

CORPORATE BOARD PRACTICES

Alexander N. Kostyuk

名誉

Meiyo
Honor
Честь

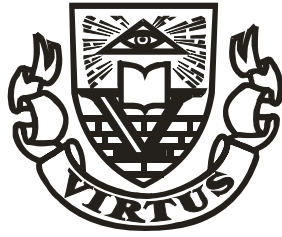
良心

Ryoushin
Conscience
Совесть

高貴

Kouki
Nobility
Доброе имя

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To Liza and Helen

“Serve to principles, but not persons”



“Служите принципам, а не личностям”

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INTRODUCTION

Boards of directors are a crucial part of the corporate structure. They are a link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers). One of the board's primary roles is to monitor management on behalf of the shareholders.

As Tricker says, in the common definition corporate governance "addresses the issues facing boards of directors". In this view, corporate governance is the task of the directors and therefore attention must be paid to their roles and responsibilities. In the broader view, boards of directors are the part of the governance system.

The way how this part of the governance system influences corporate governance depends on the governance concept used - monistic, dualistic or pluralistic. At the same time, certain governance concept shapes the boards practices.

Fundamental governance concepts have been developed in industrial countries. Countries of the Eastern and Central Europe, so named "post-communist", are still looking for an optimal concept to put it into the basis of the best board practices.

One of the countries where there is not still a firmly defined and well-developed governance concept is Ukraine. After a fifteen-year history of privatization of the state property there is a lack of approved approaches to research in the field of the board practices.

From the point of view of the Jay Conger classification of the roles of the board of directors, i.e. strategic, monitoring and advising, the supervisory boards in Ukraine are rather advisors than strategists and monitors. The members of supervisory boards believe that their main task is to give the competitive advices to the management board members. They support such behavior saying that through advising to the management board members the supervisory board members transmit the most important ideas from shareholders to executives.

Privatization, as a key factor shaping the stature of the supervisory boards in Ukraine transmitted remarkably the major features of privatization to the board practices. The most important factor is a lack of well-motivated owners rather individual to take part in corporate governance with application of the corporate board best practices. 52 per cent of shareholder equity is still owned by employee shareholders. It is waste to hope for their activity in gathering appropriate knowledge on corporate governance to pay an important attention to the supervisory board as a protector of their rights. Consolidation of their votes to

represent the common minority shareholder interests by market participants like pension funds or asset management companies is a very unique event in Ukraine. Acting alone, i.e. separately, is not an effective approach of a shareholder to get his representation on the supervisory boards. Thus, the supervisory board gates are not opened for employee shareholders.

The supervisory board gates are managed very often by executives who apply a lot of efforts to isolate the supervisory board of the major corporate value – information. An information blockade deprives the supervisory board not only of possibilities to play a role of strategist. Monitoring becomes very difficult to apply too. Therefore, there is only one function to fulfill – an advisory function.

Large institutional shareholders whose capitals origin needs more transparency do their utmost to be under shadow. Supervisory board practices reflect such kind of approach to corporate governance. Transparency and accountability are just words and nothing more. Accountability could be only partial, in the favor of large shareholders. The worst fact is that the largest shareholders were the parliamentarians in Ukraine for a long time. Therefore it was a waste hope for the legislative progress in solving the problems of weak transparency and weak accountability of the supervisory boards. They were very resistant to the adoption of the draft of a new “Corporation Act” where many board issues are settled as it is required by the best international practices. Without adoption of that Act the supervisory boards are like marionettes in the hands of the large shareholders.

Market for supervisory board members in Ukraine is the weakest contributor to the development of the best board practices. There are about 35 thousand of joint-stock companies in Ukraine which employ about 280 thousand of directors. This is almost two per cent of adults in Ukraine. Taking into account that corporate governance courses are offered by educational institutions to all interested parties starting only from 1995, thus there is very instable fundament for directors to develop their own skills.

So, the director professionalism is under pressure from the side of society. Mobility of the market for the directors in Ukraine is very weak. That is why it is very hard to hope for the smooth development of the market. The situation in Ukraine is like in Japan where the secondary market for directors is almost absent. Directors are “the corporate creatures” who worked at the company for a long time and their being on the supervisory board is rather a reward for their loyalty to the company than the reward for their professionalism.

“Director independence” as one of the major corporate governance challenges is far from the Ukrainian practices. Ukrainian companies are

still far before the approving the most progressive concept – the concept of independent directors. Director interlocking has put a net of mutual relationships and informal contacts onto the director community in Ukraine.

All these make the supervisory board practices in a transition economy less competitive than the board practices in developed countries. Lack of the board transparency, weak board accountability, lack of professionalism and weak social responsibility are the major problems of the corporate board practices in Ukraine. These are the cornerstones the corporate board practices to begin its move forward, toward the best corporate governance practices generally accepted in the world. These are the issues this book is going to deliver to the reading audience.

1

CORPORATE GOVERNANCE REGIME IN UKRAINE

Corporate governance regime

Ukrainian joint stock companies operate under the Enterprises Act adopted by the Ukrainian parliament at the early 90's. The Act does not describe many corporate governance practices such as recommendations on the board size, share of the independent directors, recommendations on certain board committees, etc. At the same time this is only the Act regulating corporate governance in Ukraine since its independence, i.e. the year 1991.

In 2000 the new Corporation Act was developed by the Parliament of Ukraine but it is still not adopted by the Parliament. There are many reasons of this situation. One of them is that many large shareholders, lobbying their interests through Parliament do not want to become more transparent, accountable and socially responsible. The draft of the Corporation Act contains many novelties such as commulative voting and representation, mechanisms to allow minority shareholders leave the company if they do not agree with the large shareholders, etc.

The year 2003 was the year of adoption by the SEC in Ukraine a Code of best practices. The Code was a result of efforts of experts of IFC and SEC. Regrettably, the Code is rather paperwork than a practical corporate governance manual. Ukrainian companies forced by the large shareholders do not ask for the Code principles.

The stock market of Ukraine is not well developed. There are only 2000 joint stock companies in Ukraine which have their shares listed on the stock exchanges. The rest 10000 open joint stock companies are still far from the stock exchange. Market capitalization of the stock market in Ukraine is only over USD5 billion. It is only 6 per cent in comparison to GDP of Ukraine. Liquidity of the stock market is very weak. There are only 10-15 companies whose stock could be taken for the actively traded at the stock market. The rest companies are passive observers.

Types of Joint Stock Companies

Open and Closed Joint Stock Companies. Joint stock companies can be both open and closed. In case of an open joint stock company the number

of founders is unlimited while a closed joint stock company's number of founders shall not exceed 50.

In a similar fashion the number of an open joint stock company's shareholders is unlimited while in case of its closed counterpart it shall not exceed 50.

Placing of Shares. An open joint stock company has a right to do placing of shares and issued securities of the company convertible into stock through both open and closed subscription. Company's Charter as well as regulations of Ukraine may establish restrictions on closed subscriptions by open joint stock companies.

A closed joint stock company is not entitled to do placing of the company's shares and convertible securities through open subscription or to offer them for purchasing to an unlimited number of persons through any other method.

Types of Company's Shares

Common and Preferred Shares. A company does placing of common shares and has a right to place one or more types of preferred shares. Par value of the preferred shares placed shall not exceed 25% of the company's charter capital.

The Charter of a company may prescribe a procedure according to which a dividend overdue or paid not fully for preferred shares, which amount was determined by the Charter, is accumulated and repaid prior to the deadline established by the Charter (commulative preferred shares). Should the Charter of a company fail to establish the deadline the preferred shares shall not be regarded as commulative.

Bodies of Joint Stock Companies

Bodies of Governance. The bodies of governance in a company include:

- General shareholders' meeting – top body for company's governance;
- Board of directors (supervisory board) – general body governing over company's activities except for issues that are the competence of the general shareholders' meeting;
- Executive bodies of company – managing company's current operation.

In a company with a number of shareholders, who are holders of voting shares, less than 50 the Charter may provide for the functions of the board of directors being performed by the general shareholders' meeting. In such a case the company's Charter shall include a provision on a certain person or a body of the company whose competence is to

decide on holding general shareholders' meetings and approving of its agenda.

Auditing Committee. An auditing committee (commission) is elected by the general shareholders' meeting in accordance with the Charter to exercise oversight over the company's financial and economic activities.

The auditing committee (controller) is entitled to:

- initiate an audit of the company's financial and economic activities at any time;
- demand that the company's financial and economic documents from the company's executives should be made available to them;
- demand that an urgent general shareholders' meeting be called.

Members of the auditing committee (controller) may not be concurrently on the Board or hold other positions in the company's executive bodies.

Shares in possession of the Board members or persons holding positions in the company's executive bodies may not vote in elections of the auditing committee members (controller).

Auditor. The auditor of the company (a person or an auditing organization) shall check the company's financial and economic activities in accordance with regulations of Ukraine on the basis of contract signed. The general shareholders' meeting approves the appointment of the company's auditor. Remuneration for auditing services is determined by the company's board of directors.

Registrar. A registrar (professional participant to the securities market keeping the register of registered stock holders) may be invited to keep and be custodian of the company shareholders' register.

In a company with a number of shareholders not in excess of 50 it may be the company itself that holds the register. If the number of company's shareholders exceeds 50 a registrar shall be appointed.

Institution of Board of Directors of Joint Stock Company

The board of directors (supervisory board) shall exercise general governance over company's activities except for issues that are competence of the general shareholders' meeting.

In a company with the number of shareholders possessing voting shares less than 50 the company's charter may provide for the general shareholders' meeting to perform the functions of the Board.

Authority of any member (all members) on the Board may be terminated early upon decision taken by the general shareholders' meeting.

The number of the Board members is not fixed or recommended by the legislation.

Chairman of the Board of a company is elected by majority vote of the total number of company's Board members if not established otherwise by the Charter.

Person performing functions of the sole executive body may not be concurrently elected as chairman of the Board.

The notion of independent director is defined in regulatory terms only when it applies to deals with interest.

Quorum to hold board of directors' meeting is stipulated by company's Charter. However, it may not be less than half of the Board members elected.

Decisions of the board of directors are passed by the majority of board of directors' members participating in the meeting.

The Charter may entitle the right of decisive vote to the chairman of the Board if votes cast by the Board members split evenly.

Solutions to issues in the competence of company's board of directors may not be delegated to company's executive body.

Exhibits

Exhibit 1. Corporate governance regime in the UK

In the United Kingdom, corporate governance is characterized by large liquid capital markets, a growing concentration of power within institutional investors, and an active takeover market. Unlike many other European countries, banks, powerful families, employees, and governments do not generally play as significant part in the governance of companies as shareholders.

In the classical public company model, shareholders elect directors, who manage the company on their behalf and report back on their stewardship at shareholder meetings, at which they can either be re-elected as directors or dismissed.

Unfortunately there is a gap between this model and reality - the interests of shareholders and (executive) directors can diverge on issues such as directors' remuneration, takeover bids MBOs and appointments within the organisation.

The key aim of business is to enhance shareholder value over the long-term. Of course, the way in which companies are governed should have regard to the interests of all stakeholders, but it is the primacy of shareholders that is paramount. However, shareholder value can be maximized only through directors having regard to the other relationships on which the company depends - such as those with employees, customers, suppliers and the community, as well as to the impact of business decisions on the company's reputation and the environment. There have been concerns in recent times that the pendulum has swung towards shorttermism and directors have neglected long-term prosperity in favour of a quick profit. For this reason, Company Law Reform is seeking to re-establish the equilibrium and ensure that both short and long term views are

evaluated in determining company success.

Historically, the United Kingdom has adopted a unitary board comprising both executive and non-executive directors. The chairman is usually, but not always, a nonexecutive director. Executive and non-executive directors have different functions within the company, but the same responsibilities under the law. However, despite this separation of functions, formal two tier board structures have not been developed in the United Kingdom.

The responsibilities of the board include setting strategic objectives, supervising management and reporting to shareholders on its stewardship. Non-executive directors contribute to the formulation of strategy and often fulfil a specific supervisory function through membership of audit and remuneration committees.

The basic framework. Shareholders elect directors, who manage the company on their behalf and report back on their stewardship at shareholder meetings. While the law requires directors to have regard to the interests of employees and to those who have contracts with the company, there is no requirement for any specific group (eg, employees) to be represented on the board.

The basic legal duties of directors fall into three categories: a duty to exercise care and skill, fiduciary duties, and statutory duties. These duties are common to all directors and are owed to the company, meaning generally the shareholders collectively, both present and future, not the shareholders at a given point in time. The duty to exercise care and skill is rather vague as there are no recognized standards of the degree of care and skill required. Nevertheless, the Courts would expect an experienced director to demonstrate a higher level of skill than a less experienced director.

Fiduciary duties are more strict than the duty to exercise care and skill. They include a duty to act in good faith, a duty not to act for improper purposes, and a duty not to engage in corporate opportunities.

Statutory duties include the appointment and removal of directors, strict and well defined categories of what directors have not to do, the appointment of auditors, disclosure of directors' interests and remuneration, annual reporting requirements, and the conduct of annual general meetings. At the time of writing, there are proposals to modernize company law. In particular, a statutory statement of directors' duties is proposed.

In addition to the legal framework, the United Kingdom governance regime includes various governance codes and regulatory requirements. The principles amongst these are the Listing Rules of the UK Listing Authority and the Combined Code appended to those rules.

Exhibit 2. Corporate governance regime in Germany

Compared with other European countries the legal framework in which German companies operate is highly specific.

Firstly, German companies operate under the two-tier concept according to which there is a clear distinction between the management board and the supervisory board. Secondly, the responsibilities of those boards and the general

meeting are laid down in detail in the Stock Corporation Law (Aktiengesetz). As a response to significant changes in the economic environment in the midnineties, such as globalisation, the increasing importance of capital markets for corporate financing and the growing information needs on the part of investors, in 1998 the legislator passed the Law for Control and Transparency of companies (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich - KonTraG). The key issues of KonTraG are as follows:

- Obligation of the management board of stock corporations to set up a risk management system (literally .risk early recognition system.) which falls within the scope of the annual audit for companies in a particular segment of the stock exchange (Amtlicher Handel).

- Additional disclosure (for example the management report has to include the risks of future development).

- Improvement of the external audit and the collaboration of the external auditor and the supervisory board. The aim is to emphasize the auxiliary function of the external auditor for the supervisory board and the auditor.s independence from management.

- Numerous supplementary provisions concerning, in particular, the responsibilities of the management board, the supervisory board, and the external auditor.

Nevertheless corporate failures as well as the problems of numerous companies at the New Market, the stock exchange segment for high-tech companies, continuously fuel the discussion on corporate governance and the need for further reforms.

The aim of such reforms will be to restore confidence in shares as an investment and to ensure the competitiveness of the structures and processes of company management and supervision. The confidence of foreign and domestic investors must be strengthened so as not to jeopardize the position of German companies in the global capital market. At a national level these objectives have recently become even more important since shares may now be included in German retirement arrangements.

The basic framework. Shareholders exercise their rights in respect of the company's affairs via the annual general meeting. The general meeting elects part of the supervisory board (the shareholder representatives) and the auditors and has the authority to remove those members of the supervisory board. Due to various laws about co-determination the supervisory board also comprises a high number of employee-representatives. Depending on the size of the company up to 50% of the non-executive directors are nominated by the employees or the unions. While the management board has full and exclusive operational responsibility the supervisory board has supervisory control.

Under the provisions of the Stock Corporation Law the management board is responsible for managing the company subject to a duty of care. It is also required to report to the supervisory board on matters such as corporate strategy, profitability, significant transactions, the development of the business and the state of the company's affairs. The position of the supervisory board as a body of control with regard to the management board was further strengthened by KonTraG. For example, the frequency of meetings was increased from two to at least four per annum and the duty to examine the financial statements and

management report was extended to the group financial statements and group management report. Additionally, broadening the rights and duties of the management board influences the control function of the supervisory board as well; for example, the management board's obligation to install a risk management system leads to the duty of the supervisory board to oversee whether this has been done appropriately.

Exhibit 3. Corporate governance regime in France

The French government has traditionally been an important stakeholder. This is partly as a result of the government's direct shareholdings in French industry though this has reduced in recent years as a result of various privatisation programs. It is also partly due to the circulation of senior executives between the civil service and the boardroom, a relationship said to be enhanced by the education system which produces both management and government officials that share a common outlook.

Historically, the French capital market has not been as liquid as some other developed markets. French companies are characterized by a strong influence of foreign shareholders, in particular foreign institutional investors. Financing has traditionally been focused on debt rather than equity, although, in the 1980s this trend has been reversed. During the last decade, steps have been taken to reform governance structures and improve the efficiency and competitiveness of the stock market.

The basic framework. There are two governance systems available to French listed companies. The unitary system is based on the formidable power of the Président Directeur Général (PDG) who deals with much of the day to day running of the company. This system is favoured by most listed companies. Alternatively, there is the option of a two-tier board system similar to that adopted in Germany. The law specifies certain powers for both shareholders and the board of directors. The PDG has the widest powers to direct and manage the company and, unless problems arise, boards often remain passive. Nevertheless, boards do have certain specified powers such as the appointment and removal of the PDG, the approval of the annual accounts, the approval of significant transactions and the determination of the PDG's remuneration.

Other significant characteristics of French corporate governance are as follows:

- Cross-shareholdings, which are on the decline as a consequence of privatisations, have allowed a small number of shareholders to retain control of companies through a series of indirect stakes.

- Until recently, directors were allowed to sit on no more than eight boards. This limit included a few but significant exceptions, such as subsidiaries of companies of which they are already a director and foreign companies. Viénot (see later) recommended that executive directors should limit the number of outside directorships to five, and following the reforms introduced by the New Economic

Regulations in 2001, this is now part of French law. Notwithstanding this limit, a large number of directorships are held by a relatively small group of individuals.

- Until recently, shareholders rights could be restricted by limiting the number of votes per share. This could act as an effective anti-takeover device where, in certain circumstances, some shares may be granted double voting rights. This system is now forbidden for new share issues. Nevertheless, such rights are maintained where they already exist.

- Workers committees must be consulted in certain circumstances, though there is no requirement for employees to have representatives on the board. Until the New Economic Regulations came into force in 2001, the government had generally refrained from introducing corporate governance reforms, leaving the private sector to react to concerns such as privatisation, the increasing presence of foreign shareholders (in particular US pension funds), the emergence of pension funds and the reform of the financial market.

Exhibit 4. Corporate governance regime in Italy

In Italy, the economic landscape has not traditionally been characterized by large liquid capital markets - rather by a relatively small number of powerful industrial families with large shareholdings in listed companies. However, by the late 1990s the corporate governance scene had shifted. The market capitalisation of the Milan Stock Exchange had risen to nearly 50% of the GDP, and the new legislation introduced by the Consolidated Law on Financial Intermediation (the Draghi law) and the related implementing regulations had gone some way to bringing conditions into line with those prevailing in other countries with highly developed financial systems. Furthermore, the financial market had become substantially international with overseas investors accounting for some 40% of trading.

Notwithstanding all the changes introduced in the 1990's, it was recognized that success in competing for access to the financial markets and minimizing the cost of capital depends to a large part on the efficiency and reliability of a company's system of corporate governance. Furthermore, it was accepted that, in an increasingly competitive environment, Italian companies must continuously benchmark their standards of corporate behaviour against those companies operating in the most advanced economies.

The basic framework. In the late 1990s, the Draghi Commission was set up by the government to report on the state of corporate governance in Italy. Its proposals, which primarily addressed cross ownership and the general structure of Italian companies, were incorporated into law (with some modification) as part of Italy's unified body of law (the "Testo Unico"). This came into force on 24 February 1998. The new law laid the foundations for a corporate governance model in tune with those countries with more highly developed capital markets.

It also introduced important reforms in terms of the responsibility of company management and supervision of the control system. However, the law makers were heedful of certain practices such as:

- the unitary board structure;
- the requirement to have a board of auditors as a control body;
- the limited board presence of managers.

2

DIRECTOR ELECTION

Directorships and the type of controlling owner

In Ukraine directors, i.e. members of the supervisory boards are elected at the annual shareholders meeting. This is a requirement of the Ukrainian legislation to corporations. They can be elected only by owners. Despite the way of development of corporate governance practices in Ukraine is close to the German ones, the legislation in Ukraine does not allow a participation of employees, if they are not shareholders, on the board through a meeting of a works council. Members of supervisory boards in Ukraine should be shareholders of the company. Members of the supervisory board can not be members of the management board (an executive governing body) and the audit commission of the same company at the same time. At the same time, it is not prohibited for them to be members of the supervisory boards of other companies.

The Ukraine's practices of simultaneous directorships differ from those popular in the Anglo-Saxon and Continental worlds. Thus, a member of the supervisory board in Ukraine holds not more than two directorships at once. The next table shows the dynamics in number of directorships in Ukraine for a director.

Table 2.1. *Number of directorships in Ukraine for a director*

Companies owned by	Number of multiple directorships held by a director in Ukraine			
	1998	2000	2002	2004
Executives	1,12	1,26	1,22	1,18
Employees	1,18	1,14	1,08	1,16
Foreign investors	1,24	1,38	1,56	1,72
Ukrainian FIGs	1,38	1,72	2,14	2,28
Ukrainian banks	1,44	1,92	2,06	2,12

With reference to above table, it is possible to conclude that there is a dependence of number of multiple directorships in Ukraine on the type of controlling owner. Thus, institutional shareholders are much more

inclined to place the same their representatives on the supervisory boards of many controlled companies. It is explained by a strong aspiration of institutional shareholders to tie the companies they control, as in the case of the Ukrainian FIGs.

The chairman of the supervisory board can be elected either at the shareholders meeting or at the first meeting of the newly elected supervisory board. Chairman of the supervisory board must be shareholder too. About 68 percent of researched Ukrainian joint stock companies have a practice of electing the chairman of the supervisory board at the meeting of the board. The rest prefer to elect the chairman at the shareholders meeting. The corporate legislation in Ukraine describes the procedure of election of the chairman of the supervisory board only at the shareholder meeting. Procedure of election of the chairman of the supervisory board at the meeting of the board should be described in details by the internal by-laws of the company.

There is strong dependence of the procedure of the chairman election on the degree of concentration of corporate ownership. The higher degree of concentration of ownership the higher likelihood of electing the chairman at the meeting of the supervisory board. It is because electing the chairman at the meeting of the board allows controlling shareholders keeping the process of corporate governance not transparent to facilitate pursuing exclusively their own interests.

A practical hint. *A choice made in the favor of election of the supervisory board members at the shareholder meeting facilitates balancing interests of shareholders and makes the process of election transparent.*

Directors are elected for the term of one year. This is quite widespread practice in Ukraine. Only 19 percent of researched Ukrainian joint stock companies elect directors for other terms, usually longer than one year. Every general shareholders meeting the members of the supervisory board report to the owners what work they have done for the last year and results achieved. In the case if shareholders are satisfied with the report heart, they, as a rule, prolong residence of the members on the board. If the owners are not satisfied with the results of work achieved by the supervisory board they elect new members on the board.

About 32 percent of researched Ukrainian joint stock companies keep members on the supervisory boards for the period more than five years. This is an evidence of the low mobility on the board. At the same time, there is quite high ratio of mobility of the chairmen on the supervisory boards. Thus, only 8 percent of companies have the same chairman on the supervisory board for the period more than five years. This is a result of

strong fight at the market for corporate control and remarkable changes in the corporate ownership structure.

Among 50 researched Ukrainian joint stock companies, 9 companies substituted the chairman of the supervisory board 5 times for the period of five years, i.e. each year; 6 companies - 4 times for the same period of time; 10 companies - 3 times; 8 companies substituted the chairman of the board 2 times; and 11 companies - one time for the period of five years.

◆ Number of companies which substituted the chairman of the board ___ for the period of five years

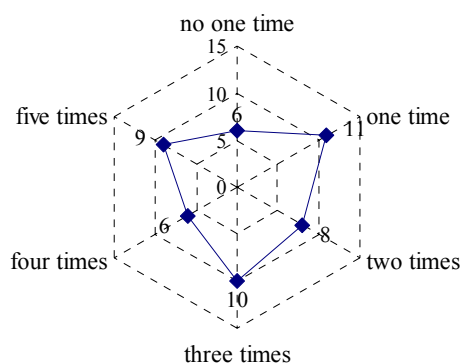


Fig. 2.1. Number of substitutions of the chairman of the supervisory board at researched Ukrainian joint stock companies for the period of five years

In Ukraine, there is still a practice of election (reelection) of all members of the supervisory boards. Practice of partial substitution (elections) of the directors is not developed at the Ukrainian joint stock companies. At the beginning of 2003 only 11 percent of researched companies practiced a partial election of directors when up to a half the board members are elected.

We should state that partial elections to the supervisory board could be taken for an effective instrument for balancing interests of shareholders and preventing a management dictate. Regrettably, there is a weak demand for the partial elections to the supervisory board in Ukraine.

The situation with partial elections to the supervisory board could be checked up through applying a principle of proportional representation of shareholders on the supervisory board. The Enterprises Act has nothing to suggest in this way.

The first attempt to introduce the principle of proportional representation was made in Ukraine by the President who wrote guidelines for corporations in 2002. The market participants were happy with such guidelines. But the legislative bodies which could put the guidelines to the laws and statements were reluctant to the President's initiative. Parliament of Ukraine blocked an approval of the new "Corporation Act" where the principle of proportional representation was written down. The Parliament's groups consisting of oligarchs and a lobby of interests of large businessmen rejected the draft of the law. The State Commission for Securities and Stock Market was silent too. They waited for the decisions of the Parliament.

As a result, an issue of the principle of proportional representation of shareholders on the supervisory board is still not solved. According to the results of research conducted by the Ukrainian Association of Investment Business, about 55,6 per cent of shareholders think that a proportional representation of shareholders on the supervisory board is the most efficient instrument to protect rights of minority shareholders. It is more efficient instrument than a large shareholder disclosure (44 per cent) and a commulative voting (41 per cent).

A practical hint. *A principle of proportional representation of shareholders on the supervisory board facilitates balancing interests of shareholders and prevents a management dictate.*

Responsibility for organizing the process of the director election in the Ukrainian companies

The Ukraine's practice of the supervisory board members election is not developed in the part of a system of criteria of the board members efficiency. As a rule, supervisory board members are not inclined to protect interests of minority shareholders. They are rather the lobby of interests of majority shareholders. The degree of the director independence is very weak. As a result, it is very difficult for shareholders to be frank and efficient in determining the right time and right reason when to change directors.

Who is responsible for organizing the process of the director election in the Ukrainian companies? According to the legislation on corporations, a company should establish an organization committee that is responsible for making the required preparations to hold a meeting of shareholders. Organization committee is elected at the meeting of the management board. As a rule, members of the management board become members of organization committee. From the point of view of the accountability the organization committee should contain shareholders, members of

supervisory board, or even employees. But the above mentioned practice is not popular in Ukraine. There are some reasons.

The first is a lack of financial motivation for shareholders or employees to take part in organization committee. There is no system to reward members of the organization committee for their participation in the process of preparation of the shareholder meeting. Probably this issue should be settled by an appropriate statement to be developed by each company.

The second reason is absence of knowledge and skills at shareholders or employees how to participate on the organization committee effectively. The process of preparation to the shareholder meeting, including the preparation for the supervisory board members election is quite complicated. Moreover, there are some arguable, not settled stages of the process of preparation that could provoke conflicts between members of the organization committee who represent interests of various groups of stakeholders, including shareholders and employees.

The third reason is a strong resistance of executives - members of the management board to work together with stakeholders in the organization committee. Executives are forced to behave in such an opportunistic manner by large shareholders. With an application to the process of election to the supervisory board, only the management board members have an access to the application forms submitted by candidates to the supervisory boards. Content of the application forms is delivered to the large shareholders who control certain members of the management board far before the shareholder meeting (15-45 days). This time is an excellent chance for large shareholders to do their utmost to promote interests of their own candidates and reduce chances of independent directors to be elected to the supervisory board. The most popular instrument used by large shareholders is a blackmailing. Unlucky candidates have to get their application forms back before the shareholder meeting.

Blackmailing is a well-developed practice of corporate governance in Ukraine. Large shareholders and executives are the most experienced in blackmailing in the part of election and promoting their candidates to the supervisory and management boards. According to our investigation about 46 per cent of Ukrainian companies experienced the above mentioned situation during years 2002-2005. This situation is popular at the companies where the fight for corporate control still lasts among large shareholders.

The next examples are the companies where there are very sufficient problems in relationships between executives and employee shareholders. As a result of such fight for corporate control the directors elected to the supervisory board have a credit of trust from the shareholders they

represent and a strong resistance of other groups of shareholders. It is very difficult for such director to keep the interests of all shareholders balanced. 72 per cent of the supervisory board members of the companies where the blackmailing during the process of selection of the supervisory board members happened, declared that they prefer to protect interest of the shareholder who elected them rather than all shareholder whether they are minority or large shareholders.

Importance of an independent organization committee is extremely important for the smooth and efficient process of election to the supervisory board. Members of organization committee establish a mandate committee. Mandate committee, responsible for accounting the shareholders who come at the shareholder meeting, is under attack in Ukraine now. The most popular violation of shareholders' rights, including the proxy manipulations, could be secured by the mandate committee. Regrettably, mandate committee is under a strict control of large shareholders and management. Under such circumstances the chances of large shareholders and executives to have only their own representatives on the supervisory board are very high.

Mandate committee could be strengthened through developing the legislation to apply the criminal responsibility to the members of mandate committee for not appropriate behavior. The second way is to increase the degree of independence of the members of mandate committee. As a result, the process of election to the supervisory board should become more transparent and effective.

A practical hint. *The process of election to the supervisory board becomes more transparent and efficient if the organization committee and mandate committee are established through balancing interests of various shareholder groups, including minority shareholders, and other stakeholders, including employees.*

Therefore, we conclude in the favor of the hypothesis on existence of a strong dependence of the procedure of the chairman election on the degree of concentration of corporate ownership, i.e. the higher level of concentration of ownership the higher likelihood of electing the chairman at the meeting of the supervisory board.

Criteria to nominate members of the supervisory boards

The Ukraine practice of corporate governance in the part of the supervisory board practices is constructed around the typical criteria to nominate members of the supervisory board. The most popular criteria, i.e. personal maturity and work experience in the related industry and

qualification are the mostly demanded by the Ukrainian joint-stock companies. About 79 per cent of shareholders in Ukraine think that the personal maturity of the supervisory board member is the most important criterion to let the candidate be elected on the supervisory board. 72 per cent of the Ukraine shareholders are sure that the work experience as executives in the related industry is not less important criterion than the personal maturity of the member of supervisory board.

It could suppose that the Ukrainian concept of corporate governance could be rather stakeholder than shareholder. But it is a wrong supposition. Thus, only 7 per cent of the Ukraine shareholders find the useful contacts as the criterion of the nominating the members of supervisory boards. At the same time, loyalty to the major shareholder is much more important criterion. 21 per cent of shareholders in Ukraine think that the loyalty to the major shareholder is one of the most important criteria to nominate members of the supervisory board.

At the same time, there is a remarkable difference in the choice of the particular criteria by various groups of shareholders. Minority shareholders give a priority to such criteria as work experience with the company as executives (72 per cent of respondents) and useful contacts (42 per cent of respondents).

Large institutional shareholders such as Ukrainian financial-industrial groups have other priorities. 84 per cent of Ukrainian FIGs prefer to choose the loyalty to the major shareholder as the most important criterion to nominate the members of supervisory boards. The second important factor is the personal maturity (68 per cent of respondents). Members of the supervisory boards in Ukraine have a little different point of view on the importance of the particular criteria of their nomination. Work experience as the members of the supervisory boards is considered by 46 per cent of respondents as one of the important criteria for successful nomination. Most of members of the supervisory boards find the work experience with the various industries more preferable than the work experience with the particular industry.

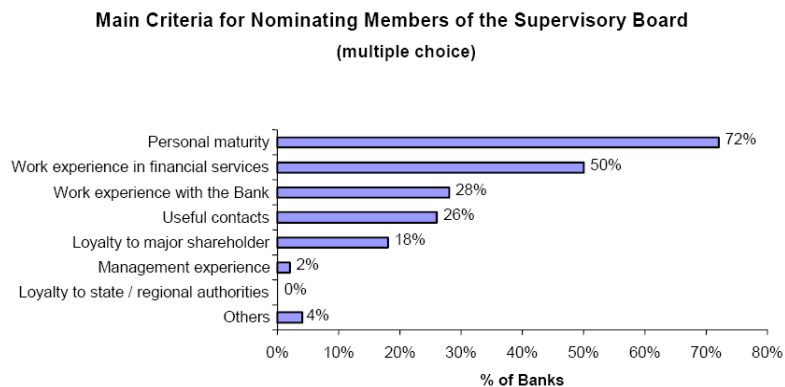
Work experience as the executives is taken by 38 per cent of respondents as one of the most important factors for the nomination. In contrast to the preferable work experience with the various industries as the member of the supervisory board, members of the boards find the work experience as the executives as the more advantageous for the successful nomination. Personal maturity as the criterion of the nomination to the supervisory board is considered by 36 per cent of the members of the supervisory boards in Ukraine as one of the most remarkable criteria of the nomination. Most of members of the supervisory boards in Ukraine are the real representatives of various groups of shareholders, i.e. they are not large shareholders themselves.

From this point of view it is very difficult for them to run the processes of the nomination and election of the members of the supervisory board in the way they prefer. Separation of ownership and control exists at the level of the supervisory board. There are only 0,32 per cent of members of the supervisory boards who own the company stock at the share not less than 10 per cent of the company stock.

Exhibits

Exhibit 1. Membership criteria in the supervisory board in the Russia banking sector

The BCBS requires banks to ensure that “board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.” Most national legislation, including the Russian Law on Banks and Banking Activities, calls for ‘fit and proper’ board members. Looking at Chart below a majority of banks look for certain qualities. Personal maturity (72%) and financial industry experience (50%) are considered as the most valuable qualities for being nominated to the SB. However, it is interesting to note that only one bank mentioned management experience as a selection criteria.



Source: IFC project of Corporate Governance in Russia, report 2004

The personal characteristics of current board members reflect the challenge of finding suitable candidates who meet most of the preferred selection criteria. While an appropriate educational background is widespread, more board members with professional experience in the financial services industry are needed. This lack of specific banking knowledge at the SB level is somewhat compensated for the fact that 82% of the SBs have the right to seek external advice; however, only 8% of the SBs have their own budget for hiring such external consultants.

3

THE CHAIRMAN OF THE SUPERVISORY BOARD - THE CHAIRMAN OF THE MANAGEMENT BOARD

Shareholder attitude to “the chairmanship dilemma”

For the market of Ukraine it is better to say “the chairman of the supervisory board – the former chairman of the management board”. It is because of the legal regulation of this issue. Thus, the Ukrainian legislation does not let the simultaneous appointments at the posts of chairmen of the supervisory and management boards.

The practice that is popular in Japan is not spread in Ukraine. In the future, it is possible to wait for such kind of practice at those Ukrainian joint stock companies which are controlled by executives (members of management board). The retiring executives would aspire to control the company after they leave the management board.

Most of shareholders in Ukraine are sure that this could be a wrong decision to appoint the former head of the management board at the post of the chairman of the supervisory board. There are three criteria of ineffectiveness of the heads of management boards as the chairmen of the supervisory boards in Ukraine. These are: strong entrenchment, weak independence and lack of professionalism, i.e. special skills to run the activity of the supervisory board.

Companies under control of Ukrainian financial-industrial groups, banks, investment companies and mutual funds will be rather common in misleading the above practice. It is because the above groups of shareholders are the strongly motivated controllers and they will not share their power with anybody else.

Besides that under a weak system of corporate governance principles in Ukraine there is a threat of entrenchment of management when they come from management board to supervisory board as chairmen. Probably, large shareholders do not intend to facilitate the managerial entrenchment that could erode the power of large shareholders.

To be certain, it should be noted here that the size of the controlling owner is not the major factor generating the negative attitude of shareholders to “the chairmanship dilemma”. Major factor is another. This is an origin of the controlling owner. Thus, shareholders-legal

entities have a negative point of view on the perspective of the appointment of the former head of the management board at the post of the chairman of the supervisory board.

Foreign institutional shareholders, performing a controlling function, do not prefer to follow Japanese practice too because they find this practice facilitating entrenchment development too. There is a well-known way out in this case.

Thus, foreign institutional shareholders want to have outside director as the Chairman of the supervisory board. The main criterion that is used by large foreign institutional shareholders is an independence of directors. Under such circumstances the next move of the head of the management board at the post of the chairman of the supervisory board does not meet the director independence criterion that is strongly appreciated by the most shareholders in Ukraine.

Among the foreign institutional shareholders, owning Ukrainian companies, almost all (94 per cent) believe that moving a head of management board at the post of chairman of the supervisory board will lead to a threat of entrenchment. Besides that, and this is very important to note, 98 per cent of foreign institutional shareholders are sure that the chairman of supervisory board, who is the former head of management board can not be named “independent”.

Ukrainian financial-industrial groups as shareholders are little less common about the problem of entrenchment. About 78 per cent of Ukrainian FIGs believe that there is a problem of entrenchment when the former head of the management board comes at the post of the chairman of the supervisory board. At the same time 88 per cent of FIGs support an idea that the former head of the management board, who became the chairman of supervisory board, is not independent.

Table 3.1. *Main criteria of ineffectiveness of the heads of management boards as the chairmen of the supervisory boards in Ukraine*

Criteria	Share of shareholders who support the criteria, per cent			
	Foreign institutional shareholders	Ukrainian FIGs	Executives	Employees
Strong entrenchment	94	78	35	52
Weak independence	98	88	42	46
Lack of professionalism	92	86	36	38

Professionalism to organize the work of the supervisory board is one more criterion of the decision against “the former head of the management board – the chairman of the supervisory board”. Almost all groups of shareholders, excluding shareholder executives and shareholder employees share the point of view that the head of the management board is not ready, from the professional point of view, to fulfill functions of the chairman of supervisory board. Day-to-day operations within the management board strongly differ from the supervisory, strategic and advisory work of the supervisory board. Thus, foreign institutional shareholders (92 per cent) support the above mentioned conclusion. Ukrainian financial-industrial groups and Ukrainian banks as shareholders are sure about the same conclusion too (86 and 82 per cent respectively). Only 4 per cent of researched Ukrainian joint stock companies have the chairman of the supervisory board who is the former chairman of the management board. As usual these are people who can not execute their duties and undertake responsibilities of the chairman of the management board because of their age.

The chairmanship paradox

It is the right time to discover a little paradox here. We investigated attitudes of the heads of management boards of Ukrainian companies concerning their wishing to become a chairman of supervisory board when they leave the management board of the same company. About 30 per cent of respondents were sure about their wishing to be the chair of supervisory board. The main barrier at their way to the objective is a lack of conceptual vision of corporate governance development by shareholders. Do Ukrainian shareholders want to apply monistic, dualistic or pluralistic concepts? Shareholders substitute each other, concepts applied substitute each other too. Thus, under the pluralistic concept of corporate governance heads of management boards in Ukraine could hope for the execution of the dreams, but... No shareholder in Ukraine, whoever he could be, would be happy to share financial and other incomes from the owning the companies with anybody else, i.e. employees, general public, financial entities, etc., that is expected to be under the pluralistic concept of corporate governance.

Heads of management boards of Ukrainian companies, having been asked about the principle differences in duties of the head of management board and chairman of the supervisory board, were not competent enough. Thus, only 18 per cent of heads of management boards of Ukrainian companies mentioned that their independence as chairmen of supervisory boards is one of the most important factors of their success at that post. Only 46 per cent of respondents were sure that they would have

to keep on balancing interests of all groups of shareholders.

At the same time, almost all respondents agreed that the most important tasks of the chairman of the supervisory board is through organizing a monitoring the activity of the management board (about 88 per cent of respondents), and representing interests of large shareholders (about 92 per cent of respondents). It says in the favor of the supposition that such kind of chairman could be rather lobbyist of interests of large shareholders, than a protector of interests of the most helpless groups of shareholders. Therefore, the last hypothesis was failed. There is no dependence of chairmanship duality practice on the type of owner and corporate ownership concentration.

Exhibits

Exhibit 1. Chairman and chief executive officer: European practices

It is generally recognised that there should be a clear division of responsibilities at the head of companies to ensure a balance of power and authority such that no one individual has unfettered powers of decision. For unitary boards, many people believe that there is merit in separating the two key tasks at the top of each listed company - the running of the board (the chairman's role) and the executive responsibility for running the company's business (the chief executive officer's role). For two tier boards the problems are less acute. Separating the posts of chairman and chief executive officer has for some time been encouraged in the United Kingdom.

As long ago as 1992 the Cadbury report extolled the virtues of having a "clearly accepted division of responsibilities at the head of a company". The Belgium Code of Conduct, being highly influenced by United Kingdom corporate governance recommendations, is also strongly in favour of separation.

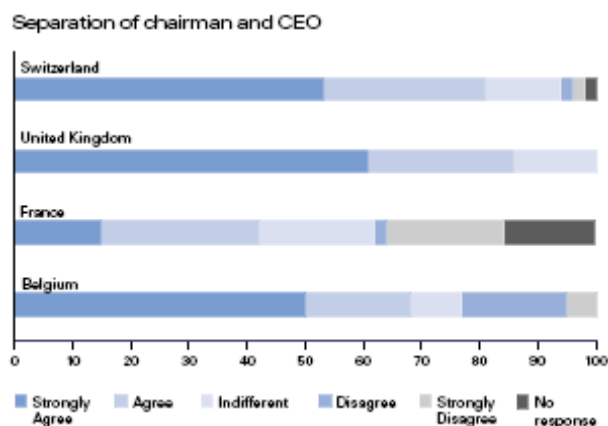
Germany and the Netherlands have two-tier boards and therefore the problems associated with a concentration of power within one individual are less acute. In two-tier boards, the management board is responsible for managing the company while the supervisory board is responsible for overseeing the management board.

French listed companies have the option of either a unitary board structure or a two-tier system similar to that adopted in Germany and the Netherlands (28% of SBF 250 companies have adopted the two-tier system.) Until recently, the roles of chairman and chief executive officer were not separated in companies with a unitary board. Following the New Economic Regulations, separation is now an option.

Separation was favoured by the AFG report, though the Viénot report maintained that companies should have the option to combine or separate.

While unitary boards are prevalent in all four countries, there are significant differences between France, on the one hand, and Belgium, Switzerland and the United Kingdom. In each country, companies retain the option to combine or separate the chairman and chief executive posts (if appropriate for the specific

enterprise), however, separation is more enthusiastically encouraged in Belgium, Switzerland and the United Kingdom.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

Exhibit 2. Pluralistic concept - the Japanese board practices

Japanese boards are the largest compared to those in the USA, the UK and Germany. The average board size for the top three construction firms is about 52, for the top three trading companies is 50, for the three largest automobile and banking companies around 43. A large size of boards in Japan is explained by the fact that board membership is often a reward for long and faithful service or major contributions to the company. The Japanese boards of directors have been transformed into a motivating and marketing tool. According to results of research by Oxford Analytica, nearly all directors are senior managers of former company employees. Almost 80 percent of all Japanese companies have no outside board members and another 15 percent have no more than two outside board members. The Japanese board chairmanship is usually an honorary, symbolic or advisory position, the last step on the ladder before retirement from the company after having been president for several years. The chairman rarely interferes with the day-to-day managerial activities of the president, though his advice may be occasionally sought on major strategic decisions or on the appointment of key managerial positions. He spends most of his time representing the firm at external functions and activities, such as meetings of trade and economics associations, government commission etc.

Formal authority is held by the company president and the board of directors, but meetings are infrequent and decisions are rubber stamped. Real authority is held by the company president and the operating committee, which meets often. Selection of new board members and election of officers is handled by the president and the operating committee. Their decisions are finalized by the formality of board and shareholder votes - in the latter case often by a clapping of hands at the shareholders' meeting.

4

BOARD SIZE AND COMPOSITION

Size of the board and the main tradeoffs

Many scholars, investors, and regulators argue that corporate boards should be small and comprised largely of independent directors. Scholarly research is often cited to support board reform, including papers documenting an inverse relation between board size and firm value, and others documenting a relation between the mix of inside versus outside directors and various indicators of firm performance.

We take the perspective that there are tradeoffs associated with different board sizes, tradeoffs that are likely to vary across firms and industries.

The major advantage of large boards is the collective information that the board possesses about factors that affect the value of firms, such as product markets, technology, regulation, mergers and acquisitions, and so forth. This information is valuable for both the advisory and monitoring functions of boards.

The major disadvantages of large boards are the coordination costs and free rider problems referred to above. We presume that coordination costs increase in board size. Economic analyses of constitutional democracies typically cite the costs of making collective decisions with the entire population as the *raison d'être* of representative government.

Therefore, the most important question in the field of the supervisory board size concerns the choice of the factor influencing the size of the board.

The international practices of the supervisory board are built around the statement that the board size should depend on the number of functional tasks undertaken by the members of supervisory boards. Functional tasks are executed within the committees of the supervisory board. Therefore, we should suppose that the presence of committees on the board contributes to increase in the number of members of the supervisory board. Regrettably, committees of the supervisory board are not popular in Ukraine (see the chapter of the book devoted to the committees of the supervisory board). Else, it is reasonable to suppose that the size of supervisory board depends on the size of a company, i.e. the larger company the larger the supervisory board. We had not found such kind of dependence (see the figure below).

Size of the board and ownership concentration

The only factor that could evidently influence the size of supervisory board in Ukraine is the type of controlling owner, including ownership structure and concentration.

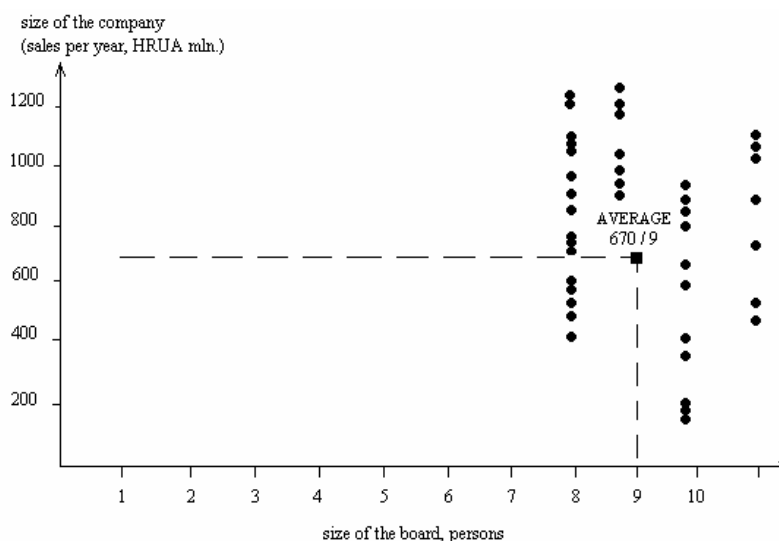


Fig. 4.1. *Size of companies and size of supervisory boards in Ukraine*

Average number of members of supervisory boards at Ukrainian joint stock companies is about 8-10. By this feature, the Ukraine's board practices are closer to Anglo-Saxon model than to German model of corporate governance.

There is strong dependence of the size of supervisory boards in Ukraine on the degree of concentration of corporate ownership. Thus, the higher degree of concentration of ownership the fewer members are on the board. Companies, where controlling block of shares (50 percent + 1 share) belongs to one owner, have boards with 5-6 members who completely represent interests of the controlling shareholder.

Reason to explain these practices is the following. Controlling owners, as a rule, want directors on the board to perform mainly the role of control. The role of strategy is performed by executive board. The role of service (advice) is not performed by directors because of lack of an appropriate decision system in companies. To perform only the role of control controlling shareholders do not need many their representatives on the board to control the companies they own.

Moreover, it should not expect that controlling owners allow other

shareholders placing their own representatives on the board to perform control too. Controlling owners in Ukraine do not want to share control of the company with other shareholders. Minority shareholders' rights are violated by controlling owners in Ukraine very often. Proportional representation on the supervisory board, that could protect minority shareholders' rights, is not allowed by legislation. Therefore, controlling shareholders are free to control their companies through placing even a few their representatives on the supervisory board.

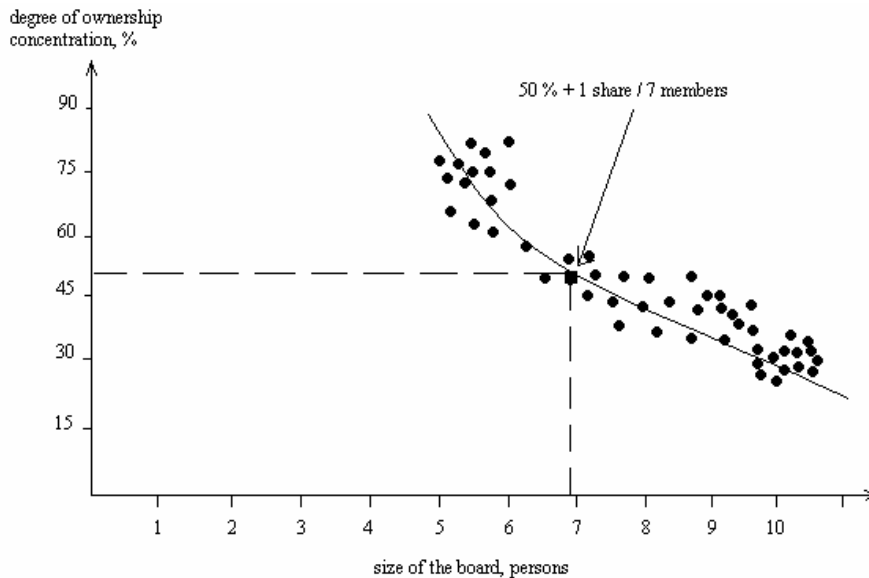


Fig. 4.2. Size of the supervisory board and ownership concentration in Ukraine

Companies where there is no one shareholder, owing even 10 percent of shareholder equity, have as a rule, more than 12 members on the board. The same concerns those companies that are under control of employees. It should not be expected that larger size of the supervisory board at companies, controlled by employees, than at those with concentrated ownership, is explained by diversity of roles, performed by directors. Directors perform mainly the role of control. They are not strategists and advisors. The reason for so large size of the board is so named "trade-union democracy". It is labeled with the following principle in the board practices: "The more the better". Number of members on the board reaches 15-16 persons.

Besides that, there is strong correlation between size of the board and origin of the controlling shareholder. Thus, companies under control

of Ukrainian financial-industrial groups are supervised by the boards, consisting of 4-6 persons. At the same time, companies, controlled by foreign institutional investors or Ukrainian investment companies have about 7-9 members on the board.

The last factor, influencing the size of the supervisory boards at Ukrainian joint stock companies is the number of committees on the board. Those boards, where there are professional committees consist of the higher number of persons in comparison to those without committees.

Therefore, the first hypothesis is completely proved. That means that such feature of the board as its size is positively correlated to the degree of concentration of corporate ownership, origin of controlling shareholder and number of committees on the board.

Size of the company has a very conditional influence on the board size. We have noted that the companies with the annual revenues over USD500 mln. have the supervisory boards consisting of 5-6 members. As a rule, large companies belong to the Ukrainian financial-industrial groups who are very strong controllers. At the same time, the larger companies should perform much more functions than smaller ones that should require the large supervisory board.

Probably, the desire of the large shareholders to grasp corporate control and corporate information through establishing quite small, but very strongly controlled supervisory board is stronger than the rationale to secure the supervision over the numerous functions to be performed by the large company.

Size of the supervisory board is suggested, discussed and approved by shareholders at the shareholder meeting. At the same time, influence of the company executives on that process could be very sufficient. Executives, composing the management board could influence the process of the board size change through participating in the work of an organization committee, responsible for preparation of the agenda of the shareholder meeting, and lobbying or ignoring interests of various groups of shareholders. As a rule, the size of the board is not written in the charter of the firm. It could be written in the supervisory board statement. It is clear to understand that under such circumstances it becomes much easier to make changes to the size of the supervisory board. Any changes to the charter require much more strict procedure and responsibilities than making changes to internal documents of the corporation, i.e. the supervisory board statement.

Board composition

Supervisory board structure in Ukraine is very specific and determined by various factors the most important of which are ownership structure, type

of the industry, market position of the company and so on. Taking into account that the Ukraine practices of the supervisory board composing are grounded on the position of a prohibition of the simultaneous membership in the supervisory and management boards, composition of the supervisory board is free of the executives and can not be compared to the board of director composition applied in the unitary board countries.

It is really difficult to study the board composition from the point of view of numerous criteria. Many investigators of the board composition introduced many criteria which need a classification. That will help in studying the supervisory board composition.

We introduce the following classification of the supervisory board composition criteria:

1. Type of shareholder representation.
2. The age of the supervisory board members.
3. Professional skills diversification.
4. Experience of the supervisory board members.
5. Employees on the supervisory board.
6. Share of the independent members of the supervisory board (to be described at the separate section).

Type of shareholder representation. Employee representation on the supervisory board is not written by the legislation as it is in Germany. That is why employees could hope for having their own representatives on the supervisory board only if they own the company shares and can be taken for the controlling owners.

Works councils which are required by the Ukrainian legislation to establish at any join-stock company have no any legally allowed mechanism to let employees take part in the corporate board formation.

Corporate and civil legislation in Ukraine allows only shareholders becoming members of the supervisory board. The companies where the corporate control is concentrated at the hands of large shareholders have the supervisory boards where members are rather nominal shareholders than real ones. As a rule, large shareholders present such members with one share of the company to meet the requirements of law.

All members of the supervisory boards in Ukraine are the shareholders representatives. This is the requirement of the Ukraine corporate legislation to allow only shareholders to choose the supervisory board members. There is only one allowed exception, i.e. when the supervisory board members are suggested by the supervisory board, management board or audit commission autonomously from the shareholders. As a rule shareholders are more active in nominating directors.

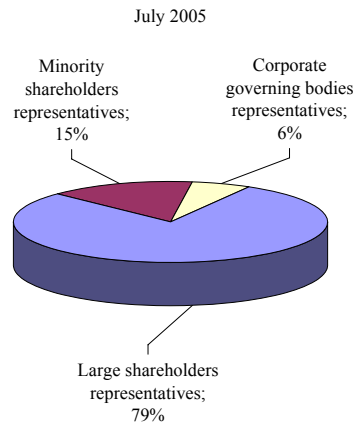


Fig. 4.3. *The Ukraine supervisory board composition*

Minority shareholders representation on the supervisory board is very interesting from the point of view of the type of the minority shareholder. As a rule, among 15 per cent of the members of the supervisory boards in Ukraine representing interests of minority shareholders there are only 2 per cent of members of supervisory boards who represent interests of outside minority individual shareholders. The rest minority shareholders representation belongs to other groups of shareholders who are minority shareholders in the certain ownership structure, i.e. employees and managers.

From the point of view of the absolute representation on the supervisory board in Ukraine there is no dominant position of any shareholder. Thus, 42 per cent of members of the supervisory boards in Ukraine represent interests of large institutional shareholders including the national and foreign. Employee shareholders have 28 per cent of members of the supervisory boards. Executive shareholders have about 17 per cent of the supervisory board representatives. The rest belong to the state (about 11 per cent of the members of the supervisory board) and outside individual minority shareholders (2 per cent).

The age structure of the supervisory board in Ukraine differs from a company to a company. The average age of members of the supervisory board in Ukraine is 48. There is a slight increase in the average age of the board members during the last five years (beginning from the year 2000) for 2 years.

At the same time the supervisory board members had the strong links with the company in the past as executives. Thus, about 74 per cent of members of the supervisory boards in Ukraine worked as executives of the same company at least during a year for the last ten years. This could

make the negative impact on the independence of the members of the supervisory boards.

Professional skills diversification as a fact that could contribute to the efficient work of the supervisory board is still very weakly developed in Ukraine. There are 38 per cent of the supervisory boards where there are no members with the audit expertise that is so much welcome internationally. Other 32 per cent of board members had never worked in the field of finances. Thus, about a third part of the supervisory boards in Ukraine have no opportunities to develop the best practices within the audit and finance committees.

The most pessimistic situation concerns such expertise as executive compensation. 78 per cent of Ukrainian supervisory boards have no members experienced in executive compensation development and monitoring. This gives a way ahead for executives to manipulate with financial results and, as a result, with their compensation, i.e. the threat for overcompensation grows remarkably.

The most popular expertise, represented by the members of the supervisory boards in Ukraine is commerce (sales). All 100 per cent of the supervisory boards in Ukraine have such kind of experts in their structures. Moreover, about 52 per cent of supervisory boards have two experts in sales.

It is worth of mentioning that the Ukraine supervisory boards need a more balanced structure with an application to the professional skills of the members of the supervisory boards.

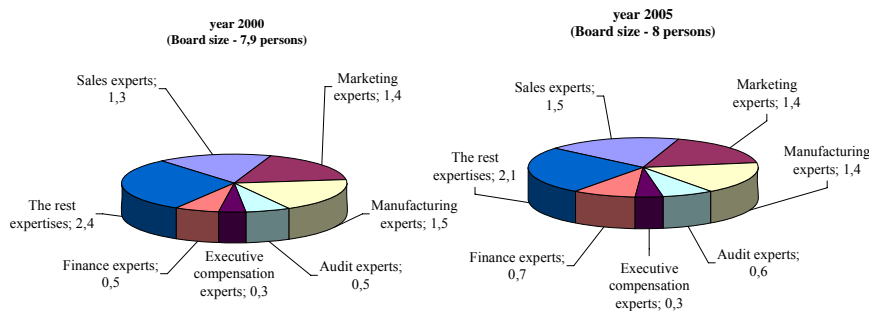


Fig. 4.4. Professional expertise of the members of the supervisory boards in Ukraine

The main reason of such a disbalanced supervisory board in Ukraine from the point of view of the professional qualifications of its members is the business customs. Thus, a huge part of the members of supervisory

board in Ukraine have a corporate origin, i.e. before coming to the supervisory board they were executives.

Executive practices in Ukraine are still based on the traditional professional qualifications mainly manufacturing and sales. Those qualifications are the heritage of the socialist planned economy. Departmental structure of Ukrainian joint stock companies is still constructed around those two functional elements of the company activity. Therefore, an initiative in the company with a relation to the corporate strategy development and execution belongs to the manufacturing and sales executives.

From this perspective the supervisory board is constructed by the same principle that has a socialist economy origin when a company exists only to manufacture and sell something. Financial stability of the socialist companies has been guaranteed and reinforced by the state authorities. Rights of the employees were secured by the state too. That heritage makes the demand for audit, financial and compensation professional qualifications among the heads of supervisory boards. Members of supervisory boards in Ukraine should learn how to develop and maintain a system of internal control with required checks and balances.

Women membership on the supervisory boards of joint-stock companies in Ukraine is very low. The share of women on the supervisory boards is equal only to 0,8 per cent. There are some explanations of such situation. First of all, women are still not considered by the shareholders as the reliable and strong representatives of the shareholder interests. Secondly, men are trusted by the employees much more than women. Thirdly, mentality of the Ukrainian men is very resistant to the thought that women can be an equal part of their team.

Experience of the supervisory board members in Ukraine is quite poor. Only 24 per cent of members of supervisory boards have a five and more year experience as supervisory board members. 63 per cent of members of supervisory board have a three and more year experience. The most negative is the fact that this poor experience is the experience with the company where the member of supervisory board works. Therefore, a multi-corporate experience is still not developed in Ukraine.

A way out for the Ukraine supervisory boards could be in employing foreign directors who could come to Ukraine with their rich experience and knowledge to share both these values to the Ukraine supervisory board members. At the end of 2005 the share of the foreign members at the supervisory boards in Ukraine was equal only to 0,3 per cent. The reason is double.

First of all the director remuneration in Ukraine is much lower than abroad. Thus, the German, French, Italian and any European director would ask for remuneration at USD50-70 thousand a year. The UK

director would ask for remuneration at USD60-80 thousand. The USA director would ask for remuneration at USD90-100 thousand. Ukrainian directors are rewarded with an amount at USD700-750 a year!!! Therefore the material incentives in the boardroom of the Ukrainian company are very weak. In comparison to the people who are controlled by the supervisory board, i.e. the management board members, the remuneration of the member of supervisory board in Ukraine is 1/25 to the remuneration of the management board members. Thus, in Germany this ratio is equal to 1/15, in France – 1/16, in UK – 1/18, in the USA – 1/19. As for Ukraine, the lowest ration is observed at the banking. It is equal to 1/36. The lowest ratio is documented for the machine-building industry. The ratio is equal to 1/21, but it is not because of the high level of the supervisory board member remuneration. It is because of the low level of the remuneration of the management board members.

The second reason of the weak demand of the Ukraine companies for the foreign directors is their very narrow and specific knowledge. As a rule, foreign directors are very difficult to integrate themselves into the system of an adequate decision making by the directors in Ukraine. Moreover the foreign directors are difficult to get used to the weakly developed strategic role of the Ukraine supervisory boards.

Qualification of one of the most important supervisory board members, i.e. the supervisory board secretary, needs much development in Ukraine. Practice of assuming the responsibilities of the board secretary by an outside independent director is still not popular in Ukraine. The general rule is when the secretary of the board is a person employed by the company. About 84 per cent of companies in Ukraine have their employees (managers) as the supervisory board members. Other 12 per cent of the companies have outside directors as the supervisory board secretary. Only 4 per cent of joint-stock companies in Ukraine have an independent director as the board secretary.

The main reason of having an employee shareholder as a board secretary is that the employee is engaged in the day-to-day activity of the company therefore it is not difficult for him to execute the routine duties of the supervisory board secretary. At the same time a dependent (on the members of the management board) status of him because he is an employee, does not allow him making the independent decisions toward major procedures of the supervisory board. Besides that a negative effect of the employee shareholder at the post of the board secretary could find itself in such criterion of the supervisory board performance as informational flows. Employee secretary of the board could be forced by management of the company distort information that should be delivered to the supervisory board members.

Employees on the supervisory board. Under circumstances of a weak

development of the secondary market for the supervisory board members a quite large share of the supervisory board members combine the work in the company with a membership in the supervisory board of the same company. As it is required by the Ukraine legislation it is prohibited to combine the memberships in the supervisory and management boards. But the way out for Ukraine joint stock companies is through electing at the supervisory board those persons who are employed as the middle-level managers, heads of departments who are not members of the management board and audit commission.

During the years 2000-2005 the trends toward the electing at the supervisory board people employed simultaneously at the company slightly entrenched. Thus, in 2005 there were 38 per cent of the supervisory board members who were employed by the same companies. At the beginning of the year 2000 about 35 per cent of the supervisory board members in Ukraine were simultaneously employed by the same companies.

It is very interesting to note that so named "intracorporate" supervisory board members are proposed as candidates at the supervisory board members basically by employee shareholders or by the management board.

In the first case employee shareholders try to compensate their weak efficiency in the knowledge of how to select the outside supervisory board members with their personal contacts with the "intracorporate" supervisory board candidates.

In the second case there is a threat of establishing the entrenchment net in the company. Under the entrenchment net the corporate executives have a chance to control the supervisory board members. At the same time, the supervisory board members are forced by the executives to distort the corporate information to be supplied to the shareholders and make the executive entrenchment not visible to the shareholders and society at all.

It is very difficult to evaluate the degree of threat to the best corporate governance principles when noting the following numbers. Thus, about 82 per cent of companies where the "intracorporate" supervisory board members were proposed by the management board experienced a conflict of interests. Their opponents, i.e. outside supervisory board members were much more effective in preventing the conflict of interests. Thus, 24 per cent of the companies with the majority of the outside members on the supervisory board experienced the conflict of interests.

Other negative effect of the intracorporate supervisory boards is about the best standards of corporate governance. Thus, the intracorporate supervisory boards have much less audit, executive compensation and

shareholders committees than those companies with the outside supervisory board members. Work of the intracorporate supervisory board turns into the rubber stamping. Advisory, strategic and control roles of the board are not executed.

From the point of view of the efficient work and entrenchment there is a strong doubt about the reasonability to elect managers of the company at the supervisory board. Conflict of interest should come quickly. Such kinds of managers as a rule are headed and commanded by the management board members as the company charter orders. From another view, the same managers are the supervisory board members who can supervise the management board more strictly. This could be a very strong reason and a very fruitful soil for the conflicts of interests. The slogan “You order me but I supervise you” makes this situation clear. This situation could exist even if the intracorporate supervisory board members are proposed by the outside shareholders, not executives or employees.

Intracorporate supervisory board members never try to act as the promoters of the company interests and philosophy to the society. About 92 per cent of the intracorporate supervisory board members never tried to take part in conferences, seminars, press-conferences and tell something to the mass-media about the company. They are not “the company brand promoters”. From this perspective it will be quite problematic to maintain an effective stakeholder policy by the supervisory board.

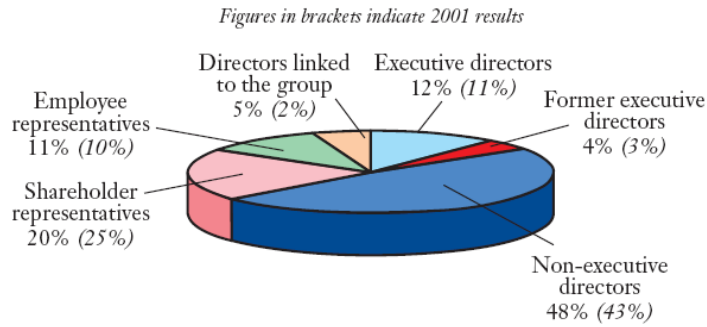
Probably it is a right time to start a new concept of the corporate board development in Ukraine from the point of view of the board composition. Under the new concept the supervisory board should be composed of the outside, independent professionals. The supervisory board in Ukraine in a whole should be composed of the professionals of the various spheres of expertise, including audit and executive compensation to make the fulfillment of the control role of the supervisory board possible.

Exhibits

Exhibit 1. Board composition in Europe

Types of director. There are six types of director, with independent non-executive members remaining the largest – and a growing – category. The proportion of directors who are “unclassified” (and, by implication, pose questions about why they are on the board) has been steadily decreasing. In the 1999 survey, it was 10%; in 2001 6% and in 2003, we were able to classify all directors within the six categories. This is an encouraging indicator of the

effectiveness of market and peer pressure for fuller disclosure. We note that the proportion of shareholder representatives has decreased, with boards becoming more independent, better representing the interests of all shareholders, not just the major ones.



The sum of the 2001 results is less than 100 because 6% of directors fell under the "unclassified" category.

Fig. 4.5. Board composition by category of director

Source: Heidrick & Struggles International, Inc., 2003.

Board internationalisation. While we can take some encouragement from the fact that the proportion of non-national directors has increased from 14% to 17%, boards of all companies remain more domestic than the companies themselves. Businesses increasingly prefer to recruit their non-executives from among the pool of directors who are playing an executive role elsewhere.

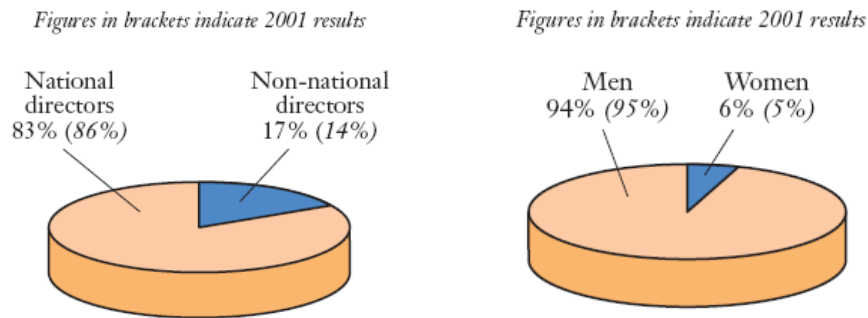


Fig 4.6. Board internationalization and diversity

Source: Heidrick & Struggles International, Inc., 2003.

Additionally, they now require a greater input from all non-executives. Finding directors who have the time both to commit to another board, and to travel regularly to meetings in another country, is proving difficult. Meanwhile,

we sense little appetite among European companies to adopt telephone or video conferencing as a substitute for face-to-face meetings.

Diversity. Although the numbers of women on boards have increased from 5% to 6%, lack of diversity remains a major concern. The low incidence of women on boards is clearly linked to the lack of women generally in the upper echelons of European business. We repeat, as we remarked in the 2001 survey, that in order to increase markedly the ratio of female to male directors, boards may need to look beyond their usual environments (the top-management structures from which non-executive board members are usually drawn) to professions where women more consistently make it to the top.

Age of directors. New in this survey is the information on the average age of non-executive directors. Pan-European comparisons are difficult to make at this stage owing to the reluctance of companies in some countries (such as Germany, Italy, Portugal and Spain) to disclose this information.

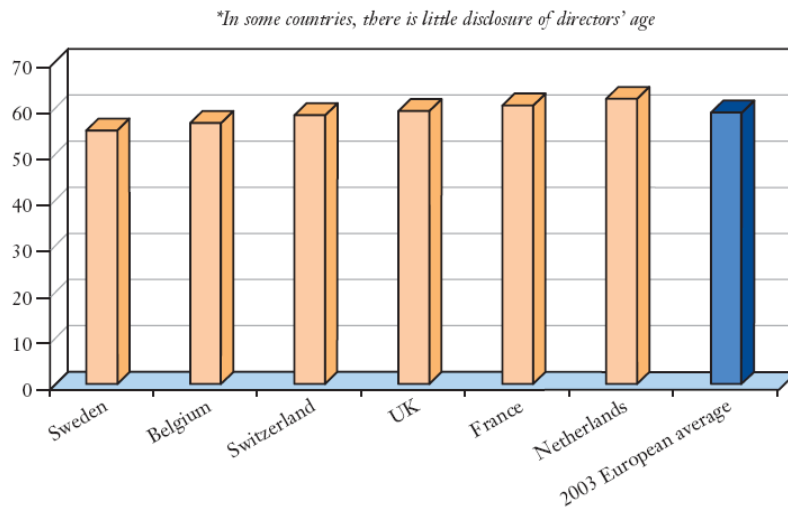


Fig. 4.7. Average age of directors by country

Source: Heidrick & Struggles International, Inc., 2003.

While we expect the level of disclosure to increase over time, at this stage we can point to a significant level of consistency among the countries shown in the chart (below), with directors tending to be between 55 and 62 years old, and an average of 58 years and 5 months.

Exhibit 2. Board structure in Europe by category of director

France. A more significant trend is the increasing internationalisation of French boards: about 23% of directors are now non-nationals (up from 16% in 2001) compared with the average European ratio of 17%. Despite their initial

reservations – logistics, language, etc – it seems that more French companies are appreciating the importance of having a board composition which better reflects their activities abroad, and the international nature of their shareholding structures. We note important steps towards full transparency on disclosure policy. Apart from information on committee members, disclosure on directors' profiles and accountabilities outside the board has improved; disclosure on compensation is also better (68% of the sample now provide information on this topic, up from 56.4% two years ago).

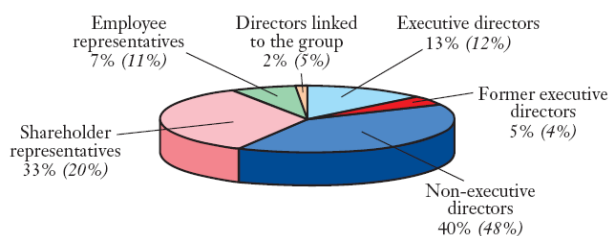


Fig. 4.8. *The France board composition (with European average)*

Source: Heidrick & Struggles International, Inc., 2003.

However, there is still room for growth, in order to reach the European average of 77%. Undoubtedly, the target of the CAC 40 companies should now be 100% transparency in the field of directors' profiles and interests. This aspect is obviously key to the assessment of potential conflicts of interest and real independence. All in all, the French situation has significantly improved, and structures are in place to encourage further progress. Nevertheless, international groups will in the near future have to face new challenges regarding their day-to-day practice. The recently issued Rapport Bouton, and the threat of new laws, are putting increasing pressure on French business to reform, and will affect the balance of power and influence within boards. The coming year will probably show whether or not French companies are truly willing to embrace change voluntarily – including improving the transparency and level of information disclosed to the business community – or instead, will have change forced upon them, through stringent regulation.

Germany. Germany has made substantial progress: increasing transparency, independence and professionalism in most German boards. Positions in supervisory boards – that were formerly regarded as purely honorary functions, with little time involvement, low pay and virtually no liability – have become professional tasks. Members have increased the time they commit to the role, are now very concerned about liability and are in the forefront in Europe in terms of board remuneration. The substantial number of board reviews carried out by some of Germany's biggest corporations – usually resulting in more professionalism and a greater willingness to address critical issues – is further evidence of a changing attitude. The percentage of non-national directors has increased from 5% to 7% in the past two years, but it remains very low in the European context (17%). Co-determination means, de facto, that only half of the

seats on the supervisory board are potentially open to international candidates, and it is still a requirement in many corporations for all board members to speak fluent German, owing to a reluctance to use interpreters in board meetings.

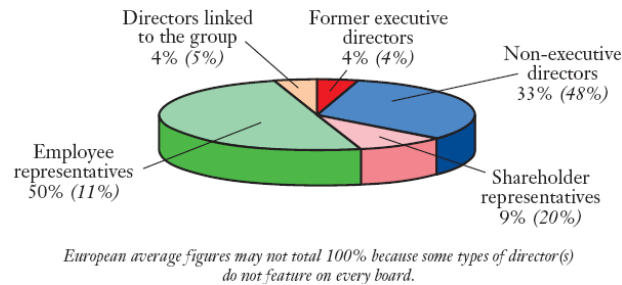


Fig. 4.9. The German board composition (with European average)

Source: Heidrick & Struggles International, Inc., 2003.

However, in order to recruit board members who can bring best-practice expertise on corporate governance into German boards, some companies have accepted English speakers in the boardroom, usually with very positive results.

Netherlands. Concentration of power among chairmen of the 24 AEX companies has further increased. These companies are chaired by 18 different non-executive chairmen (20 in 2001) each of whom has had an earlier executive career with one of 12 principally Dutch companies: multinationals, banks and a law firm. This circle is relatively small and its relationships and interdependencies raise questions about genuine independence, and the opportunity objectively to evaluate these non-executive directors.

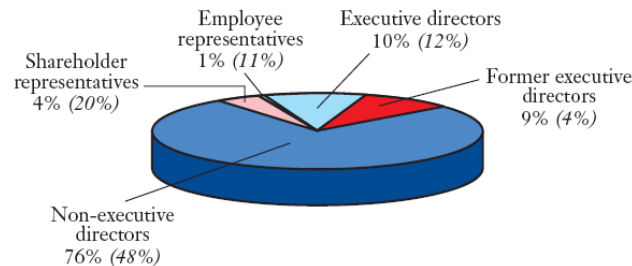


Fig. 4.10. The Netherlands board composition (with European average)

Source: Heidrick & Struggles International, Inc., 2003.

The results of an earlier Heidrick & Struggles study on succession planning indicate that non-executive chairmen of the AEX companies believe that the inclusion of former CEOs as non-executives on the board should be limited. However, their presence has actually increased (9% – up from 5% in 2001).

Background information on supervisory board members is readily available

in the Netherlands, and disclosure on company shares held has dramatically improved. However, areas which need more attention are: information on individual tenure, composition of board committees, and individual compensation details for executive and non-executive board members.

United Kingdom. All firms must describe the composition and the working of the board in a statement of compliance. As a result, the information on boards of directors is of the highest standard among European firms. Unlike many continental boards (especially in Belgium, France, Italy, Spain and Sweden), British boards very rarely have shareholder representatives. Accordingly, the independence of directors can be more readily assessed. The UK currently adopts the most exacting criteria in order to define the true independence of non-executive directors. Additionally, the quality of such directors continues to rise, as boards place more emphasis on the contribution expected from them.

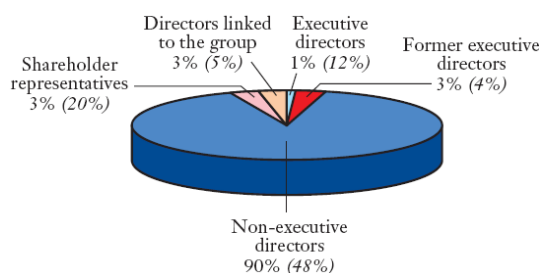


Fig. 4.11. *The UK board composition (with European average)*

Source: Heidrick & Struggles International, Inc., 2003.

The diversity of board composition continues to improve, with 27% non-national non-executives and chairmen (compared with the European average of 17%) and women accounting for 12% of directors, as opposed to 6%, on average, in Europe. As in our previous survey, remuneration remains a key issue: not least because of the talent shortfall, and the continuing difficulty of attracting international candidates of the right calibre, and with the requisite expertise.

Switzerland. Indeed, as we noted in 2001, the presence of so many multinationals results in a high figure for sales outside the domestic market, and may also be a factor in the improvement of the Swiss country rating. These companies are used to demonstrating high standards of disclosure in markets such as the USA or the UK – where they may also have a stock-exchange listing – and they tend to import elements of best practice to the Swiss market. The relatively high number of foreign board members (31%, vs. 17% in Europe) is certainly a result of the extremely high international exposure of Swiss companies, and not surprising at all. The tendency to nominate directors who are more independent, instead of drawing from the relatively small pool of prominent Swiss business representatives, is likely to lead to a further rise in the number of foreign board members in the near future.

Disclosure by Swiss companies is definitely better than two years ago, especially in two areas: the compensation of directors for their board

membership, and the information on directors' main executive positions, which is essential for assessing the independence of directors. The reverse trend on the information on tenure reflects the more stringent criteria of the 2003 survey and is in line with European results generally.

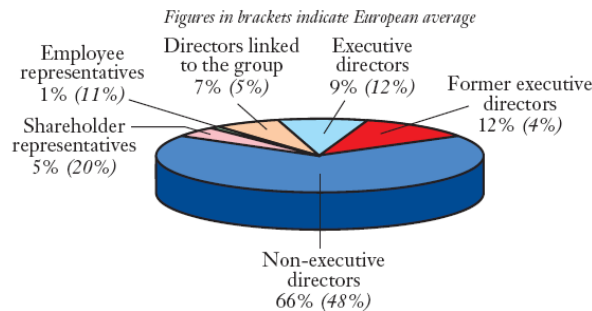


Fig. 4.12. The Switzerland board composition (with European average)

Source: Heidrick & Struggles International, Inc., 2003.

Sweden. A plus-point for Sweden is the above-average number of female board members: Sweden has the second-highest proportion of women on the board in Europe, (10% versus the European average of 6%). Additionally, while in many countries the separation of the roles of chairman and CEO is subject to an ongoing debate, Swedish public companies are required by law to keep the two functions separate.

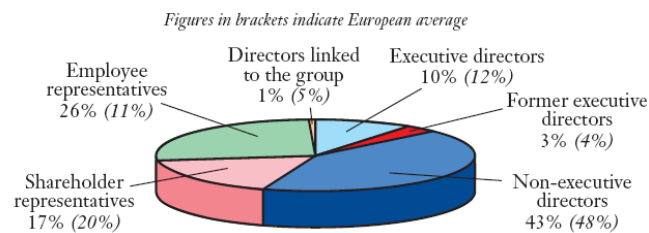


Fig. 4.13. The Sweden board composition (with European average)

Source: Heidrick & Struggles International, Inc., 2003.

Considering that the percentage of international sales for the companies in the survey is close to 90%, Sweden still does not have enough non-national directors, although an increase to 26.2% (compared with 10% in 2001) is welcome. In this survey, we also note an increase in the ratio of non-national shareholders: up from 32% in 2001 to 39%. In summary, we conclude that – apart from the problem areas that this survey identifies – Swedish companies are well positioned. As to disclosure, the level and quality of information on the composition of the board continues to be of a high standard, with very few gaps.

Spain. There is increasing pressure, both from Government Commissions and the media, to separate the roles of chairman and CEO; but change is painfully slow. The ratio of non-national directors remains low in the European context: indeed it has decreased from the previous high of 11% (2001) to 8%.

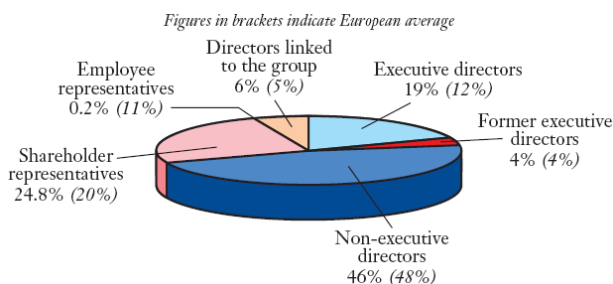


Fig. 4.14. *The Spain board composition (with European average)*

Source: Heidrick & Struggles International, Inc., 2003.

We note a more alarming fall in foreign shareholdings, from 22% to 10%. As stated in our previous survey, the presence of non-national directors on the board sends an important signal to international financial markets, and their recruitment should be seriously considered by companies aiming to attract foreign investment. Organisations seeking to increase exports, or to expand their geographic presence, would also benefit from having relevant territorial expertise on the board. Accordingly, demand for foreign independent board members is likely to increase in 2003.

Portugal. As regards the composition of the board, the proportion of executive directors remains high (58%, against 12% in Europe on average). We continue to see the lowest (along with Italy) proportion of women on boards in Europe: just 1% (against the average of 6%).

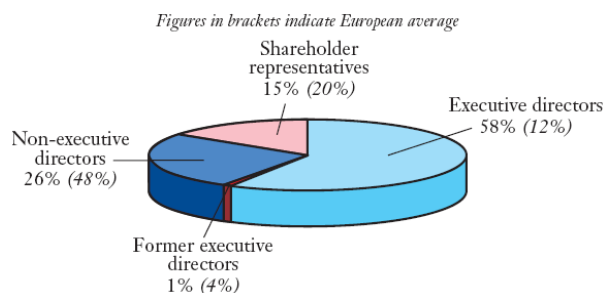


Fig. 4.15. *The Portugal board composition (with European average)*

Source: Heidrick & Struggles International, Inc., 2003.

A similarly unimpressive picture regarding the ratio of foreign shareholders – which stagnated at 24%, compared with the European norm of 31% –

demonstrates that Portuguese companies continue to be predominantly locally focused. The low ratio of non-national (8%) to national directors (92%), which has also remained largely unchanged over the past two years, sends a further negative signal to international financial markets.

Exhibit 3. Professional skills diversification of non-executive directors in Europe

The national trends for non-executive directors are similar to those for executive directors, though curiously French boards have a relatively large number of non-executive directors with financial experience whilst German Boards have relatively few financial experts amongst their non-executive directors.

For Switzerland, Belgium and the Netherlands, non-executive directors are, on the whole, more experienced in the stated areas than their executive colleagues. By contrast, in Germany, France and the United Kingdom, non-executive directors are generally less experienced than their executive colleagues. In order to sustain shareholder confidence, companies would be well advised to disclose the skills and backgrounds of their directors, in order to demonstrate the contribution each director can make. Some corporate governance codes include similar recommendations, for example, in the United Kingdom the Combined Code recommends that the names of directors submitted for election or re-election should be accompanied by sufficient biographical details to enable shareholders to take an informed decision on their election.

	Finance	Marketing Sales	Production/ Operations	Technology/ R&D	Other
France	73%	22%	24%	17%	10%
United Kingdom	89%	61%	64%	39%	68%
Germany	68%	50%	50%	41%	14%
Switzerland	88%	82%	68%	65%	32%
Netherlands	94%	88%	72%	59%	47%
Belgium	77%	59%	64%	36%	18%
Total	83%	67%	63%	50%	34%

Source: Heidrick & Struggles International, Inc., 2003.

While there is no guidance as to what is, and what is not sufficient, it would be reasonable to discuss the specific contribution of each director and, where appropriate, factors enabling the director.s independence to be determined.

Exhibit 4. Board membership criteria in the Russian banking industry

The BCBS requires banks to ensure that “board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.” Most national legislation, including the Russian Law on Banks and Banking Activities,

calls for 'fit and proper' board members.

Looking at fig. 4.16 a majority of banks look for certain qualities. Personal maturity (72%) and financial industry experience (50%) are considered as the most valuable qualities for being nominated to the SB. It is interesting to note that only one bank mentioned management experience as a selection criteria.

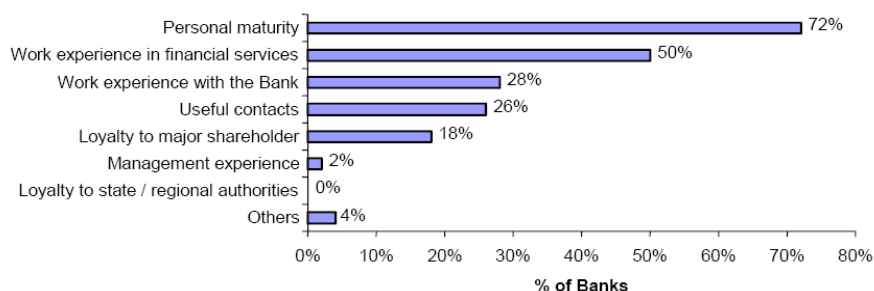


Fig. 4.16. Main Criteria for Nominating Members of the Supervisory Board (a multiple choice)

Source: IFC Corporate Governance in Russia project, report 2004.

The personal characteristics of current board members reflect the challenge of finding suitable candidates who meet most of the preferred selection criteria. While an appropriate educational background is widespread, more board members with professional experience in the financial services industry are needed (see table below). This lack of specific banking knowledge at the SB level is somewhat compensated for the fact that 82% of the SBs have the right to seek external advice; however, only 8% of the SBs have their own budget for hiring such external consultants. The short history of the Russian private banking sector explains the rather youthful average age of board members - 36.

Characteristics	OOOs	ZAOs	OAOs	Total
Average number of members	5.0	5.9	8.6	7.6
Average age of members	38	33	43	36
Average no. of members with bachelor or higher degree in economics	2.8	3.4	4.9	4.3
Average number of members with bachelor or higher degree in law	0.8	0.3	0.5	0.5
Average no. of members with bachelor or higher degree in science	0.8	1.8	2.8	2.3
Average number of members with professional experience in credit institutions	1.3	2.3	3.3	2.8
Average number of members with professional experience in investment banks	0.5	1.0	0.4	0.6
Average no. of members with professional experience in brokerage	0.3	0.1	0.3	0.2

Source: IFC Corporate Governance in Russia project, report 2004.

5

COMMITTEES OF THE BOARD

Audit commission

International board practice concerning establishing committees on the board is still not spread in Ukraine. The state obliged Ukrainian joint stock companies to establish an audit commission. But the commission is not on the supervisory board. It is not an integral part of the board. Members of audit commission are prohibited to be members of the supervisory board at the same time. Although the audit commission reports to the supervisory board, objectives of the audit commission are narrowed only to controlling financial transactions executed by the management board. Therefore, it is worth of establishing an audit committee with a broader spectrum of functions and equipped with the deepest knowledge on corporate governance mechanisms.

With reference to Sir Robert Smith's recommendations the role of the audit committee is about:

- To monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;
- To review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;
- To monitor and review the effectiveness of the company's internal audit function;
- To make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- To monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant Ukrainian professional and regulatory requirements;
- To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

Audit commission in Ukraine undertakes the role of audit committee only related to items 1, 2, 3. Members of the supervisory boards of Ukrainian companies are common about the conclusion that the level of

independence of members of audit commission is very low. 92 per cent of members of supervisory boards think that members of audit commission are dependent on the company's management.

Under such circumstances a function of the board known as an internal control that should be provided by the audit committee, is not fulfilled by audit commission at all. At the same time when we asked members of supervisory boards for their opinion to be more engaged in selecting and appointing an external auditor we received unexpected answers. Only 28 per cent of directors were certain about increasing their responsibilities for selecting and appointing external auditors. All these let us a chance suppose that directors are disturbed with the lack of independence of internal audit commission and a dictate of the company's management in the field of selecting and appointing an external auditor. But, at the same time, directors are passive in assuming responsibilities in this filed because of lack of appropriate knowledge and qualification.

The structure of audit commissions of the companies in Ukraine is very typical. Thus, almost all members of the audit commissions are insiders from the point of view of their company status. It could be much less painfully for the company if members of the audit commission were the shareholder workers, representing all levels of the company's management and workers in a whole. Regrettably, about 94 per cent of the members of audit commissions in Ukraine are the middle and top level managers whose independence is arguable and whose loyalty to the company's employees is arguable too.

Ukrainian companies could apply a concept of social responsibility toward the audit commission. A wide representation of all groups of employee shareholders would be a way out here. Moreover the audit commission composed in the above method could be quite efficient in protecting interests of employees, i.e. minority shareholders who suffer of the management dictate in Ukraine. But the management dictate is strong and the employee shareholders consolidation is very weak to expect the situation development mentioned above.

Size of audit commissions in Ukraine is from 3 to 7 members. Size of audit commissions in Ukraine does not depend on the size of the supervisory board, i.e. the hypothesis that the larger the supervisory board the larger the audit commission is not proved. Most of companies (75 per cent of the Ukrainian joint-stock companies) elect 5 members on the audit commission. The rest companies establish audit commissions consisting of 3 or 7 members. Probably, Ukrainian practices of audit commissions from the point of view of their compositions are still far from the best ones. This concerns the audit commission member independence. Only about 4 (four!) per cent of the audit commission members are

independent. The rest members are the large shareholders, former or recent employees of the same company or have very close relative relationships with executives. Under such conditions executives have very good chance to influence the activity of audit commission by administrative pressure (about 92 per cent of members of audit commissions in Ukraine are employees, i.e. subordinated to the company executives).

Remuneration of the members of the audit commission is paid monthly as a fixed amount. There are no any bonuses that could tie the motivation of the members of the commission to their performance. Thus, average amount of the remuneration paid to the member of the audit commission annually is USD210. Size of remuneration is fixed at the beginning of the year and could not be changed during a year despite the number of meetings the audit commission held. Such small size of remuneration and very fixed nature of the remuneration make the members of the audit commission quite reluctant to the reliable execution of their duties.

About 6 per cent of members of audit commissions in Ukraine have external advisors. As a rule, these are professionals having expertise in accountancy or finance. The most active members of the audit commissions in getting to services of external advisors are large shareholders or external minority shareholders. Regrettably, all these advisors are informal, i.e. the company is not informed about their existence.

Compensation committee

Another important committee, compensation committee, is established on the supervisory boards only at 10 percent of researched Ukrainian companies. These are companies mainly under control of foreign institutional investors. About 58 percent of companies, controlled by foreign institutional shareholders have compensation committees on the supervisory boards. It is worth of mentioning that this number is even higher than an average number for Germany, France and Italy. At the same time, a comparative advantage of Ukrainian executive compensation practice is erased by the fact that no company in Ukraine discloses the level and structure of executive compensation to shareholders, stakeholder and general public at all. This concerns all sectors of the Ukrainian economy, i.e. banking, manufacturing, services, high techs, mass media. Moreover, this concerns both large and small companies.

We should note that in the wake of recent corporate scandals, many countries have moved to enforce better disclosure of board and executive

compensation, and a small although increasing number also call for individual remuneration packages to be published. CEOs and other leading executives and board members are often in a unique position to abuse their position of power and in several countries this has come as a surprise to governments, the public and shareholders. It is therefore important not only to publish individual remuneration but to make the definition as broad as possible so as to avoid better camouflaged pay structures with sub-optimal incentives. The experience indicates that details of the compensation schemes are as important as the overall level in assessing the incentive structure and that remuneration also includes pension schemes, termination benefits and golden parachutes. The last two have become popular in the number of countries (e.g. Germany, France, UK) especially where large termination benefits have been associated with poor company performance.

The Ukrainian practice of disclosing the executive compensation does not exist at all. No company discloses information about the level and structure of executive compensation. This reduces the potential of influence of the compensation committee and the degree of executive monitoring gets weak too.

Lord Cadbury mentioned that executive directors should play no part in decision making on their own compensation (*Cadbury, 1992: para 4.42*). Taking into account that executives are not members of the supervisory board in Ukraine, i.e. it is prohibited by the legislation, we should broaden a term "executive" to "independent". Almost all members of compensation committees (85 percent) at the companies under control of foreign institutional shareholders are independent. That is a strong contribution to performance of the board. It is interestingly, companies, controlled by employees, have not compensation committee on the supervisory boards at all. Probably, it is because of very low number of independent directors on the boards and very stable stickiness of employees to "fixed" compensation contracts to sign with executives that reduce an importance of compensation committee on the supervisory board. Under such circumstances, executives are free to influence decision on the size and structure of their compensation through forcing a personnel department that is subordinated to executives and responsible to developing contracts for executives.

Moving beyond disclosure as a governance tool, in an increasing number of countries there are also moves to find more structural solutions, supported if necessary by guidelines. Compensation or remuneration committees are either being established or strengthened by the inclusion of independent members. For example, both the New York Stock Exchange and Nasdaq have proposed independent compensation committees as part of their listing requirements and codes and principles

in many other countries go in the same direction. The Ukrainian practice of executive compensation has no evidence of an attempt to be undertaken by the stock exchanges, the National SEC, or other regulators toward an establishing the recommendations or requirements concerning the best practices of executive compensation, addressed to the companies. It is hardly possible to suppose that there is no any wish of the regulators of the market of Ukraine for establishing the transparent standards of the executive compensation issue.

Some market participants including executives and large shareholders could be not interested in disclosing the information about the executive compensation. Moreover about 96 per cent of executives of Ukrainian companies do not understand how the disclosure of their compensation size and structure could improve the corporate governance efficiency and at least the company performance. 92 per cent of executives are sure that the disclosure of the executive compensation would lead to conflicts between executives and employees, or even with the minority shareholders. Only 3 per cent of executives of Ukrainian companies completely welcome an idea of the executive compensation disclosure implementation in Ukraine. Shareholders of Ukrainian companies have another point of view on the executive compensation disclosure. Thus, foreign institutional shareholders almost completely support the idea of disclosure of executive compensation. 98 per cent of foreign shareholders are sure about the positive effect of executive compensation. Even employee shareholders share the above point of view. Thus, more than 85 per cent of employee shareholders in Ukraine support the idea to make the executive compensation disclosed. As we noted, international experience of executive compensation system says that most large international companies have a compensation committee of two or more "outside" directors. Although all major decisions related to the top-level pay are passed through this committee, the committee rarely conducts market studies of competitive pay levels or initiate or proposes new incentive plans, and only seldom retains its own compensation experts.

Rather, initial recommendations for pay levels and new incentive plans typically emanate from the company's human resource department, often working in conjunction with outside accountants and compensation consultants. Here, executive compensation responsibility naturally varies with company size and complexity. Very large companies often have a fully staffed "Office of Executive Compensation", headed by a vice president who reports to either the Senior VP of Human Resources or to a VP of Compensation and Benefits. In smaller companies, executive compensation responsibility typically rests with the executive responsible for human resources.

Size of compensation committees in Ukraine is from 3 to 5 members.

Size of compensation committees in Ukraine does not depend on the size of the supervisory board. Most of companies (90 per cent of those companies having compensation committee on the supervisory board) elect 3 members to the compensation committee. The rest companies establish compensation committees consisting of 3 members. Probably, Ukrainian practices of compensation committees from the point of view of their compositions do not meet the international standards. This concerns the compensation committee member independence. Only about 26 per cent of the compensation committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The last two dependence criteria are the most popular in Ukraine.

About 12 per cent of members of executive compensation committees in Ukraine have external advisors. These are professionals with expertise in remuneration having quite rich experience in practice. The most active members of the executive compensation committees in getting to services of external advisors are external minority shareholders whose interests are represented on the board. Probably, getting to services of external advisors they wanted to be more competent in monitoring the executives. Moreover, cooperation of the compensation committee members with external advisors increases the degree of involvement of the directors not only in the executive monitoring process, and also in the strategy development. Regrettably, similarly to the case of audit commission, all these advisors are informal, i.e. the company is not informed about their existence.

Remuneration of the members of the compensation committee is paid monthly or only one time a year as a fixed amount. There are no any bonuses that could be paid to the members of the executive compensation committee to improve their performance. Thus, average amount of the remuneration paid to the member of the executive compensation committee annually is USD190. Size of remuneration is fixed at the beginning of the year and could not be changed during a year despite the number of meetings the executive compensation committee held. It should be noted that the remuneration of the director for his work as a committee member is in three times lower than his remuneration as the board member in a whole. This is not perspective distribution of remuneration because the work in committees could become as a formal and not motivated duty in Ukraine.

Models of executive compensation setting

Today, there are three models of executive compensation setting in Ukraine. The first model obliges Human Resource Department to develop

executive compensation. As soon as it is developed, an executive compensation plan is brought to the Office of the Head of executive board to approve. If the head is not satisfied with the salary that is stated in the executive compensation plan, he is able to make the head of human resource department for setting the compensation, desirable by the head himself and the rest of executives.

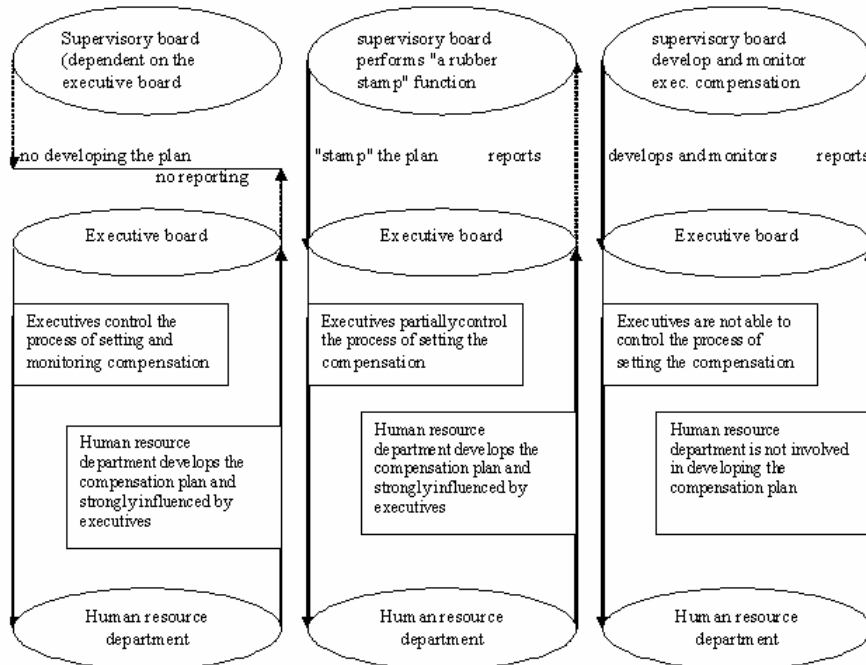


Fig. 5.1. Models of executive compensation setting in Ukraine

Besides this, it should note that executive compensation plan is not approved at the meeting of the executive board, where every member has his own point of view on the plan. The plan can be approved only by the head himself, in ordinary way, as compensation for middle-level managers.

Under such circumstances, the head of executive board is like a dictator, who is able to make any member of the executive board vote for all decisions, as the head likes, under the threat of compensation cut.

Under this model, supervisory board is not involved in developing and approving compensation for executives. The reason, as a rule, is absence of skills at members of the supervisory board how to supervise an executive compensation practice. But the most important reason is strong dependence of members of supervisory board on executives.

The above model is popular in companies, owned or controlled (on the basis of proxy votes) by executives. Executives have strong levers to manipulate compensation and set it as they want.

The second model is a little similar to the model, discovered above. Human resource department develops an executive compensation plan. But, in contrast to the previous model, an executive compensation plan, as soon as it is developed, is brought to the supervisory board. The main task of the supervisory board is to approve or disapprove the plan. If it is approved, supervisory board gives the plan to the executive board and makes them follow it. If it is not approved, the plan is brought to the human resource department back to enhance it.

Under the second model, supervisory board performs a function of "a rubber stamp". Therefore, performance of executive compensation plan depends rather on skills of human resource department than on skills of supervisory board.

At the same time, the human resource department is still under pressure, when developing the plan, of executives, who can try to force them make the plan more convenient for them. Experiencing a pressure of executives and forcing by supervisory board, the human resource department faces a compromise. Being a socially responsible means to become an enemy for executives who will make the further work of the human resource department terrible.

Therefore, the second model underlines that supervisory board supervises the executive compensation practice indirectly, through stamping the plan. At the same time, executives still save a chance to influence indirectly the process of development of compensation plan.

Under the third model, only supervisory board develops and approves the executive compensation plan. No human resource department takes participation in the process of development of the plan. From this perspective, the third model meets corporate governance principles. Executives are not able to influence the process of development and approving the plan.

As a rule, companies, using the third model, establish a special committee within the supervisory board. This is a compensation committee. Compensation committee is responsible for developing an executive compensation plan.

We could suppose that members of this committee develop the plan autonomously. We asked members of the compensation committees in Ukraine. All they replied that human resource department still participates in the process of development of the plan. As we found, compensation committee develops principles of executive compensation plan, approves compensation instruments. They do this in accordance with the corporate development plan where there are certain figures to tie

it to the size of compensation. Moreover, members of compensation committee choose performance benchmarks, bonus standard, structure of bonus standard. All this information is brought to the human resource department. Human resource department officers should fill the draft of the plan with certain figures to complete. So, even executives try to press on human resource department to obtain more preferable compensation plan, they will not be able to change principles, instruments, and size of compensation.

Finance committee

Finance committees are on the boards at only 3 per cent of researched companies. Motives to establish finance committee on the supervisory board at companies, controlled by various groups of shareholders are different. Thus, financial-industrial groups want to have finance committee on the board to control financial expenditures by executives and to have a strict control over the process of the cash expenditures and cash flows within the group in a whole. Foreign institutional shareholders establish finance committee on the supervisory board to involve directors in strategic financial decision making. Generally, strategic financial decisions are made by executives at the companies, controlled by executives themselves, employees and Ukrainian financial-industrial groups.

Among the Ukrainian companies controlled by financial-industrial groups there are 22 per cent with a finance committee on the supervisory boards. Companies controlled by Ukrainian FIGs are the most active in establishing a finance committee on the supervisory boards. Cash flows within a group is dispersed and the most important task of the members of the finance committee is to keep an eye on the process of the cash generating, distributing and accumulating by the companies engaged in the group. This task is set by large shareholders who want to consolidate all financial resources which are free for a certain time for applying the strategic goals. From this point of view, the finance committee could be like internal auditor acting in the company from inside but set by outside participants, i.e. large outside shareholders.

It is interesting to note that members of the finance committee are mainly independent, i.e. they never worked at the company as executives, they never owned large block of stock of the company, they have no relatives as executives of the company, and so on. About 72 per cent of members of the finance committees at Ukrainian companies are independent. This is a remarkable progress for the Ukrainian practice of the independent directorship under which the majority of members of supervisory boards are not independent.

At the same time, members of the finance committees are not satisfied with the level of so named “functional independence” in making decisions on the process of the control of cash flows consolidation and distributing. More than 80 per cent of members of the finance committees are sure that the large shareholders whose interests they represent on the supervisory board are inclined “to put their own hands” in the activity of the finance committee too much. Members of the finance committee feel that large shareholders do not trust them completely as directors would like. It is very strange to note for the independent directors where the issue of “a trust” should be not actual. The issue of the director professionalism should be the priority for the large shareholders.

Moreover, the finance committee members in Ukraine are common around the thought that the system of corporate financial statements are not developed in Ukraine enough to let them effectively direct such corporate area as corporate finance. The weakest element of the corporate financial disclosure system is the systematical financial reporting. About 84 per cent of the finance committee members agreed that they have a lack in receiving the financial corporate information on the systematic, smooth basis. From this point of view they are afraid of being not effective in representing interests of shareholders as the well informed directors who should be in a course of the behavior of the management board.

The most members of the finance committees have a rich experience in the field of corporate finance and appropriate education. 78 per cent of the finance committee members graduated with the degrees in corporate finance. 93 per cent of the finance committee members have at least a ten year experience in corporate finance. Their self-assessment is very high. Almost all members of the finance committees in Ukraine are sure that they are qualified enough for being the effective members of the finance committee.

The finance committee by-laws are not well-developed practice in Ukraine. The most companies still prefer to make some notes in the supervisory board by-law concerning an activity of the finance committee. There are 96 per cent of companies where there are finance committees which are regulated by the supervisory board by-law. Only 4 per cent of companies have a separate by-law on the finance committee. As a rule, information containing in the supervisory board by-law and concerning the finance committee does not cover all practices of the finance committee. For example, there are no notes regarding the composition of the finance committee from the point of view of the independent director share on the finance committee or the procedure of their reporting.

The finance committee size at Ukrainian companies is similar to the

practices of compensation committee, i.e. from 3 to 5 members. Size of finance committees in Ukraine does not depend on the size of the supervisory board. At the same time, the size of finance committee depends on the industry the company belongs. Thus, commercial banks have only 3 (in 20 per cent of cases even 2) members in the finance committee. Oil-gas extracting companies have, as a rule, 5 directors in the finance committee. Ukrainian practices of finance committees from the point of view of their composition do not meet the international standards with reference to the director independence. Only about 12 per cent of the finance committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The first two dependence criteria are the most popular in Ukraine.

There are 6 per cent of members of finance committees in Ukraine having external advisors. These professionals have expertise in corporate finances having quite rich experience in practice. The most active members of the finance committees in getting to services of external advisors are majority shareholders. Regrettably, similarly to the case of the executive compensation committee, all these advisors are informal, i.e. the company knows nothing about their existence.

Remuneration of the members of the finance committee is paid monthly as a fixed amount, as in the case of audit commission or as a fixed amount a year as in the case of compensation committee. Bonuses that could tie the motivation of the members of the commission to their performance are absent. Thus, average amount of the remuneration paid to the member of the finance committee annually is USD140. Size of remuneration is fixed at the beginning of the year upon the composing the supervisory board committees and could not be changed during a year despite the number of meetings the finance committee held.

Administration committee

The rest committees on the board, popular in the Anglo-Saxon world, are not developed in Ukraine too. Administration committees are not popular on the boards of Ukrainian companies. About 4 per cent of researched companies have on the boards an administration committee. The reason of so low popularity of administration committee on the supervisory boards in Ukraine is very contrasting to those, made previously. Ukrainian companies, whoever controlled them, want to have well-performing administrators on the supervisory boards. But the market for directors in Ukraine has a lack of directors who could effectively administer the work of the board from the point of view of its various roles, i.e. strategic, control and service.

Foreign institutional shareholders are the most active in establishing the administration committee. About 24 per cent of companies controlled by foreign institutional shareholders established the administration committee on their supervisory boards. It is obviously to recognize that the weak interest of Ukrainian companies to the administration committee will have a very negative influence on the corporate governance performance.

One of the most important disadvantages of corporate governance in Ukraine is a very weak degree of the internal regulation and control. The world practice in the internal regulation and control says that the companies should meet the specifics of corporate governance attributed to them through developing a set of internal statements. These are statements on committees of the supervisory board, executive compensation, internal control and many others. This work should be done and headed by independent members of the supervisory board who should work as members of the administration committee. It is a paradox that Ukraine, as a country where corporate governance is still in transition to the international best standards has still no firm demand for those people who will professionally and independently do the work regarding turning the chaos into the order.

More than 90 per cent of members of the administration committees of the supervisory boards of Ukrainian companies have a right imagination of what they need to do as the administration committee members. 96 per cent of respondents find the development of the system of statements of internal control as the most important task of the committee.

Regrettably, only 38 per cent of members of the administration committees in Ukraine find their work satisfactory. The main obstacle on the way to effective work of the administration committee is a strong resistance not only from the members of the management board, i.e. executives. The most surprising is the fact that members of the administration committee feel resistance from their colleagues, i.e. members of the supervisory board. Under such circumstances it is hardly possible to hope for an effective work of the board. Moreover, the supervisory board can not be considered as a team of colleagues.

Probably, members of the supervisory boards in Ukraine are so resistant to the work of the administration committee because the committee's efforts very often make the members of the supervisory board behave in another way that is not comfortable for the members of the board. Besides that a well-ordered work of the supervisory board facilitated by the administration committee could require the supervisory board members for the new skills. It could be a very strong test for the directors' professionalism. Most of directors do not want to have an exam

for their ability to work on the supervisory board. Probably it is because most of directors realize that this exam will not be taken successfully.

It should be noted that the most members of the administration committees have quite long experience in the field of business administration. 82 per cent of the administration committee members in Ukraine have at least a ten year experience in corporate administration. At the same time their education is not appropriate to their experience. Only 18 per cent of the administration committee members graduated with the degrees in corporate administration. They obtained their degrees either abroad or in Ukraine after the crash of the USSR. Before the year 1991 the Ukraine educational institutions did not offered the degrees in corporate administration at all. Despite that, the self-assessment of the administration committee members is very high. 89 per cent of members of the administration committees in Ukraine are sure that they are qualified enough for being the effective members of the administration committee.

The administration committee by-laws are not well-developed practice in Ukraine too as in the case of the finance committee. The most popular document adopted at the joint-stock companies in Ukraine and discovering the role of the finance committee is the supervisory board by-law. There are 98 per cent of companies where there are administration committees which are regulated by the supervisory board by-law. Only 2 per cent of companies with the administration committees on their boards have a separate by-law on the administration committee. From the point of view of the administration committee functions disclosing, information containing in the supervisory board by-law and concerning the finance committee does not cover all practices of the administration committee. Generally, there are no notes regarding the composition of the administration committee from the point of view of the independent director share on the administration committee, the procedure of their reporting, their remuneration. The exclusive functions of the administration committee are not written in the supervisory board by-laws not completely.

Size of administration committees in Ukraine is from 3 to 5 members. Size of administration committees in Ukraine does not depend on the size of the supervisory board. Most of companies (85 per cent of those companies having administration committee on the supervisory board) elect 3 members on the administration committee. The rest companies establish administration committees consisting of 3 members. Probably, Ukrainian practices of administration committees from the point of view of their compositions do not meet the international standards. This concerns the administration committee member independence. Only about 11 per cent of the administration committee members are

independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The second criterion of dependence is the most popular in Ukraine.

External advisors do not provide services to the members of administration committees in Ukraine at all. This is quite unusual practice in contrast to the interests of other committee members in services of external advisors. Probably, the administration committee work requires quite confident approaches to the documents regulating the supervisory board work. Moreover, administration committee is helped remarkably by the appropriate departments of the company responsible for the documentary turnover within the company.

Remuneration of the members of the administration committee, as in the case of the above considered committees is paid monthly or only one time a year as a fixed amount. There are no any bonuses that could be paid to members of the administration committee. Average amount of the annual remuneration paid to the member of the administration committee is USD160. Size of remuneration to be paid to the committee members is fixed at the beginning of the year and could not be changed during a year despite the number of meetings of the administration committee. Size of the remuneration paid to the members of the administration committee is larger than the remuneration to the members of the rest committees at Ukrainian joint stock companies.

Shareholder committee

Shareholder committee is not popular at Ukrainian joint stock companies. It is quite surprisingly because of frequent cases of violation of the minority shareholders' rights by majority shareholders and executives. This situation can be explained by two reasons. The first is unwillingness of majority shareholders to take into account interests of minority shareholders. The second factor is the very low degree of knowledge of minority shareholders on the major mechanisms of protecting their rights. One of these mechanisms is establishing and participation on the board's shareholder committee.

Only 4 per cent of researched Ukrainian joint stock companies have a shareholder committee on the board. It is interesting that all these companies do not experience agent conflicts and are very transparent. About 90 per cent of these companies are under control of foreign institutional shareholders. There are no shareholder committees at companies under control of employees and executives. Employees do not establish shareholder committee on the boards of companies, controlled by them, because they are strongly concerned with responsibility of the

company to employees (employment, wages, etc.) and weakly concerned with outside shareholders interests and institutions (stock market, capital structures, stock price, etc.). Executives prefer not to establish shareholder committees because absence of shareholder committee allows executives absorbing a total control of the company and follow their own interests without a threat to be discovered and executed by shareholders.

Members of the shareholder committee are common about the main reason of their activity, i.e. establishing and maintaining the best ways of communication of the company with its shareholders. That task is undertaken by 98 per cent of members of shareholder committees in Ukraine. Besides that, members of the shareholder committee find reasonable to make their utmost to maintain interest of the minority shareholders. Thus, about 72 per cent of members of the shareholder committees in Ukraine keep on the above task very thoroughly.

Majority of the members of shareholder committees in Ukraine find reasonable to direct activity of those people who are responsible for preparation the main event of the company corporate life, i.e. the general shareholder meeting. As a rule, executives, i.e. management board members are responsible for preparing under direction of the members of shareholder committee. About 72 per cent of the members of the shareholder committees in Ukraine think that they are obliged to direct executives when preparing the general shareholder meeting. They found such kind of work as a fulfillment of an executive monitoring function that is very important not only for large shareholders, but also for the minority shareholders. Probably, under such strong inclination of the shareholder committee to develop the measures to protect rights of the minority shareholders it could be starting point for corporate governance best practices in Ukraine to develop these practices through the shareholder committees. It is interesting to note that the minority shareholders rely on the shareholder committee very much. Thus, about 86 per cent of the minority shareholders consider the shareholder committee as an efficient mechanism of their rights protection. But this concerns only those companies where the shareholder committees exist. Minority shareholders of companies without the shareholder committee on the supervisory board are much less inclined to consider the shareholder committee as an efficient mechanism of the minority shareholder rights protection. Probably, it is because of the weak degree of information available to the minority shareholders of such companies regarding the role of the shareholder committee.

62 per cent of the shareholder committee members in Ukraine have at least a ten year experience in the shareholder relationship administering. At the same time their education is not appropriate to their experience as

in the case of the administration committee members. Only 11 per cent of the shareholder committee members graduated with the degrees related to the shareholder relationships administration. Mainly such degrees are in corporate governance. They obtained their degrees either abroad or in Ukraine at the beginning of the third millennium when the Ukrainian high-schools introduced degrees in corporate governance. Before the year 1991 the Ukraine educational institutions did not offered the degrees in corporate governance. The shareholder committee by-laws are not applied in Ukraine at all in comparison to the similar by-laws on the finance or administration committees. The most developed practice is through adopting some notes on the shareholder committee in the supervisory board by-law. There are 91 per cent of companies where there are shareholder committees which are regulated by only formal clauses written in the supervisory board by-law. These “formal clauses” concern such aspects of the shareholder committee activity as procedure of the electing to the shareholder committee, procedure of the work of the shareholder committee and procedure of decision making at the meetings of the shareholder committee. Only 2 per cent of companies with the shareholder committees on their boards included in the supervisory board by-laws more detailed and advanced practices of the shareholder committee. The list of such kind of practices is composed of the exclusive functions of the shareholder committee, the proportional representation of the various groups of shareholders on the shareholder committee, reporting to the shareholders. At the same time, like the finance and administration committees there are no any references in the supervisory board by-laws regarding the role of the independent directors on the shareholder committee.

The shareholder committee size at Ukrainian companies is similar to the practices of most other committees, i.e. from 3 to 5 members. Size of shareholder committees in Ukraine does not depend on the size of the supervisory board. At the same time, the size of shareholder committee depends on the ownership concentration.

Thus, the higher degree of ownership concentration, the higher number of members in the shareholder committee. Ukrainian practices of shareholder committees from the point of view of their compositions do not meet the international standards with reference to the director independence. Only about 6 per cent of the shareholder committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The first two dependence criteria are the most popular in Ukraine.

8 per cent of members of shareholder committees in Ukraine have external advisors. They are professionals representing various

shareholder associations and unions. The most active members of the shareholder committees in getting to services of external advisors are external minority shareholders whose interests are represented on the board. Getting to services of external advisors they tried to be more competent in protecting their own rights and rights of other minority shareholders. Similarly to the case of other supervisory board committees all these advisors are informal, i.e. the company is not informed about their existence.

Remuneration of the members of the shareholder committee is paid monthly as a fixed amount or monthly. There are no any bonuses that could tie the motivation of the members of the shareholder committee to their performance. Thus, average amount of the remuneration paid to the member of the shareholder committee annually is USD130. Size of remuneration is fixed at the beginning of the year and could not be changed during a year despite the number of meetings the shareholder committee held.

Policy committee

A policy committee is the most popular committee on the boards at Ukrainian companies. Almost 25 per cent of researched companies have a policy committee on the board. Policy committee is the most popular on the boards of the companies under control of foreign institutional investors, Ukrainian financial-industrial groups and Ukrainian investment companies and funds. The higher concentration of ownership structure the higher likelihood of establishing a policy committee on the supervisory board. It is because controlling shareholders want to have a total control of strategic directions of the company's development through a very simple mechanism to establish - a policy committee. As in the case of finance committee, only foreign institutional shareholders establish policy committee mainly to develop strategic directions, and only next to control its execution by executives, i.e. members of the executive board.

Companies, controlled by Ukrainian financial-industrial groups, executives and employees, prefer to delegate a function to develop strategic decisions to executive board. It is interestingly to know a mode of strategic involvement of policy committee at Ukrainian companies. The deepest mode of strategic involvement, i.e. helping formulating strategy, was demonstrated by policy committees of those companies under control of foreign institutional shareholders (3 replies) and with dispersed ownership (1 reply). The deepest mode of strategic involvement of supervisory boards is at companies, controlled by Ukrainian financial-industrial groups is monitoring (4 replies).

Table 5.1. *Mode of strategic involvement of the members of supervisory boards in Ukraine*

Involvement in strategy	Frequency
Review	12
Discuss	12
Approve	10
Ratify	9
Decision-taking	9
Monitor	9
Define strategic framework	5
Guide	4
Help formulate	4

Number of respondents, i.e. members of policy committees - 12

Supervisory boards at companies under control of executives are involved in strategic process only from the stage of strategy discussion (1 reply). This proves that shareholder executives are inclined to adsorb corporate control through preventing the establishing a policy committee or through delegating as weak as possible involvement in strategy process to policy committee. Surprisingly, but we found that directors of those companies, where there are no policy committees are involved in strategy process too. They do this at the ordinary meetings of the supervisory boards or at the general annual meeting of shareholders.

Regrettably, it is worth of mentioning that involvement in strategy is considered by most directors when meeting on the board, only as approving the strategy (38 respondents). 7 respondents consider their involvement in strategy through helping formulating the strategy, and 3 of them are not the policy committee members. Obviously, supervisory boards have a lack of organizational change to let all members apply their knowledge and motivation on committees of the board.

Shareholders of Ukrainian companies wanted the supervisory board members to be much more involved in the strategy development. About 84 per cent of the large institutional shareholders wanted to see the more activity of the members of supervisory board in the strategy development. Besides that minority shareholders wanted the supervisory board to perform more activity in that way too. This point of view is supported by the large number (72 per cent) of minority shareholders of Ukrainian companies. Thus, we can note a comparative higher interest of the large institutional shareholders in forcing the supervisory board members play more active role in the strategy development. This support an idea issued before that the higher concentration of ownership structure the higher likelihood of establishing a policy committee on the supervisory board.

Probably, the large institutional shareholders, both foreign and Ukrainian, have to rely on the strategic function of the supervisory board much more than the minority shareholders who are, as a rule, individual shareholders. The main reason is a higher interest of the large institutional shareholders in the financial results of the company activity, the higher degree of realizing an importance of the strategy development and implementation, and much better imagination of what the role and place the company takes at the market.

The policy committee by-laws are not well-developed practice in Ukraine despite the fact that the policy committee is the most popular committee on the supervisory boards in Ukraine. The most popular document adopted at the joint-stock companies in Ukraine and discovering the role of the policy committee is the supervisory board by-law. There are 91 per cent of companies where there are administration committees which are regulated by the supervisory board by-law. Only 9 per cent of companies with the policy committees on their boards have a separate by-law on the policy committee.

From the point of view of the policy committee functions disclosing, information containing in the supervisory board by-law and concerning the policy committee does not cover all practices applied by the members of the policy committee. Generally, there are no notes regarding the composition of the policy committee from the point of view of the independent director share on the policy committee, the procedure of their reporting to shareholders, their remuneration, requirements to the candidates on the policy committee. The exclusive functions of the policy committee, like in the case with the finance, administration and shareholder committees are not written in the supervisory board by-laws not completely.

Size of policy committees in Ukraine is from 3 to 5 members similarly to the practices of the rest committees. Size of policy committees in Ukraine does not depend on the size of the supervisory board but it slightly depends on the type of controlling owner. Most of companies (90 per cent of those companies having policy committee on the supervisory board) elect 3 members on the policy committee. The rest companies establish policy committees consisting of 5 members. There is only one exclusion, i.e. companies owned by executives. These companies have policy committees consisting at least at possible members (2 members!). This makes the policy committee as a formal body taking into account that all strategic decisions are made by executives as members of management board.

Ukrainian practices of policy committees from the point of view of their compositions do not meet the international standards. This concerns the policy committee member independence. Only about 2 per cent of the

policy committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The first two dependence criteria are the most popular in Ukraine.

External advisors, as in the case of administration committee, do not provide services to the members of policy committees in Ukraine at all. Probably, policy committee members do not need any external advisors because they, committee members, are mainly former executives supposing that that they professionalism is very high to work without any external help.

Remuneration of the members of the policy committee is paid monthly as a fixed amount, as in the case of audit commission or as a fixed amount a year as in the case of most committees of the board. Bonuses that could tie the motivation of the members of the policy committee to their performance are absent. Thus, average amount of the remuneration paid to the member of the policy committee annually is USD140. Size of remuneration is fixed at the beginning of the year upon the composing the supervisory board committees and could not be changed during a year despite the number of meetings the finance committee held.

Roles of the board

Reviewing social responsibility is a role of members of the board of those companies under control of foreign institutional shareholders. Besides this, reviewing social responsibility is undertaken by members inside of policy committee. Companies, where there is the policy committee on the board, review social responsibility in general way. Contacts and discussions on the topic of social responsibility with stakeholders, employees, minority shareholders are not undertaken by members of policy committee.

Social responsibility is considered rather as "environmental protection". Obviously, but reviewing social responsibility requires establishing a special committee on the supervisory board. In our sample companies, social responsibility is a role of policy committees, which are not familiar with its role in details.

Generally, hypothesis on committees of the board has been approved. That means that committees of the supervisory board are demanded more by foreign institutional shareholders. Thanks to this, boards are multi-role performers, i.e. strategy, control and service.

Table 5.2. *Roles of the supervisory boards in Ukraine*

Roles	Number of respondents positively answered
Involvement in strategy	44
Hire, appraise and fire executives	4
Converse with shareholders/stakeholders	4
Development of corporate vision	7
Responsibility for ethical framework	2
Ensure corporate survival	3
Determine risk position	2
Lead strategic change	3
Review social responsibilities	2
Understand current and forthcoming legislation	4

Number of respondents – 50

It is very interesting to know that only 2 per cent of companies under research have all four committees popular in Ukraine (an executive committee, an administration committee, a shareholder committee and a policy committee). From the point of view of the Jay Conger classification of the roles of the board of directors, i.e. strategic, monitoring and advising, the supervisory boards in Ukraine are rather advisors than strategists and monitors. Almost 92 per cent of the members of supervisory boards believe that their main task is to give the competitive advices to the management board members. They support such behavior saying that through advising to the management board members the supervisory board members transmit the most important ideas from shareholders and executives. This, by their beliefs, strengthens the mutual trust and understanding between shareholders and executives.

At the same time, the supervisory board members would like to be much more involved in the strategic decision making. Such decision was supported by 76 per cent of the supervisory board members.

Concerning the monitoring to be taken by the supervisory board members over the activity of the management board the Ukrainian practices of corporate governance narrate on the lack of wishing to get into the conflicts between these boards.

Supervisory board members have no enough incentives to monitor the activity of the management board if the company is controlled by the large shareholder who elected their representatives to supervisory and management boards.

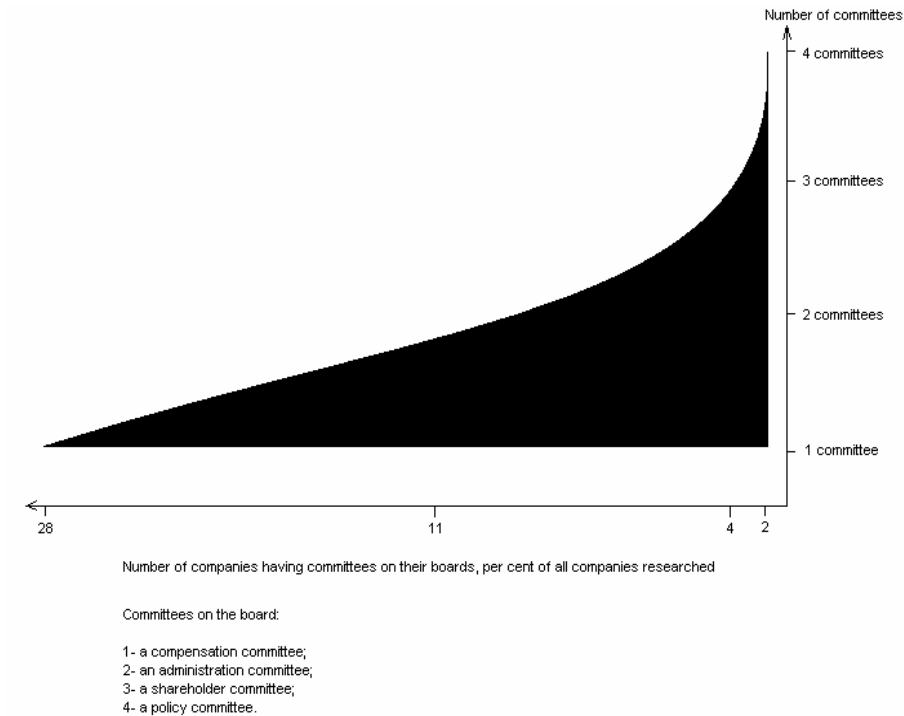


Fig. 5.2. *Distribution of committees at Ukrainian joint stock companies*

Companies, where the corporate ownership is dispersed are not effective in the establishing the supervisory board which could behave as a team rather than a group of contestants. A system of internal control is weak and monitoring functions are lost in the fight for the dominant role on the board. Minority shareholder rights are not taken by the supervisory board members as something to fight for because the reward for possible efforts is not sufficient or does not exist at all. More than 70 per cent of supervisory board members are not paid for their work at all. The last incentive, i.e. personal reputation, is still not a factor that could influence the behavior of the members of supervisory boards of Ukrainian joint-stock companies.

New horizons of the board committee development

Weak development of the supervisory board practices in Ukraine accentuates attention of the market participants and regulators on solving several problems. One of the most important problems is a weak

professional qualification of the supervisory board members to work on the particular committees effectively.

Probably the way out here is through the uniting efforts of both boards in Ukrainian companies – supervisory and management boards. The Russian practices of the supervisory board committees allow the committees to be established with membership of the representatives of both boards, i.e. supervisory and management boards. Executives are much more professional from the point of view of the tactics of the business running and they are much better informed about the company market position and performance than the supervisory board members. Therefore, executives could bring to the board committees not only the expertise of the day-to-day operations. They would bring the information and reduce the asymmetry of information between the boards.

Ukrainian legislation does not regulate the issue of the board committees in a whole content. Therefore, there are no any obstacles for the shareholders to consider the reasonability of establishing the mixed board committees. The only step the shareholders should do is the writing the appropriate notes in the charter of the company and by-laws on supervisory and management boards.

There could be quite strong of such an idea at the members of supervisory and management boards. 68 per cent of the supervisory board members in Ukraine are sure that an inclusion of the management board members on the board committees could be very positive decision. The most supervisory board members (74 per cent) think that such membership could create the spirit of the team working between two boards. 62 per cent of the supervisory board members who supported an idea of the mixed committees are sure that the next important incentive of such decision could be an improvement of the informational transparency of the company and reducing asymmetry of information between two boards. The management board members also have quite positive point of view on the issue of the mixed committees. There are 59 per cent of the management board members in Ukraine who support the idea of the mixed committees. The main reasons of such decision from the point of view of the management board members are the improvement of the strategic process (54 per cent of agreed respondents), increase in the objectivity of the performance of the management board members (46 per cent of agreed respondents). At the same time we could note that the wishes of the supervisory board members toward the establishing the mixed committees are still behind the knowledge accessible to the supervisory board members on the best practices of the board committees accepted and applied internationally.

The supervisory board members in Ukraine do not see the difference in principles of the mixed committee composition with participation of

executives. Thus, 82 per cent of the supervisory board members are sure that the executives should be the members of the compensation committee. The main argument in the favor of such decision is the supposition by the supervisory board members that executives are well-familiar with the compensation practices. Certainly, executives are well-familiar with the executive compensation practices, but such point of view erodes on of the functions of the supervisory board, i.e. control function. It is because the executive compensation is an object of the control. This means that executives can not take part in control of their own compensation.

The most unexpected results have been received in the part of the participation of executives in the audit committee. Thus, about 46 per cent of supervisory board members support an idea of membership of executives on the mixed audit committee. As a result, an executive could have a direct influence on the process of the external auditor appointment and observe the internal control at the company. Even they could rule the process of the audit commission activity – the body responsible for the audit of the activity of the management board, i.e. executives themselves. Under such circumstances the management dictate that is so popular in Ukraine now and concerning the dictate in the sphere of the employee shareholder relationships could spread toward the relationships of executives with the rest groups of shareholders. As a result an idea of corporate control sculptured by *Berle* and *Means* could die soon.

Therefore, it is obviously to note that the Ukrainian joint-stock companies are not recommended to introduce the practice of the mixed board committees, i.e. with the membership of the supervisory and management board members. It could be the wrong decision leading to the most painful maladies – the corporate control loosing.

One of the worst board committee practices is through composing quite complicated committees from the point of view of its possible functions. Thus, Ukrainian joint-stock companies establish such a committee as finance and strategy committee. This committee is a combination of separate finance and policy committees considered above. Probably, there are some threats to the best corporate governance practices through establishing such complicated committees. First of all, it is hardly possible to compose such complicated committee with professionals in specific spheres. Else the committee would require not less than 5 members. Moreover, only one member would be taken for a competent member in the specific issues considered by the committee. Under such conditions a productive team working of the committee would turn into the “guru’s speeches” when each member would take him for the only expert in the committee. The same situation is about another complicated committee as compensation and nomination when functions

regarding executive compensation and director nomination are concentrated in the hands of the same people.

One more problem that could be solved in the way of improving performance of the supervisory board committee development in Ukraine is development a system of by-laws that could be very specific to the need of each committee. Probably, accounting such criterion as the committee member independence should be considered from various positions if the concept of the director independence is applied to the board committee practices. Thus, it is quite acceptable to have not a majority of independent directors on the policy or shareholder committees. At the same time, it is extremely important to have the whole independent audit, executive compensation or nomination committees. The by-law on the supervisory board in a whole does not consider such peculiarities. These peculiarities could be accounted only by separate committee by-laws. Moreover, there is much work to do in the way of improving accountability of the board committee members in Ukraine. The most companies do not require the committees provide the supervisory board in a whole with a written reports on their work during a year. As a rule, committees report rather informally personally talking to the head of the supervisory board. From this practice it is hardly possible to move in the way of the incentive based remuneration to directors.

Probably, the cornerstone of the new paradigm of the board committee practices could be based on the broader meaning of the term “director independence”. Just saying that the director independence is a medicine for all pains the board committees in Ukraine suffer, is not a way out. Weak transparency could not provide Ukrainian boards with all benefits of improvement in the director independence.

At the same time “independence” should be considered from the broader term as “independence of mind”. This could contribute to a free discourse inside of the board room. Moreover, independence of mind could give a chance to hope for an independent decision making by each director. This could turn the board of directors to the interests of all shareholders with intention to account these interests and balance them.

Generally speaking, the supervisory board committees in Ukraine need more accountability, transparency and, that is the most important, professionalism to be the representatives of the shareholders.

Exhibits

Exhibit 1. Board committees in Europe

The three principal types of committee have all increased in number since our previous survey. The audit committee is still the most common. It is found in

80% of companies surveyed and is usually the first committee to be established, followed by the remuneration committee, which showed a 60% growth two years ago and is now found in 78% of companies in our sample.

Nomination committees ensure that directors are selected using independent and professional procedures. They show the fastest growth, from a low of 24% in the 1999 survey, to nearly 60% in our 2003 sample.

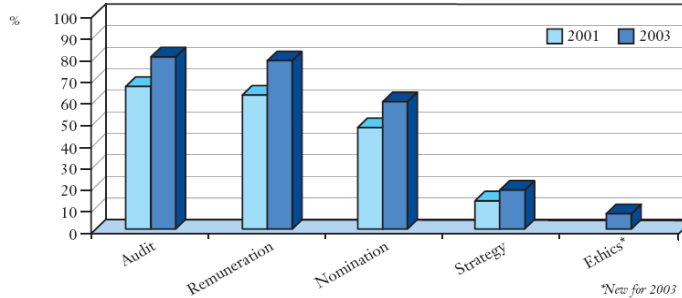


Fig. 5.3. Proportions of companies with each type of committee

Source: Heidrick & Struggles International, Inc., 2003.

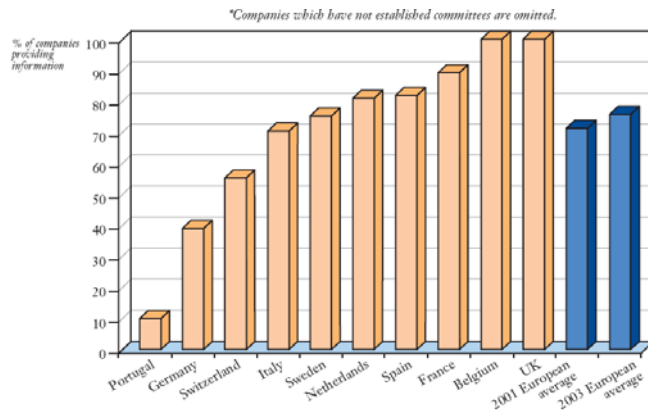


Fig. 5.4. Disclosure of composition of committees

Source: Heidrick & Struggles International, Inc., 2003.

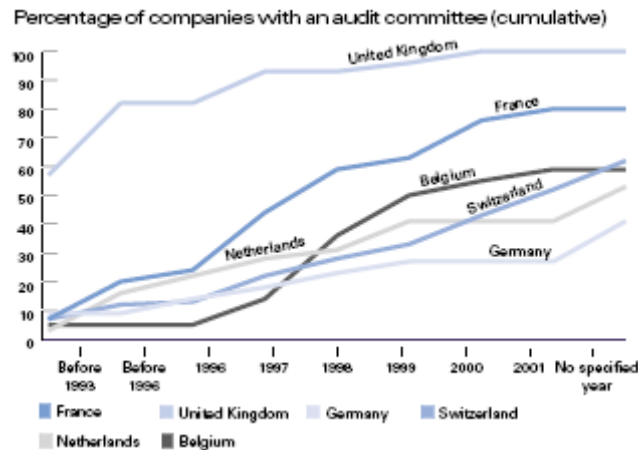
76% (compared with 72% in 2001) of companies who have committees list their committee members, allowing shareholders and the public to gauge the independence of these members.

Exhibit 2. Audit committee practices in Europe

In the United Kingdom, the Cadbury report recommended that boards of listed companies set up audit committees as long ago as 1992. It is therefore

unsurprising that the survey shows that audit committees are more established in the United Kingdom than in the rest of Europe.

Overall, 67% of respondents had established audit committees. Audit committees were found to be most widespread in the United Kingdom where all respondents reported the existence of such a committee. The extensive use of audit committees was also reported in France (80%), Belgium (59%) and Switzerland (62%). Perhaps as a result of the two-tier board structure, only 41% of German respondents and 53% of Dutch respondents had established audit committees.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

In the United Kingdom, only 18% of audit committees had been established later than 1995. Interestingly, 57% of respondents had established their committees prior to 1992, and thus before the Cadbury recommendations. The rest of Europe did not reach this level until 2000. This may reflect the power of institutional investors in the United Kingdom, or the similar nature of the United Kingdom and US governance models (note, since 1978, the New York Stock Exchange has required all listed companies to have audit committees composed solely of independent directors.) The growth in popularity of audit committees elsewhere in Europe is generally uniform. However, the number of French companies with audit committees can be seen to rise sharply following the initial impact of the Viénot report.

Similarly, in Belgium, the number of companies having audit committees can be seen to rise sharply following the recommendations of the Federation of Belgium Companies and the Cardon Commission report.

It is noticeable that in Germany and the Netherlands, the two countries operating two-tier boards, the popularity of audit committees lags behind other European countries. It has been suggested that this is probably because the implementation of independent and objective board committees is regarded as less important where supervisory boards exist.

In France, the Viénot committee report lists the principal responsibilities of

the audit committee:

- Business analysis.
- Overseeing the audit of the financial statements.
- Ensuring that accounting methods are consistently applied.
- Verifying the statutory auditors. independence and objectivity.
- Validating the work carried out by the financial department and statutory auditors, particularly the accounting methods chosen to consolidate the accounts.

The Combined Code also addresses the duties of the audit committee which, in its view, should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Also, where the auditors supply a substantial volume of non-audit services to the company, the Combined Code recommends that the audit committee keep the nature and extent of such services under review and seek to balance the maintenance of objectivity and value for money. We asked whether audit committees had formal written charters setting their responsibilities. In the United Kingdom, all respondents had established a charter describing the audit committee responsibilities. By contrast, in Switzerland and France, 68% and 58% of respondents respectively had an audit committee charter, while in Germany the proportion having an audit committee charter was even less (40%).

	France	United Kingdom	Germany	Switzerland	Netherlands	Belgium
The adequacy of the system of internal control and risk management	88%	96%	70%	92%	100%	91%
The quality of the accounting policies, judgements and disclosures	94%	100%	80%	97%	100%	91%
Consideration of the independence and objectivity of external auditors	67%	93%	90%	81%	88%	75%
Consideration of the proposed scope of the external auditors work	61%	93%	80%	70%	88%	75%
The process for monitoring compliance with relevant laws and regulations	48%	79%	70%	92%	59%	82%
Consideration of the scope, authority, and resources of internal audit	45%	86%	60%	64%	71%	67%
Consideration of the need for internal audit where no such function exists	24%	14%	20%	57%	59%	42%
Reviewing the work of internal audit and verify that their recommendations are implemented	52%	82%	30%	81%	71%	73%
The interim financial statements and the process used to prepare them	79%	93%	40%	73%	82%	83%
The preliminary announcement and financial reporting package	76%	100%	90%	73%	88%	77%
Non-financial information included in the annual report, or otherwise made public	30%	71%	40%	54%	35%	15%

Source: Corporate Governance in Europe, KPMG Survey 2001-2002

Clearly most European audit committees are responsible for overseeing the scope and results of the audit and the independence and objectivity of the auditors.

However, audit committees in Belgium and France appear less likely to oversee both internal and external audit than their counterparts.

Across Europe, most audit committees review of the preliminary announcement, financial reporting package and interim statement. The exception is Germany where few audit committees (40%) review the interim financial statements. The reasons for this are not clear.

Interestingly, a significant number of United Kingdom respondents had audit committees whose remit included the examination of non-financial information included in the annual report or otherwise released to the public. This may well reflect the importance attached to these areas in recent initiatives such as the Turnbull report and the proposals for the reform of company law. Alternatively, it may suggest a higher take up of initiatives such as ISO 14001 (Standard for environmental management systems) and EMAS (EcoManagement and Audit Scheme) than elsewhere.

Most corporate governance codes include some recommendations concerning the composition of audit committees. In the United Kingdom, the Combined Code recommends that the audit committees should comprise at least three directors all of which should be non-executives and the majority independent. Similarly, the Brussels Stock Exchange recommends that audit committees should comprise at least three non-executive directors whose authority and duties are clearly stated at the time of their appointment.

In France, the Viénot Committee recommended that at least one third of audit committee members be independent (i.e., must neither be employees nor part of the senior management of a company). The AFG report, which is less influential than the Viénot report, recommended that the audit committee should comprise at least three nonexecutive directors, one of which must be independent.

The draft Swiss Code recommends that the audit committee should be comprised of non-executive, and preferably independent, members. Furthermore, a majority, including the chairman, should have experience of finance and accountancy. By contrast, the recommendations in Germany and the Netherlands are less specific. The Peters report (Netherlands) recommended that audit committees should be comprised of supervisory board members, whilst the German Code of Corporate Governance recommends that audit committees should have at least three, but no more than five members. The rules governing how audit committees are established in Germany are embodied in the Companies Act, but the implementation itself is not mandatory.

Across Europe, the most frequently encountered audit committees comprise between three and four members. Only in Germany are larger audit committees equally as popular.

In France, Switzerland and the United Kingdom, audit committees were approximately a third of the size of the board. Turning to two-tier boards, audit committees were 29% as large as supervisory boards in Germany, but around 60% the size of supervisory boards in the Netherlands.

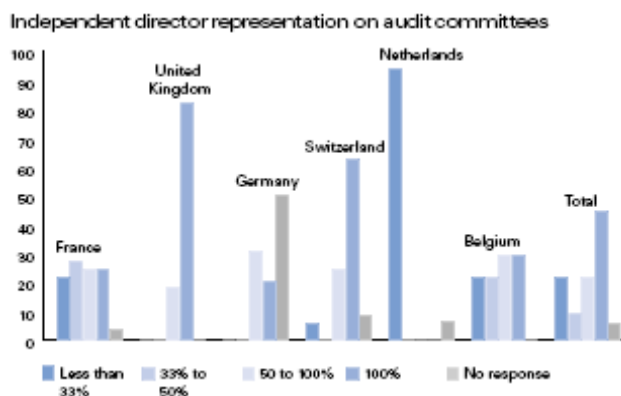
The audit committee is responsible for overseeing the financial reporting process and increasingly often, the effectiveness of the system of internal control and risk management. In carrying out its duties, the audit committee may need to challenge the judgement of management or take positions that may be contrary to

those of the executive directors. Because of this supervisory or oversight role, independence is an essential quality for audit committee members.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

All United Kingdom respondents had audit committees comprised solely of non-executive directors, and in each case the majority of members were, as the Combined Code recommends, considered independent (82% of audit committees comprised exclusively independent non-executive directors while 18% of audit committees had a majority of independent members.) In Switzerland, which has as yet no code in this area, 62% of audit committees consist exclusively of independent directors. In Belgium, even fewer audit committees were wholly independent, even though the Viénot Committee recommended that at least one third of audit committee members be independent, the results from France were mixed. Some progress has been made with 24% of audit committees consisting entirely of independents. However, there are still many committees (21% of respondents) where the independent representation amounts to less than one third of the members.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

As audit committees are sub-committees of the supervisory board in two-tier board regimes, one would expect that they would consist exclusively of independent directors.

However, this is not the case. In fact, relatively few audit committees are predominantly independent. We believe this peculiarity arises because chief executive officers, finance directors and internal auditors often attend audit committee meetings and have therefore been reported as members. Intriguingly, in Germany there was a high rate of nonresponse to the question (50%).

Exhibit 3. Remuneration committee practices in Europe

In the United Kingdom, the Combined Code recommends that to avoid potential conflicts of interest, boards should set up remuneration committees of independent non-executive directors to make recommendations to the board, within agreed terms of reference, on the company’s framework of executive remuneration and its cost; and to determine on their behalf specific remuneration packages for each of the executive directors, including pension rights and any compensation payments. The Combined Code goes on to recommend that remuneration committees should consist exclusively of nonexecutive directors who are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Similarly, in Belgium, remuneration committee are considered good practice and should comprise only nonexecutive directors. Where no remuneration committee is established, the non-executive directors should decide on the principles of executive remuneration.

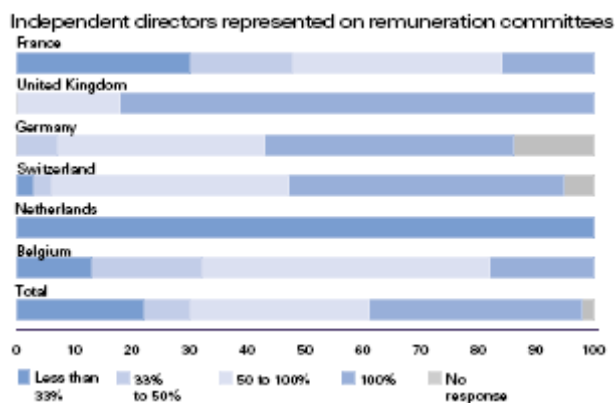


Source: Corporate Governance in Europe, KPMG Survey 2001-2002

In France, Viénot recommended that remuneration (or compensation) committees should have a majority of independent directors among their members (note, for audit committees Viénot recommended that independent directors comprise 33%). The AFG proposed that remuneration committees comprise at least three nonexecutive directors, one of which must be

independent. The draft Swiss Code also recommends that a majority of the remuneration committee should consist of independent nonexecutive directors.

In the Netherlands all remuneration committee members are supervisory board members and therefore, independent from management. Clearly, respondents did not believe this to be the case. We believe this is because executive directors and others often attend remuneration committee meetings and have therefore been reported as members.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

With the exception of France and the Netherlands, respondents from most countries had remuneration committees comprising a majority of independent directors. It is not clear why so many French respondents had not followed Viénot's recommendations nor why Dutch respondents had remuneration committees that contained so few independent directors.

All but five United Kingdom respondents had remuneration committees that were wholly comprised of independent non-executive directors.

Exhibit 4. Nomination committee practices in Europe

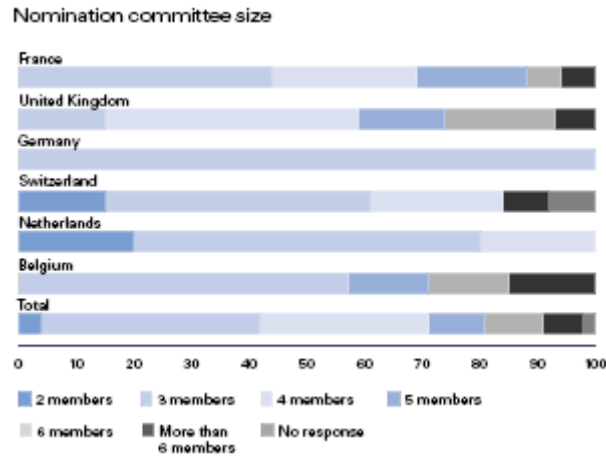
It is important that boards maintain an appropriate mixture of skills, experience and objectivity. One approach to making board appointments, which makes clear how appointments are made and assists boards in making them, is through nomination committees charged with the responsibility for proposing to the board, in the first instance, any new executive or non-executive directors.

As long ago as 1992, the Cadbury report recommended that companies establish nomination committees, but did not make this part of its Code of Best Practice. Nevertheless, in 1998, this recommendation was incorporated into the United Kingdom's Combined Code with the proviso that such committees may not be appropriate for small boards.

Nomination committees are also encouraged by corporate governance codes in Belgium, France, Germany, and the Netherlands. In Switzerland, it is likely

that nomination committees will be encouraged for large public companies.

Our survey revealed that nomination committees are most widespread in the United Kingdom where 96% of respondents reported the existence of such a committee. Elsewhere, nomination committees were not used extensively, though 39% of French respondents, 32% of Belgium respondents and 22% of Swiss respondents reported the existence of such committees. Perhaps as a result of the two-tier board structure, only 16% of Dutch respondents and 9% of German respondents had established nomination committees.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

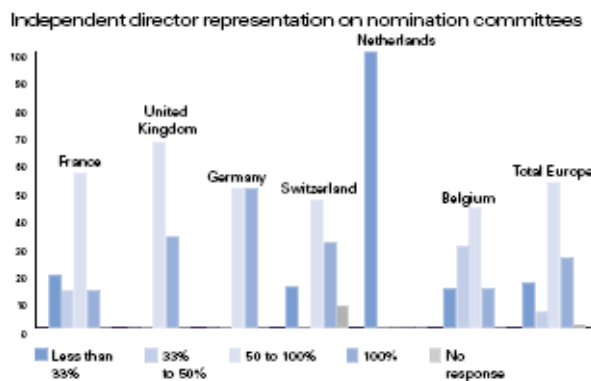
The Combined Code recommends that a majority of nomination committee members should be non-executive directors and that the chairman should either be the chairman of the board or a non-executive director. The Belgium recommendations are similar to those in the United Kingdom. Both codes are silent on the question of independence.

In France, the Viénot report goes further in recommending that independent directors should account for at least one third of the committee and that the chairman of the board should be a member of the committee, but not its chairman. More specifically, Viénot goes on to recommend that the nomination committee should draw up a plan for succession of the executive directors - including the chief executive officer.

In the Netherlands, the Peters report recommends that, like audit and remuneration committees, nomination committees should be comprised of supervisory board members. The average number of nomination committee members varies from country to country, however, most committees have between three and five members. Generally nominations committees were larger in the United Kingdom than elsewhere. Only respondents from Switzerland and the Netherlands had nomination committees with two members. Conversely, in Germany, practices were uniform, with 100% of respondents having nomination committees comprising three members. To put this in perspective, out of the 60 nomination committees surveyed, only two were in Germany. Turning to the

independence of nomination committee members, it can be seen from the chart below that the various corporate governance recommendations have been adopted in some countries, but not in others.

France, Belgium, Switzerland and the Netherlands reported nomination committees with a minority of independent directors. It is distressing that nearly 20% of French respondents have nomination committees comprising less than one-third independent directors and therefore do not follow the Viénot recommendations.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

Switzerland has no established code in this area. By contrast, respondents from the United Kingdom appear to have little difficulty in complying with the Combined Code recommendations - in each case a majority of committee members are non-executive directors, while a third of respondents had nomination committees comprised solely of non-executive directors.

In Germany, 50% of respondents had nomination committees comprised exclusively of independent directors. In the Netherlands, one would expect all nomination committee members to be supervisory board members and therefore independent from management. The reason why all Dutch respondents reported nomination committees with less than one third independent representation is unclear but may be because executive directors and others often attend nomination committee meetings and have therefore been reported as members.

Exhibit 5. Key committees in Australia

Audit Committee. The findings with respect to audit committees were generally positive. The vast majority of companies had an audit committee (239 companies (95.6%). This finding is consistent with prior research that showed that approximately 90% of Australian listed companies had an audit committee. The average size of audit committee was 3.36, with a range in size from two to seven. Of the 239 companies that had an audit committee, 175 (73.2%) had an independent chairperson. With respect to the overall audit committee independence, 66 (27.6%) were completely independent, 79 (33.1%) were

comprised of a majority of independent members, 72 audit committees (30.1%) did not have an independent majority, and in 22 instances (9.2%) the audit committee did not contain a single independent member.

Remuneration Committee. The findings with respect to remuneration committees were also positive. One hundred and ninety five companies (78%) had a formal committee, meeting separately from the full board that determined executive remuneration. The average size remuneration committee was 3.42, with a range in size from 1 to 11. Of the 195 companies that had a remuneration committee, 148 (75.9%) had an independent chairperson. With respect to the overall remuneration committee independence, 59 (30.3%) were completely independent, 72 (36.9%) were comprised of a majority of independent members, 50 remuneration committees (25.6%) did not have an independent majority, and 14 remuneration committees (7.2%) did not contain a single independent member.

Nomination Committee. While there were significantly fewer nomination committees than either audit or remuneration committees, their compositions and independence levels were similar. Less than 1/3rd of the companies had a formal nomination committee (77, 30.8%). The average size of nomination committee was 3.64, with a range in size from two to nine. Of the 77 companies that had a nomination committee, 54 (70.1%) had an independent chairperson. With respect to the independence of the nomination committees, 22 (28.6%) were completely independent, 34 (44.2%) were comprised of a majority of independent members, 18 nomination committees (23.3%) did not have an independent majority, and in three instances (3.9%) the nomination committees did not contain a single independent member.

Exhibit 6. Board roles and committees in the USA

The Center for Effective Organizations (CEO) of the University of Southern California's (USC) Marshall School of Business and Mercer Delta Consulting, LLC first joined forces in 2003 to conduct a national survey of corporate Directors in the largest U.S. corporations. They received responses from 221 Directors. Twelve percent (12%) of the respondents are CEOs/Chairs, 3% inside Directors, 72% outside Directors, 4% CEOs/Non-Chairs, 3% nonexecutive Chairs, 5% Lead Directors, and 2% other. The Directors served on an average of 2.5 Boards. Their analysis suggests the respondents come from approximately 200 of the 1,000 largest publicly traded companies in the United States. Directors who sit on more than one Board were asked to fill in the survey for the largest U.S. company on which they serve as Director. Results of the survey were compiled and analyzed jointly by Mercer Delta and USC. To simplify presentation of the results, survey responses that fell in the category of 4 or 5 on a 5-point scale were interpreted as positive/favorable responses. These include responses of "4 = effective" and "5 = very effective" on the effectiveness scale and "4 = to a great extent" and "5 = to a very great extent" on the extent scale as illustrated below. Throughout this report, for each question that used a 5-point scale, "percent favorable" represents the total percentage of Directors who responded favorably to a particular question by choosing either a 4 or 5.

Authority and Fiduciary Oversight

When asked to rate their Boards on providing fiduciary oversight, Directors generally expressed positive views of how effectively their Boards are operating. The table below presents the results. The lowest rating is on ethics, but it still receives a relatively high score. When compared to the USC’s historical data on these topics, the ratings were very similar to the effectiveness ratings in prior years.

Rate the effectiveness of the Board in the following areas:	Very Ineffective	Ineffective	Somewhat Effective	Effective	Very Effective	% Favorable (% of Directors who responded Effective/Very Effective)
Monitoring the firm’s financial performance	1%	1%	4%	41%	53%	94%
Representing the interest of shareholders	1%	0%	5%	45%	49%	94%
Advising during major decisions such as mergers or acquisitions	1%	1%	10%	41%	46%	87%
Ensuring ethical behavior within the company.....	0%	1%	11%	51%	36%	87%

Strategic Oversight

The survey results reveal that strategic oversight is an area where there is room for improvement. Only 63% of the Directors responded favorably when asked to rate their Boards’ effectiveness in shaping long-term strategy. This is an improvement over the 2003 results (55%) but still a low number. The results are similar for identifying threats and opportunities critical to the future of the company.

To what extent is the Board effective in the following areas?	Very Ineffective	Ineffective	Somewhat Effective	Effective	Very Effective	% Favorable (% of Directors who responded Effective/Very Effective)
Shaping long-term strategy	1%	6%	29%	47%	16%	63%
Identifying possible threats or opportunities critical to the future of the company.....	0%	4%	31%	46%	18%	64%

Responsibility to Stakeholders

We asked the Directors how responsible they feel to various classes of stakeholders. Sixty-two percent (62%) of Directors said that they owe the most duty to long-term shareholders. One quarter (25%) of Directors feel they owe the most duty to employees and less than one quarter to other stakeholders.

As a Board member, how responsible to the following groups do you feel?	Owe No Duty To		Owe Some Duty To		Owe Most Duty To
Long-term shareholders	0%	0%	7%	31%	62%
Institutional investors	1%	2%	18%	54%	24%
Employees.....	0%	1%	19%	55%	25%
Government/regulators.....	1%	10%	31%	40%	19%
Communities where company operates	1%	13%	41%	35%	10%
Top management team	0%	10%	31%	40%	19%

Committees

The vast majority (95%) of the Directors responded favorably when asked to rate the extent to which their Boards' committee assignments utilize the skills and experiences of Board members.

To what extent:	To a Very Small Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent	% Favorable (% of Directors who responded To a Great Extent/To a Very Great Extent)
Do committee assignments effectively utilize the skills and experience of Board members?	0%	0%	5%	55%	40%	95%

Board and Committee Membership

The survey revealed that Directors now feel they have significantly greater control over the choice of new Directors than the Chair/CEO. As shown in the table below, over two-thirds feel that this decision is most influenced by the Nominating/Governance Committee, compared to 14% who indicate the CEO has the most influence.

Who has the most influence in determining nominees for the Board?	
Nominating/Governance Committee	71%
CEO	14%
Full Board	8%
Non-Executive Chair/Lead Director	5%
Shareholders.....	1%
Other	1%

Exhibit 7. Functions of the supervisory boards in the Russia banking sector

Supervisory Boards (SB) struggle to define their proper function. SBs appear to see themselves at par with or of greater importance than the ultimate governing body of a company, the GMs. In the surveyed banks for example, a number of SBs felt it was their duty to approve additional issuances of the banks' shares (40%) and annual financial statements (12%) as well as to select external auditors (14%). In some cases, the SB elects and dismisses its own members. On a positive note, the SBs of surveyed banks consider initiating unscheduled audits as one of their key functions. However, the findings above may be partially explained by the particular shareholding structure of the respondent banks: most of the surveyed banks have relatively concentrated ownership with SB members representing all major shareholders. The meetings of the Supervisory Boards thus become almost identical to a General Meeting of Shareholders and roles get confused. In such cases, however, it is then easy to leave minority shareholders out of the process. The struggle of the SB to define its function is also evident when asked about the operational characteristics and role of the SB. As chart below shows, 40% of SBs participate in day-to-day management activities together with the Management Board but only half of the banks consider that the role of the SB is to serve as a check and balance on the management.

This clearly contradicts the Basel Committee’s view on removing the SB from operational duties. Furthermore, over 30% of the banks do not or only partially agree with the notion that it is the SB’s function to set the long-term direction of the bank and an even higher percentage does not include the SB in defining the bank’s mission. At the same time, a significant portion of SBs do not feel at all or even partially responsible for the overall soundness of the bank (38%). Such blurred borders of responsibility distort the principle of separation of duties and create unclear lines of accountability throughout the organization.

Another indicator of the role SBs see themselves performing is the size of financial transactions which are subject to SB approval. Generally, SBs approve financial transactions exceeding in value either 25% of the banks’ capital (46%) or 25% of the banks’ total assets (36%) which is reasonable. Some banks have set up fixed thresholds for this purpose. At the same time, however, 14% of bank’s SBs also approve smaller, immaterial transactions, i.e. below 20% of the banks capital.

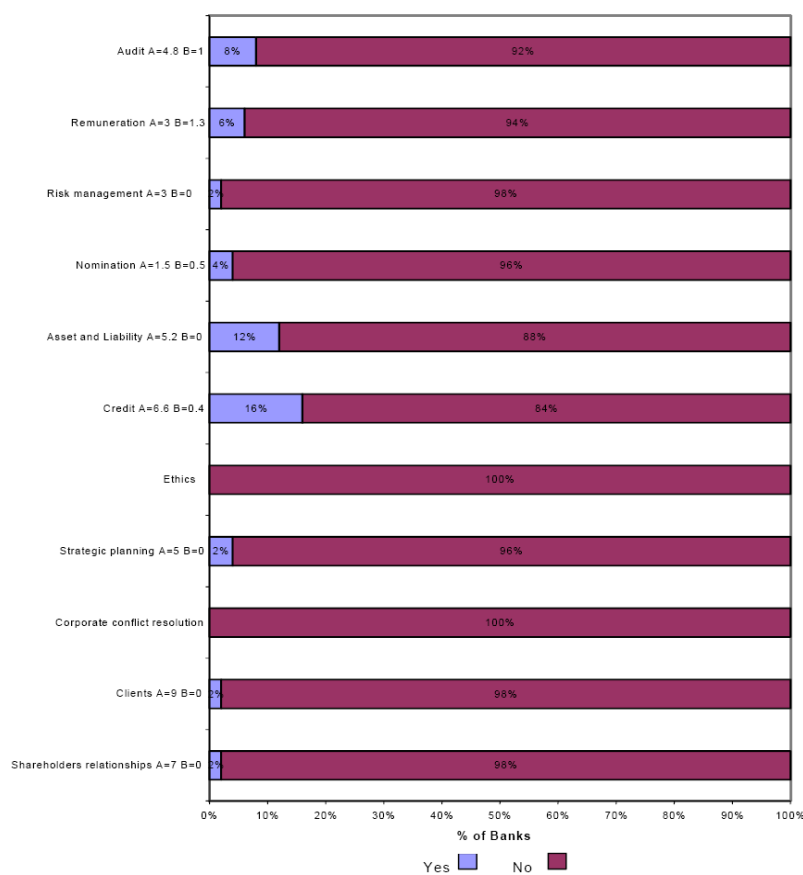


Fig. 5.5. Supervisory board committees in Russia

Source: IFC Corporate Governance in Russia project, report 2004.

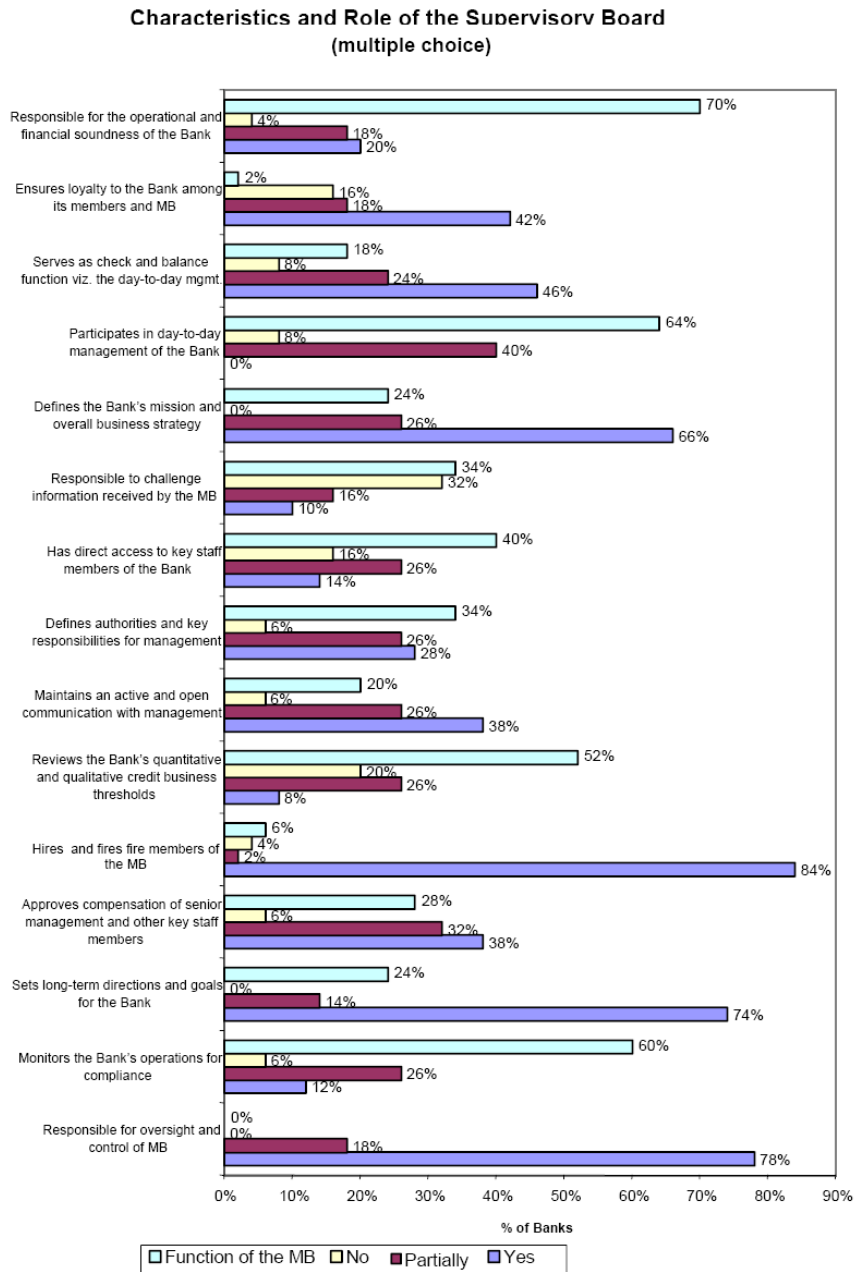


Fig. 5.6. Functions of the supervisory board

Source: IFC Corporate Governance in Russia project, report 2004.

6

INDEPENDENCE OF DIRECTORS

An independent director concept

As many theorists and practitioners wrongly think that an independence of directors is an attribute only of the Anglo-Saxon unitary board practices, we introduce another conclusion. Thus, supervisory board in Ukraine consists only of non-executive directors. But it does not mean that they all are independent. Regrettably, only their non-executive status is written in the law "On Enterprises", at the same time their independent status is not written elsewhere.

Importance of independence of members of supervisory boards in Ukraine is highly appreciated under the fight for corporate control that lasts during last five years among financial-industrial groups, foreign institutional shareholders and executives. Putting an independence criterion for assessing the board performance could contribute to an increase in efficiency of the minority shareholders protection, development of the corporate social responsibility concept, and an increase in the degree of accountability.

We referred to the Higgs report in defining the term “director independence”. The Higgs report states “that a non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement”.

Such relationships or circumstances would include where the director:

- Is a former employee of the company or group until five years after employment (or any other material connection has ended);
- Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder or director or senior employee of a body that has such a relationship with the company;
- Has received or receives additional remuneration from the company apart from a directors fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- Has close family ties with any of the company's advisers,

directors or senior employees;

- Holds cross directorships or has significant links with other directors through involvement in other companies or bodies;
- Represents a significant shareholder; or
- Has served on the board for more than ten years.

This list of the dependence criteria applied in UK and many developed countries could be discussed for Ukraine and economies in transition. Thus, the Russia practice of corporate governance narrates that the independent director should publicly declare his independent director status. This means that the director should take a part of minority shareholders and protect the principles of the corporate governance and announce about it to other participants of corporate governance. It should be a challenge thrown to the corporate governance principles violators. Such information should be written in the annual reports of the companies, noted in the company press-releases. All shareholders should know what director is independent and what director is not. Only in such case their independent status could give a push to such phenomenon as shareholder activism and minority shareholder consolidation. Regrettably, no Ukrainian company discloses the independent status of the members of supervisory boards. Annual reports are free of such information. Press-releases are over-filled with the sales and production achievements. No word about the independence of the supervisory board members.

The Russia practice of corporate governance introduces one more criterion of the director independence. Independent director should disseminate accurate information about the company and maximally facilitate to disseminate access to information by all shareholders of the company. It means the independent director should make a remarkable contribution to solving such acute problem of corporate governance as asymmetry of information. As a rule, the problem of asymmetry of information is acute at the most companies in Ukraine. Executives are very much concerned with manipulating information. From this point of view the member of supervisory board should do his utmost to maximize the information flow to the shareholders.

No priority of shareholders should exist. All shareholders are equal concerning their rights for the corporate information. In particular the independent directors in Ukraine could develop the best practices of the information transparency using the well-known mechanisms such as general shareholder meeting and works council meeting. It should note that the members of the supervisory board are not inclined to come to the works council meeting and share with the employee shareholders the required corporate information. Moreover, at the shareholder meeting members of the supervisory board are rather silent than active in their

intentions to make something clear to all shareholders presenting at the meeting.

Generally, members of supervisory boards at Ukrainian joint stock companies are not independent. Some of them own huge share of equity of the companies. As some theorists say that managerial ownership increases a managerial loyalty to the company and it could be an excellent exchange for independence of directors, the Ukraine's practices differ from that point of view remarkably. Members of the supervisory boards of Ukrainian companies face a conflict of interests as soon as they become owners of the company where they are employed. Loyalty is destroyed by the ownership rights and turned to a separatist behavior, well-known in the corporate theory as opportunistic behavior.

The most popular evidence of dependence of members of supervisory boards in Ukraine is that directors have strong relationships or even ownership at supplying or buying firms. Very often, members of the supervisory boards take a place on executive boards of various companies, even suppliers or customers. About 59 percent of directors under research follow practices, mentioned above. Some directors are relatives of large shareholders. As a result, only 8 percent of directors in Ukraine are independent. It is worth of mentioning that about 42 percent of Ukrainian joint stock companies under research have no independent directors on their supervisory boards at all. About 31 percent of researched Ukrainian companies have not more than one independent director on the board.

Corporate control contest and the director independence

As it was mentioned before, there is a very negative factor hampering the development of the independent criteria in Ukraine. This is the fight for corporate control. As a rule, large shareholders disbalance the shareholder interests in the favor of their own interests. The best way is to have their own representatives on the supervisory board. Under such circumstances it is waste to hope for an independent behavior, i.e. decision making. Only 2 per cent of members of the supervisory boards of companies, controlled by Ukrainian FIGs are absolutely independent. If a director does not represent interests of a FIG, he represents interests of other significant shareholder of the company where the FIG is a controller.

The lowest number of independent directors is on the boards at companies, controlled by Ukrainian financial-industrial groups and employees. Companies under control of FIGs have the lowest number of independent directors on the board because a controlling shareholder wants to have those persons on the board who would bring on the board contacts with suppliers, customers and the state authorities that will let

companies have more competitive advantages in comparison to their competitors through lobbying the company's interests outside. From this perspective, directors in Ukraine act as "emeritus" directors in Japan, who represent their companies in various professional associations, industrial unions, and so on, promoting the company's interests everywhere. As a result, these people are well known to outsiders, but insiders, represented by employees, do not know members of the supervisory board at all. Besides that, large owners of FIGs, i.e. controllers, want to maximize the information incomes and minimize the information outcomes about the activities of the companies, controlled by FIGs. From these perspectives, the members of supervisory boards are taken for "the secret keepers".

Companies, controlled by employees have on the supervisory boards the lowest number of independent directors because, as a rule, the boards are overfilled with their relatives or employees by themselves.

Besides this, employees are not well-performing explorers of the market for outside members of supervisory board. They have a lack of knowledge how to find well-performing directors outside of their companies. As a result, employees have nothing but electing insiders on the supervisory board. Therefore, hypothesis, saying that degree of independence of supervisory board is negatively correlated to the degree of concentration of corporate ownership and depends on origin of controlling shareholder, has been proved.

Table 6.1. *Ownership structure and number of independent directors on the supervisory boards of Ukrainian joint stock companies**

Years	Share of companies under control of ___ having at least one independent director, percent					
	Executive s	Ukrainian FIGs	Ukrainian investment companies	Ukrainian banks	Employ ees	Foreign investor s
1999	12	29	42	49	6	65
2003	17	38	100	88	14	100

* Independent director is a person who meets all seven criteria of independence suggested by Higgs

Very interesting conclusion could be done regarding the comparison of the Ukraine board practices and the worldwide ones. The best worldwide practices of the director independence require the board of directors to be composed at least a half the independent directors. This concerns the unitary board where some executives are represented surely, i.e. the President, CEO, CFO and COO. Thus, the supervisory boards in

Ukraine where no executive could be, could report even higher proportion of the independent directors. From this point of view, only 11 per cent of the supervisory boards at the Ukrainian joint-stock companies meet the requirement concerning a half of the independent directors on the board. The largest number of such boards is at the companies controlled by the foreign institutional shareholders and Ukrainian investment companies (34 and 31 per cent respectively). The lowest number of such boards is at the companies owned by executives, employees and Ukrainian banks (3, 4 and 7 per cent respectively).

By applying the higher independence standards, say the boards composed of the two third of independent directors we report sufficiently worse results. Thus, only 6 per cent of the supervisory boards at the joint-stock companies in Ukraine could meet the requirement that concerns a two third representation of the independent directors on the supervisory board. The largest number of such boards is still at the companies owned by the foreign institutional shareholders and Ukrainian investment companies (21 and 16 per cent respectively). The lowest number of such independent supervisory boards is also at the companies owned by executives, employees and Ukrainian banks (1, 3 and 6 per cent respectively).

The industrial feature of the director independence in Ukraine is a very weak from the point of view of the worldwide standards. It could suppose that the large companies of the most valuable industries for Ukraine, i.e. metallurgy and energy generating could follow the above director independence standards much more actively. Besides that such supposition could be take for valid because the large companies in Ukraine are those whose shares are listed at the stock exchanges. These companies should be more transparent and accountable than those companies which do not list their shares at the stock exchanges at all. Regrettably, the supposition has failed. Such companies, as JSC “Azovstal”, JSC “MMK Illitcha”, JSC “Zaporozhstal”, JSC “Ukrnafta”, JSC “Centrenergo” and others have no the common approach to the director independence. Despite that their sales are over USD1,000,000,000 their market value is over USD100,000,000 no company of the first level of listing at PFTS could demonstrate an outstanding performance in the director independence, i.e. the two third independent directors on the supervisory board.

It should note that the documentary background to apply the best corporate governance practices related to the director independence is still not developed in Ukraine. A worldwide practice of the director independence is based on the particular by-laws devoted to the independence of directors from the point of view of the proportion of the independent directors on the board, their rights and duties, their functions,

etc. No company of the list of the largest companies in Ukraine has a by-law particularly devoted to the independence of director policy at the company. Moreover, a generally accepted and approved by-law on the supervisory board has not the references to the director independence from the point of view of the independent director role, their special rights and duties, the required proportion of the independent directors on the supervisory board. Such kind of by-law has not any reference to the term “independent director” at all.

Very weak documentary essentials of the director independence in Ukraine are considered by various groups of shareholders in various ways. Thus, the most loyal to the adoption of the director independence by-law are the foreign institutional shareholders and Ukrainian investment companies (86 and 82 per cent of respondents respectively). At the same time the least loyal to an idea of the director independence by-law are such groups of shareholders as executive shareholders and employee shareholders. Only 8 per cent and 19 per cent respective groups of shareholders support the adoption of the director independence by-law at the companies they own. Probably, the loyalty of institutional shareholders to the adoption of the director independence by-law is explained by their quite advanced knowledge on the mechanisms of the director independence concept application.

These are very negative factors influencing an ability of the supervisory board to follow the best principles of corporate governance, i.e. balancing interests of shareholders, accountability, social responsibility and transparency.

We have decided not to make a point here and develop the topic of director independence further. Thus, at the end of 2004 we distributed a questionnaire among the directors of supervisory boards of Ukrainian companies and asked them to choose the most appropriate criteria for the director independence. The questionnaire contained all seven criteria suggested by Higgs.

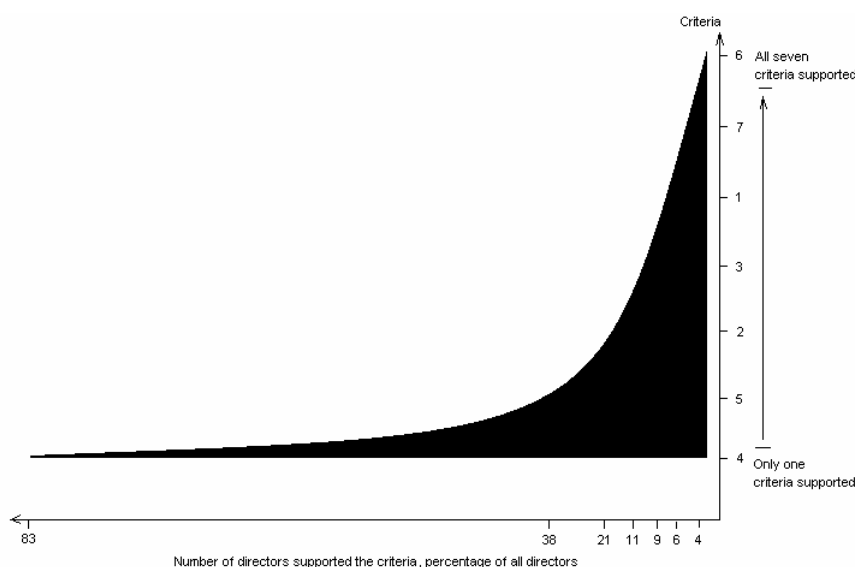
The Higgs criteria and its application in Ukraine

As a result of investigation we were very surprised to know that the degree of awareness of Ukrainian directors about the right criteria of the director independence is very low. Nobody was successful in writing all seven criteria. Only two directors marked six criteria of the board independence from the list suggested by Higgs. Eight directors (17 per cent of the directors participated in investigation) marked all seven criteria as wrong criteria of the director independence.

All 83 per cent of directors who marked at least one of the criteria suggested in the questionnaire were common in choosing that criterion.

They were sure that an independent director should not have close family ties with any of the company's advisers, directors or senior employees. So, personal relationships with the company's management are considered by Ukrainian directors as destroying independence of the supervisory board.

Moreover, directors of Ukrainian companies (38 per cent) are sure that the directors who hold cross directorships or have significant links with other directors through involvement in other companies or bodies can not be taken for independent too (see figure 6.1).



The director is not independent if he:

- 1 Is a former employee of the company or group until five years after employment (or any other material connection has ended);
- 2 Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder or director or senior employee of a body that has such a relationship with the company;
- 3 Has received or receives additional remuneration from the company apart from a directors fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- 4 Has close family ties with any of the company's advisers, directors or senior employees;
- 5 Holds cross directorships or has significant links with other directors through involvement in other companies or bodies;
- 6 Represents a significant shareholder; or
- 7 Has served on the board for more than ten years.

Fig. 6.1. *Distribution of the director independence criteria supported by directors of Ukrainian companies*

The most tragic fact is that only 4 per cent of directors think that the representing a significant shareholder on the supervisory board is a

criterion of dependence of directors. Under such circumstances we should suppose that the criteria of independence of directors concern rather relationships of directors with employees than shareholders. It is a very dangerous behavior of the directors. Taking into account that the degree of development of legislation on corporate governance in Ukraine is very low, and the legal protection of rights of minority shareholders is very low too, directors do not consider themselves as a mechanism to keep a balance of interests of shareholders, especially majority and minority shareholders. After having received the above mentioned results of investigation, we decided to find out the level of theoretical experience of directors in the field of the director independence. We were surprised by results we received. Thus, only 4 directors of 50, who participated in investigation, knew the recent work in this field developed by Cadbury, Higgs and Tyson. Two of them just heard about these reports, and the rest two were familiarized with the report contents.

Next, we wanted to know what the Ukrainian directors knew about the reasons of bankruptcy of Enron. We noted that 28 directors had a general look at the problem with Enron. Only 3 directors said that the main reason of the Enron bankruptcy was a destroyed system of the director independence criteria. We could suppose that such very low level of knowledge of Ukrainian directors on the international practices of the director independence could be explained by the lack of relative periodicals on this topic written in Ukrainian or Russian, or by the lack of time to write such kind of literature, but these are only suppositions because such kind of explanation is very naive and no more.

The members of supervisory boards in Ukraine have very low degree of the conceptual knowledge in the field of the director independence criteria. Only 8 per cent of members of supervisory boards of Ukrainian joint-stock companies are well aware of existence of the Higgs recommendations. 2 per cent of the respondents were successful in defining 5 of 7 criteria of the director independence suggested by Higgs in his recommendations. The rest 98 members of the supervisory boards in Ukraine could be taken for people who are not able to determine correctly if they are independent or not. Self-assessment is not accessible for them. The most interesting paradox here is that 42 per cent of members of the supervisory boards in Ukraine took themselves for the independent directors applying their own imagination of the director independence criteria. This finding makes the problem of the information vacuum very actual and requires the market participants playing more active role in the teaching the discipline named as “the director independence criteria and practices” to the members of the supervisory boards of Ukrainian companies.

Probably, the more convenient explanation of a relative ignorance by

the members of supervisory boards of Ukrainian companies toward the international board practices is a lack of strong public demand for development of the board practices based on the criterion of the director independence. Public interest to the issue of the director independence was born in the stream of the bankruptcy scandals in the USA and worldwide. Ukrainian board practices are not discovered well by the theorists and mass media. Bankruptcies of large companies are quite usual in Ukraine too, but the degree of transparency of bankruptcies is very low. Therefore, it is very difficult to hope for defining the role of weak independence of directors in the bankruptcies.

Supervisory board committees and the director independence

The presence of the independent directors on the key supervisory board committees is very weak. With reference to the Higgs criteria of the director independence we note the fact that only 34 per cent of the audit committees of the supervisory boards in Ukraine have at least one independent director. The audit committees of the rest supervisory boards have not the independent members at all. The most tragic conclusion is that no supervisory board in Ukraine has the audit committee composed exclusively of the independent directors. Therefore the international best practices of corporate governance concerning the director independence are failed in Ukraine. At the same time, members of the audit committees in Ukraine are much more optimistic about their so named “an independent status”. About 72 per cent of members of the audit committees take themselves for the independent directors. Herewith they applied their own criteria of the director independence. 80 per cent of the audit committee members are sure that the independence of the directors plays very important role in the smooth work of the audit committee. At last, the degree of the director concern about the importance of the director independence is much higher than the readiness of the directors to meet the basic criteria of independence.

The next very important committee from the point of view of the director independence criteria, compensation committee, does not follow the best international standards in corporate governance. Thus, only 26 per cent of supervisory boards in Ukraine have the independent directors on the compensation committee. Moreover no compensation committee in Ukraine has all its members as independent. What is that – a fact or a chance?

It is interesting to note that the members of the compensation committees in the Ukrainian joint-stock companies are not optimistic about their so named “an independent status” in comparison with their

colleagues taking the work at the audit committee. Only 32 per cent of members of the compensation committees take themselves for the independent directors. Herewith they, as the audit committee members applied their own criteria of the director independence. 42 per cent of the compensation committee members are sure that the independence of the directors plays very important role in the efficient work of the compensation committee. Shareholders in Ukraine have quite wide spectrum of opinions regarding the need for independent directors at the companies they own. Ukrainian financial-industrial groups are not sure if their companies need the independent members on the supervisory boards. 24 per cent of Ukrainian FIGs do not think that their companies need independent directors. 31 per cent of Ukrainian FIGs are skeptical about the presence of the independent members on the supervisory board. 34 per cent of Ukrainian FIGs are sure that their companies need independent directors on the supervisory board.

Employee shareholders have almost similar point of view on the issue of the independent directors. About 38 per cent of employee shareholders do not know the role of the independent directors at all. 35 per cent of employee shareholders are skeptical about the need for independent members of the supervisory board at their companies. Only 19 per cent of employee shareholders are sure that their companies need the independent directors. The most skeptical about the presence of the independent members on the supervisory boards of the Ukraine joint-stock companies are executives. 54 per cent of executives are resistant to the coming the independent directors on the supervisory boards of the company executives own.

The most optimistic about the role of the independent directors on the supervisory boards in Ukraine are foreign institutional shareholders, Ukrainian investment companies and Ukrainian minority outside shareholders as usual individuals. 84 per cent of foreign institutional shareholders, 78 per cent of Ukrainian investment companies and 75 per cent of Ukrainian minority outside shareholders are sure about the need for the independent members of the supervisory boards at the companies they own. As for their skepticism only 3 per cent of foreign institutional shareholders, 7 per cent of Ukrainian investment companies and 9 per cent of Ukrainian minority outside shareholders are skeptical about the need for the independent members of the supervisory board at their companies.

In Ukraine there is still no a widely accepted point of view what committees of the supervisory boards require more strict standards for its members' independence. The international practices narrate that the audit, executive compensation and internal (corporate) control committees should ask for the independence criteria more strictly than

other committees. Only 14 per cent of Ukrainian shareholders think that all those three committees should mostly require the director independence. 28 per cent of shareholders are sure that the director independence is a very vital factor of success for such committees as audit and executive compensation. 34 per cent of respondents find reasonable to think that the audit committee needs the director independence much more than other committees. Therefore, it is possible to conclude that the Ukrainian shareholders are far behind their colleagues from developed and most developing countries regarding the problem of realizing importance of the director independence for the effective board design.

Exhibits

Exhibit 1. Board of directors' independence in Australia

The following section provides descriptive statistics on the composition and independence of the Board of Directors, audit committee, remuneration committee, and the nomination committee.

	BOARD OF DIRECTORS		AUDIT COMMITTEE		REMUNERATION COMMITTEE		NOMINATION COMMITTEE	
	(NO)	(%)	(NO)	(%)	(NO)	(%)	(NO)	(%)
Board / committee exists	250	(100.0%)	239	(95.6%)	195	(78.0%)	77	(30.8%)
Number of members								
<i>Average (mean)</i>	6.88		3.36		3.42		3.64	
<i>Minimum</i>	3		2		1		2	
<i>Maximum</i>	17		7		11		9	
Average (mean) number of independent members	3.61	(52.4%)	2.11	(62.8%)	2.30	(67.3%)	2.65	(72.8%)
Independent chairperson	133	(53.2%)	175	(73.2%)	148	(75.9%)	54	(70.1%)
Level of independence								
<i>All members independent</i>	2	(0.8%)	66	(27.6%)	59	(30.3%)	22	(28.6%)
<i>Majority independent members</i>	117	(46.8%)	79	(33.1%)	72	(36.9%)	34	(44.2%)
<i>Some independent members</i>	117	(46.8%)	72	(30.1%)	50	(25.6%)	18	(23.3%)
<i>No independent members</i>	14	(5.6%)	22	(9.2%)	14	(7.2%)	3	(3.9%)
Total	250	100.0%	239	100.0%	195	100.0%	77	100.0%

Source: Horwath Corporate Governance Report, 2002

Evident from table below the average (mean) board size was 6.88 with a range in size from three to 17. It was noteworthy that the average number of

independent members on a board was 3.61. This comprises approximately 52.4% of the average size board. It was encouraging that 133 of the 250 companies (53.2%) had an independent chairperson. However there was some concern about the independence levels of the boards. Less than half of the boards (119, 47.6%) had a majority of independent directors. It was also of concern that 14 companies (5.6%) had a Board of Directors that did not contain a single independent member.

Exhibit 2. Director independence in the French speaking Europe

Belgium. The independence and diversity of Belgian boards has also improved. Nonexecutive directors now make up 39% of the board (24% in 2001), compared with the European benchmark of about 50%. However, the high proportions on boards of current and former executive directors (18%) and shareholder representatives (41%) indicate that Belgium still has much to do.

France. We record some changes in the composition of boards over the past two years. Shareholders' representation has decreased by 7%; and the proportion of independent non-executive directors is up, from 36% (2001 survey) to 40%. However, executives and directors linked to the group have both increased slightly. Nevertheless, the proportion of independent non-executive directors on French boards remains substantially lower than the European norm of 48%.

Exhibit 3. Director independence in Hong Kong and Singapore

The survey was conducted by JLT and Policy 21 in 2004 on a random sample of 514 publicly listed companies in Hong Kong. A total of 256 companies have been successfully enumerated and returned the questionnaires, representing a response rate of 50%. The majority of respondents considered that the independent directors should be independent of both major shareholders (93%) and the management (81%). And more than half considered that:

- There should be a limit on the number of non-executive directorships held by any person;
- The Code of Corporate Governance should contain different guidelines for companies of different sizes;
- The audit committee should consist entirely of independent directors; and
- The Chairman of the Board should not also be the CEO.

On the other hand, less than half agreed that:

- The remuneration committee should consist entirely of independent directors;
- The nominating committee should consist entirely of independent directors;
- The majority of directors on the board should be independent directors;
- The Chairman of the Board should be an independent director.

The major differences between the respondents in Hong Kong and Singapore include: the majority of directors on the board should be independent directors, (Hong Kong 25% Vs. Singapore 54%); the Chairman of the Board should be an independent director, (Hong Kong 16% Vs. Singapore 31%); and the nominating committee should consist entirely of independent directors (Hong Kong 36% Vs. Singapore 47%).

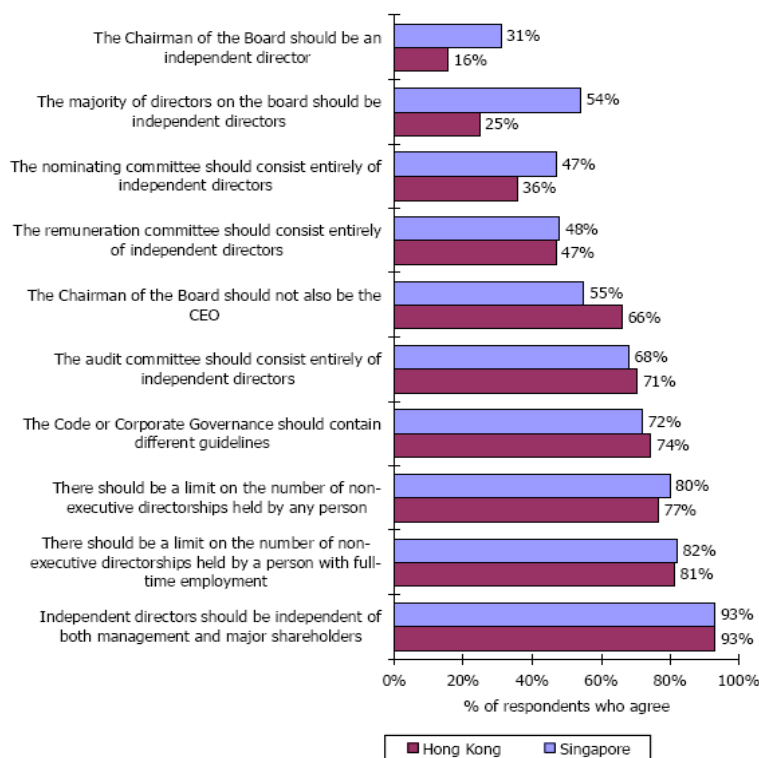


Fig. 6.2. Measures related to the board and independent directors

Source: The Corporate Governance and Financial Reporting Centre, the NUS Business School, National University of Singapore, report 2004.

Exhibit 4. Director independence practices in the USA

The Center for Effective Organizations (CEO) of the University of Southern California’s (USC) Marshall School of Business and Mercer Delta Consulting, LLC first joined forces in 2003 to conduct a national survey of corporate Directors in the largest U.S. corporations. They received responses from 221 Directors. Twelve percent (12%) of the respondents are CEOs/Chairs, 3% inside Directors, 72% outside Directors, 4% CEOs/Non-Chairs, 3% nonexecutive Chairs, 5% Lead Directors, and 2% other. The Directors served on an average of 2.5 Boards. Their analysis suggests the respondents come from approximately 200 of the 1,000 largest publicly traded companies in the United States. Directors who sit on more than one Board were asked to fill in the survey for the largest U.S. company on which they serve as Director. Results of the survey were compiled and analyzed jointly by Mercer Delta and USC. To simplify

presentation of the results, survey responses that fell in the category of 4 or 5 on a 5-point scale were interpreted as positive/favorable responses. These include responses of “4 = effective” and “5 = very effective” on the effectiveness scale and “4 = to a great extent” and “5 = to a very great extent” on the extent scale as illustrated below. Throughout this report, for each question that used a 5-point scale, “percent favorable” represents the total percentage of Directors who responded favorably to a particular question by choosing either a 4 or 5.

Director Independence

The survey results indicate that most Directors rate their Boards highly when asked to evaluate the extent to which their Boards are independent of management. The rating of 93% is slightly higher than the 2003 rating of 86%.

To what extent:	To a Very Small Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent	% Favorable (% of Directors who responded To a Great Extent/To a Very Great Extent)
Is the Board independent of management?.....	1%	2%	5%	28%	65%	93%

Board Leadership

There has been a dramatic growth in the number of Boards that have an independent Director who serves as Lead or Presiding Director. Seventy-five percent (75%) now have an independent Director who serves in this role, up significantly from 46% in 2003 and from 32% in 2001.

Please indicate whether the Board currently has the following practices:	YES		NO			
	Yes, has for more than a year	Yes, have adopted in the last year	Adoption is currently being considered	No, considered and decided not to adopt	No, never considered	No, had it and decided to eliminate
An independent Director who provides leadership to the Board (e.g., Lead Director, Presiding Director)	65%	10%	3%	10%	11%	1%

Exhibit 5. Independent director definition in Russia

The "Independent Director" definition was developed on the basis of recommendations of international financial institutions, major Russian and foreign investors and issuers, taking into consideration the Draft of the FCSM Code of Corporate Conduct and two year experience of IPA independent directors in the Russian companies' Boards of Directors.

"Independent Director":

1. is not financially or otherwise depending on the company's management, controlling (dominating) shareholders, large counterparts and competitors
2. is not a representative of the state
3. is not at the same time a member of the executive body
4. is not financially or otherwise depending on the company's affiliated persons (owners of 20%+ votes, members of the Board of Directors, auditor,...)
5. does not represent consultants, contracted by the company

6. has publicly declared his Independent Director status
7. receives the remuneration for his work at the Board of Directors only from the company
8. has necessary qualification
9. works faithfully in the BoD
10. has good reputation
11. disseminates accurate information about the company and maximally facilitate to disseminate access to information by all shareholders of the company
12. personal transactions of the director and his relatives with the company's shares (and other financial instruments) are transparent for the company and its shareholders
13. in case, if the Independent Director stops meeting the requirements of the Independent Director Status during his work at the Board of Directors, he immediately informs the company about this.
14. The Independent Director agrees to disseminate the information about material facts to shareholders upon their request, in case, if the company did not disseminate such information in a legally defined time period.

Note: Besides the above requirements it is obvious that Independent Director must comply with the current legislation when using information and making voting decisions.

Source: Corporate governance in Russia, www.corp-gov.org

There are some interesting findings from the Survey conducted by Independent Directors Association in collaboration with Investor Protection Association and Ernst & Young CIS Limited.

First of all, the most companies in Russia are concerned with the importance of the development the independent directors practices.

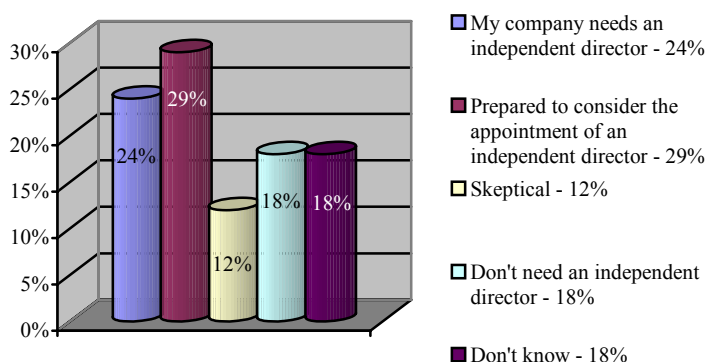


Fig. 6.3. Opinions of the Russian companies about the possible inclusion of an independent director in Board of Directors of your company

A majority of those surveyed (82%) stated that PR, shareholder and investor relations, programs to improve operational and financial management (71%), and

corporate strategy development (65%) should be vested with independent directors.

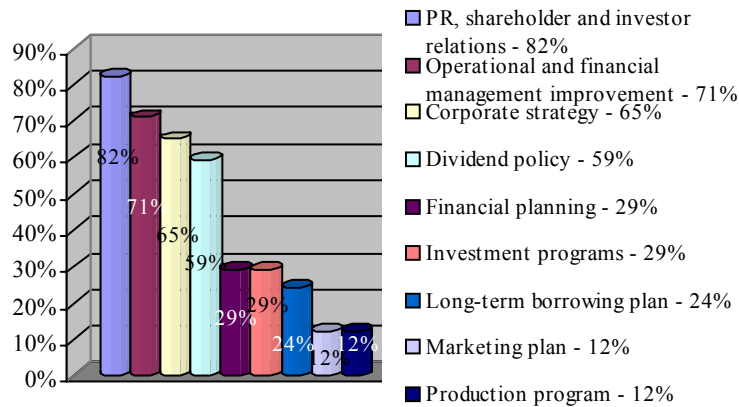


Fig. 6.4. Responsibilities of the independent directors in Russia

Those surveyed named the following as the most important qualities of an independent director:

- Management experience – 65%;
- A clean reputation - 53%;
- Board-room experience - 47%.

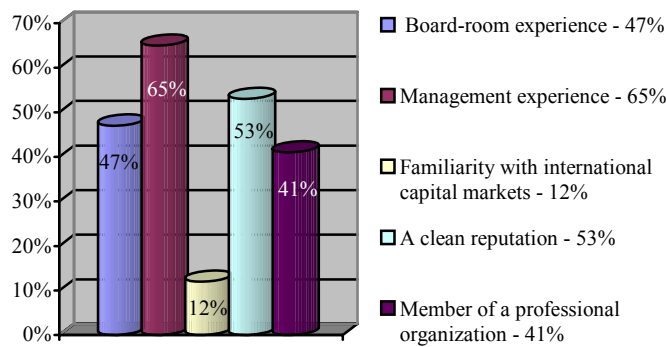


Fig. 6.5. The list of qualities of the independent directors in Russia

41% stated that an independent director should be a member of a professional organization, and 12% stated that an independent director should be familiar with the international capital markets.

82% of those surveyed stated that a Corporate Governance Code is the most effective instrument for regulating independent director activity.

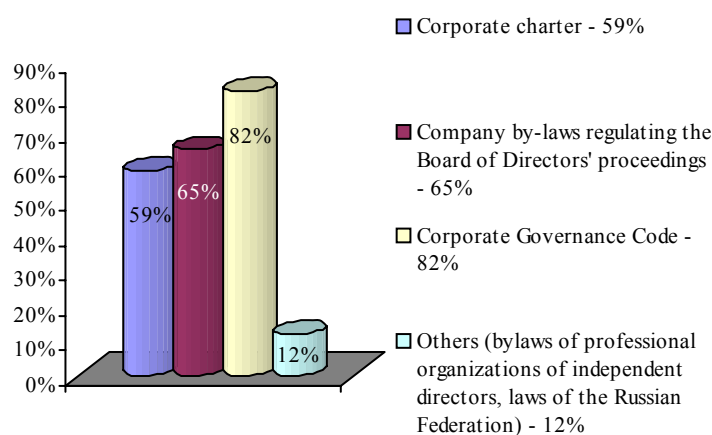


Fig. 6.6. Documents which regulate the activities of independent directors in Russia

Exhibit 6. Independent Directors in State Companies in Russia

Source: *Vedomosti* of December 22, 2004

It looks like fashion for independent directors has hit state-owned companies too. The Ministry for Economic Development proposes to replace a portion of state officials on boards of companies with government stakes with independent representatives. However, they will have to vote in accordance with directives anyway. Experts believe this is the case where independence is out of the question.

The Government holds 100% stakes in more than 160 joint stock companies, controlling stakes in more than 540 companies, blocking stakes in approximately 1,200 companies, and smaller stakes in 1,750 companies. The Government traditionally appoints state officials and managers of companies to boards of these companies. And from this year, on top of that, former state officials, who resigned due to administrative reform, are also appointed.

Election of independent directors as principal shareholders is still a rather new practice in Russia. Only a few companies and their shareholders have chosen to go for it. These include: YUKOS, Norilsk Nickel, Mechel Steel Group, Wimm-Bill-Dann, and NOVATEK. It looks like this fashion has hit state companies as well: this week the Ministry for Economic Development, according to a Ministry official, proposed to the Presidential Administration to elect individuals independent of the State to companies' boards. A number of Administration officials said that they had not received such letter from the Ministry for Economic Development.

“Seats on boards of directors in key companies are occupied by high ranking state officials with tight time schedules, so they not always have time to sort out problems of each company”, says an official from the Ministry for Economic Development. In his opinion, independent directors will cope with this work

better and enhance efficiency of boards.

Nonetheless, directors elected by the state-owned stakes will not be fully independent from the state anyway. According to the above official, it is proposed to make agreements with them on representation of the state interests and, regarding key issues, these individuals will have to vote in accordance with the government directives.

If the Kremlin agrees with such idea, several state-owned companies may have independent directors next year, notes the source of Vedomosti newspaper. The source did not specify, which companies exactly these will be, but the Ministry addressed various associations and groupings with the request to name persons ready to represent the government in 25 companies, including: RAO UES of Russia, Gazprom, Transneft, Rosneft, Svyazinvest, RZHD, Channel One, Aeroflot, Sheremetievo, Vneshtorgbank, ALROSA.

Eight organizations provided their lists (the majority of them sent copies to the Vedomosti newspaper), proposing in total around 100 candidates. In particular, the Association of Independent Directors recommends Yevgeny Yasin, Academic Supervisor at the Higher School of Economics, on the boards of Transneft and Svyazinvest, Lord Robert Skidelsky, a member of the House of Lords, – to the board of Channel One. The Russian Institute of Directors specified Igor Kostikov, a former chairman of the Federal Securities Commission, and Seppo Remes, a former member of the board at RAO UES of Russia and current board member in OMZ (United Machine Engineering Works) and Pskovenergo. The All-Russia Association of Privatized and Private Enterprises proposed Igor Ziuzin, the Chairman of the Board at Mechel Steel Group, and the Association for Protection of Investors' Rights (API) recommended Vadim Kleiner of Hermitage Capital Management on the board of Gazprom, Alexander Branis of Prosperity Capital Management and Oleg Fiodorov of UFG on the board of RAO UES of Russia, and Pavel Teplukhin, the President of Troika Dialog management company, on the board of Transneft.

Experts note that directive voting emasculates the Ministry's good idea. "The whole idea will lose its meaning, if directives will have to be abided by," unanimously stated Mr. Kleiner and Oleg Roumyantsev, an API representative. "An independent director should vote at his own discretion based solely on economic practicality", explains Mr. Kleiner, while Mr. Roumyantsev states that directive voting does not comply with the Corporate Conduct Code approved by the Government. And one of the candidates from the above list promises to refuse representing the state, if offered to vote by directives. "What matters is not the voting itself, but having an opportunity to influence the decision making process", demurs Mr. Remes, "I know that I'll have to vote by directives, this is not the best option, but it's acceptable"

Exhibit 7. Induction and professional development of the UK directors (Higgs recommendations)

A comprehensive induction programme should be provided to new nonexecutive directors (paragraph 11.1) and is the responsibility of the chairman, supported by the company secretary (paragraph 11.4).

Every company should develop its own comprehensive, formal induction programme that is tailored to the needs of the company and individual directors. The following guidelines might form the core of an induction programme.

As a general rule, a combination of selected written information together with presentations and activities such as meetings and site visits will help to give a new appointee a balanced and real-life overview of the company.

Care should be taken not to overload the new director with too much information. The new director should be provided with a list of all the induction information that is being made available to them so that they may call up items if required before otherwise provided.

The induction process should:

1. Build an understanding of the nature of the company, its business and the markets in which it operates. For example, induction should cover:

- the company's products or services,
- group structure / subsidiaries /joint ventures,
- the company's constitution, board procedures and matters reserved for the board,
- summary details of the company's principal assets, liabilities, significant contracts and major competitors,
- the company's major risks and risk management strategy,
- key performance indicators, and
- regulatory constraints.

2. Build a link with the company's people including:

- meetings with senior management,
- visits to company sites other than the headquarters, to learn about production or services and meet employees in an informal setting.

It is important, not only for the board to get to know the new non-executive director, but also for the non-executive director to build a profile with employees below board level, and participating in board strategy development. 'Awaydays' enable a new non-executive director to begin to build working relationships away from the formal setting of the boardroom.

3. Build an understanding of the company's main relationships, including meeting with the auditors and developing a knowledge of in particular:

- who are the major customers,
- who are the major suppliers, and
- who are the major shareholders and what is the shareholder relations policy – participation in meetings with shareholders can help give a first hand feel as well as letting shareholders know who the non-executive directors are.

On appointment, or during the weeks immediately following, a new director should be provided with certain basic information to help ensure their early effective contribution to the company.

7

DIRECTOR REMUNERATION

Remuneration of members of the supervisory boards in Ukrainian joint-stock companies is the most controversial issue of the corporate board practices. Despite the firm belief of the shareholders that the director remuneration is one of the most important factors influencing the board performance, there are still many companies (21 per cent) where directors are not remunerated for their work on the supervisory board.

The situation with the remuneration of the directors in Ukraine is coming to the turning point. Thus, there is a strong trend toward the point of view that the outside directors should be remunerated certainly. There are only 3 per cent of outside directors on the supervisory boards of Ukrainian companies who are not remunerated for their work. At the same time the situation around the inside directors is not clear. There are still many inside directors (23 per cent) who are not rewarded for their work on the board at all. Despite those factors that could be negative describers of the director compensation practices in Ukraine there are certain director remuneration practices that could be freely and reliably described. These are:

- size of the remuneration;
- structure of the remuneration;
- frequency of payments;
- assessment of the director performance.

Size of the director remuneration

Size of the director remuneration in the Ukrainian joint stock companies is USD480 a year. This is an equivalent to the salary of the CEO (head of the management board of the same company) for 10 days of working at the company. Generally said, relation between annual remuneration of the supervisory board director and CEO in Ukraine is 1 to 34 (1/34). Germany provides absolutely other numbers – 1 to 15. The US companies generate slightly higher than German ones – 1 to 21. This could evidence in the favor of the undervalued role of the supervisory board and lack of the well-justified approaches to the director remuneration in Ukraine. Size of the director remuneration depends on *the size of a company*. Thus, larger companies pay more to the directors. Thus, the average remuneration to the director at the company with

annual revenues over USD100 mln. is USD890. At the same time, the average director remuneration at the company with annual revenues below USD10 mln. is USD370. As a rule, large companies pay to their directors more than smaller ones because they are controlled by large shareholders who are inclined to pay more to their representatives on the supervisory board. The next factor influencing the size of the director remuneration is *the company performance*. The highly performing companies (profitability is over 20 per cent a year) pay more to their directors than those companies which perform not so well. At the same time it should underline the following fact. There are no highly performing companies where the director remuneration is low, i.e. all highly performing companies pay much to their directors. Although, there are low performing companies which pay to their directors much too. Thus, there are 18 per cent low performing companies where the size of the director remuneration is over USD890, i.e. higher the average remuneration at the large, highly performing companies. This is explained by the lack of monitoring by the shareholders over the process of the director remuneration setting and the subjunctive assessment of the director performance by the directors themselves.

There is a dependence of the size of the director remuneration on *the industry* where a company operates. Slightly higher remuneration is at the companies representing metallurgy, oil refinery and energy generating industries. Explanation of such trend is the strong market performance of the companies of those industries. Those industries are export directed or they have a strategic importance for the state. That is why the size of such companies is high, and their market performance is high too.

Table 7.1. *Dynamic of the size of the director remuneration in Ukraine*

Type of companies	Size of the director remuneration in Ukraine, USD			
	1999	2001	2003	2005
Low sized	290	340	350	370
Medium sized	320	370	410	480
Large companies	360	490	640	890

Table 7.1. provides an excellent data on the dynamic of the size of the director remuneration in Ukrainian joint stock companies. The main conclusion to make here concerns the strengthening the segmentation of the size of the director remuneration on the size of the companies. Thus, at the end of 1999 the sizes of the director remuneration in Ukrainian companies were almost similar despite the size of the companies. During the last five years the situation changed remarkably. Large companies became to pay to their directors much larger amounts than their smaller

partners and competitors. This trend could be a positive factor for development of the market for directors. Only those companies which are ready to pay more to its directors will be run by the most efficient directors. Therefore, the role of the supervisory board in corporate governance in Ukraine should be improved.

Structure of the director remuneration

In Ukraine the structure and principles of development of the director remuneration plans differ from those, which are widely used abroad.

Ukrainian companies do not use shares in a form of compensation to members of the supervisory boards although stock options could provide a direct link between the director rewards and share-price appreciation, since the payouts from exercising options increase the wealth of directors with increases in stock price, i.e. market value of the company. Stock options are prohibited by legislation in Ukraine. Prohibition is applied to any form of the company's shares instruments, including long-term plans.

We distributed questionnaires among shareholders of Ukrainian companies to find out their point of view on the possible use of stock options. Those Ukrainian companies, under control of FIGs and other institutional investors would not use shares as an instrument of compensation system because it leads to spreading the structure of corporate ownership. In those companies, where controllers are employees, shares could not be used to motivate members of the supervisory board to perform more effectively because employees are not aware about opportunities of use of shares as an instrument of compensation system. Those companies under control of executives would not use shares to improve performance of the directors because executives do not want to loose various levers (proxies, ownership rights) as a result of the stock remuneration to directors.

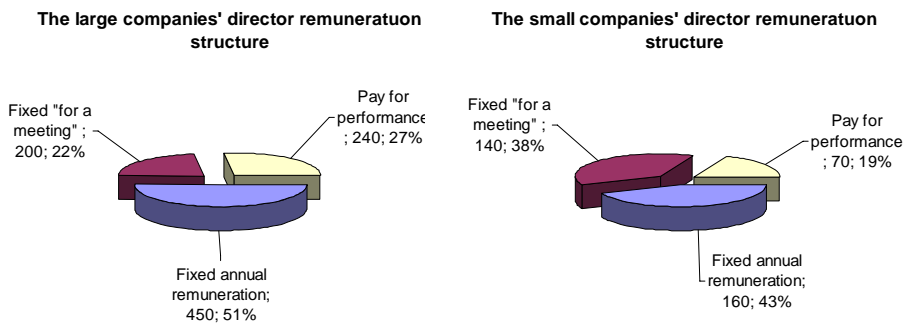


Fig. 7.1. The large and small companies' director remuneration structures

Structure of the director remuneration in Ukraine is under transformation. Despite the size of the company the largest share of the director remuneration belongs to the fixed annual remuneration (51 per cent and 43 per cent for large and small companies respectively). At the same time there is a strong dependence of the share of the pay for performance remuneration on *the size of the company*. The larger the size of the company, the larger share of the pay for performance remuneration in the total amount of the director remuneration. The large companies rely more on the pay for performance remuneration than on the fixed for a meeting remuneration in rewarding its directors.

Fixed annual remuneration is set accordingly to the standards applied in the industry and corrected to the size of the company and its performance. Fixed annual remuneration could not be changed during a year despite the number of the supervisory board meetings the member of the board attended and his contribution (performance) in the total work of the board. All board members receive an equal fixed annual remuneration. There are only 6 per cent of Ukrainian joint stock companies where the size of the fixed annual remuneration is tied to the professional qualification and work experience of the supervisory board members.

Fixed for a meeting remuneration is paid to the director with a reference to the number of the supervisory board meetings the director attended during a year. Size of the fixed for a meeting remuneration is set similarly to the standards applied for setting the fixed annual remuneration. Therefore, the companies pay more the fixed for a meeting remuneration if they are large, highly performing and represent metallurgy, oil refinery or energy generating industries. The share of Ukrainian joint stock companies where the size of the fixed for a meeting remuneration depends on the director qualification too is extremely low. Thus, at the end of 2005 there were only 2 per cent of such companies in Ukraine.

Pay for performance remuneration is paid to the directors accordingly to their contribution to the market performance of the company. Market performance measures, as a rule, are the dynamic of the profitability, dynamic of sales and size of the net income gained during a year. Regrettably the low number of Ukrainian joint stock companies uses the pay for performance remuneration to reward their directors. At the end of 2005 there were 18 per cent of companies which used the pay for performance remuneration. At the same time there is a positive dynamic in use of the pay for performance remuneration in Ukraine. Thus, at the end of 2000 there were only 4 per cent of companies which used that form of the director remuneration.

Shareholders of Ukrainian joint stock companies have a strong wish

to strengthen the role of the pay for performance remuneration in rewarding the directors. About 62 per cent of shareholders in Ukraine think that the pay for performance remuneration needs further development. At the same time only 14 per cent of shareholders were sure about the main criteria of development of the pay for performance remuneration, i.e. performance measures, performance standards¹, structure of the performance standards. These essentials for the application of the pay for performance remuneration are widely applied in developed and developing countries but Ukraine needs more time and efforts of shareholders to learn all these elements.

Performance measures. More than 80 per cent of those Ukrainian companies which reward its directors with pay for performance remuneration use a single performance measure in their remuneration plans, other companies use two or more measures. Only in fewer cases, the multiple measures are “additive” and can essentially be treated like separate plans. In other cases, the measures are multiplicative, in which the bonus paid on one performance measure might be increased or diminished depending on the realization of another measure.

There are no cases when bonus payments are determined by a “matrix” of performance measures. While companies use a variety of financial and non-financial performance measures, almost all companies rely on some measure of accounting profits. The Ukrainian practice of the director remuneration is still relying on a single performance measure.

Performance standards. Performance standards used for developing the director pay for performance remuneration have very narrowed application in Ukraine. The most popular is “budget” standard. Almost 92 per cent of Ukrainian companies use this standard. The most loyal to “budget” standard are employees, executives and financial-industrial groups as shareholders.

¹ “Budget” standards include plans based on performance measured against the company’s business plan or budget goals (such as a budgeted-net-earnings objective). “Prior-Year” standards include plans based on year-to-year growth or improvement (such as growth in sales or EPS, or improvement in operating profits). “Discretionary” standards include plans where the performance targets are set subjectively by the board of directors following a review of the company’s business plan, prior-year performance, budgeted performance, or a subjective evaluation of the difficulty in achieving budgeted performance. “Peer Group” standards include plans based on performance measured relative to other companies in the industry or market (often a self-selected group of peer companies). “Timeless Standards” include plans measuring performance relative to a fixed standard (such as an 10% return on assets, where the “10%” is constant across years, or moves in a predetermined way independent of actual performance). Finally, “Cost of Capital” refers to performance standards based on the company’s cost of capital (such as a plan based on economic value added, EVA).

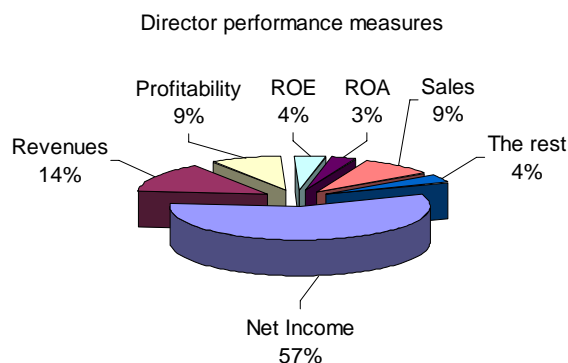


Fig. 7.2. Director performance measures used in Ukraine

“Prior-Year” standard is popular at companies under control of foreign institutional shareholders and Ukrainian banks. “Prior-Year” standard gives a smaller space for the management speculations with numbers and following their own interests than “budget” standard. Therefore, this gives a chance that the director performance will not be distorted by the management efforts.

“Peer Group” standard belongs to the external type of standards². Taking into account the fact that directors of the company have no any chance to manipulate with the performance numbers to receive more reward for themselves, “Peer Group” standard is the most appropriate to use at companies where the system of internal control is not developed enough to reward directors too. “Peer-Group” standard is more popular at companies under control of Ukrainian banks and foreign institutional shareholders.

Table 7.2. Share of the pay for performance director remuneration in the total director remuneration Ukraine

Forms of the director remuneration	Large companies		Small companies	
	2000	2005	2000	2005
Fixed annual remuneration	62 %	51 %	56 %	43 %
Fixed for a meeting remuneration	30 %	22 %	35 %	38 %
Pay for performance remuneration	8 %	27 %	9 %	19 %

² External type of standard relates to the standards which are based on the measures of external origins (performance measures of other companies).

There is a strong obstacle to use “Peer Group” standard in Ukraine. The name of this obstacle is a weak informational efficiency of the market. The Ministry of Statistics does not provide the market participants with the needful information on the industry performance. The more perspective situation in this way is in the banking where the National Bank of Ukraine has set a number of requirements to make banks disclose information about their performance. The rest industries, metallurgy and energy generating in particular, are far from the information transparency.

Despite the above mentioned problem in the development of the practice of the pay for performance director remuneration there is a growing interest of shareholders to this form of remuneration.

There is a very interesting trend to underline. Both large and small companies in Ukraine applied their efforts toward the strengthening the role of pay for performance director remuneration. In both cases the share of the fixed annual remuneration of directors decreased from 62 per cent (large companies) and 56 per cent (small companies) in 2000 to 51 per cent and 43 per cent in 2005 respectively. At the same time the share of the pay for performance director remuneration increased from 8 per cent (large companies) and 9 per cent (small companies) in 2000 to 27 per cent and 19 per cent in 2005 respectively.

Therefore it is reasonable to conclude that the size and structure of the director remuneration in the joint stock companies in Ukraine both depend on the size of companies. But the small companies are much more close to the large companies in the field of the structure of the director remuneration than in the field of the size of remuneration of directors.

Frequency of payments

Frequency of payments of remuneration to the directors in Ukraine is a remuneration item that unites companies of all possible sizes and market performance. The common practices are used by all companies.

Annual fixed remuneration is paid to directors monthly. Total amount of the annual fixed remuneration to be paid to a director is divided equally for 12 months. There are only 4 per cent of Ukrainian joint stock companies where the fixed annual remuneration is paid in advance at the total annual amount.

Fixed for a meeting remuneration is paid to directors in Ukraine just after the meeting of the supervisory board or at the beginning of the month following the month when the supervisory board meeting was held. At the second case the fixed for a meeting remuneration is paid together with the appropriate (monthly) amount of the fixed annual remuneration. The first practice of the fixed for a meeting remuneration

payment is applied by 84 per cent of Ukrainian companies. The second practice of the fixed for a meeting remuneration payment is used by 16 per cent of the joint stock companies in Ukraine.

Pay for performance remuneration is paid in one of two ways. The first way is used by 94 per cent of companies. According to that way the remuneration is paid to the directors at the end of the recent year or at the beginning of the next year. This depends on the efficiency of the company in preparing the required analytical reports to measure the director performance.

The second way of the pay for performance remuneration payment to the directors is used only by 6 per cent of joint stock companies in Ukraine. According to that way the remuneration is paid to the directors quarterly, i.e. at the end of the recent quarter or at the beginning of the next quarter. This way of remuneration payment is very difficult for application in Ukraine because this would ask for the strict standards in the financial reporting that is one of the most problematic aspects of corporate governance in Ukraine.

Frequency of the remuneration payments to the chairman of the supervisory board is similar to the practice applied to the ordinary members of the supervisory board at Ukrainian companies. Chairman of the board in Ukraine is paid at the end of the recent year or at the beginning of the next year if this remuneration concerns the pay for performance remuneration.

Annual fixed remuneration is paid to the chairman of the board, as a rule, monthly. Similarly to the ordinary members of the board total amount of the annual fixed remuneration to be paid to the chairman is divided equally for 12 months. There are only 5 per cent of the chairmen at Ukrainian joint stock companies where the fixed annual remuneration is paid in advance at the total annual amount.

The only practice that makes different the chairman from the ordinary directors relates to the fixed for meeting remuneration. Almost all chairmen in Ukraine are paid with the fixed for a meeting remuneration just after the meeting of the supervisory board. This practice is applied to 96 per cent of chairmen of the supervisory boards of the joint stock companies in Ukraine.

Assessment of the director performance

The Ukrainian joint stock companies have much to do in the way of approaching the procedure of assessment of the director performance to the international standards and best practices. Formal assessment of the director performance procedures are still not developed in Ukraine. Only 7 per cent of companies assess the director performance through a formal

performance appraisal system this is designed and applied within the supervisory board. At the same time there is a dependence of using the formal performance appraisal system on the size of the company. Thus, large companies use this approach to assess the director performance more actively than their smaller partners and competitors. There are 11 per cent of large companies which use that assessment procedure.

The most popular procedure for assessment of the director performance in Ukraine is through individual feedback from shareholders. There are 64 per cent of companies which use that procedure to evaluate the director performance. It should be noted that the higher the degree of ownership concentration the higher degree of application of that procedure by the company. Large shareholders are very active in assessing the director performance personally. There are 72 per cent of large companies which use personal approach to assessment the director performance.

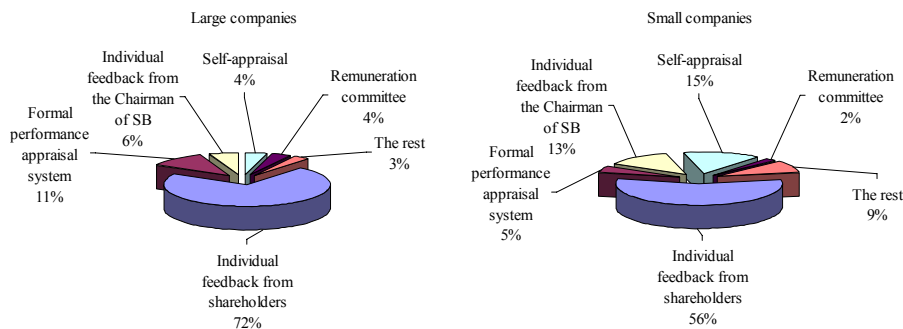


Fig. 7.3. Procedures for assessment the director performance in large and small companies

With reference to *fig. 3* it is reasonable to conclude that there are two different approaches used by large and small joint stock companies in Ukraine to assess the director performance.

The first approach, applied by large companies is built around the strong role of the large shareholder and formal procedures to assess the director performance. The role of the director self-assessment and assessment by the chairman of the supervisory board is weak.

The second approach, used by small joint stock companies is about the growing role of the self-assessment by the directors and assessment by the chairman of the board. The role of the director performance assessment by shareholders themselves is relatively weaker than for the large companies. Generally said the first approach to assess the director

performance is a root of the Continental model of corporate governance used in Germany and some other European countries. The role of large owners-controllers represented by banks is extremely important in assessing the director performance. The second approach is closer to the Anglo-Saxon model of corporate governance where the role of chairman of the board in assessing the director performance should increase. Probably, shareholders of small Ukrainian companies where the ownership structure is dispersed have no such control power, as in the case of the large companies, to have a preferable position in assessing the director performance. They will have to rely on chairman of the board.

These two approaches in the assessment of the director performance are the consequences of the privatization in Ukraine that is followed with the fight for corporate control, ignoring and violating the minority shareholder rights and low knowledge of individual minority shareholders on the best procedures in assessment of the director performance.

Exhibits

Exhibit 1. Remuneration and evaluation of the SB members in the Russian banking sector

It is notable that 42% of the banks do not compensate board members for their work. This may impact a member’s sense of obligation to the bank. Where board members do receive remuneration, it is mainly in the form of a fixed salary (38% of the banks). Other forms of remuneration, such as share options or profit participation, are not popular. Only 36% of the banks disclose the remuneration of their board members, and 10% plan to do so in the near future. Of those who disclose such information only one fifth disclose it on an individual basis. The preference is for the banks to disclosure the remuneration on a collective basis.

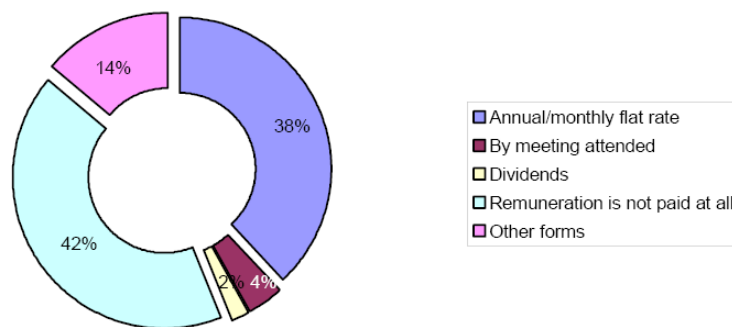


Fig. 7.4. Forms of remuneration paid to SB members in Russia

There is a clear lack of formal performance assessment procedures for SB members. Only 6% of the banks have a formalized process, while 58% of banks state this is done by individual feedback from shareholders. In 32% of cases, of the banks pointed out that evaluations are provided by the Chairman of the SB. More worryingly, one quarter of the banks pointed out that there is no need to implement a formal performance assessment process.

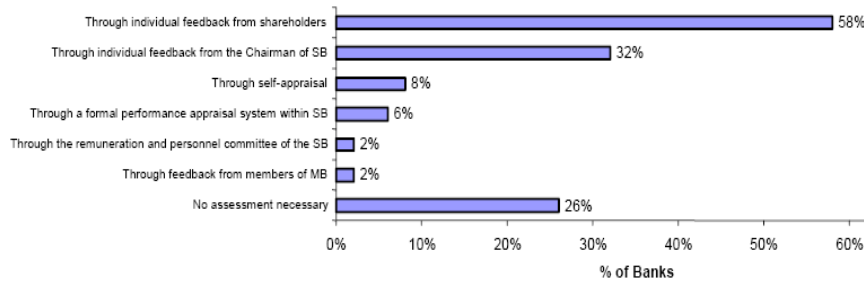
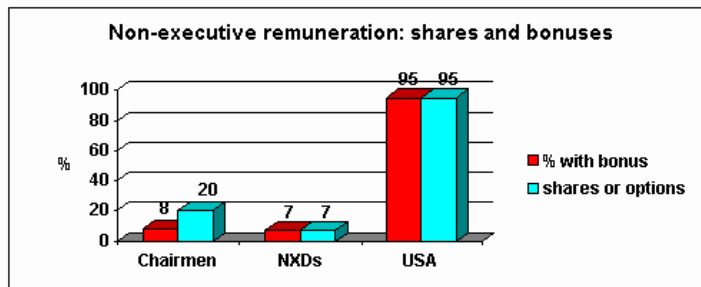


Fig. 7.5. Assessment of the SB members performance in Russia

Source: IFC Corporate Governance in Russia project, 2004.

Exhibit 2. Remuneration Within The UK IT Sector

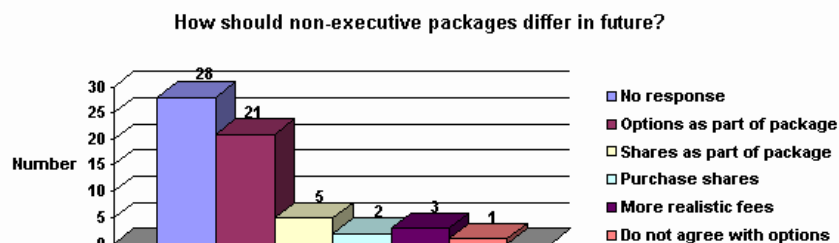
The survey by DTI was sent to over 250 directors, over a third of whom responded (81 responses). The came from 56 non-executive directors and 25 non-executive chairmen, covering 62 public and 19 private or unspecified companies. 47 respondents were in companies with a turnover of £1-50 million, 12 in £51-100m, 14 in £101-250m, 5 in £251-500m, and 2 in companies with a turnover above £500m.



Of the 81 non-executive directorships surveyed, only 11% currently receive shares or share options as part of their compensation, and only 7% receive any bonuses, 6% based on company performance. The overwhelming majority (93%) received no bonuses at all, and none received bonuses based on their own

specific performance. There was a noticeable difference between chairmen and directors in the question of share-based rewards: 20 % of chairmen receive these as contrasted with only 7% of directors. However there was no real difference with regard to bonuses – the figure was 8% and 7% respectively.

However, over half of the non-executives surveyed (59%) believed their package should include options and/or shares. This is driven by the feeling that non-executive fees are low for the expertise, time and responsibility involved. Shares or options provide a cost-effective means of increasing the remuneration so long as the company (with the non-executive’s help) performs well. Only 2% disagreed with giving options to non-executives.



Despite the absence of shares from the remuneration package, the survey revealed that 68% of respondents felt they were encouraged to hold shares in the company. If, as the survey shows, companies are actively encouraging share ownership amongst non-executive directors, pressure will mount on these companies to provide non-executives with beneficial means of acquiring shares. Whilst they can buy shares in the market for public companies, this is not possible with private companies.

It is interesting to note that a recent Pearl Meyer & Partners survey in the US showed that 95% of external (ie: non-executive) directors receive shares or share options in addition to fees. The US fee levels roughly match the level of fees paid in the UK (see Fee Levels below). Ten years ago only 25% of US external directors received shares or share options, so the increase to 95% is a dramatic and recent shift. It remains to be seen if the UK will follow suit, though many non-executive directors clearly feel that this would be justified as a fair return for their contribution.

Bonuses. The survey clearly shows that bonuses are a rarity; 93% of non-executive directors do not receive any form of bonus. The survey then asked what changes, if any, respondents would like to see to NED remuneration in future. There was no expressed desire to provide non-executive directors with cash bonuses – all of the comments were either for higher fee levels or share and share option schemes. Shares are felt to be a better way of aligning directors’ interests with those of the shareholders, providing a fair reward for non-executive influence where it is difficult to provide meaningful performance objectives for cash bonuses.

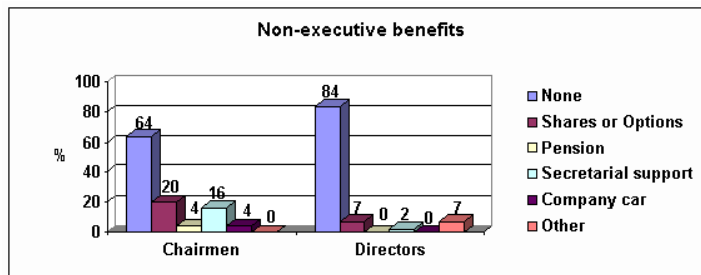
Fee Levels. The average level of fees in the 81 directorships was £25,476 for a time commitment of 29 days, with the average chairman’s fees being £44,520

for 47 days and the average non-executive director's fees being £16,974 for 21 days. This mirrors the average cash compensation for US IT non-executives of \$41,081 (approx. £25,516), although 95% of US non-executives also have stock based remuneration. There was a wide spread of fee levels, from £1,440 to £150,000 per annum, but these closely matched the time commitment spread (from 6 days to 160 per annum). The effective fee level per day was on average £976 (chairmen £1,064, directors £937), with a fairly tight spread. The maximum effective fee rate per day was just over £2,000. The following table looks at the fee element of non-executive director's remuneration. In the UK this is over 90% of the total value received:

	Chairman / NEDs	Median fee per annum	Range
Quoted	Chairman	£35,000	£15,000 to £150,000
	NEDs	£18,000	£1,500 to £30,000
Unquoted	Chairman	£24,000	£15,000 to £30,000
	NEDs	£12,000	£10,000 to £23,500

The method of payment of these fees was predominantly on a retainer basis (88%) with the balance of non-executive directors' fees paid for attendance at board meetings and other corporate committees.

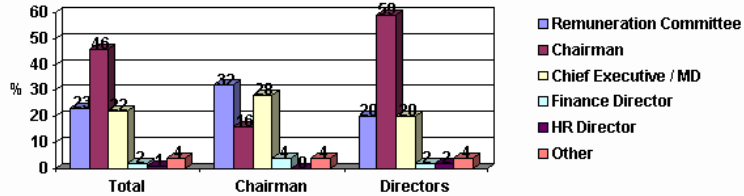
Benefits. Not surprisingly, considering the part time nature of the non-executive role, the vast majority (78%) do not receive any additional benefits such as pension, company car or other benefits typically included in the executive director's remuneration package. The breakdown of benefits received by non-executive directors is shown in the following chart. The most common extra benefit is secretarial support, mostly provided for chairmen as opposed to non-executive directors.



Who Sets the Remuneration Levels? Remuneration levels are of course agreed by the Board, but the survey asked who does the work to set the recommendation. Overall, in 23% of cases it is the Remuneration Committee, in

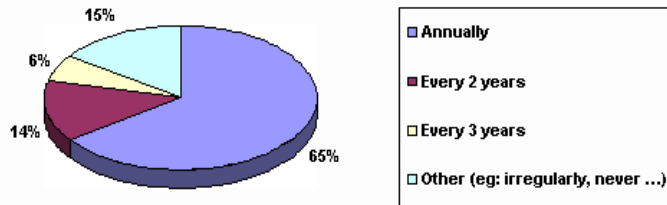
46% of cases it is the Chairman, 22% of the time it is the Chief Executive, 2% the FD, 1% the Human Resources Director and 4% of the time 'Other'. As would be expected, the overall breakdown is different when we look at the figures for chairmen vs non-executive directors: the Chairman takes the lead far more often in the case of setting fee levels for non-executive directors, and the remuneration committee/chief executive dominate in setting the chairmen's fees.

Who takes the lead in setting non-executive remuneration?



Most companies (65%) review non-executive fees on an annual basis, with 14% reviewed at 2 years, 6% at 3 years and the remainder 'irregularly', 'unspecified' or 'never'.

Frequency of review of non-executive fees



8

MEETINGS OF THE SUPERVISORY BOARD

Board meetings and type of controlling owner

It should note and take into account the dual structure of the boards in Ukraine, i.e. supervisory and management board and the process of the separation of ownership and control in Ukraine that still lasts as the result of privatization of the state property the supervisory board practices in the part of the board meetings are very unique and need a very thorough classifications before its investigating. Moreover, the legislation development in Ukraine is very weak from the point of view of the putting the various board practices in order. From this perspective we apply the following criteria to investigate the supervisory board meeting practices in Ukraine:

- Frequency of the meetings;
- The meeting duration;
- The meeting agenda;
- The meeting place;
- The meeting time;
- The meeting openness;
- Information.

Frequency of the meetings

Members of the supervisory boards at Ukrainian joint stock companies meet as a rule quarterly. It is required by charters of companies and the Enterprises Act. Regrettably, there is still no dependence of number of meetings on number of committees on the boards. Probably, committees on the board do not generate many ideas to discuss it at the meetings of the supervisory board. This is a strong evidence that committees on the board are still working not effectively and do not contribute to improve performance of the supervisory board in whole.

Supervisory boards at the companies, where corporate ownership is strongly concentrated, hold meetings less frequently than at those companies, where corporate ownership is dispersed. This is because controllers have a chance to have both the supervisory and management

boards under their control, allow only their representatives to be on the boards. Therefore, it is worth of underlining that under such situation the supervisory board has nothing to supervise. Their supervision is rather nominal than actual.

Generally, there is no dependence of frequency of the board meetings on type of controlling shareholder. Although, it is possible to conclude that slightly more frequent meetings of the boards are held at companies where ownership is concentrated in hands of executives and employees.

Table 8.1. *Ownership structure, size and frequency of meetings of the supervisory boards at Ukrainian joint stock companies*

Board practices	Companies controlled by					
	Executives	Ukrainian FIGs	Ukrainian investment companies	Ukrainian banks	Employees	Foreign investors
Size, persons	12-15	4-6	8-11	8-12	12-15	7-9
Frequency of meetings a year, cases	5-7	4-5	5-6	4-6	6-7	4-6

Besides corporate ownership concentration, frequency of supervisory boards meetings in Ukraine depends on two factors. These are struggle for corporate control and the degree of knowledge of minority shareholders on corporate governance.

The highest number of meetings of the supervisory board is at the companies where the struggle for control is still lasting. These are companies where there is a huge stake of the state. The supervisory board holds about 6-7 meetings a year. Moreover, in some cases violation of rights of minority shareholders is the factor which makes the board meet more frequently. This concerns situations when these minority shareholders are not numerous or represented by institutional investors, whose degree of knowledge on corporate governance is quite high. This does not concern companies where minority shareholders are employees or individual outside shareholders. Therefore there is strong evidence that frequency of board meetings is negatively correlated to the degree of concentration of corporate ownership and does not depend on origin of controlling shareholder.

The meeting duration

As a rule, meeting lasts not longer than 1 and half hour. The most usual duration of the meeting is 1 hour and 20 minutes. As a rule, an agenda of the meeting is written in the way to let the board members pay certain time to solve all questions of the agenda. There is only one factor strongly influencing the meeting duration. This is a presence of the committees on the supervisory board. As a rule, boards with the committees pay less time for meeting. It takes about 1 hour for such kind of the supervisory board to meet. Probably, the board committees allow the supervisory board in a whole save time for approving items of the agenda which are under responsibility of the supervisory board committees.

At the same time there are many case of extremely short and formal the supervisory board meetings. 98 per cent of the supervisory board members in Ukraine agreed that at least one board meeting a year was taken on the formal basis and took not more than 30 minutes. Formality is demonstrated through the rubber stamping the papers delivered at the board meeting by the secretary of the supervisory board. 54 per cent of the board members informed that at least half of the supervisory board meetings taken a year were formal and short.

Taking into account that the supervisory board committees are not developed in Ukraine such high degree of the supervisory board meeting formality sets a very serious danger to the company. 72 per cent of the supervisory board members are strongly concerned with the high degree of formality of the supervisory board meetings. Probably, the only efficient way out here is through developing the best practices of the supervisory board committees.

The next factor that does not let the supervisory board meetings avoid the formality invasion is the lack of the financial incentives for the supervisory board members. More than two third of the supervisory board members are not rewarded for the participation on the supervisory board. Financial incentives are not developed with an application to the supervisory boards in Ukraine. From this perspective the supervisory board members are not inclined to pay their time to contribute to the supervisory board work. Their time is not compensated!

Members of the supervisory boards in Ukraine are obliged to follow many procedures to make the supervisory board work. Society is waiting from them for their loyalty to the basic principles of corporate governance, i.e. accountability, social responsibility and transparency. Minority shareholders hope that the supervisory board members would be loyal to the balancing shareholder interests. There are many people who would wait for the outstanding results from the supervisory board

members. They do not want a rubber stamping supervisory board. At the same time, no efforts are made by these people to establish the appropriate conditions for the well-ordered and active work of the supervisory board. No incentives of the financial origin are set to hope for the effective, not formal work of the supervisory board.

It is interesting to find out the time spent by the members of the supervisory board in Ukraine to prepare to the meeting of the board. Preparation to the supervisory board meeting takes about 5 hours for a director. Taking into account that the frequency of meetings of the board is five a year the supervisory board member pays about 27 hours a year for preparation to the meetings. Let's remember that the total time of the supervisory meetings at a company is equal to 6,5 hours a year, the relationships between the preparation time and the meeting time is 4/1. The international practices of the supervisory board meetings differ from the point of view of the preparation and the meeting time. Thus, the France practices outline the relationship as 4,5/1, the Germany practices – 4,2/1, the Canada practices – 8,5/1, the USA practices – 9/1. Under the circumstances of the high degree of formality of the supervisory board meetings and low number of the supervisory board committees the Ukraine supervisory board performance is expected to be much worse than international practices evidence.

Table 8.2. *The international board practices: the preparation and meeting time of the supervisory boards**

Country	Number of meetings a year	Duration of a meeting, hours	The time spent by director to prepare to a meeting	Total time of the meeting preparation and holding	Relationship – preparation / meeting time	Position
USA	7	3,5	32	248,5	9/1	1
Canada	6,5	2,7	23,0	167	8,5/1	2
France	6,1	2	9	67	4,5/1	3
Italy	6,8	2,2	9,5	79,5	4,3/1	4
Germany	5,5	1,8	8,4	52	4,2/1	5
Ukraine	5,4	1,2	5	33,5	4/1	6

* data relate only to the single directorship members. Multi-directorships members could have other data.

From the point of view of the time spent by the members of the supervisory board in Ukraine it takes about a working week (36 hours) to fulfill all responsibilities related to the work on the supervisory board. If we relate the time spent by the supervisory board members to work (a week) from one side to the time spent by the members of the executive

board (52 weeks) and the executive remuneration (USD14.000 a year) from another side we give a birth to a new remuneration target for the supervisory board members. This is amount of USD270 a year. It is very low amount in comparison to the life expenses in Ukraine. This amount will be enough only to cover the food expenses during two and half month and nothing more.

That is why it is hardly possible to suppose that this could motivate the supervisory board members work effectively. But, this amount evidences about the very low contribution of the supervisory board members in the company directing and supervising from the point of view of such factor as the time spent to execute their responsibilities as the supervisory board members. Certainly the time of work should be increased remarkably. Probably, the time of preparation to the supervisory board meetings could be increased by developing the supervisory board committee practices which are still not developed in Ukraine. At the same time this will require the supervisory boards in Ukraine more knowledge how to organize the work of the board with participation of the committees.

Working on committees of the supervisory board requires much more time from the members of the board. Thus, the total preparation time to the meetings of the supervisory board during a year including the work time in committees is 46 hours in comparison to 27 hours for the members of the supervisory board without committees. Probably the work on the committees of the supervisory board requires its members a higher degree of responsibility, commitment and involvement in the board activity.

The meeting agenda

Agenda of the meeting is prepared by the secretary of the supervisory board. Taking into account that the members of supervisory boards are rare independent, secretary of the board experiences a strong pressure by the members of the board and even by large shareholders to include certain questions in the agenda.

Therefore, the Ukrainian practices of preparation of the agenda of the supervisory board meeting are like the timeless conflict i.e. there is a strong fight not only for the votes of the supervisory board members, but also for the initiative in preparing the agenda of the meeting. Thus, large shareholders, to be sure that their decisions will be approved, should keep to the following strategy. The first stage – control of the process of preparation of the supervisory board agenda. The second stage – fight for the votes of supervisory board members. The third stage – fight for votes of the required number of shareholders to see their proposal approved by

the general shareholder meeting.

Moreover there are many cases when the agenda of the supervisory board meeting is clarified or added with the new questions even at the supervisory meetings. About 18 per cent of companies have a practice of the final composing the agenda during the supervisory meeting. This is an excellent chance for manipulation with the votes and administrative pressure.

Besides that, questions of the agenda are very often change its order during the supervisory board meeting although the international board practices suggest that the agenda of the supervisory board meeting should be composed in a firm order before the meeting. That worse practice is applied by 59 per cent of joint-stock companies in Ukraine.

The contents of the agenda are generally around the control function. Supervisory board members in Ukraine have a practice of approving the reports at the meeting. These are reports concerning financial statements (annual report), reports of the audit commission, etc. All their efforts are constructed around approving, less discussing, and even less planning. Strategy, as a function of the supervisory board is performed not well, because the lack of motivation.

There is one more reason of such passive behaviour of the supervisory boards in Ukraine concerning the strategy developing and approving. As a rule, large shareholders have their representatives not only on the supervisory board. The same strong influence of large shareholders is at the management board too. Under such circumstances the management board grasps the strategy function in a whole. The real advisors to the management board are large shareholders. They are advisors to the supervisory board too. This situation is widespread in the companies with a concentrated ownership. Therefore, it is not a surprise to conclude that the agenda of the meeting of the supervisory boards of most Ukrainian companies is for “rubber stamping”.

The meeting place

Meetings of the supervisory boards in Ukraine, as a rule, are held in the offices of the companies. In the most cases there are no special rooms for meeting of the supervisory board. Every time, before meeting to be held, secretary of the supervisory board should care about finding the most appropriate room for the meeting of the board. The most popular practice is to have the meeting of supervisory boards in the room for meetings of the management board that is prepared for such kind of meetings as the best. Under such circumstances “a homeless status” of the supervisory board does not contribute to the development of the collaborative spirit of team working inside of the supervisory board. Only about 8 per cent of

companies in Ukraine provide a special room where only the meetings of supervisory board take place.

The issue of the supervisory board meeting place is not settled in the supervisory board by-laws. It is recommended throughout the world to include a note on the place of meeting of the supervisory board in the by-law. Regrettably, only 6 per cent of joint stock companies in Ukraine have a very clear and justified approach to the place of the meeting choice. This means that as a rule the corporate office is written in the supervisory board by-law as the most preferable place to have a meeting of the board.

The place of meeting is fixed by the head of the supervisory board. The secretary of the board is responsible for informing the supervisory board members about the place of meeting. As a rule, the head of the supervisory board does not consult with other members of the supervisory board what place of meeting to choose if the meeting is expected to be held in the office of the company. To fix another place of meeting of the board the head of the supervisory board is keen on discussing with the rest members of the board.

The meeting time

As a rule, meetings of the supervisory boards in Ukraine are held at the first half of the working day, i.e. between 9 a.m. and 1 p.m. Almost 75 per cent of Ukrainian companies have the above mentioned practice. There are 8 per cent of companies where meetings of the supervisory board are held when the working day is over, i.e. as a rule after 5 p.m. There is no a factor, besides the wishing of the members of supervisory board, which could influence a decision of supervisory board members when to have a meeting. Some supervisory board members are sure that having a meeting at the first half of the working day gives them an excellent opportunity to invite required persons to discuss some issues, i.e. members of the management board, members of the audit commission and workers of the company.

The meeting time is recommended by the head of the supervisory board. This recommendation is distributed by the supervisory board secretary among the rest members of the supervisory board. As a rule, there are not conflicts among the members of the supervisory board regarding the time of the meeting.

There are quite active discussions around the issue of the day of the meeting. Some members of the supervisory board who do not work as the full-time employees of the company require much more thorough approach to such an issue as the day of the meeting. They could be employed by other companies therefore they need to be very careful in

constructing the optimal timetable of the meeting of the supervisory board.

There are no any firm requirements written in the supervisory board by-law concerning the time and day of the meeting of the supervisory board. The companies “recommend” in by-law on the supervisory board when to have a meeting. There are 8 per cent of such companies. Most companies do not prefer indicating in the supervisory board by-law any recommendations on the time and day of the meeting. They write in the by-law that the chairman of the supervisory board is responsible for the choice of the most appropriate for the rest board members the time and day of the meeting.

The meeting openness

Supervisory boards in Ukraine, as usual are not opened for other visitors. Members of the supervisory boards are not inclined to invite at the board meeting representatives of employees, stakeholders from outside of the company, large shareholders, minority shareholders. The only visitors who are quite welcome are executives, i.e. members of the management board.

Probably this is an evidence of the situation when members of the supervisory boards are not inclined to keep to a balance of interests of all stakeholders, or even shareholders. They care only about a management monitoring. More than 90 per cent of companies in Ukraine experience a practice when management board members are invited at the meeting of the supervisory board. About 45 per cent of companies do it twice a year. Only 6 per cent of supervisory boards in Ukraine invited at their meetings representatives of employees, 3 per cent – minority shareholders.

From the documentary side of this issue only 6 per cent of joint-stock companies in Ukraine have the well-ordered mechanisms and approaches how to relate to the openness of the supervisory board meetings. These companies wrote these mechanisms and approaches in the supervisory board by-law.

The rest companies in Ukraine rely only on the wisdom of the chairman of the supervisory board who is responsible for making a decision on the category of visitors of the board meeting. At the same time if this issue is not regulated by the by-laws of the supervisory board this gives an excellent chance for the chairman of supervisory board to speculate with his power in the favour of those groups of shareholder, these are mainly large institutional shareholders, he represent as the board member.

Information

Information that should be released at the supervisory board meeting is analyzed by respective functional departments of the company, delivered to the secretary and the head of supervisory board. Secretary of the board is responsible for sorting all information supplied. The secretary of the board prepares a kit of reports. These kits are delivered to the members of supervisory boards before the meeting, including the agenda.

Regrettably, only 24 per cent of members of supervisory boards of Ukrainian companies are satisfied with the quality, content and volume of the information supplied to them before the meetings of supervisory board. 18 per cent of members of supervisory boards receive only an agenda before the meeting of the board. The rest information on the company activity is supplied during the meeting. This makes the work of the supervisory board when meeting less efficient.

The policy of the information disclosure to the members of the supervisory boards in Ukraine is far from the internationally accepted standards.

First of all, reports are developed not systematically. This does not give the supervisory members a chance to keep a hand on the pulse of the company market position. For the second, there is a very sufficient lag in the report developing. Quarter reports on financial performance on the company are prepared by the end of the next quarter. This does not let the supervisory board members have enough time to analyze the financial quarterly reports in the shortest time and in the most efficient way. For the third, reports delivered to the supervisory board members do not meet the financial disclosure standards accepted internationally. As a rule, reports are overfilled with the numerous numbers on the production and sales performance of the company. At the same time the financial information is almost absent in the reports. For example, it is almost impossible for the supervisory board members to find out the ways and efficiency of the cash flows management, i.e. ways of its application and period of its return.

Exhibits

Exhibit 1. *Under transition to the German corporate governance model*

We need to reject a generally accepted point of view that the Ukraine board practices related to the board meeting frequency are the part of the Continental model. From the point of view of international comparison of the supervisory board practices with an application to the meetings of the board, the Ukraine practices are close only to those, popular in the German speaking countries, i.e.

Germany and Switzerland (see fig. 1). As a rule, supervisory boards in Germany and Switzerland take 5-6 meetings a year. The same number of meetings is encountered by the supervisory boards in Ukraine. Probably, this is a reason to note that the Ukraine supervisory board practices such as committees of the board, independent directors are close to those, undertaken in Germany and Switzerland.

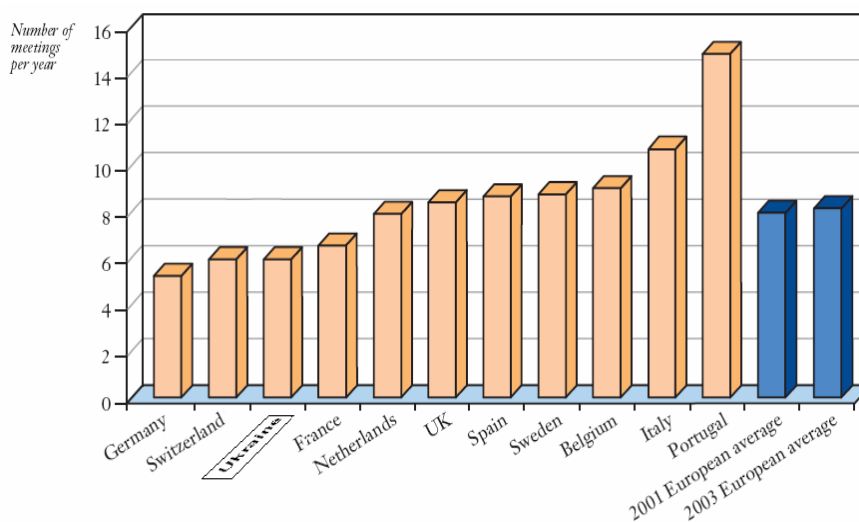


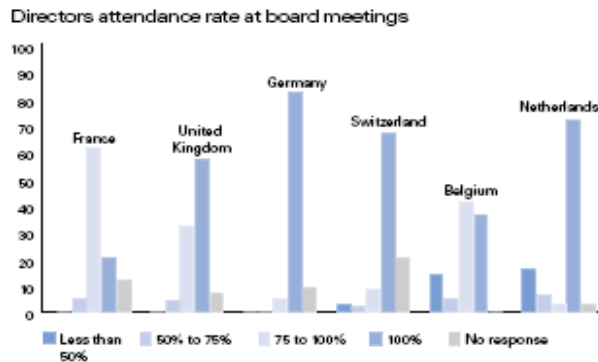
Fig. 8.1. International comparison of number of meetings of supervisory board

In the Heidrick & Struggles Europe-wide survey, some of the findings regarding German companies are explained by the country’s legal structure: for example, the relative infrequency of board meetings. The day-to-day management of the board is usually delegated principally to the chairman, who is responsible for addressing critical issues before they are discussed and approved in the board meeting.

The entire board therefore plays a more formal role, and is not involved at all in the company’s operations. Accordingly, four to five board meetings a year is usually regarded as sufficient. Furthermore, it would be hard from the logistical point of view to assemble very large boards more often, and difficult to ensure confidentiality in plenary meetings. Thus, there tend to be more frequent gatherings of small groups of board members, where strategic issues can be discussed. Wherever possible directors should participate in board meetings. Absence does not exonerate a director from liability.

Swiss boards appear to be marginally better attended than their United Kingdom counterparts which is perhaps expected as United Kingdom boards meet much more frequently. Paradoxically, French boards (which are predominately unitary in nature) are surprisingly poorly attended even though they meet relatively infrequently. This may in part be explained by the fact that a large number of French directors serve on multiple boards though this phenomenon is not entirely unique to France. It should be noted that both the

Viénot II and AFG recommendations suggest that annual reports include disclosure of the number of board meetings during the year and the attendance record.

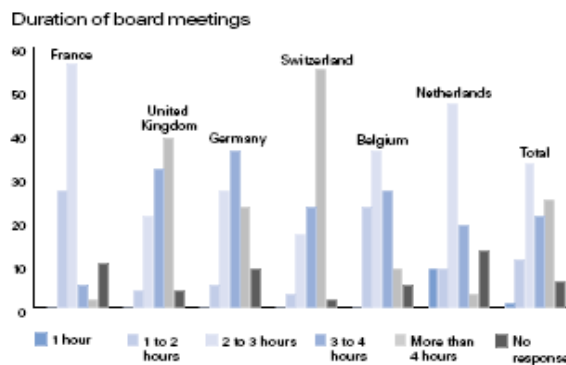


Source: Corporate Governance in Europe, KPMG Survey 2001-2002

Turning to two-tier boards, the attendance rate is very high in Germany, where 82% of supervisory board meetings are attended by all members. Such high attendance rates may in part be explained by the fact that there are relatively few supervisory board meetings in Germany. Also, it should be noted that attendance is encouraged by the Corporate Governance Rules for German Quoted Companies which recommend that annual reports include details of members who have participated in fewer than half of the supervisory board meetings.

Dutch companies also operate a two-tier board system, but attendance at supervisory board meetings is not as high as that in Germany. Perhaps this is to be expected as supervisory boards meet more frequently in the Netherlands.

Reminiscent of the Corporate Governance Rules for German Quoted Companies, the Peters report recommends that individual members of the supervisory board should be called to account for frequent non-attendance.



Source: Corporate Governance in Europe, KPMG Survey 2001-2002

The average duration of board meetings (supervisory board meetings where applicable) by country is shown below.

It can be seen that board meetings in the United Kingdom and Switzerland are generally longer than board meetings elsewhere. For supervisory boards, the duration of meetings in Germany tends to be longer than those in the Netherlands.

Exhibit 3. Working methods of the supervisory boards in the banking industry in Russia

Corporate governance best practices foresee regular meetings with well-documented and informed board members who have direct access to senior management for additional information as required and do not shy away from seeking outside advice if deemed necessary. Board committees focusing on special issues add much to the overall work effectiveness of the SB. An audit committee overseeing the bank's internal and external auditors and addressing control weaknesses, non-compliance issues and other problems identified by the auditors in a timely fashion is considered to be an absolute minimum. A nomination committee, a committee for remuneration and a risk management committee are additional, useful specialized bodies of the Supervisory Board. The survey reveals that the SB meets on average 9 times over the course of a year, with an average attendance rate of 88%. This is in line with the international best practices.

Only 26% of banks consider the role of the SB to challenge the information received from the Management Board and 42% do not grant SB members direct access to key staff members of the bank. As already noted, 82% of the SBs have the right to hire external consultants for advice, but only 8% have a separate budget for this. It is positive to note though, that more than half of the banks report that their SB maintains active and open communication with top management.

Exhibit 4. The Pricewaterhousecoopers report highlights

During May and June 2004, *Corporate Board Member* magazine conducted the annual What Directors Think study (the USA boards). Ten thousand studies were sent by mail to the directors of the top 2000 publicly traded companies. A 12.8% response rate was achieved with 1279 questionnaires returned.

I. About your board and its meetings

1. Typically, how long are your full board meetings? N=843

2 hours or less 38 / 4%

3 – 4 hours 302 / 36%

5 – 6 hours 318 / 38%

7 – 8 hours 118 / 14%

9 – 10 hours 34 / 4%

More than 10 hours 33 / 4%

2. How many hours per month do you estimate that you spend on board matters

for this company, including review and preparation time, meeting attendance, and travel?

(Mean, Median, Mode, Range, N) 19 / 15 / 10 / 1-300 / 1239 - hours

3. How has the recent board governance reform changed the frequency of your full board meetings? N=841

Increased	Stayed the same	Decreased
248 / 29%	590 / 70%	3 / 1%

Number of full board meetings per year (Mean, Median, Mode, Range, N)

6 / 5 / 4 / 1 – 24 / 430

4. How would you rate the amount of information you receive to prepare for board meetings?

N= 1272

I receive more Information than is Necessary to properly Prepare for meetings.

175 / 14%

I receive the appropriate amount of information necessary to properly prepare for meetings.

1040 / 82%

I do not receive all the information necessary to properly prepare for meetings.

57 / 4%

5. If your chairman is also the CEO, have you appointed a lead, outside director who will preside at executive sessions and assist in setting board agendas? N= 814

Yes 439 / 54% No 145 / 18% N/A Chair is not CEO 230 / 28%

NOTE: removing those respondents whose Chairman is not the CEO – N= 584

Yes 439 / 75% No 145 / 25%

6. How often does your board hold executive sessions during board meetings without the CEO?

N= 840

Yearly - 35 / 4%

Quarterly - 434 / 52%

Monthly - 43 / 5%

Never - 15 / 2%

Other - 313 / 37%

Other:

2 times – 36

5 times – 12

6 times – 25

every board mtg – 202 / 24%

Exhibit 5. *The Mercer Delta Consulting report highlights*

The Center for Effective Organizations (CEO) of the University of Southern California's (USC) Marshall School of Business and Mercer Delta Consulting, LLC first joined forces in 2003 to conduct a national survey of corporate Directors in the largest U.S. corporations. They received responses from 221 Directors. Twelve percent (12%) of the respondents are CEOs/Chairs, 3% inside

Directors, 72% outside Directors, 4% CEOs/Non-Chairs, 3% nonexecutive Chairs, 5% Lead Directors, and 2% other. The Directors served on an average of 2.5 Boards. Their analysis suggests the respondents come from approximately 200 of the 1,000 largest publicly traded companies in the United States. Directors who sit on more than one Board were asked to fill in the survey for the largest U.S. company on which they serve as Director. Results of the survey were compiled and analyzed jointly by Mercer Delta and USC.

To simplify presentation of the results, survey responses that fell in the category of 4 or 5 on a 5-point scale were interpreted as positive/favorable responses. These include responses of “4 = effective” and “5 = very effective” on the effectiveness scale and “4 = to a great extent” and “5 =to a very great extent” on the extent scale as illustrated below. Throughout this report, for each question that used a 5-point scale, “percent favorable” represents the total percentage of Directors who responded favorably to a particular question by choosing either a 4 or 5.

Board Information

Directors generally expressed positive views on the information Boards receive to carry out their work. More specifically, 95% of the Directors rated their Boards favorably when asked to rate the extent to which their Boards receive sufficient information to carry out their responsibilities. They also said their CEOs keep them informed about significant company matters and that their Boards are knowledgeable about key risks facing the company. These are the same results that were found in 2003.

To what extent:	To a Very Small Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent	% Favorable (% of Directors who responded To a Great Extent/To a Very Great Extent)
Does the Board receive sufficient information to carry out its responsibilities?	0%	0%	5%	45%	50%	95%
Does the CEO keep the Board informed about significant matters affecting the company?	0%	0%	4%	33%	63%	96%
Is the Board kept informed of key risks facing the company?	0%	0%	11%	43%	46%	89%

Only 27% of the Directors indicated that to a great or very great extent their Boards have independent information channels that provide useful information about company operations and management practices. This represents no change from 2003.

To what extent:	To a Very Small Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent	% Favorable (% of Directors who responded To a Great Extent/To a Very Great Extent)
Does the Board have independent information channels that provide useful information about company operations and management practices?	3%	24%	46%	20%	7%	27%

Communication

Sixty-five percent (65%) of the Directors said that Board members and the CEO communicate between scheduled meetings to a great or very great extent.

To what extent:	To a Very Small Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent	% Favorable (% of Directors who responded To a Great Extent/To a Very Great Extent)
Do Board members and the CEO communicate between scheduled meetings?	0%	6%	29%	43%	22%	65%

Other Board Practices

Ninety-five percent (95%) of the respondents say that their Boards have regular executive sessions for outside Directors. Sixty-eight percent (68%) of the respondents say that their Boards have an annual strategic retreat for the Board and top management. This is a significant increase from 2003 (53%). Forty-six percent (46%) of the respondents say that their Boards require their outside Directors to visit the company operations during the year.

Please indicate whether the Board currently has the following practices:	YES		NO			
	Yes, has for more than a year	Yes, have adopted in the last year	Adoption is currently being considered	No, considered and decided not to adopt	No, never considered	No, had it and decided to eliminate
Regular executive sessions	85%	10%	0%	0%	4%	0%
An annual strategic retreat for the Board and top management team	57%	11%	7%	7%	18%	0%
A requirement that outside Directors visit company operations during the year	38%	8%	10%	9%	35%	0%

Who From Senior Management Regularly Attends Board Meetings?

In addition to the CEO, other company executives often attend and participate in Board meetings. The Chief Counsel and CFO attend Board meetings most frequently (85-91% always attend). It is much rarer for business unit heads (31%), the leader of HR (19%), and the CIO or head of Marketing (9% each) to always attend these meetings.

How often do the following Non-Directors attend Board meetings?	Never	Rarely	Sometimes	Often	Always	On Board
Chief counsel	1%	3%	4%	7%	85%	3%
Business unit heads	0%	4%	22%	43%	31%	0%
Head of HR	6%	19%	35%	22%	19%	1%
CFO	0%	0%	1%	8%	91%	7%
CIO	8%	28%	40%	15%	9%	0%
Head of Marketing	10%	29%	37%	15%	9%	0%
Other executives	0%	10%	51%	28%	11%	1%

CONCLUSION

Board of directors discussions are about the finding the most appropriate concepts of corporate governance and models of board of directors for developing the best corporate governance practices.

We concluded that the unitary boards popular in Anglo-Saxon world are concerned about simultaneous accounting all three board of director's functions, i.e. strategy, control and advice. Presence on the board both executive and non-executive directors makes the board of director standards very detailed. In this context, the Anglo-Saxon world has two different approaches to the problem of simultaneous accounting all functions of the board.

Thus, the US standards are based on the regulation outside of the company's community, i.e. state regulatory bodies, say SEC. System of internal control in the USA is based around three elements, i.e. financial disclosure, board committees and independent directors. The UK standards are based on the initiative approaches from inside of the company's community, when the board of directors is regulated through a net of recommendations (Codes) which are developed rather by non-governmental institutions with reference to the initiative or order of governmental bodies. System of internal control in the UK is based on two elements such as director independence and board committees.

The Continental world has another approach to accounting the roles of the board of directors. Under the German model the supervisory board practices are regulated mainly by the state legislation overfilled with the social elements. The employee-oriented board legislation and practices are the major obstacles on the way of the supervisory board team working. The large bank representatives and employees are non-homogenous members of the supervisory boards. They have very different interests. Thus, the function of the strategy is not executed by them successfully. The board of directors is concerned of executing such functions as control and advice. The strategy function is delivered to the management board. Therefore, the roles of the director independence and board committees are not so well developed as in the case of the USA and UK.

The Ukrainian board practices are the residual derivatives of the Continental world practices. From the point of view of the roles of the board of directors, i.e. strategic, monitoring and advising, the supervisory boards in Ukraine, applying Continental model of corporate governance, are rather advisors than strategists and monitors. Main task of the supervisory board members is to give the competitive advices to the

management board members. Better saying, supervisory board members are the “transmitters” of the thoughts of mainly large shareholders to the management board. Thus, they support such behavior saying that through advising to the management board members the supervisory board members transmit the most important ideas from shareholders and executives. This, by their beliefs, strengthens the mutual trust and understanding between shareholders and executives. It is quite waste action because the large shareholders representatives are both on supervisory and management boards. Therefore, the function of advice is nothing but an illusion.

Concerning the monitoring to be taken by the supervisory board members over the activity of the management board the Ukrainian practices of corporate governance narrate on the lack of wishing to get into the conflicts between these boards. Therefore, there is a lack of motivation of the supervisory board members to execute a control function. Thus, the supervisory board members in Ukraine are “the non-conflict creatures”.

Supervisory board members have no enough incentives to monitor the activity of the management board if the company is controlled by the large shareholder who elected their representatives to supervisory and management boards at the same time.

Companies, where the corporate ownership is dispersed are not effective in the establishing the supervisory board which could behave as a team rather than a group of contestants. A system of internal control is weak and monitoring functions are lost in the fight for the dominant role on the board. Minority shareholder rights are not taken by the supervisory board members as something to fight for because the reward for possible efforts is not sufficient or does not exist at all. More than 70 per cent of supervisory board members are not paid for their work at all. The incentive of “last resort”, i.e. personal reputation, is still not a factor that could influence the behavior of the members of supervisory boards of Ukrainian joint-stock companies.

Therefore, the Ukrainian board practices have much to go to transform into the best Continental world practices exploiting the broader spectrum of the board functions, i.e. the control and advice functions. But the strategic objective is to find the levers how to introduce successfully to the board practices all three board functions, i.e. strategy, control and advice, well-applied in the Anglo-Saxon world.

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