepal has two institutional investors—Citizens Investment Trust and NCM Mutual Fund—who hold a small fraction of outstanding equity (~110 million rupees or 2.3 percent of market capitalization). The Citizens Investment Trust is a state controlled investment trust that manages both individual accounts as well as employee pensions, the other is a closed end mutual fund listed on the NEPSE. Companies can also manage pension funds for their employees. No foreign investors are currently licensed to invest in the market. In addition to stringent licensing requirements, foreigners are restricted from investing in certain sectors.

**Ownership Framework.** Nepal’s business houses continue to play an important role as corporate owners, normally comprising the “promoter groups” that control 40-60 percent of many listed companies. The State holds shares in some banks and other financial institutions, and some subsidiaries of foreign multinationals are also listed: e.g. the largest company in Nepal is Standard Chartered Bank, controlled by the British bank, and the eighth largest is Unilever Nepal.

Based on available information, ownership structures are relatively straightforward, with controlling shareholders holding over 50 percent of the stock of the typical company. However information on ownership is incomplete and business houses do have stakes across multiple companies, albeit with simpler structures than found in many other Asian countries.

**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:** Materially Not Observed

**Corporate Legal Framework.** The Company Act 1997 (CA) sets the rules for the governance and regulation of companies and is based on common law. A new company act has been drafted and awaits the endorsement of the King.

**Company Types.** Partnerships and sole proprietorships remain important business forms. The two company types specified in the CA are Private Limited Companies and Public Limited Companies. Private companies do not sale shares to the public and can have no more then 50 shareholders. There are also a few other company forms with government ownership that have been created by special legislation. The OCR estimates that there are 923 registered domestic public limited companies and 33,915 registered private limited companies. However, it is difficult to wind up companies, and it is believed that majority of the registered public limited companies are not currently active.
**Securities law framework.** The Securities and Exchange Act 1983 (SEA) and the Securities Exchange Rules 1993 are the basic securities law, and provide for investor protection, market regulation, securities dealing and related matters, and the prevention of fraud and insider trading. A new Securities and Exchange Ordinance has been drafted as has a Secured Transaction Ordinance, each waits for the endorsement of the King.

**Listing rules.** The Listing By Rules 1996 provide requirements in terms of minimum capital, minimum number of shareholders and fraction of equity floated to the public, and provision of basic information to the NEPSE and SEBO. In practice, public disclosure requirements do not apply to companies listed on the B tier.

**Code.** Directive 6, issued by the NRB, provides mandatory corporate governance standards for banks. Directive 12 provides similar standards for other financial institutions. Requirements include a code of ethics for the directors and employees that addresses conflicts of interest, minimum qualifications for the CEO, an audit committee, and starting this year that all financial companies have a “professional director” from a list approved by the NRB. These directives also prohibit directors, officers and significant shareholders from accepting loans from the company. There is no code for non-financial companies, however SEBO has discussed developing one.

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

**Assessment: Partially Observed**

**Securities regulator.** The Securities Board of Nepal (SEBO) was established under the SEA, and began operations in January 1983. SEBO has the responsibility for regulating the issue of securities and oversees issuers, brokers, and issue managers. SEBO is also supposed to oversee NEPSE, however NEPSE state ownership and control limit SEBO’s authority. SEBO has no oversight over the CIT. SEBO also conducts research, raises awareness regarding the securities markets and works with ICAN to develop accounting standards. They sometime attend the AGMs of listed companies.

SEBO has seven members, including the chairman. The Chairman is appointed by the government and has a tenure of four years. The other commissioners represent the Ministry of Finance, Ministry of Law, Justice and Parliamentary Affairs, Ministry of Commerce, Industry and Supplies, NRB, the FNCCI, and ICAN.

SEBO cannot issue secondary regulation, only guidelines.

**Stock exchange.** The Katmandu based Nepal Stock Exchange (NEPSE) is Nepal’s only exchange, and its trading floor is the only place that equity is allowed to be traded. NEPSE has 23 member-brokers; trading is by open outcry. The NEPSE oversees listing requirements, monitors trading activity, licenses brokers, and reviews financial statements. The government and NRB are the principal shareholders, the members of the exchange have a small stake. The nine member board is chaired by a nominee of the Ministry of Finance, the NRB and SEBO are also represented. The NEPSE can suspend trading, de-list, and move a company from group A to group B for not filling reports or meeting other requirements.

**Central depository.** Nepal does not have a central depository. Share certificates are issued by companies and kept by the shareholders. Company boards must approve the transfer or issue of new share certificates.

**Banking and other regulators.** The NRB is the regulator of the banking system; it oversees statutory requirements and prudential rules and regulations and has wide enforcement powers. Through its requirements for banks and other financial companies, including the requirement that they must ultimately be listed, the NRB has become the principal *de facto* regulator on corporate governance matters for many listed companies. Decisions by the NRB can be and are appealed to the courts.

A forum for capital market authorities, including the NEPSE, SEBO and NRB, meets regularly to co-ordinate policy and share information. The NRB is also represented on the board of SEBO and NEPSE.

**Judiciary.** Decisions by regulators and the Companies Board are regularly appealed. While the average court case in Nepal take less time then other countries in the region—including India and Pakistan—and compare favorably in terms of cost and number of procedures; courts lack expertise and the time is takes to resolve a dispute—1-2 years—remains substantial. Proposed legislation would create a specialized commercial court. Certain corporate governance related cases are heard by the Royal Commission for the Control of Corruption.

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2 Banking Companies Ordinance, Section 40A
3 Doing Business 2005
Company Registrar. Under the CA the Office of the Company Registrar (OCR) is given the authority to supervise the registration of companies, enforces certain disclosure requirements, and has investigative and fact-finding powers. The OCR approves prospectuses after prior approval by SEBO.

The OCR has limited resources and makes very limited use of its nominal powers. It lacks a proper documentation and filing system. Company registration functions are carried out by the OCR in Katmandu, there are no other offices.

Established by CA, the Company Board is a court like body that in theory has jurisdiction over a range of disputes involving shareholders and the company. While nominally independent, the Company Board shares staff and space with the OCR; its three members do not work full time and have other jobs. In practice, the independence and competence of the Board have been questioned. 90 percent of its ruling is regularly appealed. Draft legislation would replace the Board with a commercial court.

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: Not Observed

Authority, integrity and resources of regulators. SEBO has limited legal authority and even more limited resources. Important regulatory and oversight functions are carried out by the OCR, NRB and NEPSE instead. Proposed legislation would shift some of these powers—such as approving prospectuses and licensing brokers—to SEBO.

The SEA gives SEBO a broad mandate for overseeing and developing securities markets. The act also gives SEBO the power to issue fines, and revoke licenses. Failing to submit certain documents to SEBO can be punished with up to two years in prison. These powers are not used. In practice SEBO will seek clarification and attempt to pursue issuers or others to comply with regulation. It may also instruct NEPSE to suspend trading of a company’s stock.

SEBO’s funding is limited, consisting primarily of funds provided directly by the government. The Ministry of Finance must approve major expenditures, and in general SEBO has little independence from the government. SEBO has 25 employees, including seven support staff.

SECTION II: THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS

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

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

Assessment: Materia not observed

(1) Secure methods of ownership registration

Every company (public and private) is required to maintain its own shareholder register (CA, §35); shares are certificated. There is no central securities depository or central registry, and no general practice of independent share registries (although some companies do delegate the responsibility of keeping the share registry to third parties). Companies issue share certificates to shareholders as primary evidence of share ownership, after registering new shareholders in the share register (CA, §29). There is no legal concept of nominee ownership.

The current system appears to function without significant risk to shareholders at current levels of transaction volume. There are very few reported cases of forgery or other similar problems with share certificates. Some companies with large numbers (e.g. 40,000) of shareholders reportedly have difficulty in carrying out the share registry function.

(2) Convey or transfer shares

NEPSE handles clearing and settlement for transactions executed on the floor of the exchange. Following trade execution, the buying broker deposits cash with the exchange, and the selling broker deposits the share certificate(s). On T+3, cash is transferred to the selling broker, and NEPSE issues a “Transaction Completion Letter” to the issuer, which then has three months to update the register and issue a new certificate to the buying broker in the name of the new shareholder. Some companies issue the certificates within a standard 7 day period, while others reportedly extend the period to 45 days and beyond. The current system does not meet international standards for share transfer (e.g. delivery versus payment).

The board of each issuer must approve the share transfer, introducing basic conflict of interest for listed companies. The company articles can give a right of first refusal to shareholders.

4 Share transfers can be legally rejected by the board for a variety of reasons, including incomplete transfer applications, court orders, etc.
existing shareholders, but only for shares held by promoters (CA, §15(g)). The NRB must approve the transfer of shares held by promoters in banks and other financial companies.

(3) Obtain relevant and material company information on a timely and regular basis

Information about public limited companies is difficult to obtain in many cases. Lack of compliance of filing requirements (and procedural problems at the OCR) leads to most filed information being frequently unavailable at the OCR and the NESPE. Special contacts at the company are frequently required to obtain information from the company.

(4) Participate and vote in general shareholder meetings

Ordinary shareholders have the right to attend shareholder meetings. Holders of preferred shares are not normally allowed in the meeting of ordinary shareholders unless the agenda relates to those shares (CA, §51).

(5) Elect and remove board members

**Process.** Ordinary shareholders elect directors through a combination of proportional representation and cumulative voting.

**Cumulative voting/proportional representation.** Corporate ("institutional") shareholders have the right to appoint directors to the board, in proportion to the number of shares they own in the company. The remaining shareholders (in practice termed "public shareholders") elect remaining directors through cumulative voting. Corporate shareholders who have appointed directors cannot participate in the voting (CA, §§59, 71(2)). Directors must be shareholders. In practice, promoters and controlling shareholders directly appoint most directors, and the public (minority) shareholders elect the remaining directors.

Shareholders can remove a director by passing resolution in general meeting (CA, 73(2b)). In banks and finance companies regulated by the NRB, the board must appoint an additional "professional director", from a list of experts approved by the NRB (currently 85) (BAFI, §17, 12(2)).

(6) Share in profits of the corporation

Dividends are set by the AGM, based on the audited financial results (including any statutory reserve contributions and provisions) and a recommendation from the board (CA, §64(4)). The AGM cannot increase the recommended dividend, but can direct the board to decrease the dividend (CA, §64(4)). Banks and insurance companies cannot declare and pay dividends unless the shares floated to the public are fully paid, and without the prior approval of the NRB (BFI, §44 & 46, Insurance Act, §21 & 22).

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

**Assessment: Largely observed**

(1) Amendments to statutes, or articles of incorporation or similar governing company documents

Amendments to the company articles, memorandum of understanding, statutes and bylaws require the adoption of a resolution to amend company's articles and memorandum of association (CA, §18). Special resolutions must be passed by a 75% supermajority of capital present and voting.

AGM minutes must record the total number of shareholders present, the percentage of the representative of total shares, any decisions taken in the meeting and the voting results. Copies of the minutes must be circulated to shareholder within one month of the date of meeting, and file with the OCR (CA, §62).

(2) Authorization of additional shares

**Issuing share capital.** Capital is increased in two steps. First, the AGM can increase authorized capital through a special resolution (75% supermajority). Any company then wishing to increase capital within the limits of authorized capital can do so by a simple majority at the AGM. Neither step can be delegated to the board. Companies must publish a prospectus for the issuance of any new shares.

**Pre-emptive rights.** Existing shareholders have pre-emptive rights. Secondary share offerings are made as rights issues (CA §42). Existing shareholders have at least 35 days to buy the new shares in proportion to their existing shareholding. If shareholders fail to subscribe to the bonus shares within the time allowed, unsubscribed shares can be sold to other shareholders, as per the decision of the board. There is no mechanism to waive pre-emptive rights.

(3) Extraordinary transactions, including sales of major corporate assets

**Sales of major corporate assets.** Specific provisions in the company law regulating large transactions are limited. There are no special rules that govern the approval of large or extraordinary transactions, and no rules requiring shareholder approval of large related party transactions. Mergers require special majority approval of the AGM (although in
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:

**Assessment: Materially not observed**

1. **Sufficient and timely information on date, location, agenda, and issues to be decided at the general meeting**

   **Meeting deadline.** Public limited companies must call the AGM every year, within six months from the date of the close of financial year, which is frequently the 15th of July (CA, §63). If a company fails to call the AGM, any shareholder can complain to the OCR. The OCR can then instruct the company to convene the AGM.

   **Meeting notice and available information.** The notice period for AGMs is 21 days (15 days for extraordinary meetings). The meeting notice must be sent to shareholders and should include the date, time, and place of meeting, the agenda to be discussed, and other information (CA, §54). The meeting notice must also “…be published at least twice in the newspaper of national standard.” The Company Act does not require companies to provide background information on agenda items, although in practice some companies owned and/or managed by multinational companies such as Unilever, Bottles Nepal Pvt. Ltd (Coca-Cola), and Standard Chartered Bank, do send such background information. Financial statements are also with sent with the meeting notice.

   Other information useful for the AGM is publicly available (in theory) from the OCR (company documents) and the company (the directors register). In practice, information at the OCR can be difficult to obtain, because of non-compliance with filing requirements and institutional problems at the OCR.

   Law is silent on the location of the meeting. In practice the meeting is normally held at the location of the registered office of the company. Voting procedures are normally governed by the company articles. In practice, on all matters other than the election of directors, voting is taken by show of hand.

   **Quorum rules.** The quorum requirement for the first meeting is at least 7 shareholders, representing 67% of the total shares. If the first meeting does not meet quorum, a second meeting must be held in at least 7 days; quorum for the second meeting is reduced to 33% (CA, §60, 64).

2. **Opportunity to ask the board questions at the general meeting**

   **Forcing items onto the agenda.** Shareholders representing 5% of voting rights may apply to the board to include an item on the agenda for discussion at the AGM (CA, §64(2)). In general, items cannot be voted on unless they are on the agenda. However, the agenda can be replaced if 67% of the total shareholders entitled to vote in the meeting vote for inclusion of a new agenda. This latter right has not been used in practice.

   **Questions.** Shareholders can and do ask questions pertaining to the agenda listed for discussion.

   One of the major policy issues surrounding the AGM in Nepal is the role played by minority shareholders during the meetings of many companies. According to reports from market participants, many minor shareholders attend meetings for the sole purpose of getting food and “transportation fees”, and agitate loudly to maximize these fees. Many shareholders split their shareholding into small packages among their family members to maximize the value of shareholder “gifts” received at meetings, which range in the general meetings of listed companies from Rs. 200 to Rs. 500 per shareholder, a sum which can be larger than the value of dividends. Various attempts by companies and banks (most notably by the Nepalese Bankers Association) to collectively stop the practice have ended in failure. Many companies respond to these requests (and demonstrations at meetings when the board attempts to reduce these gifts) by not having meetings at all. These distractions are also a significant disincentive for private companies to list.

   A small group of shareholders (self-termed “VIP shareholders”) carry this form of “shareholder activism” further by threatening demonstrations at the AGM if they are not catered to.

3. **Effective shareholder participation in key governance decisions including board and key executive remuneration policy**

   The remuneration of board members is fixed in the company articles. The remuneration of the key executives is fixed by the Board (CA, §75). Shareholders elect or appoint directors and auditors, and make most key company decisions (excepting delisting).
### 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:** Materially not observed

**Classes of shares.** The Company Act of 1997 has a strong bias towards "one-share one-vote". All ordinary shares have voting rights, and there are no classes of ordinary shares with differing rights. Companies can issue preferred shares, which are typically non-voting, redeemable and cumulative, with a fixed return. However, these shares are rare, and only a handful are listed. Voting caps are not possible under company law.

**Ownership disclosure by companies.** Shareholders have the right to inspect share register, and can obtain a copy for a relatively small fee (in practice Rs 5 per page (CA, §35(4) & (5)). However, there is no disclosure of (what is called in other jurisdictions) ultimate beneficial ownership, or disclosure of shareholders acting in concert. According to market participants, this results in difficulties in monitoring related party transaction and other conflicts of interest.

Companies are required to inform NEPSE if there is a change in ownership such that a single person holds 5% or more shares (Listing Rules, §15(k)). However, these disclosures are not made public. For banks and financial companies NRB Directive 4 requires the disclosure of individual shareholders holding more than 0.5% of capital. However, this requirement does not cover corporate shareholders or promoters.

**Ownership disclosure by shareholders.** There is no requirement for disclosure of ownership by shareholders. There are no provisions in the law for shareholders or regulators to understand the indirect or ultimate beneficial ownership of companies.

**Disclosure of shareholder agreements.** There is no disclosure of shareholder agreements (except at the time of incorporation). The existing law only mentions shareholder agreements in private companies. In practice, they are mostly used in private companies incorporated as joint ventures, and cover the appointment of the CEO and other management, and restrictions on transfers of shares (by way of lock-ins and rights of first refusal).

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

**Assessment:** Materially not observed

1. **Transparent and fair rules and procedures governing acquisition of corporate control**

   **Basic description of market for corporate control.** There is no market for corporate control in Nepal, no takeovers, and almost no mergers. Changes in substantial shareholdings do not take place in listed companies.

   **Tender rules/mandatory bid rules.** There are no rules governing the substantial acquisition of shares, tender offers, changes in control, or mandatory bid or other rules requiring a shareholder to make an offer for shares once a certain threshold is crossed. The OCR has a limited authority to approve merger and acquisition (CA, §135).

   **Delisting-going private procedures.** There are no provisions dealing with voluntary delisting, and no squeeze-out or sell-out rules. Involuntary delisting is handled by the stock exchange, and can take place when the listing rules are violated (SEA 1983, Listing Rules). In practice, companies are delisted when they do not pay listing fees, and when they are non-operating. Delisting is rarely used by the NEPSE to protect minority shareholders. One state controlled bank requested NEPSE and SEBO to be delisted in 2004, and permission was granted on an ad hoc basis.

   Public companies can convert to private companies when (i) the number of shareholders has been reduced to fifty or less, and (ii) the company passes a special resolution in the GM. In practice these conversions are rare.

   **Abuse of buy-backs/treasury shares.** Companies are expressly prohibited from buying back their own shares, or making loans based on their own shares as collateral. (CA, §47).

2. **Anti-take-over devices**

   A number of factors inhibit the takeover market, including concentrated ownership, and board rights of first refusal to purchase shares. As noted above, there is no regulation of the takeover market (including anti-takeover devices).

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

**Assessment:** Materially not observed
### (1) Disclosure of corporate governance and voting policies by institutional investors

**General obligations to vote/disclosure of voting policy.** There are few institutional investors, no overall regulation, and no rules to require the disclosure of voting or voting policy by institutional investors acting in a fiduciary capacity.

**Special Rules for Institutional Investors / Pension Funds.** No regulations.

**Blocked shares/record date.** Public companies may close the shareholders’ register for a maximum of 45 days in a year, but not exceeding 30 days at one time. Notice must be published at least twice in the national daily newspapers (CA, §35(4)). During the period when the register is closed, trades can take place on the exchange, but the transfer of shares is not recorded in the register.

In practice, public companies close the shareholders’ register for the 15 days prior to the AGM.

### (2) Disclosure of management of material conflicts of interest by institutional investors

No rules or regulations are in place, beyond the legal requirements for disclosure of conflicts of interest as noted elsewhere in the report.

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**Principle IIG: Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.**

**Assessment: Partially Observed**

**Rules on shareholder cooperation in board nomination/election.** None.

**Rules on communication among minority shareholders.** None.

**Proxy solicitation or other formalities required.** No special rules for institutional shareholders.

**Rules on communication among institutional investors.** None.

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### SECTION III: THE EQUITABLE TREATMENT OF SHAREHOLDERS

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

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

**Assessment: Materially Not Observed**

#### (1) Equality, fairness, and disclosure of rights within and between share classes

Shareholders that attend the AGM and harass the board or managing director are normally given special treatment in the form of food, money or other favors—other shareholders do not benefit from this treatment.

**Availability of share class information.** The CA allows for only two classes of shares, ordinary voting shares and preference shares, and describes the basic rights of each.

**Approval by the negatively impacted classes of changes in the voting rights.** This is not addressed in the CA, but a company may include a requirement in its articles that preference shareholders must approve any variation in the rights attached to their shares.

#### (2) Minority protection from controlling shareholder abuse; minority redress

While the law provides certain channels for shareholder redress, in practice redress is not forthcoming, or is carried out in a way inconsistent with legal norms.

**Ability to call meeting.** Under the CA, the OCR can demand the company hold the AGM if it fails to do so (§63). Twenty five percent of shareholders, or shareholders holding ten percent of the paid up capital, can also request, through the OCR, that the company call an extraordinary meeting (§67). The one known case where the OCR did call a general meeting was disputed in court. Proposed legislation would allow SEBO to call for the meeting if the AGM is not held.

**Withdrawal rights.** There is no equivalent of withdrawal or dissenters’ rights.

**Ability to sue to overturn meeting decisions.** Under the CA (§128&129) shareholders can appeal to the Company Board to void decisions of the AGM if made improperly. Such rulings can and are appealed, and it is not clear how often these decisions are in fact voided.

**Redress from regulators.** With limited legal authority and more limited resources, regulators provide little in the way of redress for shareholders. When action is taken, it tends to be appealed to the courts, where the regulators decision are frequently appealed.
overturned. Under the CA the OCR can direct companies to pay promised dividends (§140), allow them to inspect the companies books (§136), and more generally conduct investigations and order directors and other officers to take actions required under the law, or reverse illegal ones (§137). SEBO also has fairly broad powers under the SEA and can investigate shareholder complaints, but rarely uses these powers in practice (some have never been used), except to request issuers to correct their behavior or to refer complaints to the NEPSE.

**Ability to sue directors.** The law allows derivative suits against directors, employees or other persons on behalf of the company by a single shareholder holding 2.5 percent of the companies shares or a group with at least 5 percent(CA §132), but no such suits have been filed before the Katmandu District Court.

| (3) Voting by custodians and nominees. | The law does not recognize shareholder custodians or nominees. |
| (4) Obstacles to cross border voting should be eliminated. | Foreign share ownership is heavily regulated, and there are no known foreign portfolio investors in Nepal. |
| (5) Equitable treatment of all shareholders at general meetings | Under the law, all holders of ordinary shares have the same voting rights, and minority shareholders regularly participate in AGMs. However Nepal’s unusual form of shareholder “activism” has led some companies increasingly to not hold the AGM or place their head quarters outside of Katmandu to limit participation. |

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

**Assessment: Partially Observed**

**Basic insider trading rules.** The CA completely prohibits directors, or the auditor, managing director, or company secretary from buying or selling shares in the company (§53). A person must own shares before being nominated to be a director. Under the SEA (§ 30), a person having inside information which could effect the share price shall not benefit from that information or pass it on.

**Insider trading disclosure.** Listing rules require that the NEPSE be informed if a shareholder exceeds 5 percent ownership in a company. This information is not distributed to the public.

**Criminal/civil/administrative penalties.** Trading by insiders can lead to fines or up to two years imprisonment. However there are no known cases of such trading, or of penalties being applied. The NEPSE can suspend trading if undisclosed material information is believed to be affecting trading or the stock price. Information on these suspensions is not provided to the public.

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

**Assessment: Materially Not Observed**

**RPT approval rules/rules for approval of board/AGM.** There are no special requirements for approval of related party transactions or their disclosure, and no authority attempts to monitor them. Such transactions are believed to be common.

**Conflict of interest rules and use of business opportunities.** Persons facing a potential conflict of interest are prohibited from serving as directors, however a majority of shareholders may waive this restriction (CA§73). Shareholders are not allowed to participate or vote on issues in the general meeting where they have a potential conflict of interest (CA§57). Banking, insurance and other financial companies cannot make loans to directors and their family members, the chief executive or shareholders with more than 1 percent of shares. Currently other companies face no such prohibition, however the draft Companies Act would limit loans to the directors and shareholders of all companies.

**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**

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5. They may participate in a capital increase, and buy shares in proportion to their existing shares.

6. BFI (§38) and the Insurance Act of 2049 (§14)
Assessment: Largely Observed

While employees do not have a specific right to sit on boards, they are represented on a labor relations committee which contains two employees and two managers. Creditors normally only nominate directors in the unusual situation where they also have shares in the company.

Corporate social responsibility and codes for stakeholders. The special place of tourism in the economy and the current political climate have made corporate social responsibility an increasingly prominent issue. The Federation of Nepalese Chambers of Commerce & Industry has instituted a training program on corporate social responsibility and developed a code of business ethics. The carpet industry has instituted a program to certify carpets made without the use of child labor, and similar initiatives are underway or being developed.

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

Assessment: Largely Observed

Redress mechanisms available to stakeholders. Under labor law, employees can bring litigation against the company for violation of their rights, and such cases are not unusual. The Constitution of Nepal allows environmental groups to bring the company to court for violation of environmental law, however such cases are rarer. In the past creditors had few options in the face of unpaid loans, now secured creditors—including banks—have much stronger avenues for redress.

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

Assessment: Materially Not Observed

All companies are required to provide 10% of pre-tax profits to employees as a bonus using a prescribed formula. There is little link between the potential bonus and individual performance.

Rules on employee stock option plans. Stock options are not used in Nepal, and there is no law regarding their use.

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

Assessment: Partially Observed

The director’s report is required to have certain information on the broader prospects for the company (CO§83). In practice, poor disclosure also limits stakeholders’ access to information.

Annual report discloses economic and financial prospects. Yes.

Annual report discloses significant facts on employees. No.

Information is sufficient and reliable. No.

Information is timely and regular. No.

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: Not Observed

Whistleblower rules. There is no law specifically protecting whistleblowers.

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

Assessment: Partially Observed

Effectiveness of bankruptcy, security/collateral, and debt collection/enforcement codes. Nepal has no real framework for insolvency: the provisions on liquidation in the CO are considered to be inadequate and have not been used in practice and there is no provision for reorganization during insolvency. There is no possibility in the law to void transactions designed to harm creditors (fraudulent conveyance) and non-financial companies do not have minimum capital or net worth.
requirements. Lenders, especially the two large state controlled banks, also have a poor reputation regarding due diligence and screening borrowers.

In response to a large number of non-performing loans, the NRB, supported by the international donor community, has introduced a number of measures to strengthen creditors' rights, improve loan quality and encourage loan recovery. The two main state banks have been restructured, and the NRB has issued directives to improve the governance of all banks and other financial companies. Banks have been given the power to recover collateral directly—though borrowers still resort to the courts to prevent such recovery—and a Debt Recovery Tribunal has been established. New laws on insolvency and establishing an asset management corporation have been drafted.

However the most controversial and perhaps far reaching reform has been the 2002 directive by the NRB on the “blacklist”. This list includes the significant shareholders (now 15%) and directors of companies that are in default and have not restructured the loans with the bank. Those on the list (and the companies in which they have large shareholdings or are directors) cannot borrow more, and cannot serve as directors for a bank. Many directors and shareholders on the list gave personal guarantees when borrowing, however not all did, and the blacklist reflects a relaxation of the concept of limited liability. It also remains very under the control of the banks, with limited possibility of appeal by those listed.

The blacklist has motivated some borrowers to repay part of their bad loans: by July 2004 652 borrowers had been removed from the list, having restructured 3.16 billion NR in bank loans, almost 19% of the total. However there is a strong feeling in the business community that, especially given the current political and economic climate, the list has affected too many directors and shareholders whose companies are legitimately distressed. The NRB has revised the directive to provide a grace period for “non-willful” defaulters, however it remains to be seen what sort of impact this will have in practice.

SECTION V: DISCLOSURE AND TRANSPARENCY

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

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

Assessment: Materia lly not Observed

(1) Financial and operating results of the company

Under the law, public limited companies (including all listed companies) must prepare annual reports, which are mailed to shareholders and sent to the OCR and the stock exchange. In practice, only Group A companies regularly prepare these reports, and quality is uncertain. Financial statements are prepared in conjunction with national accounting standards, and are not consolidated (see Principle VB below).

**Annual report.** The annual report must include the audited annual financial statements, the audit report, an “directors report” with additional information and background to the financial statements, including (a) a review of activities of the previous year; (b) effects of national and international position on company business; (c) achievements during the current year outlook for future; (d) industrial and business relationships; (e) changes in the board of directors and reason thereof; (f) major factors influencing financial results; (g) comments on the auditor's report; and (h) level of recommended dividends.

**Semi-annual report.** Banks and finance companies release semi-annual reports. Other listed companies do not.

**Quarterly report.** No quarterly reports are required.

(2) Company objectives

According to the requirements of the Company Act, the director’s report included with the annual report should include a review of the previous year’s activity, achievements during the current year and outlook for the future, and major factors influencing operations.

(3) Major share ownership and voting rights

For general listed companies there is no requirement for the disclosure of ownership in the annual report. For banks and financial companies NRB Directive 4 requires the disclosure of individual shareholders holding more than 0.5% of capital. However, this requirement does not include corporate shareholders and promoters.

There are no special voting rights for ordinary or preferred shares (see Principle IIIA).

(4) Remuneration policy for

There is no requirement to disclose board or management compensation. Basic

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8 “Nepal: The Legal and Judicial Environment for Financial Sector Development” World Bank, March 2005, provides a more in depth discussion of these reforms.

9 Information provided by the Credit Information Bureau.
| Corporate Governance Assessment Nepal |

| Board and key executives, and information about directors | Information is in practice included in the annual report, including the names (and photographs) of directors. The board report also includes changes in the composition of the board, and the reason for the change (CA, §83). |
|------------------------------------------------------------|
| (5) Related party transactions | Law and regulation does not require disclosure of related party transactions. The Accounting Standards Board plans on issuing a standard based on IAS 24 in the next year. According to NRB Directive 4 banks and finance companies must disclose details of loans disbursed to directors, promoters, employees and shareholders holding more than one percent of capital. |
| (6) Foreseeable risk factors | Current annual report formats and accounting standards have limited requirements for forward looking statements, but do include a requirement for a discussion of "outlook for the future". There are no requirements for the disclosure of material risk factors. |
| (7) Issues regarding employees and other stakeholders | There are no specific requirements for disclosure of issues regarding employees or other stakeholders. |
| (8) Governance structures and policies | Comply-or-explain in force. There is no code of corporate governance, and no comply or explain mechanism. Some information on governance practices should be available from the company articles. Regulator enforcement practice. Not applicable. |

**Principle VB:** Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

**Assessment:** Materially Not Observed

**Compliance with IFRS.** The Nepal Chartered Accountants Act 1996 established the Institute of Chartered Accountants of Nepal (ICAN). The same Act established the Accounting Standards Board. ICAN issues national accounting standards based on recommendations from the Accounting Standards Board. All 7,000 members of ICAN are required to assess compliance with the adopted national standards. However, no law requires that financial statements of listed companies (and banks and other public interest entities) be carried out using national accounting standards, or that audits assess compliance with them. Since 2003, the Board has issued 8 NAS that require mandatory compliance, five that require voluntary compliance, and will draft 8 additional exposure draft standards over the next year. National standards are based on the equivalent international accounting standard, but with some significant material differences. In particular, no consolidated reporting is required.

**Review/enforcement of compliance.** No law or regulation requires that listed companies (and banks and other public interest entities) prepare financial statements in accordance with national accounting standards. Because they are not required by law, because they are new, and because understanding of the standards in the market has not widely expanded in the market, compliance is very limited (and no companies interviewed were preparing statements according to NAS. Some banks with international parents (in particular Standard Chartered Bank) are preparing reports in accordance with IFRS, but these are not reduce to the public.

**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:** Materially not observed

**Compliance with ISA.** ICAN is responsible for promulgating national auditing standards (NSA), as authorized in the Nepal Chartered Accountants Act 1996. ICAN issues auditing standards based on recommendations from the Audit Standards Board, which was also established in the Nepal Chartered Accountants Act. ICAN members are required to use the adopted national standards in carrying out their audits. However, no law requires that audits of listed companies (and banks and other public interest entities) be carried out using national audit standards. National standards are equivalent to International Standards of Audit (ISA) with small additions based on national regulation. Since 2003, the Board has issued 22 standards based on the first 22 ISA, and the next 8 (through ISA 30) will be issued by July 2005.

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10 National accounting standards were not reviewed in detail for this report, and any assessment of differences with IFRS are based on interviews with market participants.
**Who must be audited.** All limited liability companies (including banks and insurance companies) must be audited (CA, §85).

**Auditor independence.** The national standards adopted by ICAN include the full adoption of the ISA Code of Ethics. However, its recent introduction, the lack of training of many registered auditors, and the lack of a legal requirement to follow the national audit standards have so far resulted in minimal impact. The Company Act also (inconsistently) defines auditor independence.11

There are no general requirements or recommendations for auditor rotation. Auditors of banks and financial institutions (the specific partner in charge) must be rotated after three consecutive financial years. (BAFI, §60(2)). There are no legal prohibitions against auditors performing other work for audit clients. In practice, auditors perform tax and bookkeeping services for their audit clients.

**Audit committee.** There are no general requirements for an audit committee; banks and financial institutions have been required since 2001 to have an audit committee of the board headed by a non-executive director. See Principle VIE.

**Competent and Qualified Audit Enforcement.** Audit requirements are enforced through ICAN’s self-regulatory powers; there is no requirement that audits be conducted in line with national audit standards, and no public or government oversight body. ICAN recognizes that conflicts of interest within the organization prevent consistent audit enforcement. A handful of audit reports are qualified each year.

**Auditor qualifications.** ICAN has about 7,000 members, of which 292 have passed the exam to become a Chartered Accountant. About 50% of Chartered Accountants are actively practicing auditors. This number is considered by ICAN to be insufficient. The remaining registered auditors generally have very low qualifications and training.

Correspondent representatives of the international network firms (KPMG, Ernst & Young, Deloitte) are the leading firms in Nepal. Audit firms cannot be foreign owned. There are reputable second-tier reputed auditing firms which also have a strong presence in the local market. Market participants complain that the major firms are monopolized by the donors and international financial institutions. In addition, audit fees are very low, reducing incentives to increase audit quality.

Auditors of listed companies must be a member of ICAN and hold Certificate of Practice, but are not required to be Chartered Accountants (Nepal Chartered Accountants Act 1996 §16,28). In practice, ICAN believes that a majority of listed companies are audited by Chartered Accountants. The auditors of banks and financial institutions must be appointed from a list of Chartered Accountants maintained by the NRB.

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**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.** Auditors of public companies are appointed by shareholders. However, unlike in many jurisdictions where the AGM appoints the auditor on the recommendation of the board (or management), in Nepal the auditor is nominated from the floor by the shareholders. As a result, nominations can be unpredictable, with frequent changes of auditors and no board and management control over auditor quality.

Company law is silent on the specific reporting relationship between the auditor and the company. In practice, the auditor reports to the board of directors or management. For financial institutions, the auditor reports to the audit committee (BAFI, §64). Auditors can be sued by shareholders in the “event of any loss to the company, to any shareholder, or to any creditor.” However, proving loss is difficult. There have been no reported cases of lawsuits against auditors.

**Auditor insurance.** There is no market practice of purchasing insurance by auditors.

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

**Assessment:** Partially Observed

Information is available through annual reports and—nominally—from the OCR. In practice, information is reportedly difficult to obtain from the OCR, and hampered by low compliance with filing requirements. Shareholders may inspect, AGM minutes, the share register, and accounts, at the company.

**Material facts.** Listed companies are required to disclose price-sensitive information to the exchange. This information is then made available to member brokers.

**Published information (papers, web).** The principle channel for information dissemination is the required circulation (by post) to all shareholders of public companies. In addition, abridged annual reports are published in newspapers. According

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11 A number of persons are disqualified to be appointed as auditors: (a) Director, employee or worker of the company; (b) partner of the director or employee of the company; (c) Debtor of the company; (d) Close relatives of the director of the company or his partner; (e) A person who has been convicted on any charge pertaining to auditing; (f) A person who has been declared insolvent; (g) Person or firm holding one percent or more shares of the company; (h) Person convicted for criminal offense of moral turpitude.
to securities law, listed companies must file their statements to SEBO and the Stock Exchange within four months from the close of the financial year. (SEA, §15A). However, this is inconsistent with the filing requirements in company law (six months, 21 days before the AGM) and banking law (five months). (CA, §63, BAFI, §59) These requirements are very expensive for companies with large numbers of shareholders.

The draft proposed securities and company ordinances harmonize these requirements, and allow companies to publish financial statements on websites in lieu of sending by post.

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 Observed

Disclosure of conflicts of interest by analysts, brokers, rating agencies, etc. There is limited informal brokerage research in Nepal, and no rating agencies. There are no specific provisions regulating the conflict of interest by analysts. Brokers are regulated by laws and regulations designed to protect customers and reduce conflicts of interest.

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: Materially not observed

Basic description of board. Companies in Nepal are governed by single-tier boards. The role of Chairman and Managing Director (CEO) are usually separated, but is more common when a single shareholder holds substantial a large position directly or through other family members. (Nepal Investment Bank is one example of this practice). The role of the Chairman is not clearly defined. The Chairman presides over board and shareholder meetings, and is given the deciding vote in the case of a tie (CA Section 61(1), 61(4) and 78(5)).

The appointment of a company secretary is mandatory in public companies with at least Rs.10,000,000 (approx US$138,888) in share capital (CA, Sections 142 and 143)

Size requirements and typical size. Public company boards must by law have between 3 and 11 members (CA §70); private companies have no restrictions. Normally, size of the board of listed companies varies from 5 to 9 members.

Nomination and election. The board is normally elected by majority vote by the AGM, but at the request of 20% of capital, the board is elected by group voting (a form of proportional representation – see Principle IIA.5). The term of the board is set in the articles, up to a maximum of 4 years. Board terms are not staggered. Retiring directors are eligible for re-appointment. (CA, § 74).

Eligibility requirements. Directors must be shareholders, except those directors appointed by corporate shareholders (CA §72). In practice, directors hold 10-100 shares to meet the qualification. There are no general education or work experience qualifications. Except for banks and financial institutions where directors (other than those representing State bodies) should have a bachelor’s degree or at least 5 years of work experience in banking or government.

Directors are also unqualified if they are younger than 21, not of sound mind, insolvent, convicted of a crime, or have been convicted of acting against the company (CA §73). In addition, directors cannot have any personal interest in any contract, or agreement with the company.

Adequacy of duties of loyalty and care. The law contains only a very general outline of the duties and powers of the Board of Directors. The CA contains no description or definitions of the duties or responsibilities of directors. The legislation does not give definition of duty of care and loyalty for board members. There are no lawsuits against directors.

NRB Directive 6 adds significantly to the duties of bank directors. Bank directors are required to “supervise and monitor activities with a higher degree of wisdom and competence.” They must make sure that they comply with relevant laws, and make sure they are not violated.

Insurance for directors. There is no practice of providing insurance to directors.

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

Assessment: Partially observed

The law contains a number of provisions that regulate the conflicts of interests of directors. However, there is no general
**Principle VIC:** The board should apply high ethical standards. It should take into account the interests of stakeholders.

**Assessment: Partially Observed**

The development of corporate social responsibility and company codes of ethics is at an early stage in Nepal. Boards have no general responsibilities or duties regarding ethics and social responsibility; and generally companies should not violate any existing laws. NRB Directive 6 establishes the requirement for banks to adopt and observe the NRB Code of Ethics.

The Corruption Act 2002 prohibits the giving of bribes and involvement in corruption. Boards are not required to take the interests of stakeholders (e.g. employees, creditors, consumers, suppliers, local communities) into account when making corporate decisions.

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

**Assessment: Materially Not observed**

<table>
<thead>
<tr>
<th>(1) Board oversight of general corporate strategy and major decisions</th>
<th>Board functionality by law, in practice, as recommended by Code. Board functionality is not defined in law, and there are no guidelines of best practice. According to the Company Act, the board “…shall make all arrangements regarding the business of the company, and exercise its rights and discharge its duties.” Director training, IOD. There are no organized director training programs in Nepal, and no organizations providing recommendations on good practice.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2) Monitoring effectiveness of company governance practices</td>
<td>Boards reportedly do not set company governance standards, oversee compliance, or evaluate their performance on a regular basis.</td>
</tr>
<tr>
<td>(3) Selecting / compensating / monitoring / replacing key executives</td>
<td>The board has complete authority to appoint the managing director and other members of the management team, and set their compensation (CA, §76, 77).</td>
</tr>
<tr>
<td>(4) Aligning executive and board pay with long term company and shareholder interests</td>
<td>There is no law, regulation, or recommendation requiring or recommending that boards review key executive and board remuneration. Board remuneration is set in the articles of the company. The general meeting must vote for amending the clause dealing with remuneration. The draft Company Ordinance gives the power to set board remuneration to the general meeting, to provide flexibility and a proper check on unreasonable remuneration. Remuneration varies from company to company; the amount depends on the size of the company. Market participants report that remuneration is sufficient incentive for the board members to devote required time to fulfill their duties.</td>
</tr>
<tr>
<td>(5) Transparent board nomination / election process</td>
<td>There are no mechanisms aimed at maintaining the transparency of the nomination process. For the election of directors not appointed by promoters / corporate shareholders, the nomination process is generally open and all qualified shareholders may stand for election.</td>
</tr>
<tr>
<td>(6) Oversight of insider conflicts of interest, including misuse of company assets and abuse in RPTs</td>
<td>Boards have no explicit role in approving related party transactions or conflicts of interest between shareholders (see Principle IIIIC).</td>
</tr>
<tr>
<td>(7) Oversight of accounting and financial reporting systems, including independent audit and control systems</td>
<td>The financial statements must be approved by the Board, and signed by all the directors (CA, §83(2)). Although there are no specific requirements under the CA 1997 for the managing director or CFO to certify the financial statements, in practice both normally do so. Bank directors are required to establish “sound written policies in respect of investment, credit, management of assets and liabilities, profit planning and budgeting, capital planning”, and to ensure implementation.</td>
</tr>
<tr>
<td>(8) Overseeing disclosure and communications processes</td>
<td>The board plays no explicit role in the process of disclosure and communications.</td>
</tr>
</tbody>
</table>
**Corporate Governance Assessment Nepal**

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

**Assessment: Partially observed**

| (1) Director independence | **Director independence in law and in Code.** There are no general independence requirements for board members. The draft Company Ordinance introduces the concept of independent directors, with one or two independent directors required depending on the size of the board. The definition of independence in the draft is based on EU directives.

From 2005, banks and financial institutions are required to appoint a “professional director”, selected from an NRB list of approved professional experts (BAFI, §12(2)). Although the professional director has full voting rights, he or she is appointed by the board, not elected or appointed by shareholders.

**Director independence in practice.** The majority of most boards consists of the controlling shareholders, and these boards do not generally exercise independent judgment. A form of independence exists of the practice of having the “public shareholders” elect those directors that are not appointed by promoters. In one bank, for example, out of seven directors, two are elected by public shareholders, and five are appointed. In practice, these directors are seen as representatives of small shareholders, and can be seen as playing an informal independent role. However, in general, most boards do not have the capability of exercising judgment independent of the promoters. Because the NRB requirements do not come into effect until 2005, there has been no implementation of the “professional director” requirement in banks. |

| (2) Clear and transparent rules on board committees | **Audit committees.** There are no requirements for public / listed companies to form audit committees. The draft Company Ordinance introduces the concept of the audit committee, for large listed companies; the proposal size, duties, and responsibilities of the committee.

Commercial banks must form audit committees (NRB Directive 6, §2.2), to be chaired by a non-executive director. Banks must draft by-laws for the audit committee. The audit committee must review the bank's financial condition, internal controls, the audit program, program related to branch expansion, and the findings of the internal auditor. Internal auditors must report to the committee. The audit committee must review the audit report of the external auditor, initiate necessary corrective action, ensure publication of the annual report, and that the accounts are adequate, including provisioning. While all market participants believe that the audit committee requirement is an important step forward, some commented that in many banks the audit committee does not yet play an informed and independent role.

**Other committees.** There are no requirements in the law to form any other committees, and no practice of creating other committees. |

| (3) Board commitment to responsibilities | **Restrictions on the number of board seats.** For public companies, there are no regulations or requirements governing the maximum number of board seats that an individual can hold. Directors of banks or financial institutions cannot be a director in another financial institution (BAFI, §18(1)e).

**Board meeting requirements.** By law, boards of public companies must meet at least six times per year (CA, § 78(2)). Boards of banks and financial institutions must meet at least 12 times per year (BAFI, §23(1)).

**Public availability of board attendance.** In practice, board attendance is recorded in the minutes. |

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

**Assessment: Partially Observed**

Boards can generally obtain legal and other professional advice required in the day-to-day operations of public companies. However, there are no provisions that permit individual members to seek professional advice. In practice, all relevant information is provided to the board of directors, because most of the directors represent promoters / controlling shareholders, who also control management.
**AGM:** Annual General Shareholders Meeting

**CA:** Companies Act, 1997

**CEO:** Chief executive officer

**CIT:** Citizen’s Investment Trust, Nepal

**Cumulative voting:** 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.

**EGM:** Extraordinary Shareholders Meeting

**GDP:** Gross Domestic Product.

**ICAN:** Institute of Chartered Accountants Nepal

**IFRS:** International Financial Reporting Standards

**ISA:** International Standards on Auditing

**NEPSE:** Nepal Stock Exchange

**NRB:** Nepal Rastra Bank, the central bank

**OCR:** Office of the Company Registrar

**Pre-emptive rights:** 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.

**Proportional representation:** Proportional representation gives shareholders with a certain fixed percentage of shares the right to appoint a board member.

**RPT:** Related party transactions. The OECD Principles of Corporate Governance hold that it is important for the market to know whether a company is being operated with due regard to the interests of all its investors. It is therefore vital for the company to fully disclose material related party transactions to the market, including whether they have occurred at arms-length and on normal market terms. Related parties can include entities that control or are under common control with the company, and significant shareholders, such as relatives and key managers.

**SEBO:** Securities and Exchange Board of Nepal

**SEA:** Securities and Exchange Act, 1983

**SOE:** State owned enterprise.

**Shareholder agreement:** 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.

**Squeeze-out right:** 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.

**Withdrawal rights:** Withdrawal rights (referred to in some jurisdictions as the “oppressed minority,” “appraisal” or “buy-out” remedy) give shareholders the right to have the company buy their shares upon the occurrence of certain fundamental changes in the company.
This report is one in a series of corporate governance country assessments carried out under the Reports on the Observance of Standards and Codes (ROSC) program. The corporate governance ROSC assessments examine the legal and regulatory framework, enforcement activities, and private sector business practices and compliance, and benchmark the practices and compliance of listed firms against the OECD Principles of Corporate Governance.

The assessments:

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

To see the complete list of published ROSCs, please visit 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/

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