

# THE KOSTYUK REPORT: CORPORATE BOARD PRACTICES IN UKRAINE

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## Abstract

The author reports on the corporate board practices in Ukraine. The roles of board of directors are mainly about control. The strategic and advisory roles are not developed. The mode of strategic involvement of the members of supervisory boards in Ukraine is mainly about reviewing and approving. Thus, the board of directors in Ukraine is "a rubber stamp". The degree of independence of directors is very low. Major board practices in Ukraine are: small number of independent directors on the board; low frequency of meeting of the board; small number of committees on the board; the management board influences the supervisory board. Board practices in Ukraine need a sort of recommendations, similar to those, made in UK at the end of 1990s, and at the start of the third millennium. This concerns mainly the work of committees and developing the strategic role of the board.

**Keywords:** board of directors, executive directors, committees, chairmanship, independence

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## Introduction

Boards of directors are a crucial part of the corporate structure. They are link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers). The board's primary role 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 in 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 are developed in industrial countries. But, at the same time, bankruptcies of large corporations and corporate scandals that attacked the USA at the beginning of the third millennium, destroyed traditional view on the role of corporate boards.

Jay Conger noted that boards are under fire. Investors, governments, agencies, communities, and

employees are scrutinizing boards' performance and challenging their decisions like never before - and it is likely this attention will only increase. Shareholders and stakeholders do not want to consider corporate boards as "rubber stamps for management" as Philip Styles said. Directors should be strategists, controllers and advisors for management at the same time.

As Bob Monks said, recovering corporate world is possible in the case of development of shareholder activism. Corporate sector needs shareholders who would be active in decision making on composition, roles and duties of their representatives inside of corporations - directors.

Shareholder involvement in decision making on board practices was supported by legislative initiatives, such as Sarbanes-Oxley in the USA, codes of best practices by Higgs, Turnbull, Tyson, Smith. All these efforts were done to make boards become more transparent, accountable and responsible to shareholders.

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 the Ukraine. After a ten-year

history of privatization of the state property there is a lack of research in the field of the board practices. There are no still corporate governance codes and white papers on corporate board best practices. Therefore, the primary objective of this research is to improve transparency of the board practices in the Ukraine and try to find out links between board performance and type of owners of corporation.

## 1. Methodology of research

Very detailed investigation of the most active, top-performing Ukrainian joint stock companies has been undertaken to reach the major objective of research. The following items of board practices have been researched:

- size of the boards;
- frequency of the board meetings;
- independence of directors;
- committees on the board;
- director nomination;
- director election;
- employee participation on the board;
- the chairman/CEO duality.

Research was comprised of two stages. At the first stage, we delivered questionnaires to Heads of Supervisory Boards and Deputy-Heads of Supervisory Boards of 240 companies. Feedback on questionnaires was received from 53 companies. They belong to the most developed industries - metallurgy, machine-building, energy generating and energy distributing. Further, we selected the most completed questionnaires (50) to conduct research and process questionnaires.

At the second stage of research we used observation. We observed 50 companies whose directors had provided us with questionnaires completed. The following data sources were used to observe corporations:

- annual reports of Ukrainian joint stock companies;
- annual reports of the State Securities and Exchanges Commission in Ukraine;
- annual reports of the First Stock Trade System in Ukraine;
- stock market reports, developed by famous Ukrainian investment companies.

The periods of investigation are from 1998 to 2003, and 2004.

The following criteria of board performance were investigated:

- board independence;
- board involvement in strategy process;
- executive monitoring by the board;
- board involvement in director nomination;
- board committees development.

The following hypotheses are to be tested:

1. Size of the supervisory board is positively correlated to the degree of concentration of corporate ownership, number committees on the Board and depends on origin of controlling shareholder.

2. Frequency of board meetings is negatively correlated to the degree of concentration of corporate ownership and does not depend on origin of controlling shareholder.

3. Degree of independence of supervisory board is negatively correlated to the degree of concentration of corporate ownership and depends on origin of controlling shareholder.

4. Committees of the supervisory board are demanded more by foreign institutional shareholders.

5. There is dependence of the mechanism, used to nominate directors, i.e. large shareholders, supervisory boards, executive boards and audit commission, on structure of corporate ownership and type of controlling shareholder.

6. There is strong dependence between the degree of concentration of corporate ownership and the procedure of the chairman election, i.e. the higher level of concentration of ownership the higher likelihood of electing the chairman at the meeting of the supervisory board.

7. Type of controlling owner influences an ability of employees to participate in corporate governance.

8. There is dependence of chairmanship duality practice of the type of owner and corporate ownership concentration.

## 2. Research results

### Size of the board

*Hypothesis 1: Size of supervisory board is positively correlated to the degree of concentration of corporate ownership, number of committees on the board and depends on origin of controlling shareholder.*

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 the 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 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 to place 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 are not unusual in Ukraine. Proportional representation on the supervisory board, that could protect minority shareholders rights, is not allowed. Therefore, controlling shareholders are free to control their companies through placing even a few their representatives on the supervisory board.

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.

### Frequency of meetings

*Hypothesis 2: Frequency of board meetings is negatively correlated to the degree of concentration of corporate ownership and does not depend on origin of controlling shareholder.*

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.

Boards at the companies, where corporate ownership is strongly concentrated, hold meetings less frequently than at those companies, where corporate ownership is diffused. 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 the supervisory board has nothing to supervise. Their supervision is rather nominal that actual.

**Table 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

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.

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.

As a result, the second hypothesis is proved. Frequency of board meetings is negatively correlated to the degree of concentration of corporate ownership and does not depend on origin of controlling shareholder.

### Independence of directors

*Hypothesis 3: Degree of independence of supervisory board is negatively correlated to the degree of concentration of corporate ownership and depends on origin of controlling shareholder.*

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.

Generally, members of supervisory boards at Ukrainian joint stock companies are not independent. Some of them own huge share of equity of the companies. 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 practice, mentioned above. Some directors are relatives of large shareholders. As a result, only 8 percent of directors in the 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.

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 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.

**Table 2.** 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					
	Executives	Ukrainian FIGs	Ukrainian investment companies	Ukrainian banks	Employees	Foreign investors
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

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.

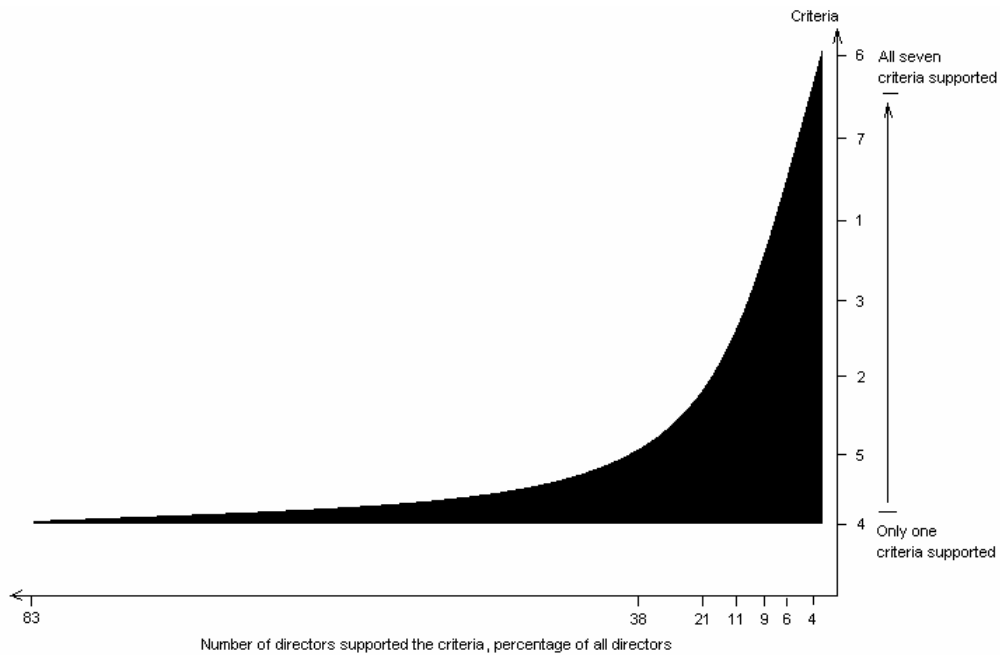
Besides this, employees are not well-performing explorers of the market of outside members of supervisory board. They have a lack of knowledge how to find well-performing directors outside of their companies. As a result, employees have nothing but electing insiders on the supervisory board. Therefore, 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.

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.

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 criteria. 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 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. 1. Distribution of the directors 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 criteria 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 shaken 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.

## **Committees**

*Hypothesis 4: Committees of the supervisory board are demanded more by foreign institutional shareholders.*

International board practice concerning establishing committees on the board is still not spread in the 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 to 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.

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.

We should note that in the wake of recent scandals, a number of 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 topical in a 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 makes the potential of influence of the compensation committee lower 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 law, 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 any evidence of an attempt to be undertaken by stock exchanges, the National SEC, or other regulators toward an establishing recommendations or requirements concerning the best practices of executive compensation, addressed to the companies.

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 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.

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 set the compensation, desirable by the head himself and the rest of executives.

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 pass the plan to the executive board and make 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 perform 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. But, the human resource department is still under pressure, when developing the plan, of executives, who can try 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.

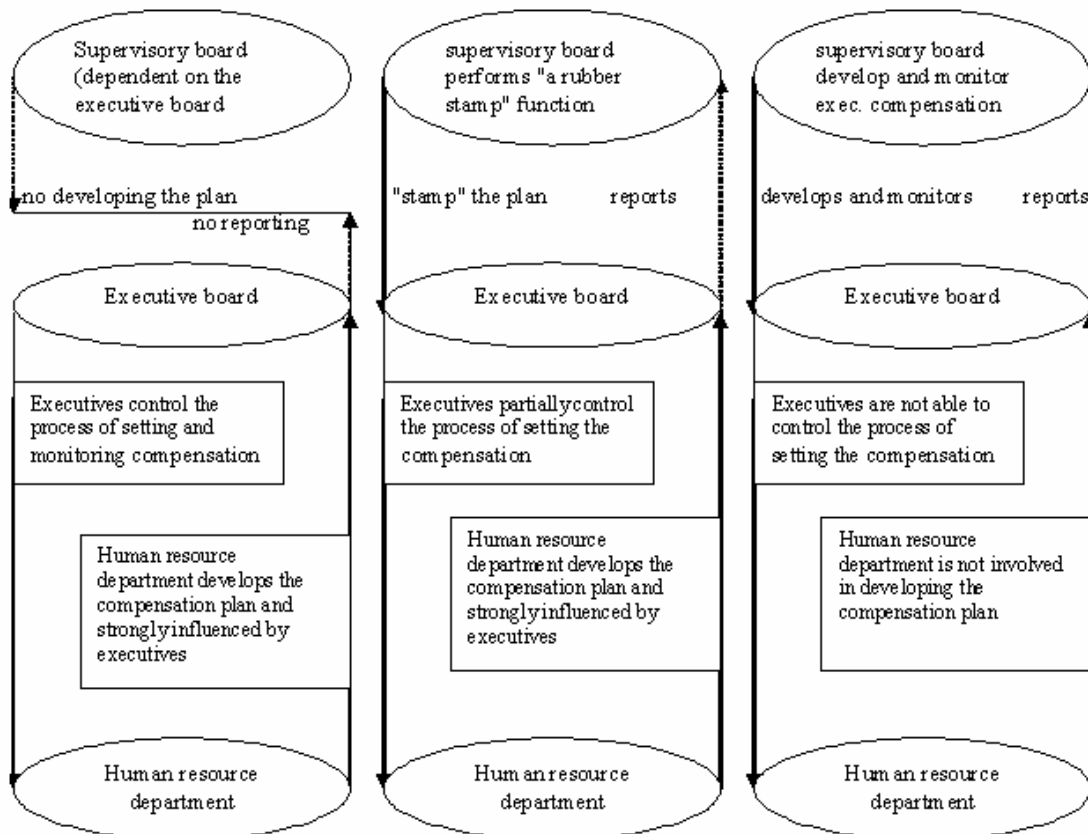


Fig. 3. Models of executive compensation setting in Ukraine

Under the third model, only supervisory board develop and approve the executive compensation plan. No human resource department take 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 committees are on the boards at only 3 percent 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. 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.

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 percent 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 may effectively administer the work of the board, from the point of view of its various roles, i.e. strategic, control and service.

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

A policy committee is the most popular committee on the boards at Ukrainian companies. Almost 25 percent of researched companies have a policy committee on the board. Policy committee is the most spread 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 at companies, controlled by Ukrainian financial-industrial groups is monitoring (4 replies).

**Table 3.** 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 absorb corporate control through preventing the establishing a policy committee or through delegating as least 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.

**Table 4.** 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

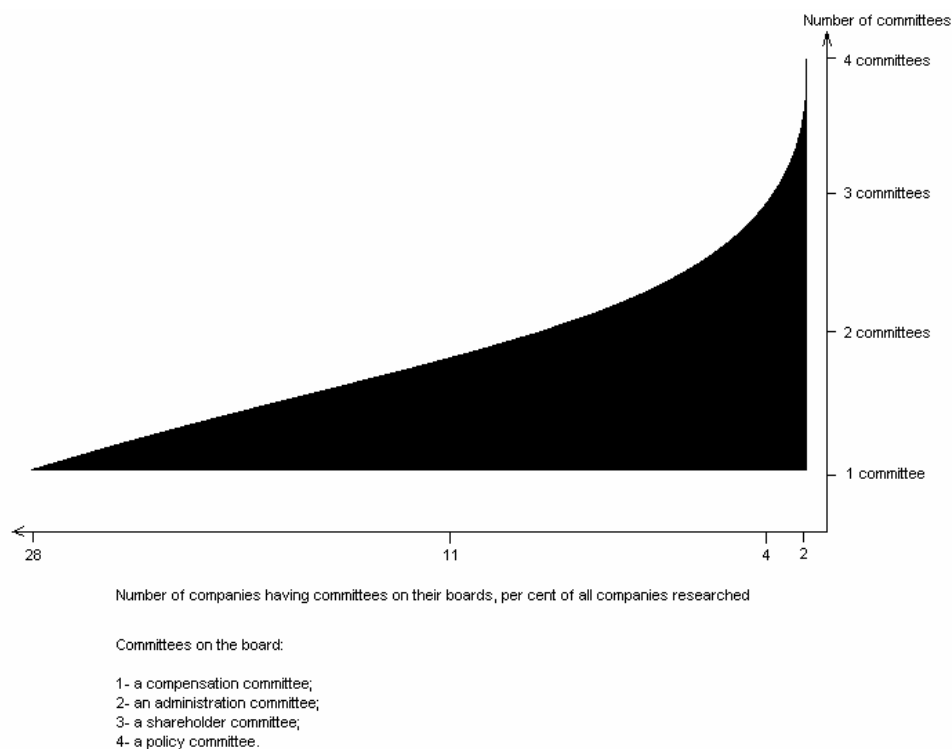
Regrettably, it is worth of mentioning that involvement in strategy is considered by most directors when meeting on the board, only as approving the strategy (38 respondents). 7 respondents consider their involvement in strategy through helping formulating the strategy, and 3 of them are not policy committee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

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 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.

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).



Fir. 2. Distribution of committees at Ukrainian joint stock companies

## Director nomination

*Hypothesis 5: There is dependence of the mechanism, used to nominate directors, i.e. large shareholders, supervisory boards, executive boards and audit commission, on structure of corporate ownership and type of controlling shareholder.*

There is also a tendency to reinforce the effectiveness of the board (and in some cases to reduce the power of the CEO) by establishing a nomination committee, often with a recommendation that it also be staffed by independent directors. This is an area probably least developed by boards in executing their tasks. For example, although almost all the FTSE 100 companies have a nomination committee, for the remainder of the FTSE 350 the ratio is only 30 per cent. The Higgs Report also noted a high level of informality surrounding the process of appointing non-executive directors. Almost half of the nonexecutive directors surveyed for the report were recruited through personal contacts or friendships and only 4 per cent had had a formal interview. In Italy and Spain, a nominee's name and qualifications are not even included in proxy documents, a practice which has now led to complaints by some institutional investors. Less information is available for other countries although anecdotal evidence points to similar informality. However, some commentators have questioned the use of nomination committees on the grounds that this is a genuine shareholder function. These concerns raise the issue of the mandate and duties of

nomination committees and its composition. Elsewhere, there are a number of approaches to the issue. In Sweden some companies have created external committees composed of the larger shareholders, including the main institutional investors, and chaired by the chairman of the board. Such an external committee coordinates the selection/nomination process and lends transparency to the process. A similar situation exists in Norway. In Italy, a nomination committee is only required on a voluntary basis by the Preda code but compliance is minimal.

In the Ukraine there are no nominating committees on the boards in contrast to the USA board practice. A question: "Who is responsible for nominating new directors?" is still not answered in Ukraine, although countries with the best corporate governance practices have already answered and named a Chairman of the Board to be responsible for selecting candidates to be nominated to the board. That is way the procedure of nominating new directors in Ukraine is very simple and little chaotic at the same time.

Shareholders are provided an opportunity to nominate directors by themselves. But to do this, shareholders must own quite sufficient stake in the company. Every shareholder who owns shares of the company at the volume above 2 percent of shareholders equity can propose his own candidate on the supervisory board.

Moreover, directors can be nominated by the supervisory and the management boards independently. The procedure of nomination requires

a meeting of the board where candidates are proposed.

The companies with dispersed ownership structure have a practice of nominating directors by governing corporate bodies - the supervisory and the management boards, or the audit commission. It is really hard to accumulate 2 percent of shares at Ukrainian companies under conditions of weak activity of individual, minority shareholders to nominate a director.

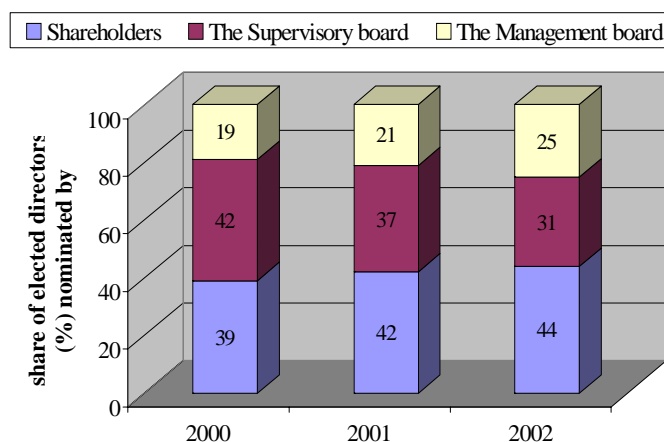
All candidates on the board in any way must be shareholders and can not be simultaneously nominated on the management board or on the audit commission which is independent body of corporate governance. All candidates must fill the standard application form. Required information is rather formal than describing ability of the candidate to execute his duties on the supervisory board effectively. This application form is delivered by the shareholders to the management board. The management board is responsible for preparing the shareholders meeting. Therefore, all application forms are collected by the management board to be considered at the shareholders meeting. At the shareholders meeting owners vote for candidates.

Supervisory board can not influence the process of nominating, for example, through applying an exclusive right to supervise the process of nominating and reject or approve candidates,

approved by executives. Members of the supervisory board can not press on the members of the management board to control the process of nomination of directors.

In 2002, the most successful in nominating directors were shareholders. About 44 percent of elected directors were nominated by shareholders. Only 4 percent of these elected directors were nominated by minority shareholders. It says that process of nominating directors does not protect rights of minority shareholders in Ukraine.

Surprisingly, the management board is a step ahead of the supervisory board in successful nomination of directors. Thus, 31 percent of elected directors were nominated by the management board. Only 25 percent of directors were nominated by the supervisory board. Moreover, exactly executive board has a direct impact on the process of nomination of candidates to the supervisory board. Everybody, who is allowed to nominate candidates, should deliver an application form to executive board that is responsible for processing all these proposals and make it ready for voting at General Shareholder Meeting. Certainly, executives receive information about nominated candidates at the earliest stage and, if the candidate is not loyal to executives, have enough time to try to do something to avoid electing these candidates.



**Fig. 1.** Groups of the director nominators and their efficiency in nomination

These trends could evidence about an executives' wish to eliminate separation of ownership and control in the Ukraine. Moreover, decrease in successful nomination of directors by the supervisory board says that shareholders do not want sit on the supervisory board themselves. They prefer to have there their representatives. This is very serious conclusion because such behavior of shareholders could be explained by their wishing to be controllers in indirect way, i.e. through electing directors and executives who would represent their interests. Even large shareholders meet each other only one time a year - at the shareholders meeting. Sitting on the

board is to obligatory, time-consuming and even boring duty for them.

Therefore, we conclude that there is dependence of the mechanism, used to nominate directors, i.e. large shareholders, supervisory boards, executive boards and audit commission, on structure of corporate ownership and type of controlling shareholder.

### **Director election**

*Hypothesis 6: There is strong dependence between the degree of concentration of corporate ownership*

and the procedure of the chairman election, i.e. the higher level of concentration of ownership the higher likelihood of electing the chairman at the meeting of the supervisory board.

In the Ukraine directors, i.e. members of the supervisory boards are elected at the annual shareholders meeting. They can be elected only by owners. 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.

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.

There is strong dependence of the procedure of the chairman election on the degree of concentration of corporate ownership. The higher level 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 keep the process of corporate governance not transparent to facilitate pursuing their own interests.

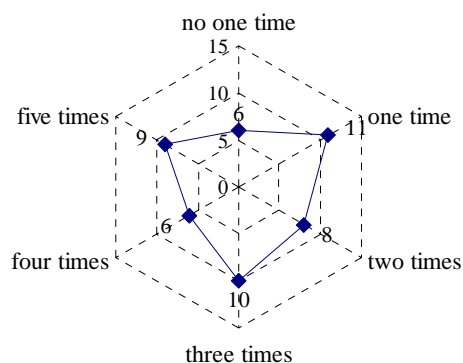
Directors are elected for the term of one year. This is quite wide-spread practice in the Ukraine. Only 19 percent of researched Ukrainian joint stock

companies elect directors for other terms, usually longer than one year. Every annual 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 on 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.** Number of substitutions of the chairman of the supervisory board at researched Ukrainian joint stock companies for the period of five years

In the 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.

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.

## **Employee participation**

*Hypothesis 7: Type of controlling owner influences an ability of employees to participate in corporate governance.*

In contrast to Germany, in the Ukraine law does not require that a part of the supervisory board to be elected by employees. Therefore, employee participation is a very hard issue to implement into the life.

International practice of employee participation places an emphasis on availability of mechanisms to let employee representatives be informed by supervisory board about important decisions. One of such mechanisms is collaboration of members, elected by shareholders, and those, elected by employees on the board.

In the Ukraine employee participation is available only at the companies where employees are majority shareholders. Taking into account that in the Ukraine employee shareholders activism is not popular, and cumulative representation on the board is not fixed by the law, it is not worth of supposing that minority shareholders, employed by the company can participate in corporate governance on the supervisory board.

At the same time, it should mention that type of controlling owner influences an ability of employees to participate in corporate governance. Thus, foreign institutional shareholders, who are more loyal to interests of employees, make a policy committee on the supervisory board to have tight contacts and feedback with work councils at the company.

As a rule, decisions on employment and wages are made only after consulting between supervisory board and work council. It is a very difficult to conclude what share of proposals by work council is approved by supervisory board, but it is possible to conclude an existence of mechanism how employees can participate in corporate governance - through work council and policy committee on the supervisory board. Programs, initiated by owners, to develop professionalism of employees, and paid by owners, are most popular at companies under control by foreign large institutional shareholders.

Probably, respecting a human capital is evidence, or at least an intention of shareholders to allow this "human capital" participating in corporate governance. It is hardly possible to suppose that companies, controlled by entrenched executives and self-oriented, not accountable Ukrainian financial-industrial groups would allow employees share corporate control with them.

Therefore, we have just proved the hypothesis that type of controlling owner influences an ability of employees to participate in corporate governance.

### **The chairman of the supervisory board - the former chairman of the management board**

*Hypothesis 8: There is dependence of chairmanship duality practice of the type of owner and corporate ownership concentration.*

The practice that is popular in Japan not spread in the 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.

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 strongly motivated controllers and they will not share their power with somebody else.

Foreign institutional shareholders, performing controlling function, do not prefer to follow Japanese practice too because they find this practice facilitating entrenchment development. Therefore, foreign institutional shareholders want to have outside director as a Chairman of the supervisory board.

Only 4 percent 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 as the chairman of the management board because of their age.

Therefore, the last hypothesis was failed. There is no dependence of chairmanship duality practice of the type of owner and corporate ownership concentration.

## **Conclusions**

Supervisory board performance, as corporate governance mechanism, depends on the type of controlling shareholder and corporate ownership concentration. Almost all hypotheses support dependence of board practices on the type of controlling owner and corporate ownership concentration. Thus, companies, controlled by Ukrainian financial-industrial groups, banks, executives and employees have low-performing supervisory boards. Board practices at these companies are similar to those, popular in Germany. These are:

- small number of independent directors on the board;
- low frequency of meeting of the board;
- small number of committees on the board;
- management board influences the supervisory board.

The main reason on closing the board practices in the Ukraine to those in Germany is increase in concentration of ownership that is following with

increase in corporate control, violation of the minority shareholders' rights, increase in number of conflicts of interests and decrease in transparency of the Ukrainian joint stock companies. All these are generally accepted corporate governance practices in Germany.

Supervisory boards at companies under control of foreign institutional shareholders, have another practice. They perform not only the role of control,

as Ukrainian controlling shareholders, they perform the roles of strategy and service. When performing these roles, they are strongly accountable to shareholders, employees and society. Regrettably, majority of Ukrainian shareholders still consider supervisory board exclusively as a controlling body of corporation, weakly involved in strategy and advising. As a result, it is hardly possible to expect that supervisory board would perform its roles well.