

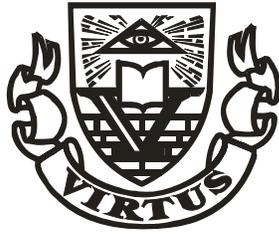
CORPORATE GOVERNANCE IN A TRANSITION ECONOMY

Alexander N. Kostyuk

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ALEX KOSTYUK
Published by Virtus Interpress

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“Serve to principles, but not persons”

*To my daughter Liza.
I hope that you will live in
a democratic country and
be proud of being a Ukrainian.*

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PREFACE: RECONSIDERING BERLE & MEANS

The new millennium presented citizens of the corporate world - shareholders, executives, employees and others - with the bankruptcies of Enron and other giants of the most developed segment of the corporate world - the USA. Corporate America, which was perceived before as an example to follow, showed the corporate world citizens many disadvantages in the existing systems and instruments of corporate governance. This rather deflated the trust of shareholders in the existing principles and concepts of corporate governance both in developed and developing countries, including Ukraine.

Recent studies, undertaken by *Saul Estrin*, *Adam Rosevear*, *Alex Krakovsky*, *Alex Pivovarsky* contributed remarkably to understanding the corporate governance mechanisms in Ukraine. All these experts concluded that many corporate governance mechanisms, such as the board of directors, financial reporting and others, hardly work in Ukraine.

One of the well-known reasons is the absence of an Act of Joint Stock Companies. The draft of this Act had been written in 2001. However, the Act has still not been approved by the Ukrainian parliament, where a strong political lobby protects the rights of large owners, named "oligarchs". Therefore, joint stock companies in Ukraine have to work with reference to "The Act of Enterprises", which does not explain the nature of many corporate governance mechanisms, i.e. board committees, non-executive directors, executive nomination, executive monitoring, etc. As a result, corporate governance in Ukraine allows violation of minority shareholders rights, weak transparency, inadequate corporate social responsibility. Under such circumstances, one of the ways out is through developing a set of internal statements (within each company) to make all these corporate governance mechanisms work. Owners should be responsible for doing this work.

Regrettably, all these researchers just analyzed the corporate governance mechanisms in Ukraine and did not try to find out, what the type of owner is the most efficient in Ukraine, i.e. employees, executives, foreign institutional shareholders, Ukrainian financial-industrial groups. Moreover, nobody researched the reasons why corporate governance mechanisms, which are so popular worldwide, are still not applied in Ukraine effectively. There are about 35 thousand joint stock companies in Ukraine that is much more than in many developed economies. Annually, the state commission on securities and stock exchanges notes over 12 thousand of cases of breaking the principles of corporate governance in

Ukraine. From this perspective, it is very important to know the role of ownership structure in corporate governance, i.e. why owners buy shares and what corporate governance mechanisms they use.

The results of our research, presented in this book are very important for Ukrainian joint stock companies, which suffer from agent conflicts. An increase in agent costs reduces growth opportunities at the market. Therefore, after developing corporate governance mechanisms, such as executive compensation, board of directors and its committees, financial reporting and executive monitoring, it will be possible to say that this research is based on the principle of social responsibility, deflated strongly as a result of the bankruptcies in the USA and worldwide.

We tried to do our utmost to put our research on the basis of the most ancient problem in corporate governance - separation of ownership and control, proposed by *Berle* and *Means*. Who are shareholders in Ukraine? Are they investors, controllers or both?

Berle and *Means* found that shareholders of the beginning of the 20th century in the USA were rather investors than controllers. That time, attracted by the stock exchange, investors forgot about their duty to control the corporation. Therefore, managers, who had stayed inside of the corporation, picked up the reins of powers, dropped down by shareholders, who had stayed at the stock exchange. Probably, it was "a silent consent" between managers and shareholders. Is the same "a silent consensus" in Ukraine at the beginning of the third millennium?

The central message of "*the Modern Corporation*" is the need to go beyond traditional legal and economic theory to develop a new concept of the corporation that can serve as a foundation for a theory of corporate governance. Only then, *Berle* and *Means* contended, could Americans come to terms with the emergence and significance of corporate economy. Aimed with this understanding, the community would then be in a position to demand that the modern corporation serve the interests of all society.

Are the corporations at transition economies serving interests of society? The answer is still explored. We are going to find a reply for the corporate governance practices popular in Ukraine.

Berle and *Means* were not content that corporations must be run only in the interests of shareholders. The role of shareholders in decision making is dominant in comparison to stakeholders. Shareholders, with reference to their dominant role in corporate governance, must bear much more responsibility for the company in whole than stakeholders. In this case, interests of society will be taken into account. Herewith, the role of ideal shareholder would play a superior role in corporate governance. *Berle* and *Means* were not sure that an ideal owner exists.

All groups of shareholders, playing at the market at the time of *Berle* and *Means*, could not be taken for ideal owners. Passive shareholders are

reluctant to apply corporate governance mechanisms. Therefore, they are not able to control management of companies and prevent managerial opportunism and agency conflicts development, destroying shareholder wealth. Large shareholders, taking care of keeping their own interests, do not care of keeping interests of all shareholders balanced. Under such circumstances block shareholders will distort a system of mechanisms of corporate governance to make it centered only at their own interests. Therefore, interests of minority shareholders are violated, that leads to conflict of interests among shareholders and destroys shareholder wealth too. Management of companies, owing their stock, need not those mechanisms of corporate governance at all, responsible for controlling themselves. But, absent of transparent executive compensation system, decision system, monitoring system, lets management avoid accountability to the rest shareholders. Under such circumstances executives are motivated to increase their own wealth through well known unjustified high compensation, insider stock trading and assets tunneling. We are not sure that *an ideal owner* exists with application to the corporate governance practices in Ukraine. But we are aimed to finding *the most effective owner* in transition economy - employees, executives, institutional shareholders. We want to stay on the position that an ideal shareholder is an expert in balancing interests not only between shareholders and management. He is able to take an active participation in balancing interests of all shareholders, despite their stake in company, their intentions on free riding or long-term shareholding, their social status, etc. To do all these, ideal owner finds incentives to govern companies and equips himself with required knowledge. So, incentives and knowledge should follow an ideal owner. Besides this, ideal shareholder, well-motivated and equipped with knowledge, is an owner, who feels himself responsible not only for his own stake in a company, but for the company in whole. He bears this responsibility not only to shareholders, management, employees. He bears this responsibility to the society in whole. So, ideal owner is well-motivated, equipped with knowledge and responsible for his company in whole, to society. He must know WHY to own stock of company, HOW to own stock, and how to make these WHY and HOW responsible to society in whole. We are not going to propose a new concept of corporation - a third millennium concept. We only want to conclude whether there is a concept of corporate governance, special for transition economy - economy, where the corporate governance practices are still in transition from a chaos to the best corporate governance practices, applied in the developed countries. We do not want to refuse *Berle* and *Means* ideas. We want just to reconsider it.

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CONCEPTS AND MODELS OF CORPORATE GOVERNANCE: THE CASE OF UKRAINE

The success of the various countries can often be linked to the type of privatization that was followed to take businesses from state-owned enterprises to joint stock companies to public companies (*Djankov S., G. Pohl, 1996*), (*Carlin W., M. Landesmann, 1997*).

In general there are three types of privatization process: the first one is a mass privatization model, state-owned assets being distributed free of charge to the general public through vouchers that can be traded for ownership shares in state-owned firms (*Earle J., A. Telegdy, 1998*). This model is sometimes referred to as the voucher privatization method and was used in the Czech Republic and Russia (*Barberis N., M. Boycko, A. Shieifer, N. Tsukanova, 1996*). The second model allowed management and employees buying company assets. This method was the method adopted in Poland. The third model, and arguably the one which produced the most successful result, involved selling majority control to an outside investor (*La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, 2000*). This third model was followed in Hungary and also in Estonia. As *Christine Mallin (2004)* suggests that the method of privatization has tended to have more of an immediate impact on the development of corporate governance than the legal framework in these countries.

From this perspective, Ukraine is a unique country to research. All three methods of privatization were used in Ukraine step by step. The first was the method which allowed management and employees to buy company shares (1992-1995). The second was the voucher privatization (1995-1999). The third method was that of selling shares to outside investors (1999-recently). Let us consider how corporate governance changed during each method of privatization.

Privatization methods and corporate governance concepts

Corporate governance practices in Ukraine underwent many changes during the process of privatization that took place during the last ten

years. The process of privatization can be divided into several stages, two of which were over by 1999.

At the same time the process of deregulation of major industries of Ukrainian economy was initiated. This concerned metallurgy, chemical industry and others. The state wanted to give the levers of governance into the hands of private (individual or institutional) owners.

In the first stage, privatization in Ukraine was very liberal. By a liberal feature of privatization is meant that those companies that wanted to be privatized were privatized. So, the first stage was given over to the will and intentions of Ukrainian companies. To support efforts of participants of management and employees in privatizing companies, the state authorities introduced the law "On Enterprises". According to this law, some important characteristics of corporate governance system were introduced.

First, the dual board structure was imposed. The same board structure is applied in most European countries. Thus, all joint-stock companies with more than 50 shareholders should establish the supervisory and management boards. The supervisory board is responsible for monitoring executives, advising executives and representing the interests of shareholders to various groups of stakeholders. The management board is responsible for executing decisions made by shareholders at the annual general meeting, and supervisory board. Second, the continental model of supervisory board was introduced. According to this model, used in continental Europe, the supervisory board performs rather a function of a controller, than a function of a strategist. Thus, shareholders of the companies in Ukraine wanted supervisory boards rather to control the activity of the management board than to develop strategy for the company.

Third, regarding the ownership structure model, the first stage of privatization initiated development of the insider model, popular in Europe. According to this model, the only owners of the companies are the management and employees. They are inside the company.

Fourth, the market regulators wanted Ukrainian open joint-stock companies to follow the monistic concept of corporate governance. According to this concept, the company behaves in the interests the shareholders. Shareholders consider the companies they own only as instruments to create wealth. Interests of stakeholders such as financial institutions, banks, and government agencies are secondary.

In the first stage of privatization, the State wanted employees of Ukrainian companies to decide whether to privatize their companies or not. Regrettably, lack of effective audit firms, capable of estimating companies' values (par value, book and market values) greatly distorted actual "investment" value of companies, and many of them were bought by employees and management at very low cost. At the same time, the

activity of management and employees in privatizing companies was limited because of the shortage of money and lack of employee desire to become owners of companies (Krakovsky, 2002).

After finishing the first stage in 1995, the second stage was initiated by the state authorities. This was the voucher privatization. During 1995, the Ukrainian parliament was anxious to the best method of privatization, other than selling shares to employees and management. As a result of parliament's hesitation, the process of privatization slowed. In November 1995, the President of Ukraine, who was not satisfied with the work of parliament of Ukraine, initiated the second stage of privatization.

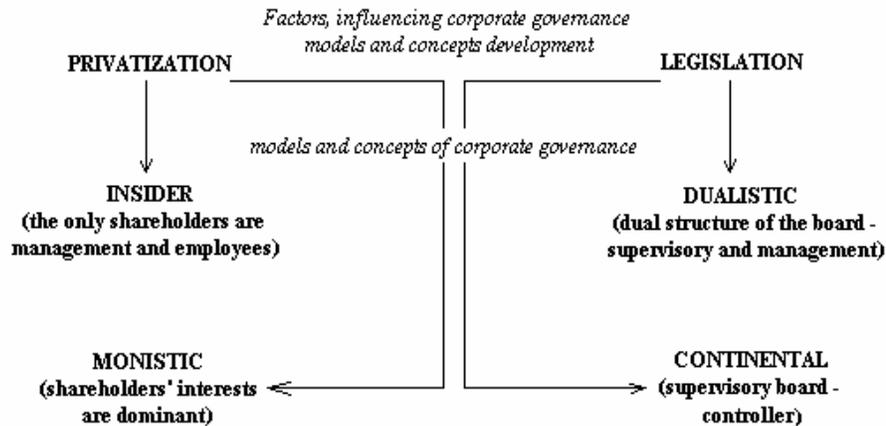


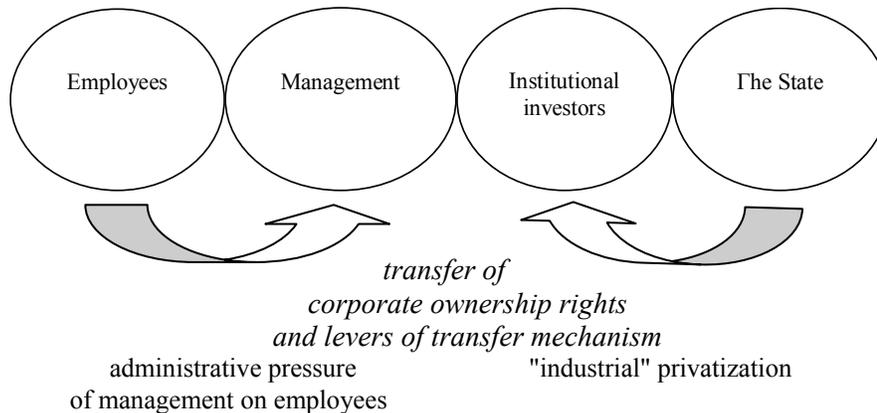
Fig. 1.1. Models and concepts of corporate governance, developed at the first staged of privatization - insider method

The third stage was named as "mass" privatization. All citizens of Ukraine obtained so-called "vouchers", which certified their right of ownership of the state property. From point of view of many experts, mass privatization had a very negative impact on development of corporate sector in Ukraine (Krakovsky, 2002). Individual investors - citizens of Ukraine - had no skills or wish to manage assets they own. They were not ready to become owners of the enterprises.

Moreover, legislative and institutional fundamentals for transferring corporate rights from ones to others were not still developed in Ukraine. There is still no Corporate Law. There is only a general Law on Enterprises concerning all types of enterprise. The stock exchanges, to facilitate transferring corporate rights, were established only in 1996. Soon thereafter, in April 1996, tender offers of the state property were initiated. The state authorities planned to attract attention of foreign

and 69 percent in 2001. But the share of employees had dropped down from 62 percent to 54 percent. At the same time the share of institutional shareholders increased from 10 percent in 1998 to 19 percent in 2001. The shares of the state and small individual outside shareholders had decreased.

As a result, two mechanisms of transferring ownership rights were developed in the third stage of privatization. The first method is administrative pressure used by management of companies to deprive employees of the shares they own and sell the shares to management. The second is the privatization itself, i.e. share auctions, used by the state to sell shares to institutional shareholders.



Source: *Kostyuk (2003)*

Fig.1.3. *A mechanism of concentration of corporate ownership structure in Ukraine during 1999-2001*

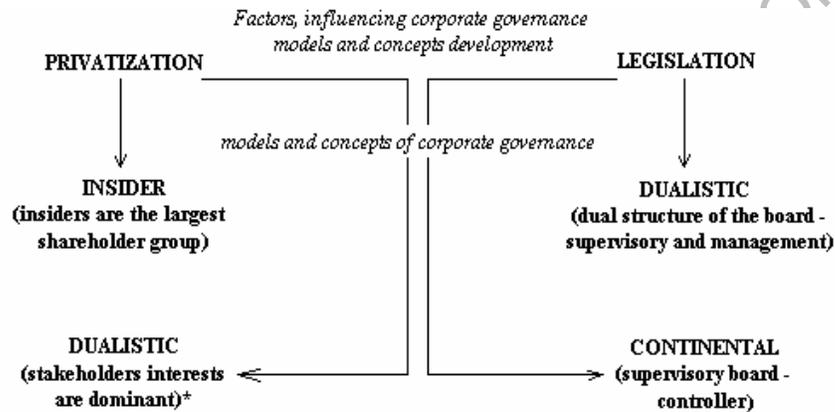
As *Kostyuk (2003)* concluded that an increase of the role of institutional shareholders in corporate governance in Ukraine during the third stage of privatization had led to the transformation of models and concepts of corporate governance.

Privatization process, corporate law and governance

Regrettably, the process of privatization was not reinforced by appropriate changes in legislation. The draft of the law "On Joint-Stock Companies" is still in parliament under consideration. The draft was written three years ago. Parliamentarians are not quick to approve the law because they are concerned about the lobbying interests of large institutional and individual shareholders. According to the draft, the

law would effectively protect the interests of minority shareholders, especially employees and minority individual outsiders.

The Code of Best Practices, developed by the IFC in Ukraine and introduced to the general public in June 2003, is still more a paper document than a contributor to the development of the best corporate governance practices. The Ukrainian parliament, stock exchanges, the State Commission on Securities and Stock Market, Ukrainian joint stock companies have not utilized the Code in whole or in part to develop statements and other documents in the field of corporate governance.



* stakeholders are considered as shareholders and asset management firms)

Fig. 1.4. Models and concepts of corporate governance, developed at the third staged of privatization - industrial method

The stock market, as an external mechanism of corporate governance, is still not made much use of by Ukrainian joint stock companies. There are about 35,000 joint stock companies in Ukraine, but only about 2,000 of them have listed their shares at the stock exchanges. As a result, the book value of companies is lower than market value, i.e. companies are undervalued. This is an excellent opportunity for large institutional investors to dominate at the stock market and use opaque procedures to buy the rest of the state property. This is an excellent ground for growing a speculative motive of investors. Thus, the market of Ukraine needs more transparency and knowledge on functioning the mechanisms of corporate governance, especially internal, to establish a good base for developing good corporate governance.

CORPORATE GOVERNANCE IN UKRAINE: THE ROLE OF OWNERSHIP STRUCTURES

Introduction and literature review

Process of privatization in Ukraine was investigated by a few researchers. Thus, *Alexander Pivovarsky (2001)* made a conclusion that privatization is followed with increase in ownership structure concentration. He underlined that there is a positive correlation between ownership concentration and corporate performance. But, at the same time, Pivovarsky did not explained the role of various groups of large shareholders, such as Ukrainian financial-industrial groups, banks, investment funds in corporate governance from the point of view of best practices. He has not found out attitudes of large shareholders in Ukraine concerning such corporate governance terms as transparency, accountability and responsibility.

Alexander Krakovsky (2002), well-known practitioner in corporate governance, narrated on the corporate governance worst practices in Ukraine. He insisted that large shareholders do not follow the corporate governance best practices. They do not care about transparency and responsibility. Moreover, minority shareholders are helpless, because they are not protected by the legislation, they are not equipped with knowledge of corporate governance mechanisms and they are not used to consolidate they minority power to run companies in their interests.

Vitalii Repei (2000) attempted to find the most efficient system of corporate governance in economic environment with poor institutions. Ukrainian corporate sector is analyzed as a case. The data from 318 companies from different industry sectors and regions are used to test the effects of different types of ownership structure on enterprise restructuring and economic efficiency. He found that private organization outsiders with high concentration of ownership rights (in our research such kind of shareholders are insiders), govern enterprises most efficiently. There is evidence to improve institutional structure for successful economic development.

Zheka (2003) examined the effects of different ownership structures and of the quality of corporate governance on the Farrell measure of efficiency. Data Envelopment Analysis and Limited Dependent Variable Estimations were applied to the set of Ukrainian joint-stock companies

listed on the First Securities Trading System. The domestic organization ownership was found to enhance efficiency the most, while managerial ownership had a detrimental effect on efficiency. Surprisingly, and this is a paradox, foreign owned firms were relatively inefficient; however foreign ownership was found to have a positive and significant effect on corporate governance quality. State ownership and concentrated ownership rights improved efficiency. The quality of corporate governance was found to have a positive impact on efficiency of domestically owned firms.

Andreyeva and Schnytzer (2002) examined empirically the short run responsiveness of company performance to ownership and market structures, sector and regional specificity, and varying degrees of soft budget constraints. For a cross-sectional data set of Ukrainian firms, the paper provided evidence that post-privatization governance systems impact significantly on efficiency, notwithstanding the influence of privatization per se. The study reported improving short term performance with ownership concentration, which, for Ukraine, is particularly notable in manager-owned firms. Another finding was that market environment, reflected by market structure and softness of budget constraints had a notable role in determining short run firm performance. Finally, the results suggested a significant influence of industry affiliation and regional location in shaping firm performance in Ukraine

Melnychenko and Ernst (2002) developed an “agency problem index” for each model that reflects incentives, commitment and information asymmetry. The empirical portion of the paper tested the effects of state ownership and management of state corporate rights on enterprise performance, defined in terms of value added, and sales net of excise and value-added taxes, for a sample of 466 JSCs for 1999-2000. In addition to basic factor variables, the principal independent variables included the agency problem index, state ownership, and dummies for sectors. Both state ownership and the agency problem index had a significant negative impact on enterprise performance.

Lazarenko and Sobolev (2001) exposed a number of basic trends of development of the joint-stock capital structure in contemporary Ukraine, among which the priority was given to the: gradual reduction of the *insiders’* share under the preservation of their considerable specific weight, and continued concentration of property in hands of the large shareholders. Both of these tendencies testify the process of the property concentration in hands of the enterprises’ management.

Probably, the most detailed investigations of privatization process in Ukraine have been undertaken by a group of activists at London Business School, headed by *Saul Estrin (1999)*.

London Business School conducted research of evolution of corporate structure in Ukraine from the date of privatization of each

researched company to spring of 1999. The main objective of research was to discover structure of corporate ownership. As a result of research they found that insiders own about 55 per cent of corporate ownership but there was a trend of selling of shares by employees to management of the companies.

This process was strengthened both by a strong entrenchment of management of Ukrainian companies and lack of interest of employees to own shares. Employees wanted high dividends but they had not it. Stock market was a dark territory to them because of lack of knowledge on how to trade there. So, they had only one chance to gain a return on shares – to sell it to managers, waiting for them in their board rooms.

Moreover, there was no sufficient transfer of corporate ownership from insiders to outsiders.

Thus, Ukrainian companies will have to experience evolution of the structure of corporate ownership. Transformation of the structure of corporate ownership in Ukraine is still going on². There is no evidences of active concentration of corporate ownership in the hands of outsiders. The share of ownership, belonging to foreign institutional investors increased by 1999 only from 2 to 3.2 per cent. Real owners are under the shadow of nominal owners represented by financial-industrial groups. As a rule they are main players at the market for corporate control in Ukraine thanks to large financial resources they possess.

According to research mentioned above, an average Ukraine company had only 15 managers, who own its shares. Number of employees, owing shares of the company where they work, is 599. Number of legal entities, as owners, is only 6. Among them only 2 were represented by investment funds and companies.

If a change in Management Board of the company is considered as a positive factor in corporate governance, then it is possible to conclude that outsiders are more effective in corporate governance. They changed members of Management Board almost in two times often than insiders. But the most active in changing members of Management Boards was the State as owner. Almost 83.3 per cent of members of Management Boards of Ukrainian companies, controlled by the State, were changed by 1999.

All above mentioned changes in the structure of the corporate ownership in Ukraine, happened by 1999 were not accompanied with changes in corporate performance. No insiders, no outsiders demonstrated higher performance in corporate governance. According to the personal investigations by authors, number of companies went

² Transformation of the structure of corporate ownership during the post-privatization period is the following: employees sell their shares to outsiders and management; the State and insiders sell shares to outsiders; outsiders become the biggest group of owners.

bankrupts after they were privatized, was equally distributed among companies owned by outsiders, and those, owned by insiders.

Methodology of research

The last stage of privatization named as "industrial" privatization started at the end of 1999. Large foreign investors became active in coming to Ukraine with investments. There was a light at the end of tunnel for all those who wanted play at the market for corporate control of Ukraine by worldwide recognized rules, based on transparency and responsibility. That time the President of Ukraine issued a fiat according to which only industrial companies from Ukraine or abroad could take part in tender offerings of shares of Ukrainian companies which must be privatized. Regrettably, no fundamental research had been undertaken since 1999 in the field of corporate governance in Ukraine, especially it concerns changes in the structure of corporate ownership.

To find out how "industrial" privatization influences the structure of the corporate ownership in Ukraine, we have undertaken investigation of the structure of corporate ownership of 270 Ukrainian companies, whose shares are in the different levels of listings at PFTS (OTC market). We prefer to use a PFTS companies database to those, represented by stock exchanges (there are eight stock exchanges in Ukraine), because the largest companies prefer to list the shares exactly at PFTS.

The period under research was from December 1998 to December 2003.

We have developed the following hypothesis to test:

1. "Industrial" privatization leads to transferring the corporate ownership from the State to institutional shareholders, and from employees to management.
2. Companies, which had concentrated ownership structure, were passive in equity issuing, because blockholders do not want to lose corporate control.
3. Interests of management and institutional investors at the market for corporate control are different.
4. Executives block participation of other large shareholders in corporate governance.
5. The higher concentration of corporate ownership structure by management, the lower they are concerned with size of compensation they obtain, as they have an opportunity to gain stock return and cash dividends.
6. Increase in concentration of ownership structure leads to decrease in market performance of a company because equity costs get up remarkably.

Research results

The first conclusion that must be done is that during above mentioned period of time, Ukrainian companies experienced remarkable changes in the structure of ownership (see *table 2.1*).

Table 2.1. *Structure of corporate ownership in Ukraine and Russia*

Owners	Russia			Ukraine		
	1999	2000	2001	1999	2000	2003
Insiders	58	45	34	44	57	64
Outsiders	33	48	55	36	35	30
The state	5	7	6	20	8	6

According to data containing in *table 2.1* it is possible to conclude that the share of insiders in the structure of corporate ownership in Ukraine remarkably increased (from 44 до 57 per cent). Herewith, the share of outsiders almost did not change. That means that "industrial" privatization has led to transferring the corporate ownership from the State to insiders.

It is interesting to remark that in Russia the changes in the structure of corporate ownership were different. Thus, over the period from 1999 to 2001 the structure of Russian companies became less concentrated in comparison with Ukrainian companies.

Increase in the share of insiders in the structure of corporate ownership in Ukraine is explained not only with activity of institutional investors, but also with aspiration of executives of Ukrainian companies to concentrate corporate control in their hands through buying shares at employees (see *fig. 2.1*).

According to *fig. 2.1* the most active in obtaining corporate control were institutional investors and executives of Ukrainian companies. Thus, the share of executives in corporate ownership structure during 1998-2003 increased from 6 to 17 percent. In comparison with institutional investors, who obtained a right for corporate control from the State, executives of Ukrainian companies used levers of personal pressure on employees of the companies to make them sell their shares to executives of companies.

Thus, development of the process of concentration of corporate ownership structure in Ukraine is controlled by two groups of investors. These are management (executives) of the companies and institutional investors.

The latest trends in development of market for corporate control evidence that the State as a shareholder leaves corporate ownership structure.

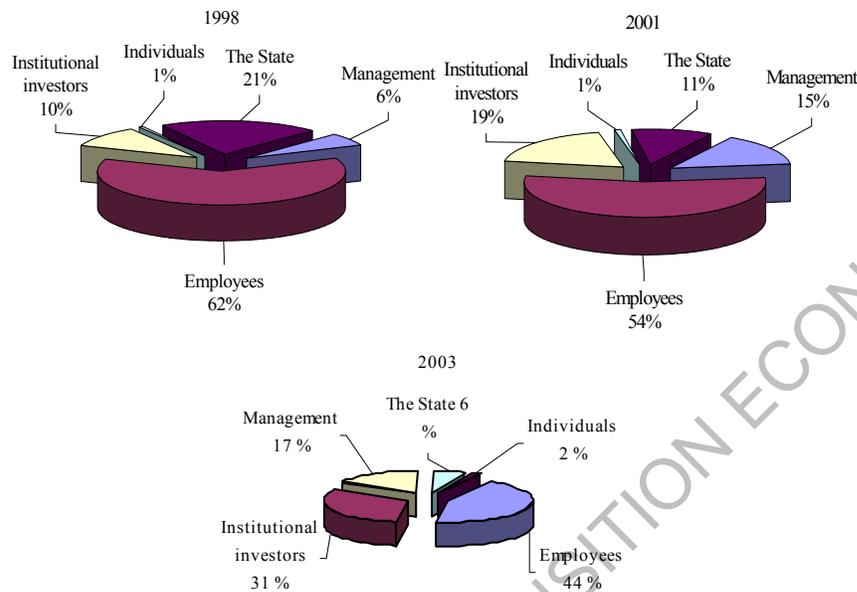


Fig.2.1. *Distribution of corporate control in Ukraine*

This is very progressive element of development of market for corporate control in Ukraine. At the same time employees leave corporate ownership structure too. It is possible to suppose that this is positive feature of development of market for corporate control too, taking into account that employees are not efficient in corporate governance. This supposition could be taken for conclusion, but for ways, which are used by management to make employees sell their shares. For example, if executives of the company want to obtain a corporate control through buying shares, they make employees sell their shares to them. If employees refuse this "offer", they will be fired. Employees got used to store their jobs but not their ownership.

Moreover, during 2001-2003, management of Ukrainian companies started to use one more mechanism to grasp corporate control – proxy voting. It is not difficult for management to make employees give proxies to management. We have accounted more than 60 cases how such mechanism works. As a rule, executives come to the General Meeting of a works council, that happens before the Annual shareholder meeting, and order employees, who are shareholders, to give proxies to management. Doing in such way, executives obtain corporate control with no costs. This is a management dictate.

Mechanism of concentration of corporate ownership structure in Ukraine during 1998-2001 is illustrated by *figure 1.3*.

Increase of the share of management and institutional investors in corporate ownership structure in Ukraine is followed with changes in capital structure of Ukrainian companies. During 1998-2003, those companies, which have concentrated ownership structure, were passive in equity issuing. Only 6 per cent of companies with concentrated ownership structure issued equity. Companies with dispersed ownership structure attracted almost 9 per cent of financial resources through equity issuing.

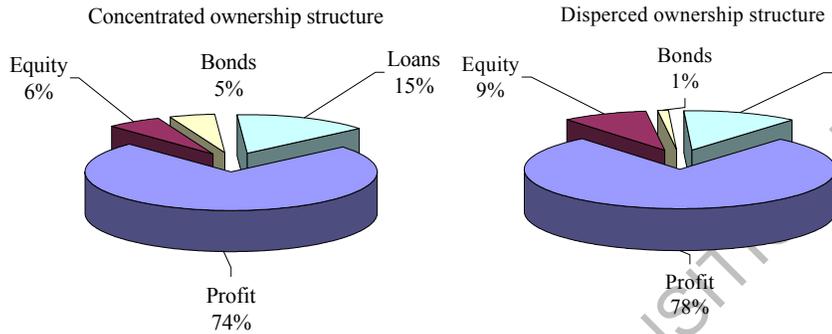


Fig.2.2. Structure of financial resources, attracted by companies with concentrated and dispersed ownership structures

One of the most interesting findings under the process of concentration of corporate ownership structure is a separation of interests of management and institutional investors at the market for corporate control.

Thus, among 270 enterprises under research, executives own shares in amount not less than 25 per cent of shareholders equity, at 42 companies. Institutional investors own the same amount of shares at 49 companies. Both management and institutional investors own shares in amount not less than 25 per cent of shareholders equity of the same company just in 9 cases.

Under such circumstances the hypothesis according to which executives block participation of other large shareholders in corporate governance is vital (*Morck, Shleifer, Vishny, 1988*). Moreover, executives of companies try to maximize size of assets, but not earnings of the company.

82 of 270 researched companies reported losses by the end of 2001 fiscal year. Herewith, 72 of 84 companies purchased fixed assets during 2001. Doing so, management of companies tried to deprive institutional investors of cash dividends.

Under circumstances of vitality of hypothesis of blocking by

management a participation of institutional shareholders in corporate governance, and absence of intentions of management to finance the company activity with equity, the objective of purchasing shares by management is very interesting to know.

Thus, the main objective of purchasing shares by management is obtaining a total control over the compensation policy. At the companies, which are under control of management, management can compensate their passive behavior at the stock market by fixing size of compensation to themselves at the high level.

The last finding does not support a Mehran's hypothesis, according to which the higher concentration of corporate ownership structure by management, the lower they are concerned with size of compensation they obtain, as they have an opportunity to gain stock return and cash dividends (Mehran, 1995).

That is why, at the markets under asymmetry of information, the hypothesis concerning behavior of management is named as "agents behavior, based on compensation" and sounds as the following.

At the markets under asymmetry of information, where management try to maximize outcomes from stock ownership, but they are not equipped with knowledge how to be efficient owners, they try to use their shares not as instrument of stock return, but as an instrument of corporate control. Herewith, the main objective of obtaining a corporate control by management is grasping by them a total control over the compensation system. So, maximizing compensation at the highest level, management compensate expenses, related to buying shares.

One more evidence in the favor of existence of the above mentioned hypothesis is a direct dependence of concentration of corporate ownership structure in the hands of management and costs of equity. This dependence is illustrated by figure 2.3.

With reference to figure 2.3, it is possible to conclude that concentrating the ownership by management of companies leads to increase in equity costs. This conclusion supports hypothesis by Fama and Jensen. The hypothesis states that an increase in concentration of ownership structure leads to decrease in market performance of a company because equity costs get up remarkably.

At the same time, it is interestingly to remark, cost of debt (corporate bonds) has not increased. It was not sensitive to the above mentioned changes in ownership structure. So, it is worth of concluding that concentration of corporate ownership in Ukraine was followed with a strong separation of two submarkets for corporate investments – market for equity capital and market for debt. Players at the market for equity capital were rather controllers than investors. Debt market participants were rather investors than controllers.

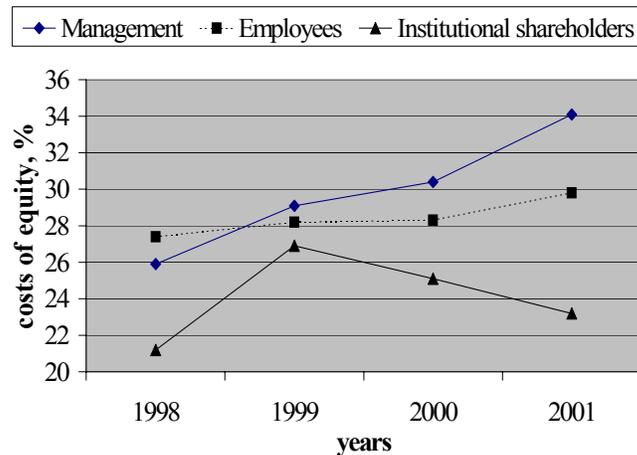


Fig.2.3. *Dynamic of change in costs of equity at the companies which are under control of various groups of shareholders*

Moreover, increase in concentration of ownership structure provokes worsening liquidity of shareholders equity. Large shareholders, who are rather controllers than investors, do not intend to lose a control over the company, which can happen as a result of new equity issue. The same trends were found by *Demsetz H., K. Lehn (1998)*.

The above mentioned hypothesis by *Fama and Jensen (1983)* can be slightly corrected in relation to problem of asymmetry of information. Remarkably higher costs of equity of the companies under control of management in comparison with those, controlled by institutional investors, can be explained by lack of knowledge of management of Ukrainian companies about basics of stock liquidity management, particularly in the part of initial public offerings.

Different efficiency of various groups of insiders about equity management is an excellent evidence of:

- different level of knowledge of these shareholders about basics of investments and corporate governance;
- differences in objectives of investing in the companies;
- different level of informational efficiency about recent performance and market outlooks of stock market in whole and certain company in particular.

Conclusion

Evolution of corporate ownership in Ukraine neglects a number of distortions in corporate governance practices. Increase in corporate

ownership concentration, in contrast to findings by many researchers, is followed with management entrenchment and a large shareholder weak transparency and responsibility.

Fight for corporate control is not based on the best practices in corporate governance. Oligarchs, representing Ukrainian financial-industrial groups, promote their interests to the State authorities, when the State sells its stakes in companies. All these, so named “trade actions” are not transparent, because large shareholders want to be unknown, and as a result, not accountable and responsible to society.

Executives of companies do not want to spend their own money to obtain corporate control through making employees sell shares. Nowadays, executives make employees give proxies to them. Thus, executives grasp corporate control for no costs.

Employees, who do not know why they own shares, how to own shares and how to make these WHY and HOW responsible to society, stay apart from all these events. They are static observers of the fight for corporate control.

So, all what Ukraine has now, when the process of privatization has almost finished, is not transparent institutional shareholders, entrenched management and passive employees.

The road ahead for corporate governance in Ukraine should start from legislative measures, for example adopting a project of “Joint Stock Companies Act” by parliament, to protect rights of minority shareholders and make motives and behavior of large shareholders transparent. These measures must be accompanied by development of mechanisms, such as stock exchanges, to let shareholders sell their shares or buy it. But all these measures can be effective only if shareholders find out WHY they own shares, HOW to own shares, and how to make these WHY and HOW responsible to society.

EMPLOYEE SHAREHOLDING: THE CASE OF UKRAINE

The role of employee ownership

Previous investigations of corporate ownership in Ukraine, undertaken by researchers, just analyzed the corporate governance mechanisms in Ukraine and did not try to find out, what the type of owner is the most efficient in Ukraine, i.e. employees, executives, foreign institutional shareholders, Ukrainian financial-industrial groups. Moreover, nobody researched the reasons, why corporate governance mechanisms, that are so popular worldwide, are not still applied in Ukraine effectively. We mean board of directors, compensation system, capital structures and so on. There are about 35 thousand joint stock companies in Ukraine. Annually, the state commission on securities and stock exchanges notes over 12 thousand cases of ignoring the principles of corporate governance in Ukraine.

From this perspective, it is very important to know *the role of employee ownership in corporate governance*, i.e. why employees own shares and what corporate governance mechanisms they use.

Research framework

To find out how "industrial" privatization influences the role of employee shareholdings in corporate governance in Ukraine, we have undertaken investigation of the structure of corporate ownership of 270 Ukrainian companies, whose shares are in the different levels of listings at PFTS (OTC market). We used a PFTS companies database to those, represented by stock exchanges (there are eight stock exchanges in Ukraine), because the largest companies prefer to list the shares exactly at PFTS. The period under research was from December 1998 to December 2003.

The most important finding we made, related to the ownership structure, concerns an increase of the share of institutional shareholders and management in the corporate ownership structure in Ukraine during 1998-2003. An increase in the share of institutional shareholders in the structure of corporate ownership in Ukraine is explained, as we already mentioned in the previous chapter, by activity of institutional investors at

the market for corporate control, and aspiration of executives of Ukrainian companies to concentrate corporate control in their hands through buying shares at employees.

According to *fig. 2.1* the most active in obtaining corporate ownership were institutional investors and executives of Ukrainian companies. The share of employees decreased for 18 per cent. At the same time the share of executives in corporate ownership structure during 1998-2003 increased from 6 to 17 percent. In comparison with institutional investors, who obtained a right for corporate control from the State as a result of industrial privatization, executives of Ukrainian companies used another way to have a corporate control - levers of personal pressure on employees of the companies (see *fig. 1.3*).

Development of the process of concentration of corporate ownership in Ukraine is not controlled by employees. They are behind of management and large institutional shareholders.

As we noted before, during 2001-2003, management of Ukrainian companies started to use one more mechanism to grasp corporate control – proxy voting. Employees, as a rule, want to consider themselves linked to the company by their place of work than by ownership rights. Under such circumstances it is not difficult for management to force employees give proxies to management. Doing in such way, management obtain corporate control with no costs. Trade-unions are only static observers and they do not want to go against executives too. This is a management dictate.

In Ukraine, employee shareholders still prefer to consider their own interests over the interests of a company. Thus, pay-out ratio for companies, controlled by employees, is the highest in comparison to companies, owned by other groups of shareholders. As a rule, employees do their utmost to use the net income gained to pay cash dividends. Investment projects are not developed enough. This is a proof of the short-term behavior of employee shareholders in Ukraine.

Table 3.1. *Pay-out ratios at the companies under control of various groups of shareholders*

Groups of stakeholders	Pay-out ratios, %			
	2000	2001	2002	2003
Executives	24	22	26	28
Commercial banks	32	35	38	32
Ukrainian investment companies and funds	36	41	39	36
Foreign institutional investors	27	28	24	27
Ukrainian financial-industrial groups	48	57	54	52
Employees	47	48	51	57

One of the most effective indicators of efforts of the companies in the way of innovation is the level of research and development expense and the proportion of these expenses in the total operating expenses.

With reference to *table 3.2* it may be concluded that there is a strong dependence of innovation efforts on ownership type of the companies.

Table 3.2. *Structure of operating expenses in Ukraine*

Groups of controllers	Structure of operating expenses, %			
	R&D	Sales & Marketing	General & Administrative	Total
Executives	21	54	25	100
Employees	23	56	21	100
Foreign investors	39	47	14	100
Ukrainian financial-industrial groups	27	51	22	100
Ukrainian commercial banks	29	53	18	100

In comparison to employee shareholders and executives, foreign institutional investors, as controlling owners, are much more inclined to bear research and development expenses than those companies, controlled by Ukrainian financial-industrial groups or executives. The share of research and development expenses in operating expenses in the companies under control of foreign institutional investors is 39 per cent, in comparison to 23 per cent at the companies under control of employees.

Foreign owners try to manage the companies in the way to get one step ahead of competitors. Almost always foreign owners begin with development of concept to manage innovation.

At the same time at the companies, controlled by employees the share of general and administrative expenses is very high (21 per cent). This is almost equal to the share of research and development expenses (23 per cent). Companies are inclined to increase rather sales and marketing expenses than research and development expenses.

Remarks

In Ukraine, employee shareholders perform much worse than other groups of shareholders, say, foreign institutional shareholders and Ukrainian financial-industrial groups. This is because of very low degree of knowledge of shareholders how to govern companies, their low

welfare and weak legal protection of employee shareholders rights.

Low welfare makes employee shareholders make "anti-investment" decisions when distributing net income gained by the companies they own. As a rule, employee shareholders prefer to use net income gained to pay dividends in cash, in contrast to foreign institutional shareholders who use net income to invest in perspective projects.

Weak legal protection of employee shareholders rights gives executives a chance to destroy activism of employee shareholders. As a rule, executives use two methods. The first is administrative pressure on employee shareholders to make them sell their shares to executives at very low prices. The second is a proxy voting, that is a result of administrative pressure too.

Under such circumstances, employee shareholders lose a motivation to own shares and participate in corporate governance and stay a part of the fight for corporate control in Ukraine.

CORPORATE GOVERNANCE IN TRANSITION ECONOMY
ALEX KOSTYUK
Published by Virtus Interpress

MARKET FOR CORPORATE CONTROL

Privatization process and market for corporate control

With reference to founders of the process of privatization in Ukraine, privatization would lead to appearance of effective owners. Political compromise of voucher privatization was much better than leaving corporate sector of economy under the control of the State beurocracy. Meanwhile, voucher privatization gave a lot of shares of Ukrainian companies to a big number of Ukrainian private shareholders. A few of them were informed and educated enough to use their rights as owners of corporations. That is why voucher privatization can hardly be named as successful.

Despite arguments toward negative impact of mass privatization on the market for corporate control, economic theory still supports mass privatization. *R. Coase* states: "Those owners who are not effective in corporate controlling, will sell their corporate rights to those who can do this. By doing so, the market will care about itself".

This theory, although, is based on the supposition that the market must be perfect for executing such transactions. But this supposition can be fully denied in practice (*Rosenbaum E., F.Bonker, H.-J.Wagener, 1999*).

Black, Kraakman and Tarasova (1999) were the first who argued the myth about perfect state of the market for corporate control in the countries where process of mass privatization lasts. They mentioned that mass transfer of assets from ineffective to effective owners was not mass as the process which gives a birth to transfer of assets - process of mass privatization. They stated that there were a lot of barriers for efficient transfer of rights for corporate control.

Dike (1999) supports this idea too. He proved that effective transfer of rights for corporate control is possible only in the perfect markets. Markets where the process of mass privatization is far from the perfect state.

Krakovsky (2002) narrates about various evidences of the point of view that mass privatization has not led to establishing a perfect market.

First of all, there were a lot of cases of assets and revenue tunneling in Ukraine. Such cases are popular not only in Ukraine. It is spread in

Czech Republic, Bulgaria and Russia (Djankov, 1999). After tunneling is complete a company turns into a bankrupt (Pinto B., S. Van Wijnbergen, 1995).

For the second, ownership rights are not secured. Thus, after privatization of the state property the state authorities argue ownership rights of new owners. The state authorities deprive new owners of their property not only in the case if the owners do not follow their investment obligations. Very often such cases have political and even criminal ground. In such cases the state authorities are executors of orders made by business circles with uncertain reputation. For the third it is very difficult to apply "due diligence" if investor wants to buy Ukrainian company. Ukrainian companies do not in general have system of financial statements which would meet all requirements of international standards. That is why there are a lot of cases when new owners found huge uncovered loans by the companies they own. Buying Ukrainian company which is not listed in stock exchange is like "buying a cat in a sack". For the fourth, it is very difficult for the state to effect primary issue of the shares in the transparent manner. There is no developed infrastructure of institutions which would be facilitating the process of primary issue of the shares. The only way is tender offer. But a high level of corruption in the state authorities in Ukraine does not let transfer a right of ownership to the most efficient owners.

Market corporate control in Ukraine: the major players

About 40 % of corporate ownership in Ukraine belongs to individuals, who are residents. A lot of them own very small number of shares. Structure of corporate ownership which belongs to Ukrainian individual investors is pictured below.

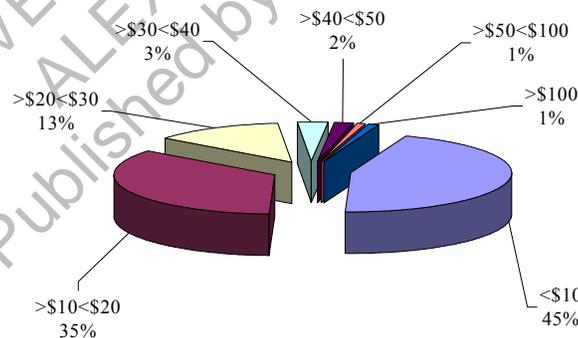


Fig.4.1. Structure of corporate ownership which belongs to Ukrainian individual investors

Taking into account that services of brokerage companies in Ukraine are from USD 50 for transaction and even higher which is higher than average value of shares Ukrainian investors own, that is why it is hardly possible to hope for smooth development of market for corporate control.

The above mentioned examples of barriers on the way of development of market for corporate control in Ukraine are very convincing. Let's find out how these barriers shaped the profile of the market for corporate control in Ukraine over 1998-2001.

During the above mentioned period of time the most active players at the market for corporate control were financial-industrial groups (FIG). Exactly FIGs purchased shares of Ukrainian companies with the aim to obtain corporate control.

With reference to results of trades at PFTS (OTC-market), exactly FIGs obtained corporate control through purchasing large blocks of shares (more than 10 % of shareholder equity).

In comparison with them management of Ukrainian companies used another strategy to obtain corporate control. They purchased shares at private shareholders, mainly employees, at small amounts.

Structure of participants of transactions at the market for corporate control by number of transactions at volume not lower than 10 per cent of shareholders equity for the period of time from 1998 to 2001 is below.

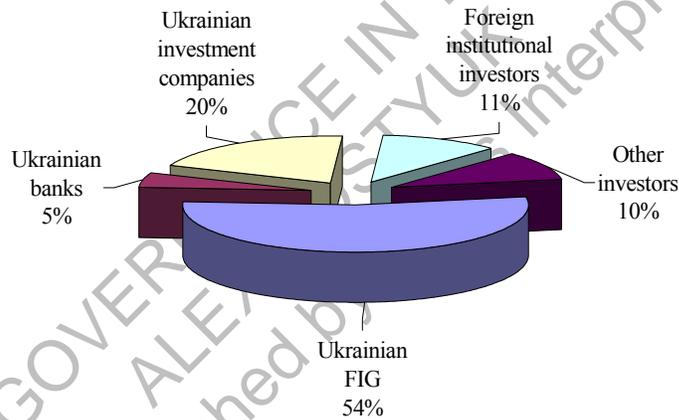


Fig. 4.2. Structure of participants of transactions at the market for corporate control of Ukraine by number of transactions at volume not lower than 10 per cent of shareholders equity for the period of time from 1998 to 2001

With reference to the above figure it is possible to conclude that the most active players at the market for corporate control in Ukraine were FIGs. More than half deals at the market for corporate control (54 per cent) were made by FIGs.

Industrial structure of deals at the market

The main industries to which the attention of FIGs was paid were energy generating industry, metallurgy and machine building.

The next figure contains the structure of deals of buying by FIGs large (more than 10 per cent of shareholders equity) stock of shares of the companies of the most attractive industries.

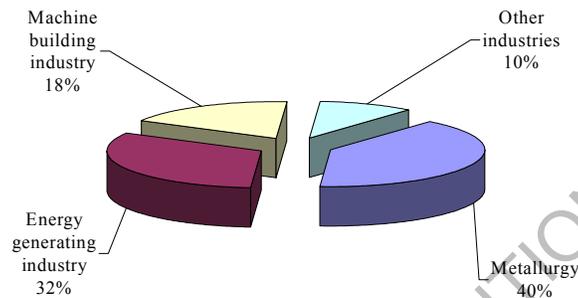


Fig. 4.3. Structure of deals of buying by FIG big (more than 10 per cent of shareholders equity) stock of shares of the companies of the most attractive industries during 1998-2001

Concentrating attention at the companies of metallurgy and energy generating industry, FIGs obtain a control not only over the companies of the above mentioned companies but and over the economic situation in Ukraine. It is because metallurgy and energy generating industry contribute about 45-50 per cent to GDP of Ukraine.

Besides this, metallurgy is strongly export oriented industry. More than 45 per cent of export of goods and services from Ukraine belongs to companies of metallurgy. High market performance of companies of metallurgy is a strong factor, contributing to stability of national currency, budget execution and high employment.

Energy generating industry has strong impact not only at economic but also politic development of Ukraine. Through obtaining a control over energy generating companies, FIGs simultaneously obtain a mighty lever for political control in Ukraine.

Markets for corporate control and shareholder equity

It should mention that efforts of FIGs to obtain corporate control over the companies of above mentioned industries contribute very much to worsening of equity liquidity of controlled companies.

Thus, having bought a large stock of shares, FIGs do not trade it later even despite very comfortable situation for selling shares. Such passive behavior of FIGs at the market for corporate control leads to worsening in liquidity of stock market of Ukraine and the stock market turns into the market for corporate control with strong controllers but weak traders.

Negative impact of development of market for corporate control at performance of the stock market of Ukraine can be proved with dynamic of stock price spread (*see table 4.1*).

Table 4.1. *Spread of price of equity of companies under control of various groups of investors **

Groups of controllers	Stock price spread		
	1999	2000	2001
Ukrainian FIGs	54	59	68
Ukrainian banks	44	55	52
Employees	48	58	56
Management	51	52	58
Ukrainian investment companies and mutual funds	36	42	39
Foreign investors	37	36	34

* more than 50 per cent of shareholder equity

Data of the *table 4.1* support point of view that market for corporate control in Ukraine is still not effective because it's development hampers development of market for corporate investments.

The most popular owners in the structure of corporate ownership in Ukraine - FIGs and management - behave very actively at the market for corporate control, and further passive behavior at the market for equity capital influences very negatively at the market opportunities of the companies, controlled by them.

As a result of the above mentioned behavior of owners, those companies which are under their control experience stock price spread which is much higher than at those companies, which are controlled by less numerous groups of owners - foreign institutional investors and Ukrainian investment companies and funds.

Exactly an activity of large owners at the market for corporate control in Ukraine explains positive correlation between stock indexes of a lot of industries. Under such circumstances portfolio investors have troubles with diversification of investment risks, trading shares of Ukrainian companies. Active trading in shares of popular companies is almost

impossible.

This let us issue a hypothesis about market for corporate control under asymmetry of information.

"Development of market for corporate control under asymmetry of information hampers an improvement in liquidity of market for equity and creates a serious barrier at the way of improving the market opportunities by the companies".

Table 4.2 contains results of correlation analysis of industrial stock indices in Ukraine.

Table 4.2. *Coefficients of correlation of industrial stock indices (index SPBU-30 over the period of time from January 1999 to January 2002)*

Industries	Correlation coefficients				
	Metallurgy	Energy generating	Chemistry	Oil-gas refinery	Others
Metallurgy		0,91967	0,813741	0,922194	0,24054
Energy generating	0,91967		0,63049	0,912997	0,21361
Chemistry	0,813741	0,63049		0,80285	0,28554
Oil-gas refinery	0,922194	0,912997	0,80285		0,19504
Others	0,240541	0,213611	0,285549	0,195045	

Under circumstances when the stock market in Ukraine can not perform efficiently its basic function - providing companies with financial resources and turns into the market for corporate control, those efficient outsiders who have very well diversified portfolio, are not able to contribute to increase of investment opportunities of the companies through active purchasing and trading shares. Presence in the structure of corporate ownership of large owners such as FIGs and management of the companies, and outsiders, such as foreign institutional investors, will undoubtedly provoke conflicts of interests between insiders and outsiders due to different approaches of these owners to corporate governance. Insiders are inclined to provoke increase in asymmetry of information. Outsiders aspire to improve informational transparency of the companies.

FINANCIAL-INDUSTRIAL GROUPS AT THE MARKETS FOR CORPORATE CONTROL AND INVESTMENTS: THE CASE OF UKRAINE

Evolution of FIGs in Ukraine

At this stage of development of the national economy the dominating part of Ukraine's GDP is manufactured by enterprises which are controlled by financial and industrial groups. One should note that, as a rule, the national financial and industrial groups are neither serious investors nor active users of innovations, nor the engine of reforms. At the same time, financial and industrial groups help coordinate the activities of enterprises they control and reduce their expenses. In any case, the activity of financial and industrial groups is a reflection of the real economic situation in Ukraine.

The history of Ukrainian financial and industrial groups started from the Decree of the President of Ukraine "About financial and industrial groups" of 25 January 1995. According to this decree, financial and industrial groups are "legal bodies established through amalgamation of industrial enterprises, organizations, banks and other business players with their property and financial resources pooled for centralized management of manufacturing, research and commercial activity".

This Decree set up a system of organizational and legal procedures for the functioning of financial and industrial groups based on principles of transparency of relations and financial accounting. This decree regulated the activity of financial and industrial groups which to some degree limited the possibilities for the groups. Wishing to have the biggest scope of possibilities, the groups were formed by means of informal relations until the abolishment of the decree in 1999. This fact explains the non-transparent structure of the property of these groups which were founded in the period of the decree's duration. As examples of such financial and industrial groups we can name "Finance & Credit", "Privat-Invest", "Ukrsibbank". As regards "The Industrial Union of Donbass", it went through the restructuring process in 2000, and today it has a fairly transparent structure of property.

Financial and industrial groups include commercial banks. Unfortunately, scientific literature does not clearly define the role of

commercial banks in these structures. Moreover, this literature does not pay attention to the efficiency of corporate control within financial and industrial groups. So, the main task of our research is to define the place and role of commercial banks in the structure of financial and industrial groups, as well as factors ensuring the efficiency of corporate control over the property of financial and industrial groups.

Methodology of research

The research we are planning to carry out will proceed in several stages.

During the first stage we will investigate the general characteristics of Ukrainian financial and industrial groups: “Finance & Credit”, “Privat-Invest”, “Ukrsibbank” and “The Industrial Union of Donbass”. The result of the research on this stage will be a brief description of financial and industrial groups from the viewpoint of their motives, strategies and role of banks in their structures.

During the second stage we will conduct the modelling of the groups’ profiles according to the motives of the property acquisition by these groups. As a result of this modelling we will get two matrices.

The first matrix will be based on such criteria as the place and role of banks in the structure of financial and industrial groups, as well as the range of diversification of the groups’ businesses. Using these criteria we will determine the motives behind the acquisition of property by these groups, which range from investment to speculative motives.

Then we will study the peculiar features of the corporate control of financial and industrial groups, juxtaposing the property that they acquired with their motives. These peculiarities will be based on the following criteria: depth of corporate control, the degree of the property transparency, level of property concentration. The right use of the last criterion will provide the corporate control rating. We will study in detail the methodology of its formation. For this purpose we will use a hypothetical example.

There are two financial and industrial groups. Each of them consists of eight enterprises. The distribution of the share of the shareholders capital for enterprises in such groups is shown in *Table 5.1*.

The methodology for the formation of the corporate control rating has several phases. During the first phase we will give a certain mark to the size of the block of shares. This method gives eight marks (from 1 mark for the smallest size of a block of shares (0,1-10 per cent), till 8 marks for the biggest possible block of shares (100 per cent)), which is shown in column 1-2 of the *Table 5.1*.

Table 5.1. *The distribution of the share of the shareholders capital for enterprises in such groups*

	Rating	Ownership concentration	Number of companies controlled by certain FIG		Points for each FIG	
			FIG №1	FIG №2	FIG №1	FIG №2
1	1	2	3	4	5	6
2	8	100%	3	2	24	16
3	7	75,1-100%	1	4	7	28
4	6	60-75,1%				
5	5	50,1-60%	2	1	10	5
6	4	40,1-50,1%				
7	3	25,1-40,1%				
8	2	10-25,1%				
9	1	0,1-10%				
10	Total amount		6	7	41	49
11	Average rating		6,8	7		
12	Total number of companies		8	8		
13	The share of companies selected to the total number of companies controlled by FIG		75%	87%		

During the second phase we enter (into the columns 3-4) the data about the number of enterprises in groups according to their shares of participation which is shown in column 2 of the *Table 5.1*. After that, by summing up, we calculate the number of enterprises, the information about which is given in columns 3-4 of the *Table 5.1*. The results are entered into the squares of the *Table 5.1*, which are located on the intersection of the columns 3-4 and the line 10 of the *Table 5.1*. Then we divide the number of enterprises (in which financial and industrial groups participate in the nominal capital) by the general number of the group's enterprises. The results will be entered in the line 13 of the *Table 5.1*.

During the third phase we calculate the general mark for every financial and industrial group. In order to do that we multiply the number of enterprises in groups by the mark that corresponds to this particular range (columns 5-6 of the *Table 5.1*). Then the results of the multiplication are summed up. By doing so we receive the general marks for the groups, which we put at the intersection of columns 5-6 and the line 10 of the *Table 5.1*.

During the fourth phase we find an average mark for the group that we enter into the line 11 of the *Table 5.1*. We do it by dividing the general mark for the group by the number of enterprises (in which financial and industrial groups participate in the nominal capital and the share of their participation is known).

The final phase is the making of the corporate control rating based on the mark which is average for the group. For example, the average mark for the first financial and industrial group is 6,8 and for the second financial and industrial group – 7. This shows the advantages of corporate control in the second case.

This rating will enable us to use such criterion of the efficiency of corporate control as the level of property's concentration. As a result we will be able to use all criteria, to carry out the modelling of the group's profile and to get the second matrix.

The last phase will determine the most efficient financial and industrial group for Ukraine based on the modelling of its characteristics.

Brief outline of financial and industrial groups in Ukraine

Financial and industrial group “Finance and credit”

The virtual owners of the group are the residents of Ukraine Konstantin Zhevago and Aleksey Kucherenko. The operational governance is carried out by Sergey Veselov and Igor Frunze. The core of the group is the joint-stock bank “Finances and Credit”. The interests of the bank represent the priorities in the activity of this financial and industrial group. The motive for the acquisition of property by this group is speculative. The main strategy of the group is diversification. This group consists of enterprises of the following branches: metallurgy, automobile industry and energy distribution. It should be noted that enterprises within the group are not among the leaders of domestic and foreign markets. That is the reason why they have to adjust to these markets' conditions.

The group tried to achieve the vertical integration in the metallurgical branch as it made the unsuccessful bid to buy 70 per cent worth block of shares of the open joint-stock company “The Khartsyzsky pipe factory”. The ownership of the two enterprises of the automobile branch - the open joint-stock companies “Avtokraz” and “Rossava” - does not allow the group to achieve the effects of the vertical integration, the most important of which is the addition of suppliers' profits.

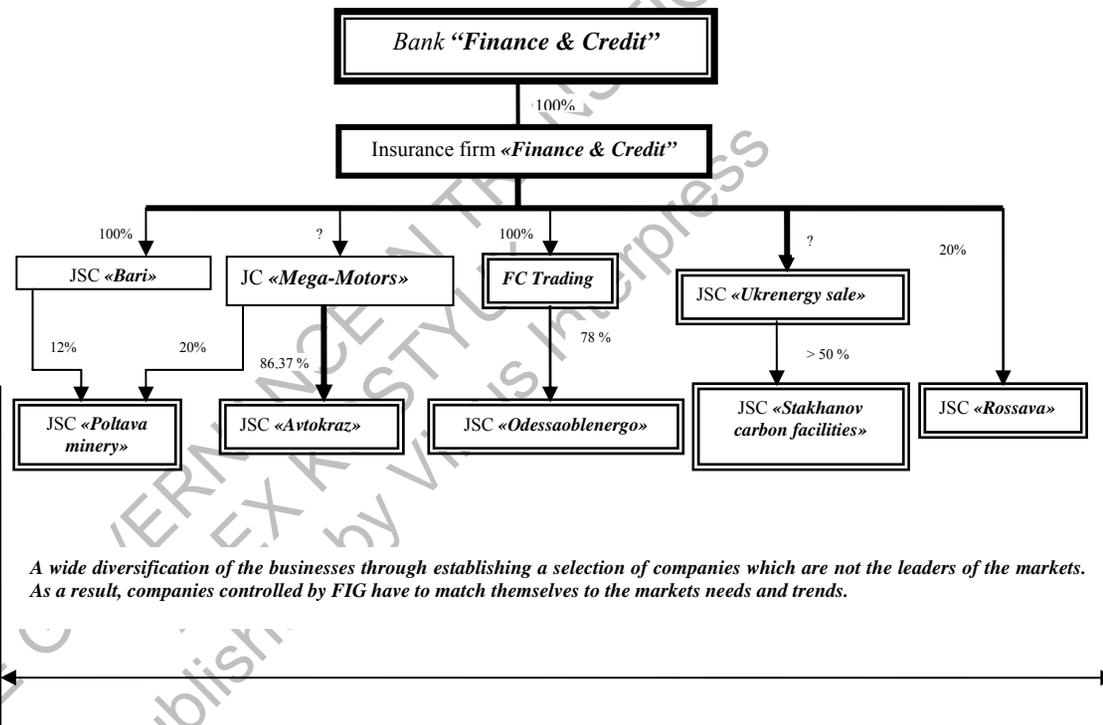


Fig. 5.1. Financial-industrial group "Finance & Credit"

This can be explained by the fact that the tires manufactured by the joint stock company “Rossava” are not an important item of expenses for the open joint-stock company “Avtokraz”, unlike metallurgical enterprises in which the expenses for the purchasing of raw materials produced by the mining enterprises make up 38-52 per cent of their expenses. Moreover, in the future one can expect considerable changes in the product policy, which means the renewal of equipment and the uncertainty of the source of tires’ acquisition.

The possibility of further privatization of enterprises, which would ensure the vertical integration for the group, is doubtful. The reason for that is the fact that in Ukraine there are some groups, which have a higher potential in the same branches than the financial and industrial group “Finance & Credit”. Besides, these groups possess considerably bigger financial resources.

The results of our analysis demonstrate that the financial and industrial group “Finance & Credit” has widely diversified business areas that logically correspond to the speculative motives of the group’s behavior on the corporate property’s market. This confirms the lack of vertical integration within the business areas of the group and the backward position of its enterprises on domestic and foreign markets.

Financial and industrial group “Privat-Invest”

The core of the group is the joint-stock bank “PrivatBank”. Its owners are the residents of Ukraine G. Bogolyubov, I. Kolomoyskiy and A. Martynov. The bank is one of the biggest in Ukraine, but the real foundations of its business are little known to the wide Ukrainian public.

As previously mentioned, the bank is a center of the group’s structure, but in contrast to the financial and industrial group “Finance & Credit”, its interests are not the group’s priorities. The bank is used only as a generator of cash.

The group has an investment motive for the acquisition of ownership. The goal of the group is the mastering of different branches of economy. Its interests spread to petrochemical, metallurgical, chemical, agricultural and other branches of economy.

As regards the strategic approach to the formation of the financial and industrial group “Privat-Invest”, its portfolio of corporate property is very diversified. The principle business areas include chemical and petrochemical industry, ferrous metallurgy and agriculture. The group has also diversified its activities in such branches as machine-building, ship-building, trade and communication.

As the remarkable share of the group’s profits is generated by enterprises of petrochemical and metallurgical branches, whose earnings

are mutually commensurable, we can see the effective measures aimed at reducing the economic risks. This can be explained by the fact that the financial strength of the group is determined by two business areas.

We should also stress that the financial and industrial group “Privat-Invest” is vertically integrated in such branches as petrochemical industry, ferrous metallurgy and agriculture. Let us study in more detail the efficiency of integration in all of these branches.

In petrochemical branch the vertical integration of the group is complete as shown by its enterprises. Such enterprises as open joint-stock companies “Ukrnafta” and “Naftokhimik-Prykarpattya” produce oil and petroleum products, which are sold by the joint-stock companies “Nikolayevnefteprodukt”, “Sumynefteprodukt”, “Chernikovnefteprodukt” and other companies of the group. The drawback of the vertical integration of the financial and industrial group in this branch is the deficit of production capacity for the secondary refinement of oil (*Figure 5.2*).

In the branch of ferrous metallurgy the group has concentrated more than 30 per cent of Ukraine’s production capacities for the dressing of iron ore (Southern, Iguletsky, and Suha Balka mining and metallurgical plants). The financial and industrial group “Privat-Invest” has also monopolized the production and dressing of manganese in Ukraine (Marganetsky and Ordzhenekinzensky joint-stock companies). The output of these plants is a raw stuff for such enterprises of the group as Nikolayevsky plant of ferroalloys, Zaporozhsky plant of ferroalloys and Petrovsky integrated plant. It is important to say that the production capacities of ore-dressing plants of the group by far exceed the needs of the group’s metallurgical plants. As a result, the financial and industrial group “Privat-Invest” works both on the market of the primary processing of metals and the market of metal products.

In the branch of agriculture the financial and industrial group “Privat-Invest” is vertically integrated. Unlike other branches, the integration here is partial (There are no not-sufficiently profitable agricultural enterprises). The structure of the chain of the vertical integration is the following.

The joint-stock companies “Bozhedarovsk grain elevator” and “Braginsk elevator” store grain and prepare it for further processing. The grain is processed by the joint-stock companies “Mogilevsk granaries” and “Khmelnitsk bakery”. These production capacities are very nicely balanced. According to this, the vertical integration of the financial and industrial group “Privat-Invest” is the most efficient in the agricultural branch.

Our analysis shows that the financial and industrial group “Privat-Invest” is engaged in a large-scale and diversified business. Its major branches are petrochemical industry and ferrous metallurgy.

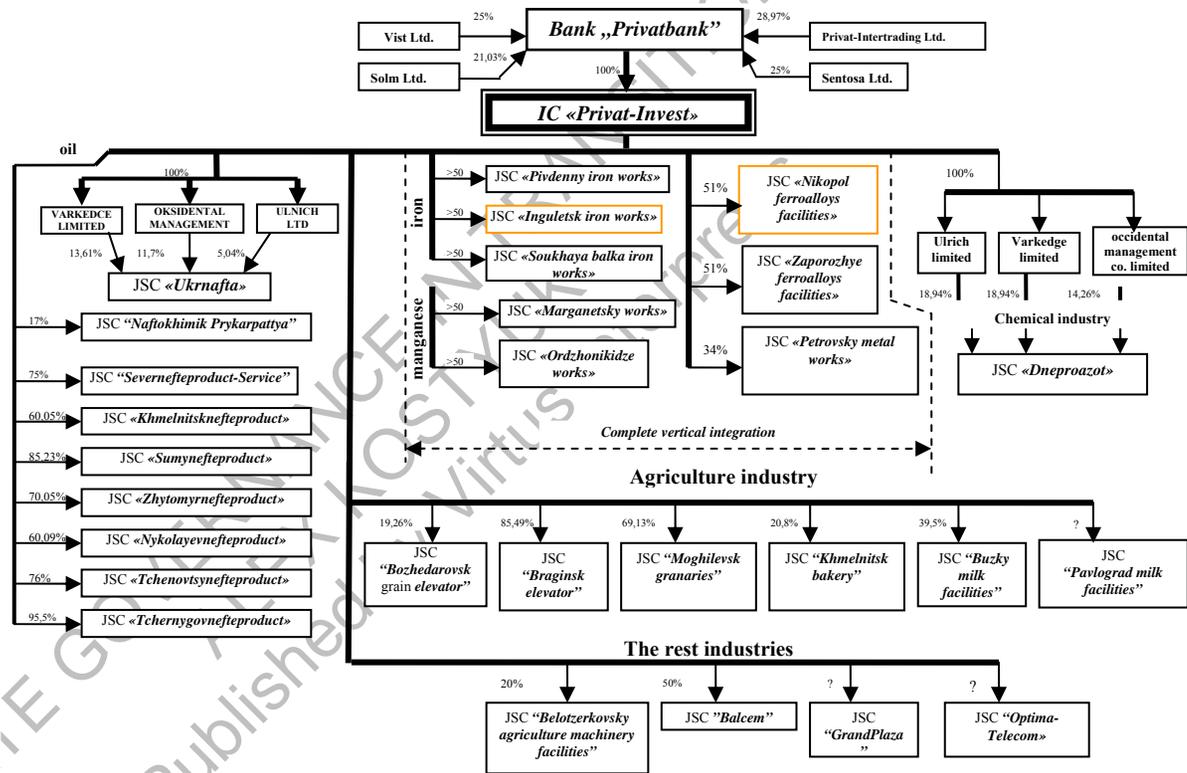


Fig. 5.2. Financial-industrial group "Privat-Invest"

Financial and industrial group “UkrSibbank”

The virtual owners of the group are the residents of the Russian Federation Oleg Derypaska and Roman Abramovich (92 per cent of the registered capital) and the resident of Ukraine, the deputy of Ukraine’s parliament Alexander Yaroslavsky (8 per cent of the registered capital). Regarding the place of the bank in the structure of the financial and industrial group, it is an intermediary in the group’s financial and investment operations. The bank “UkrsibBank” represents the interests of the Russian residents in Ukraine.

The group has an investment motive for the acquisition of property. The group’s objective is to strengthen the positions of the Russian investors in the branches of nonferrous metallurgy, petrochemical industry and cellular communication in Ukraine. A wide range of business areas of “UkrSibbank” demonstrates the level of its diversification. The group includes enterprises of ferrous and nonferrous metallurgy, petrochemical industry, communication, car manufacturing and other branches of the national economy.

Speaking of the degree of diversification of “UkrsibBank”, we should note that nearly half of the group’s revenue is produced by enterprises of nonferrous metallurgy. Another half of the group’s profits is brought by other businesses.

Figure 5.3 shows that the financial power of the group depends on one particular business area, which is nonferrous metallurgy. This demonstrates that the business risk is not evenly spread among the business areas of the group. It is also important to remember that the financial and industrial group “UkrsibBank” is not independent. Its objective is the strengthening of positions of the Russian investors in various branches of Ukrainian economy, with the best results achieved in the branch of nonferrous metallurgy. That is why the insufficient degree of the group’s diversification needed for the reduction of economic risks is not the group’s drawback. The strategy of the group’s formation is determined on a higher level (business structures that “UkrsibBank” is a part of).

It is also important to remember that the group is fully vertically integrated in the branches of nonferrous metallurgy and petrochemical industry. 90 per cent of the primery aluminium manufactured by the belonging to the group “Nikolayevsky’s aluminium plant” is exported because of the lack of processing capacities in the domestic branch of nonferrous metallurgy monopolized by “UkrsibBank”.

The results of our analysis demonstrate that the financial and industrial group “UkrsibBank” was set up in order to enable the Russian investors to master the Ukrainian market.

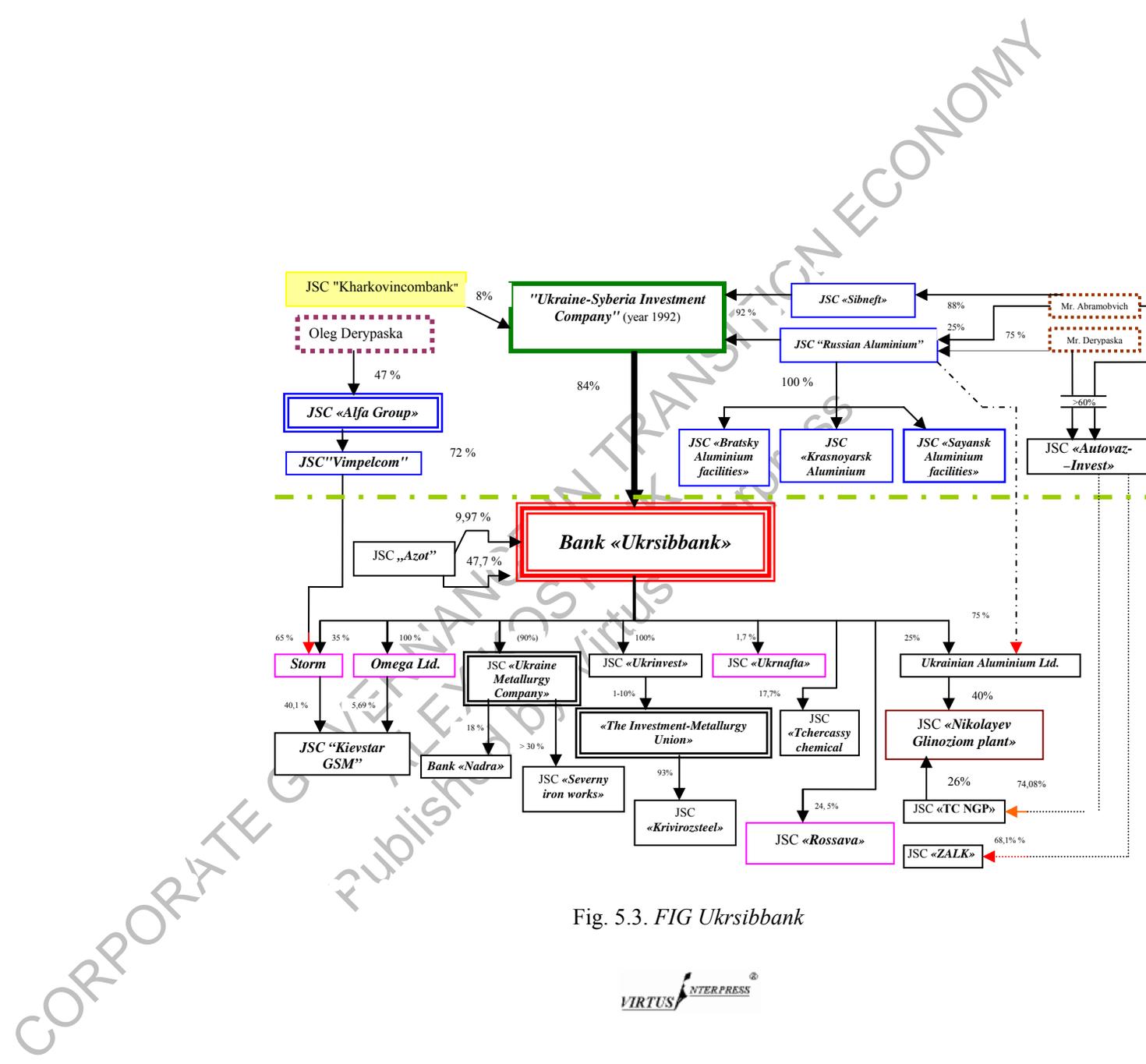


Fig. 5.3. FIG Ukrsibbank

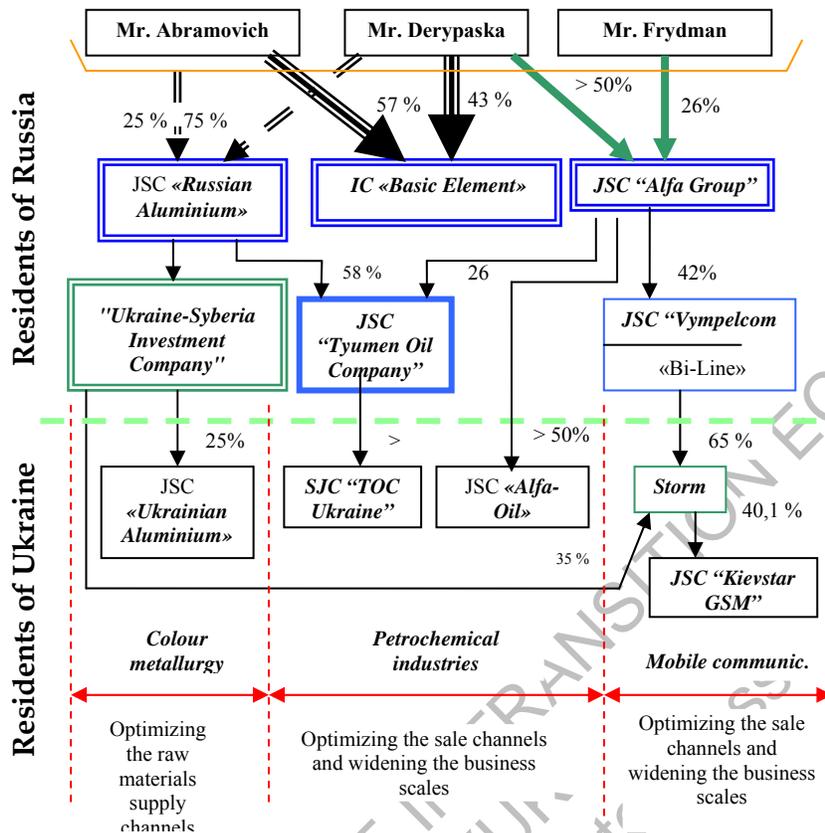


Fig. 5.4. Business interests of the residents of the Russian Federation in FIG UkrSibbank

This explains the dependence of the group and the intermediary role of “UkrsibBank” for the consolidation of positions in Ukraine’s economy. The group achieved the biggest success in the branch of nonferrous metallurgy and monopolized the domestic production capacities. That was a goal of the group.

Financial and industrial group “The Industrial Union of Donbass”

The biggest and the most influential financial and industrial group is the “The Industrial Union of Donbass”. It was founded in Donyetsk in December 1995. Its cofounders are the regional branch of the Academy of technologies of Ukraine, Donetsk city chamber of commerce, open joint-stock company “Azovintekx” (the town of Moriupol), closed joint-stock company “Vizavi” (Fig. 5.5). The last one became the most

prominent in the group. The founders of “Vizavi” are Vitaliy Gayduk and Sergey Levochkin. It is believed that the shares of the company are distributed in the following way: with 51 per cent belonging to Gayduk and 49 per cent belonging to Levochkin. The directors of the “The Industrial Union of Donbass” are Sergey Taruta and Oleg Mkrtychan.

It is worth mentioning that the group does not include any banks. According to this “The Industrial union of Donbass” is not a classical case of financial and industrial group. The dominant share of the group’s transactions is carried out through the commercial bank “Dongorbank”, which is connected to the group and which performs the function of the settling organization.

The share of resources generated by the Ukrainian banks serving the group as creditors is rather low in the structure of the group’s financial resources. The reason for that is that the potential of Ukrainian banks does not allow to carry out a full-scale crediting of the big business of the group (Small credits given by the domestic banks and the high interest rate can not satisfy the group’s demand for liquidity).

The main sources of finance for the group’s activities are prepayments for the future delivery of products and the group’s own revenues. On the one hand, the independence of “The Industrial Union of Donbass” from the banking institutions is an advantage, but, on the other hand, for such a big group it is very difficult to work for a long time using only its own resources.

The group has a specialized investment interest in the acquisition of property.

The objective of the group is the strengthening of its positions in the branch of nonferrous metallurgy.

The strategy of the group’s formation is vertical integration. The group has managed to unite enterprises with a closed technological chain (coal – coke – metal) which represents a vertical integration in the branch of nonferrous metallurgy.

More complex is the definition of the role of machine-building enterprises in the strategy of the group’s formation, as it is impossible to define the tools used by the group for gaining control over these enterprises.

If the group has control over the machine-building enterprises through participation in the authorized capital, then the following ways are possible:

- the group carries out interindustrial vertical integration by closing the chain (coal – coke – metal – metal-consuming products);
- the group carries out minor diversification in the branch of machine-building.

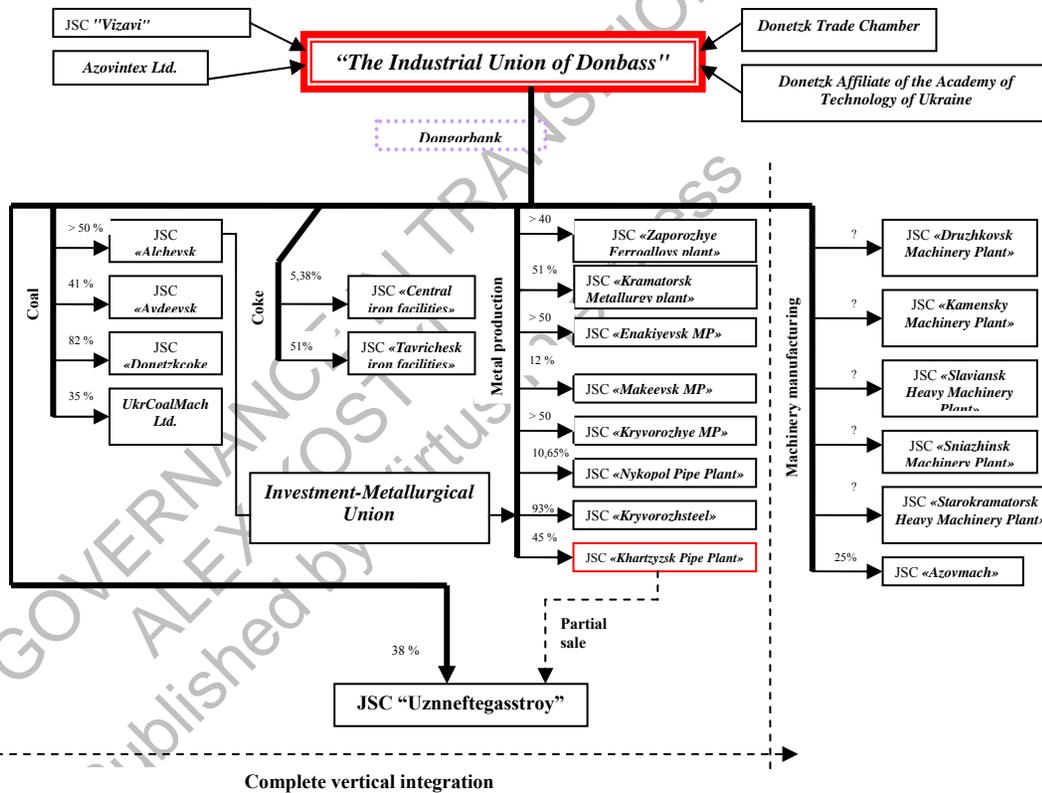


Fig. 5.5. Financial-industrial group "The Industrial Union of Donbass"

Only the motivation of persons making decisions about the purchasing of shares of machine-building enterprises can prove which of the strategic alternatives the group pursued.

Practically all profits of the “The Industrial Union of Donbass” are brought by the coke and chemical plants, metallurgical and tube-producing plants. This means that the dominating business is ferrous metallurgy.

If the group controls the machine-building plants by using instruments different from property rights, then in this case these enterprises do not play an important role in the formation of the group. They are only a segment of the market for the sales of metallurgical products controlled by the group.

The results of our analysis show that the “The Industrial Union of Donbass” is not a classical financial and industrial group because of the absence of a bank in the group’s structure.

The commercial bank “Dongorbank” plays a role of a settling organization for the group. The dominant business area is ferrous metallurgy, in which the group has a full vertical integration. The integration of the “The Industrial Union of Donbass” in this branch is ideal because of the well-balanced production capacities of the coke, chemical and metallurgical plants.

The activity of “Uzneftegasstroy” – an enterprise within the structure of the group - is not the group’s business area. Its shares were bought in order to ensure successful sales of the tubes produced by the open joint-stock company “Khartzyzsk Pipe Plant” on the market of Uzbekistan.

Motives for the acquisition of property by financial and industrial groups in Ukraine

Motives for the acquisition of property by financial and industrial groups

Speculative motive of the financial and industrial group “Finance & Credit”

Speculative motive of financial and industrial group “Finance & Credit” is a result of evolutionary development. The initial motive was an investment one, which is proved by the fact that earlier the group took part in privatization tenders, which could have ensured its vertical integration in some branches. But these attempts were not successful. On this stage the chances of “Finance & Credit” victory in these privatization tenders have been significantly reduced.

This is explained by the fact that, besides “Finance & Credit”, there are some groups in Ukraine which have a higher potential in the same branches of economy and have bigger financial resources. These particular features ensure their competitive advantages in privatization tenders. Further development of the group by means of organic growth within the existing enterprises is not possible, because the organic growth within the existing enterprises is possible only on the stages of the market’s formation and development, whereas the group’s enterprises carry out their operations on the markets which are already mature. Poor prospects for the development of the “Finance & Credit” group and its enterprises contradict the investment motive of the property’s acquisition.

As a result of such circumstances the investment motive of the group has been transformed into speculative motive consisting in the acquisition of property, which, later on, is to be sold at a higher price.

The conclusion that on this stage the “Finance & Credit” is driven by this motive was made on the basis of the following facts: business areas of the group are diversified, vertical integration has not been achieved in any of these business areas, enterprises within the group’s structure are not among the markets’ leaders. As mentioned earlier, these peculiarities of the group are logically correlated with the speculative motive of the property’s acquisition.

In our view, the following alternatives of “Finance & Credit” development are possible:

- The merger with a bigger group, which will be able to increase its market share and production capacities using the assets of “Finances & Credit”.
- Selling by “Finance & Credit” of all of its other enterprises with the exception of the open joint-stock company “Finance & Credit”.

In case of the merger with a bigger group, the range of corporate rights of the owners of “Finance & Credit” would be considerably narrowed. Because of that we believe that more preferable is the second option as the money received from the sale of assets can be used for the development of the open joint-stock company “Finance & Credit”, which operates on the promising Ukrainian market of banking services.

Diversified investment motive of the financial and industrial group “Privat-Invest”

This motive means that the group invests in enterprises of different branches with the goal of their development. By doing this the financial and industrial group forms such group of enterprises, which can ensure the increase of its market share, production capacities and attainment of

vertical integration. In case of successful realization of this motive's activities, diversified financial and industrial groups are formed. These groups have several business areas, they are vertically integrated and have strong positions. Such financial and industrial groups manage to reduce their economic risks (as a result of diversification) and to achieve cost saving (by adding the profits of suppliers through vertical integration), which ensure the viability of these groups.

The financial and industrial group "Privat-invest" diversifies its activities in various branches of the national economy. The main business areas are ferrous metallurgy and petrochemical industry, where the group has managed to achieve vertical integration, increase its production capacities and markets' share. In this way the risk of the group's activity is spread among several business areas, in which the group has strong positions. This proves the diversified investment motive of the group in the acquisition of property.

Investment motive of the financial and industrial group "UkrSibBank"

Before studying the motive of the property's concentration by this group it is necessary to pay attention to the group's goals. As mentioned earlier, these goals include the strengthening of positions of Russian investors in some branches of Ukraine's economy. That is why the group is not independent. According to this, the vertical integration and the degree of diversification in this case can not be the criteria for determining the motives of the acquisition of property by the financial and industrial group, because its strategy is formed at a higher level (business structure that includes the "UkrSibbank" group as one of its elements).

In our opinion, the group has the investment motive for the acquisition of property, because the group tries to maximize its potential in certain business areas.

For example, the financial and industrial group "UkSibbank" has monopolized the production of aluminium in Ukraine and gained a considerable share of the domestic market of cellular communication (GSM). Such an enterprise of the group as the joint-stock company "Azot" is a leader of the domestic market of mineral fertilizers. The attainment of such good results in the increase of production capacities and the conquering of the markets make it possible to conclude about the clear-cut investment motive of property's acquisition.

At the moment the portfolio of "UkrSibbank's" enterprises is quite promising. That means that the group can also develop autonomously, and, considering the support that the Russian investors can render, the viability and the prospects of the group are doubtlessly high.

Specialized investment motive of the financial and industrial group “The Industrial Union of Donbass”

This motive means that the group buys property in order to increase the production capacities, expand its market share and achieve the vertical integration in certain branches of economy.

Such groups have a substantial number of enterprises belonging to the same branch. Various technological cycles that make a closed production process are carried out within these enterprises. During the formation of the group one tries to achieve such a combination of enterprises that would not allow any disbalance of production capacities within the production process of the branch.

Groups that were formed in this way conduct a large-scale activity, have an opportunity to save costs (adding the profits of suppliers as a result of vertical integration). Very often these groups achieve a monopolistic position on the market. The drawback of such financial and industrial groups is that they are highly risk-prone as a result of the lack of diversification.

We have already mentioned the high potential of the “The Industrial Union of Donbass” in the branch of ferrous metallurgy, where it has an efficient vertical integration. This branch is a major business area of the group that made it possible for the group to increase its production capacities and occupy a substantial market share. These facts demonstrate the high specialized investment motive of the group in the concentration of its property.

It becomes obvious that Ukrainian financial and industrial groups have totally different motives in the acquisition of property, which is proved by their wide range from investment to speculative motives. Each of these motives can influence the strategic approach to the group’s formation, its potential and prospects, which is shown in *Fig. 5.6*.

In our opinion, in accordance with this profile, the most promising financial and industrial group is “Privat-Invest”. This opinion is based on the fact that by means of diversification this group has spread its economic risk among several business areas.

Moreover, in some business areas the group has integrated vertically and achieved some leading positions, which enabled it not only to adjust itself to the market’s conditions, but also to influence it in a certain way. The liquidity generated by financial and industrial group “Privat-Invest” made it possible to mobilize significant resources. That is the group’s advantage for the participation in privatization tenders. We can see that the role of “Privat-Invest” as the group’s cash generator does not consist in assisting the enterprises within this group, which are quite liquid themselves.

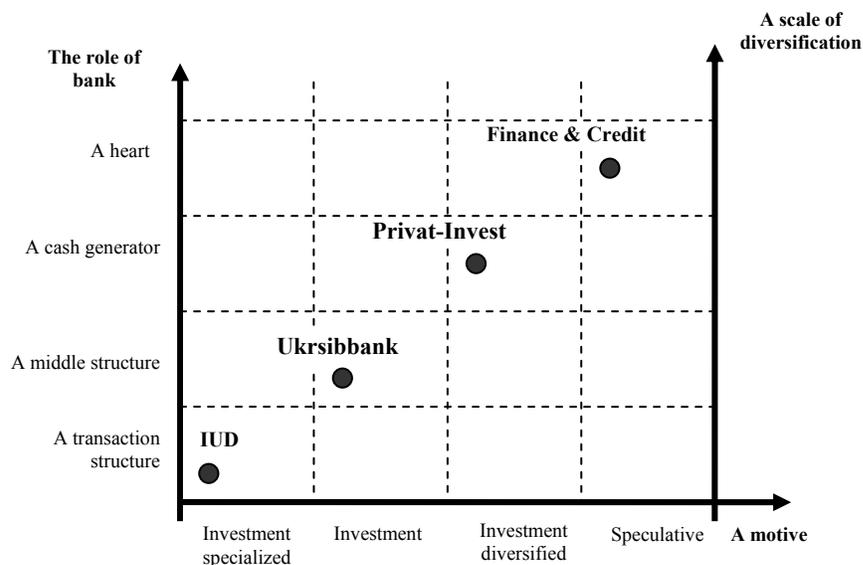


Рис. 5. 6. The profiles of FIGs

Peculiarities, which determine the efficiency of corporate control of the property acquired by the groups and their motives

As mentioned earlier, the main criteria, which determine the efficiency of corporate control within the group, are the system hierarchy, degree of property's concentration and degree of property's transparency. Within these criteria we will analyze the efficiency of corporate control for each financial and industrial group.

Peculiarities, which determine the efficiency of corporate control within the financial and industrial group "Finance & Credit"

The degree of property's concentration by the group is high. The average size of a block shares is 53,3 per cent. The group's participation in the authorized capital of some enterprises differs considerably. For example, having consolidated with the German partners, "Finance & Credit" can vote with the number of shares equal 86,37 per cent at the meeting of shareholders of the joint-stock company "Avtokraz". That makes it possible to make any decisions regarding the joint-stock company. Such

rights, but without consolidation with others, the group enjoys with 78 per cent worth block of shares of the joint-stock company “Odessaoblenergo”. Having consolidated with foreign partners, the group controls 32 per cent of shares of the joint-stock company “Poltava Iron Facilities”, which enables the group to nominate its candidates to the company’s managerial bodies, initiate extraordinary meetings of shareholders and block any decisions concerning reorganization, liquidation and changes of the company’s charter. 20 per cent worth block of shares of the joint-stock company “Rossava” allows the group only to nominate its candidates to the managerial bodies and initiate extraordinary meetings of shareholders. Having the control over the joint-stock company “Ukrenergosbyt”, which in its turn has the controlling block of shares of the joint-stock company “Stahanovsky plant of technical carbon”, makes it possible for the group to make any decisions concerning the company with an exception of its liquidation and changes in the charter.

The property of the group is not transparent. It is impossible to trace its structure on the basis of official data. The reason for that is the fact that most of its assets the group owns through joint enterprises, off-shore companies and other intermediaries. The non-transparent structure of ownership prevents the group from using its full potential, which is a drawback if the group wants to participate in privatisation tenders, receive credits and attract investors.

The system of corporate control of the financial and industrial group “Finance & Credit” consists of two levels. The first level is the financial and investment company “Finance & Credit”, which completely belongs to the commercial bank “Finances and Credit”. We suppose that the creation of this level of corporate control is explained by the desire of owners to make within the group’s structure some centres responsible for financial and investment activity (commercial bank “Finance & Credit” and investment company “Finance & Credit”). 80 per cent of enterprises within the group have the second level of corporate governance and control that covers off-shore companies, joint ventures and other enterprises. The multi-level system of corporate control reduces their efficiency, but in some cases it is necessary. For example, foreign partners, with whom joint enterprises are founded, can have considerable financial resources, experience and potential for working in particular branches. We believe that this explains the existence of joint ventures (“Bari” and “Mega-Motors”) on the second level of corporate governance and control over such enterprises of the group as joint-stock companies “Poltavsky Iron Facilities” and “Avtokraz”. The necessity of off-shore companies FC “Trading” on the second level of corporate control of the joint-stock company “Odessaoblenergo” is doubtful.

The level of concentration of the property of the group “Finance & Credit” (consolidated with foreign partners) is high. This reflects the specific character of Ukraine’s corporate control market. In comparison with foreign experience of speculative transactions, in which the buying of blocks of shares of enterprises worth 5 per cent results in considerable changes in the structure of property, the Ukrainian market of corporate control is less susceptible to changes in equity participation. Such situation can be explained by nonsufficient development of the stock market and main instruments of corporate control. The structure of the group’s property is not transparent, which is a drawback for participation in privatisation tenders and attraction of investments. The multi-level system of corporate control reduces its efficiency, but in case of some enterprises it is a necessity.

Peculiarities, which determine the efficiency of corporate control of the financial and industrial group “Privat-Invest”

The level of concentration of the group’s property is not high. The group has controlling block of shares in more than 65 per cent of its enterprises. In more than 30 per cent of enterprises the financial and industrial group “PrivatBank” owns blocks of shares, which give it the quorum at shareholders’ meetings. Such level of the property’s concentration gives the group a wide range of rights at the meetings of shareholders.

The property of this group, as well as the “Finance & Credit” group is not transparent. Off-shore companies own the major part of enterprises. It is very difficult to determine their connection with the group on the basis of official data. The non-transparent structure of ownership limits the possibilities of the group, which is a drawback for the group’s participation in privatization tenders.

The system of corporate control of the financial and industrial group “Privat-Invest” is very efficient as shown by the purposeful and efficient realization of the strategy. We can surmise that all blocks of shares of the group are managed by one organ in spite of the fact that enterprises are owned by off-shore companies. In our opinion, the governance of enterprises, which are under control of the group, is carried out by the investment company “Privat-Invest”, which is a property of the commercial bank “PrivatBank”. That is why the multi-level system of corporate management and control is non-existent.

We can make a conclusion that, in spite of the intricate and non-transparent structure of the property owned by the financial and industrial group “Privat-Invest”, governance of the group is efficient enough. This is explained by the high degree of the property’s concentration and the efficient system of corporate control mechanisms, where the major place

belongs to the transfer of assets' management to the single organ within the group "Privat-Invest".

Peculiarities, which determine the efficiency of corporate control within the financial and industrial group "UkrSibbank"

The level of the property's concentration of "UkrSibbank" is not high. The average size of blocks of shares is about 37 per cent. According to the national legislation, this size of equity participation allows to nominate candidates to the managerial bodies of joint-stock companies, initiate extraordinary meetings of shareholders, block decisions concerning reorganization, liquidation and changes in the company's charter. If the group consolidates with its Russian owners it can receive a wide spectrum of rights at the meetings of shareholders of ferrous metallurgy enterprises.

For example, the commercial bank "UkrSibbank" together with the joint-stock company "Russian aluminium" owns 100 per cent of shares of the open joint-stock company "Ukrainian aluminium", which makes it possible to make any decisions regarding the company's activity. In its turn, the open joint-stock company "Ukrainian aluminium" owns 40 per cent of shares of the open joint-stock company "Nikolayevsky aluminium plant".

Further 26 per cent of this plant's shares belong to the joint-stock company "Avtozaz-Invest", which belongs to the Russian owners of "UkrSibbank". Consequently, the owners of the financial and industrial group "UkrSibbank" can concentrate 66 per cent of shares of the open joint-stock company "Nikolayevsky aluminium plant". This makes it possible to make any decisions concerning this enterprise with an exception of reorganization, liquidation and changes in the company's charter.

Compared with the structure of property of the groups "Finances and Credit" and "Privat-Invest", the structure of property of "UkrSibbank" is more transparent. This enabled us to determine that the commercial bank "UkrSibbank" performs the function of an intermediary in the activity of the group. To some extent, the relatively transparent structure of property reveals the potential of the group, which is an advantage during the participation in privatisation tenders.

The system of corporate control is rather complex and has two levels. The first level is the "Ukrainian-Siberian investment corporation". Its Ukrainian owners were the founders of the commercial bank "UkrSibbank". The commercial bank "UkrSibbank" is the second level. It carries out the management of the blocks of shares that belong to the

group. The multi-level system of corporate governance and control reduces its efficiency, but considering the dependency of the group, the two-level system of corporate control is the most acceptable option.

By analysing the efficiency of corporate control within the financial and industrial group “UkrSibbank” we have found out that the multi-level system of corporate control is an objective necessity and reflects the specific character of this group. The transparent structure of property shows the group’s potential, and herefore it is an advantage during participation in privatisation tenders.

Peculiarities, which determine the efficiency of corporate management and control within the financial and industrial group “The Industrial Union of Donbass”

The level of concentration of property by the group is not high. The average block of shares of the group is 36 per cent. It is necessary to point out that the group’s participation in the authorized capital of certain enterprises differs significantly.

For example, the group has controlling blocks of shares in more than 26 per cent of enterprises, which makes it possible to make any decisions concerning the activities of an enterprise with an exception of reorganization, liquidation and changes in the company’s charter. In 6 per cent of enterprises the group has blocks of shares allowing it to make any decision concerning these enterprises. In 20 per cent of enterprises the group owns blocks of shares allowing it to block any decisions made at the meetings of shareholders. In 27 per cent of enterprises the group owns up to 12 per cent of shares, which enables it to nominate candidates to the managerial bodies of these enterprises and initiate the extraordinary meetings of shareholders. In 21 per cent of enterprises the group owns 25-35 per cent of shares, which allows the group to nominate its candidates to the managerial bodies of these enterprises, initiate the extraordinary meetings of shareholders and block decisions concerning reorganization, liquidation and changes in the company’s charter.

Most sources indicate that at the meetings of shareholders of “The Industrial Union of Donbass” consolidates with other owners, which helps broaden the scope of its rights.

Unlike groups like “Finance & Credit”, “Privat-Invest” and UkrSibbank”, the property of the “The Industrial Union of Donbass” is transparent, as one can verify the information about it in the official sources. The transparent structure of the property shows the group’s potential, which is an advantage during the participation in privatisation tenders, receiving of credits and attraction of investments.

The system of corporate control does not have the hierarchy with the exception of the joint-stock company “Kryvorozhstal”. The lack of hierarchy is partially explained by the transparency of the property’s structure and ensures a sound control over the enterprises within the group’s structure.

The degree of the property’s concentration is not high. The efficient management of “The Industrial Union of Donbass” ensures consolidation with other owners of enterprises within the group, transparent structure of property and lack of hierarchy in the corporate control system.

We will try to model the profile of the financial and industrial group, which characterizes the efficiency of corporate control within the property acquired by the group in accordance with the motive. As mentioned earlier, the main criteria determining the efficiency of the group’s corporate control is its depth, degree of transparency, degree of property’s concentration and depth of corporate control. The table of the rating of corporate control in accordance with the level of property’s concentration will provide us with the right use of the last criterion.

Having the rating of corporate control, we can use all the criteria, which determine its efficiency within the property acquired by the group and in accordance with the motive. Using these criteria we build a new matrix (*Fig. 5.7*).

In our opinion, this matrix does not allow us to make a positive conclusion about the efficiency of corporate control within the property acquired by the financial and industrial group. The reason for that is the fact that in accordance with this matrix, the groups that we analyze have advantages and disadvantages depending on the criterion we use. So, this matrix shows only the peculiarities of the groups.

The only possibility to determine the financial and industrial group with the best control of the acquired property is to find out, by which means the group carries out the efficient control.

For example, the financial and industrial groups like “Finance & Credit” and “Privat-Invest” have the highest degree of property’s concentration. It is worth mentioning that “Privat-Invest” manages big blocks of shares independently. It differs from the financial and industrial group “Finances and Credit”, which has a high level of property’s concentration due to the consolidation with foreign partners. Among the groups that we have analyzed “Privat-Invest” has the biggest corporate rights due to the degree of the property’s concentration.

Table 5.2. *The rating of corporate control*

Rating	Ownership concentration degree	Number of companies controlled by FIGs				Points for each FIG			
		Finance & Credit	Privat-Invest	Ukrsibbank	IUD	Finance & Credit	Privat-Invest	Ukrsibbank	IUD
8	100%	2	6	2	0	16	48	16	0
7	75,1-100%	2	4	1	1	14	28	7	7
6	60-75,1%	0	5	0	0	0	30	0	0
5	50,1-60%	1	8	0	5	5	40	0	25
4	40,1-50,1%	0	1	2	3	0	4	8	12
3	25,1-40,1%	1	3	3	2	3	9	9	6
2	10-25,1%	1	4	4	3	2	8	8	6
1	0,1-10%	0	0	2	1	0	0	2	1
Total amount		7	31	14	15	40	167	50	57
Average mean		5,71	5,39	3,57	3,80				
Total number of companies, controlled by FIGS		11	35	15	21				
The share of companies selected to the total number of companies controlled by FIG		63,64	88,57	93,33	71,43				

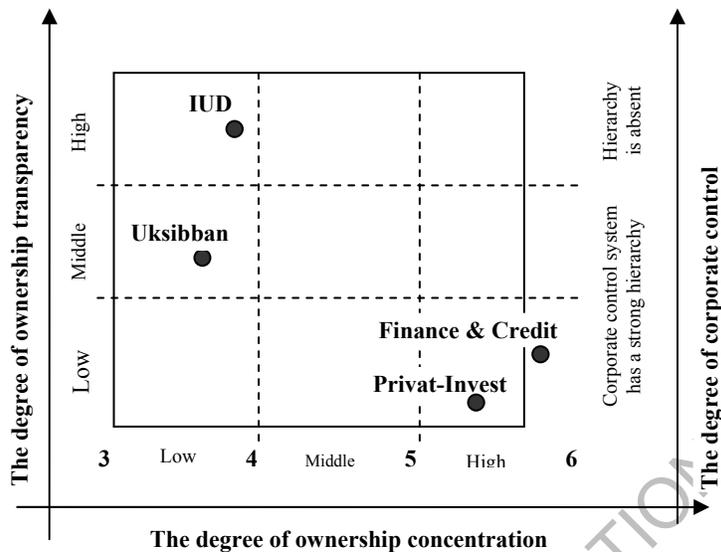


Fig. 5.7. The profiles of FIGs

The next criterion is the degree of the property's transparency and the depth of corporate control. The matrix shows that "The Industrial Union of Donbass" has the highest indicators according to these criteria (Fig. 5.7). At the same time, we believe that the management of shares in the group "Privat-Invest" is carried out by a single body. This makes it possible to liquidate the hierarchy of the corporate control system in spite of the complex and nontransparent structure of property.

As we see, the financial and industrial group "Privat-Invest" has the highest concentration of property. Governance of the group is carried out very efficiently which leads us to the conclusion that this group could considerably minimize such drawbacks as nontransparent structure of property and hierarchy of the corporate control system. That is the reason why, in our opinion, the financial and industrial group "Privat-Invest" has the most efficient control of the acquired property.

Conclusions

As a result of our research we have discovered that the role of banks in the functioning of various financial and industrial groups is different. Frequently, the whole group works in the interests of some particular bank. But, there are also cases when a group uses a bank as a generator of cash, as intermediary or when a bank plays an auxiliary role. The strategic approaches to the groups' activities are also different. Some groups integrate vertically, other groups diversify their activity.

The efficiency of corporate control within groups is determined by such criteria as the degree of property's concentration and the depth of corporate control. Financial and industrial groups differ much in accordance with these criteria. The role of banks, strategic approach to the formation of financial and industrial groups, the efficiency of corporate control of the property acquired by the groups depend on the motive of the property's acquisition, as well as such factors as the group's size, the branch and the group's relationship with its environment. This is shown by the results of our research of the biggest financial and industrial groups in Ukraine "Finance & Credit", "Privat-Invest", "UkrSibbank", "The Industrial Union of Donbass".

From the viewpoint of the motive of property's acquisition and the efficiency of its management, the best model of the financial and industrial group is "Privat-Invest" with the commercial bank "PrivatBank" at its core. The conclusion about the advantages of "Privat-Invest" in comparison with other groups in our research is based on the following facts. The function of cash generator carried out by the commercial bank "PrivatBank" allows the group in short periods of time to mobilize considerable sums of money needed for the acquisition of property, which is impossible for the financial and industrial groups without powerful banks in their structure. It is also important that "Privat-Invest" diversifies its activity. This makes it possible to reduce the economic risks. Moreover, in some business areas the group is vertically integrated and has the leading positions, which enables it not only to adjust to the markets' condition, but also to influence it. The efficiency of corporate control of the property acquired by "Privat-Invest" is explained by the high degree of its concentration, as well as by the liquidation of the excessive hierarchy of the corporate control system.

The most important criteria that financial and industrial groups have to meet for the efficient functioning on the Ukrainian markets are: a powerful bank capable of carrying out the function of cash generator within a group; high degree of business diversification; optimum vertical integration within the chosen business areas; high degree of property's concentration; minimized hierarchy of the system of corporate control.

During the research we studied one more criterion – the degree of property's transparency. The foreign experience highly values the degree of property's transparency, but Ukrainian practice of corporate governance still follows another principle – a principle of information nontransparency within the structure. Under the present conditions of Ukraine's corporate control market the efficient work of groups is possible even when this principle is ignored. This is explained by the lack of appropriate legislation protecting the property rights, low activity of small shareholders and unwillingness of the groups themselves to make transparent their motives of participation on the corporate control market.

CORPORATE BOARD PRACTICES IN UKRAINE

The role of boards of directors

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.

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.

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 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 6.1. *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 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.

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.

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 6.2. *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

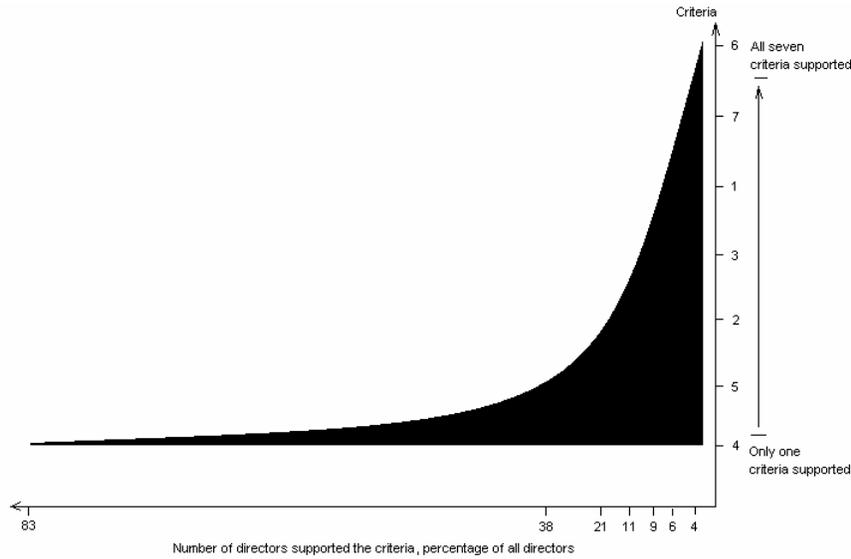
We have decided not to make a point here and develop the topic of director independence further. Thus, at the end of 2004 we distributed a questionnaire among the directors of supervisory boards of Ukrainian companies and asked them to choose the most appropriate criteria for the director independence.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

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 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 field 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 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 for setting 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 passes 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 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. 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.

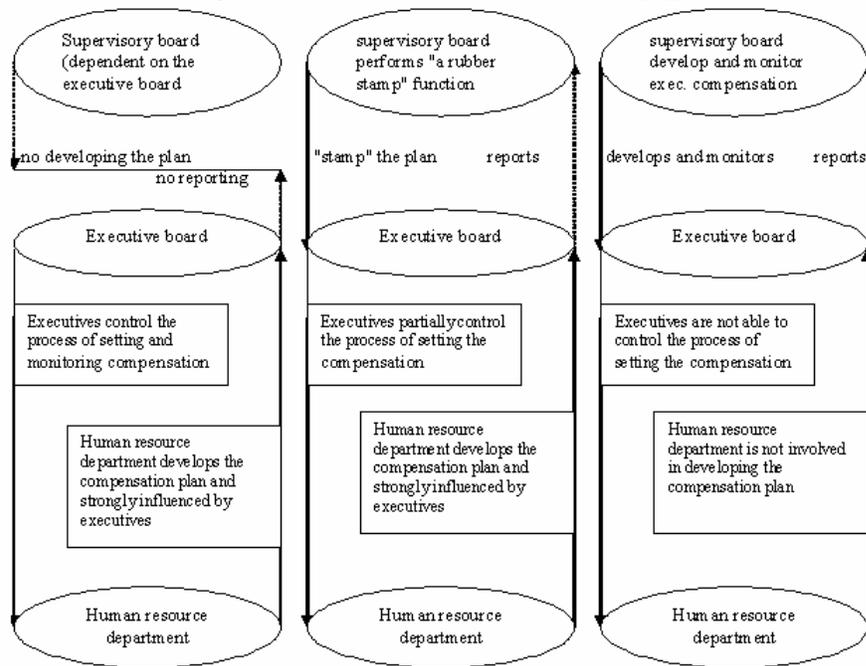


Fig. 6.2. Models of executive compensation setting in Ukraine

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 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 interests 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 is at companies, controlled by Ukrainian financial-industrial groups is monitoring (4 replies).

Table 6.3. *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 adsorb 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.

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.

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.

Table 6.4. 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

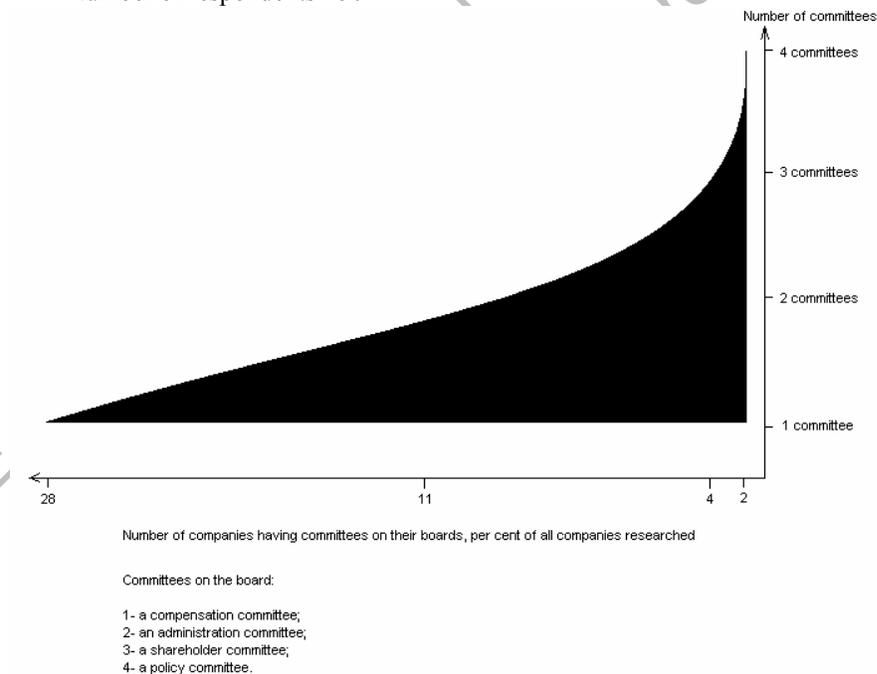


Fig. 6.3. Distribution of committees at Ukrainian joint stock companies

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).

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 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 the Chairman of the Board to be responsible for selecting candidates to be nominated to the board. That is why 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 their 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 the 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 by the management board or by 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.

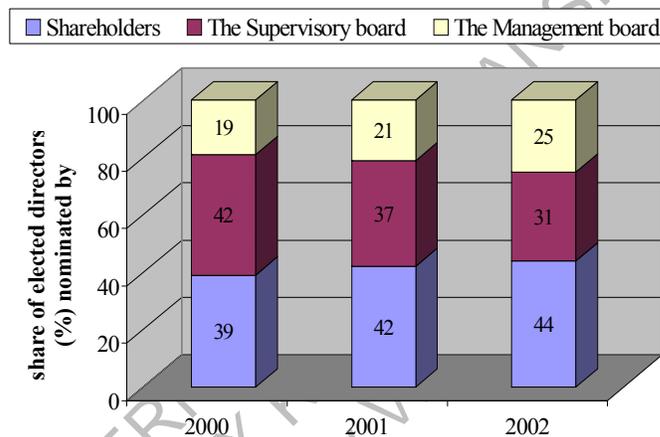


Fig. 6.4. Groups of the director nominators and their efficiency in nomination

These trends could evidence about an executives' wish to eliminate separation of ownership and control in Ukraine. Moreover, decrease in successful nomination of directors by the supervisory board says that shareholders do not want to 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 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 widespread practice in 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, 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

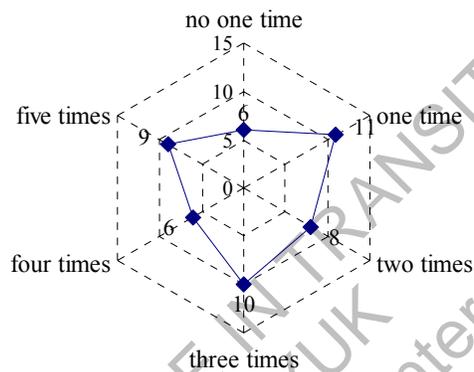


Fig. 6.5. Number of substitutions of the chairman of the supervisory board at researched Ukrainian joint stock companies for the period of five years

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 the researched companies applied 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 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 Ukraine employee participation is available only at the companies where employees are majority shareholders. Taking into account that in Ukraine the employee shareholders activism is not popular, and cumulative representation on the board is not fixed and promoted 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 the work councils at the company.

As a rule, decisions on employment and wages are made only after consulting between the supervisory board and the work council. It is a very difficult to conclude what share of proposals by the work council is approved by the supervisory board, but it is possible to conclude an existence of mechanism how employees can participate in corporate governance - through the work council and the policy committee on the 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 for sharing 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 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 the strongly motivated controllers and they will not share their power with anybody 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 the 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 Ukraine to those in Germany is an 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.

CORPORATE GOVERNANCE IN TRANSITION ECONOMY
ALEX KOSTYUK
Published by Virtus Interpress

MARKET FOR EXECUTIVES IN UKRAINE: EXECUTIVE DECISION MAKING AND ITS EFFICIENCY

Executive performance and ownership structure

Transformation of the structure of corporate ownership in Ukraine should be followed with transformation of approaches to decision making at all levels. This concerns executives, who are responsible for the day-to-day management of a company. As Berle and Means noted, to govern companies effectively, executives should avoid conflict of interests and managerial opportunism. This will facilitate reducing agency costs and improve corporate performance. From this perspective, executive nomination and monitoring play the most important role in reaching the above objective. Both these corporate control mechanisms are established by shareholders. Therefore, we suppose that the executive performance depends on the structure of corporate ownership and the type of controlling owner.

Regrettably, since the beginning the process of privatization in 1992 no research has been conducted to answer the question: "Is there a relationship between ownership structure and efficiency of decision making by executives?".

To find the answer at this question, it is very important to research the market for executives in Ukraine.

Literature review

According to our investigation, about 380 thousand executives (members of the executive board) are employed by Ukrainian joint stock companies. *Saul Estrin* and *Adam Rosevear* (1999) concluded that major executives in Ukraine behave in very opportunistic manner and provoke conflicts of interests. The degree of executive monitoring is very low. Major executives were former employees of the company, where they are presently on the executive board. This is a large contribution to an increase of the degree of managerial opportunism.

Estrin (2000) and *Kostyuk* (2003) report, that the most, widespread throughout the world, mechanisms to monitor executives are not

developed in Ukraine. Particularly, this concerns such mechanisms as executive compensation, audit committees of the supervisory board, market for corporate control, bankruptcy system. The only mechanism that can be actually efficient in Ukraine to monitor executives is the meeting of shareholders, where executives will have to report to shareholders and become monitored by them. Therefore, ownership structure should play very important role in the executive monitoring.

Research methodology

To answer the above mentioned question in the field of decision making in Ukrainian joint stock companies, we conducted an investigation. Companies, having shares listed in PFTS (OTC market) were taken to research. Total number of companies is 60. The ways of conducting research: observations and questionnaires. Research was started in November 2001 and finished in March 2004.

Questionnaires were sent to members of Supervisory and Management Boards of Ukrainian enterprises, financial analysts, shareholders and stakeholders.

The following hypotheses were developed:

1. inside executives are still dominating over the outside executives on the executive boards of Ukrainian joint stock companies.
2. Performance of inside executives in deciding agency conflicts is very weak.
3. Employee-shareholders are the least efficient in nominating and electing executives.
4. The degree of accountability and transparency of inside executives is very weak and does not meet requirements of all shareholders, despite their type.
5. All groups of shareholders are sure that outside executives are much better equipped with knowledge how to make decisions effectively than inside executives.
6. Ownership structure is the key factor in creating an efficient system of mechanisms for executive decision-making at Ukrainian joint stock companies.

Results of research

The markets for Heads of Supervisory Board and Management Board are still not developed in Ukraine. Especially, this concerns the secondary market for heads of supervisory and management boards. Outside directors and executives are not still demanded, as it could suppose,

taking into account the world trends at the market, where independent outsiders are the key element of the board. The main reason of weak development of the market can be explained by still lasting process of separation of control and ownership.

Moreover, the class of professional, independent heads of supervisory boards is still under development. Should Ukraine follow international standards in the board practices, i.e. at least a half of the directors on the board should be independent, the market for directors in Ukraine would require about 160 thousand persons. It is hardly possible to happen in the nearest future, because only 6 percent of the researched Ukrainian joint stock companies wrote the term "independent director" in their internal statements, i.e. the statement on the supervisory board.

One more reason of weak development of the market for executives (heads of management boards) is very low transparency of the market and lack of well-developed procedures to be applied by the supervisory boards to nominate and elect executives¹. Heads of supervisory boards who are responsible for recruiting new executives, prefer to choose candidates for a post of the head of management board from those, who work in the company during a long period of time. Doing so, directors try to secure all risks, related to nomination of executives. Probably, under the weak developed secondary market for executives, directors have nothing, but nominating candidates who are insiders.

From this perspective, the secondary market for executives in Ukraine is much similar to the secondary market for executives in Japan. Executives prefer to work in a company as long as possible. The situation, when executives are fired, is considered by them as "a wrack of all hopes". Only personal relationships will allow executives to find a job

¹ In 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 Supervisory 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.

in a new company. Probably, this provokes managerial entrenchment, when executives are concerned more for "keeping the chair" than for contributing to shareholder wealth.

There is no still a professional rating of executives in Ukraine. There are no companies that would evaluate the degree of professionalism of executives. Therefore, if directors want to nominate somebody from outside of the company, they will have to nominate their friends or ask their friends and colleagues for appropriate candidates. This approach is a threat to independence of directors, who become tied by friendly or even relative relationships with executives.

Table 7.1. Profiles of the Heads of Supervisory and Management Boards of Ukrainian joint stock companies

Features	Heads of Supervisory Boards	Heads of Management Boards
Average age, years	51	44
Experience of executing certain duties (as a Head of Supervisory Board or head of Management Board) in other companies, years	3	10
Experience of work in the company on various posts, years	-	20
Share of Heads of the Boards who worked in the company before their appointment, %	18	90

With reference to *table 7.1* it should conclude that heads of supervisory boards in Ukraine are not experienced enough (a three year experience is the most popular) to direct the companies. Executives are much more experienced. Executives experienced a ten year work on the management boards.

It is worth of mentioning that the share of heads of the management boards who worked in the company before their appointment, increased from 86 percent in 2001 to 90 percent in 2003. This is an evidence of the lack of improvement in development of the secondary market for executives in Ukraine. The market for directors in Ukraine has the same negative trends. Thus, the share of heads of the supervisory boards, who worked in the company before their appointment increased from 6 percent in 2001 to 18 percent in 2003. This is a very negative trend, evidences that the degree of independence of directors reduces from year to year.

Besides this, heads and members of the supervisory boards in Ukraine, as a rule, experienced a work on the management board of the same company. All this contributes to an increase in the degree of

entrenchment of directors and interdependence of members of the management and supervisory boards.

Results of research evidence that decisions made by heads of supervisory boards concerning recruiting executives are made in uncertainty². To reduce uncertainty, Ukrainian companies prefer to elect directors from insiders, i.e. strongly dependent, who will further elect executives from insiders too. Under such circumstances, it is hardly possible to hope for development of the control role of directors. All these create a fruitful soil for the managerial entrenchment growth and decrease in the degree of director independence.

According to *table 7.2* it must be concluded that inside executives become more demanded in Ukraine. That is the proof of the first hypothesis, i.e. *inside executives are still dominating over the outside executives on the management boards of Ukrainian joint stock companies*. Especially, this concerns the companies where the majority of shareholders are represented by employees³. In contrast to shareholders-employees, foreign institutional shareholders are the most loyal to services of outside executives.

In a whole, the share of Ukrainian joint stock companies, headed by "intracorporate" executives, increased during 2001-2003 from 74 to 76 percent. The following contains a very interesting comparison. The share of companies where shareholders are not satisfied with qualification of "intracorporate" executives increased over the same period of time too (from 54 to 58 percent). The share of companies where shareholders are

² 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.

³ Employees became shareholders as a result of the first stage of privatization, that started in 1992 and was over by 1995. At this stage, privatization in Ukraine was very liberal. By a liberal feature of privatization is meant, that those companies, which wanted to be privatized, were privatized. Only employees could take part in privatization. No foreign institutional shareholders, both national and foreign, no outside individual investors were allowed to participate in privatization. So, the first stage was given to the will and intentions of Ukrainian companies, i.e. employees and management.

Frankly said, the State wanted employees of Ukrainian companies to take a decision whether to privatize their companies or not. The State property fund reported that about 39 percent of Ukrainian open joint stock companies (5.800 companies) were privatized by employees. Regrettably, lack of effective audit firms, capable to estimate companies' values (par value, book and market values) sufficiently distorted actual "investment" value of companies and many of them have been bought by employees and management by very low expenses.

not satisfied with qualification of outside executives decreased over 2001-2003 (from 42 to 37 percent). So, the comparative performance of outside directors is higher than inside executives, but shareholders prefer to elect inside executives.

Table 7.2. *Dependence of structure of ownership and origin of executives*

	Majority of shareholders are represented by			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
Share of companies headed by "intracorporate" executives, per cent	96	83	54	72
Share of companies where shareholders are not satisfied with qualification of "intracorporate" executive, per cent	70	56	38	49
Share of companies where shareholders are not satisfied with qualification of outside executives, per cent	52	34	15	41

Existing only "intracorporate" market for executives in Ukraine is a strong contributor to hampering a professional development of inside executives as soon as they climb up by corporate ladder at the top. Inside executives are inclined to entrench after they become Heads of Management Boards. About 72 per cent of responding shareholders were sure that inside executives ignore interests of shareholders and provoke a conflict of interests.

Very often professional qualification of inside executives does not meet requirements of shareholders. Thus, about 61 per cent of respondents representing shareholders, answered that they were not satisfied with the degree of qualification of inside executives. Therefore, the second hypothesis, i.e. *performance of insider executives in deciding agency conflicts is very weak*, is vital.

It should be noted that foreign institutional investors are the most efficient group of shareholders of Ukrainian joint stock companies in making a decision about recruiting executives. By the way, foreign institutional investors are efficient in recruiting both inside and outside executives.

With reference to *table 7.2*, the most inefficient decisions concerning recruiting executives are taken in the companies under control of

employees⁴. This proves the third hypothesis, i.e. *employee-shareholders are the least efficient in nominating and electing executives*. Probably, the degree of knowledge of employee-shareholders of Ukrainian companies on strategic decision making, i.e. nominating and electing executives is very low. Employee-shareholders prefer to elect members of the executive board of those candidates, who work in the company at the various positions for a long time. This explains why the degree of executive monitoring is very weak when the company is controlled by employee-shareholders.

According to the results of conducted research, the worst performance is shown by inside executives in the field of corporate communication policy and investor relations. The results obtained are a surprise. Inside executives, weakly equipped with required knowledge on corporate governance and pursuing their own interests through setting high compensations, have nothing but provoking and supporting asymmetry of information in relations with general public and investors including shareholders. Therefore, the fourth hypothesis, i.e. *the degree of accountability and transparency of insider executives is very weak and does not meet requirements of all shareholders, despite their type*.

Inside executives are inclined to provoke conflicts with middle-level managers who are their subordinates. They are not efficient in solving the conflicts provoked by them (see *table 7.3*).

Inside executives are inclined rather to fire middle-level managers than solve the problem through mutual discussion and decision making. So, inside executives of Ukrainian joint stock companies are mainly authoritarians.

Table 7.3. *Efficiency of "Intracorporate" executives in solving conflicts with their subordinates*

⁴ The latest trends in development of market for corporate control evidence that the State as a shareholder, leaves corporate ownership structure. This is very progressive element of development of market for corporate control in Ukraine. At the same time employees leave corporate ownership structure too. It is possible to suppose, that this is positive feature of development of market for corporate control too, taking into account that employees are not efficient in corporate governance. This supposition could be taken for conclusion, but for ways, which are used by management to force employees sell their shares. For example, if management of the company want to obtain a corporate control through buying shares, they force employees sell their shares to them. If employees refuse this "offer", they will be fired. Employees got used to store their jobs but not their ownership.

Moreover, during 2001-2003, management of Ukrainian companies started to use one more mechanism to grasp corporate control – proxies voting. It is not difficult for management to force employees give proxies to management. We have accounted more than 60 cases how such mechanism works. As a rule, executives come to the General Meeting of the works council, that happens before the Annual shareholder meeting, and order employees, who are shareholders, to give proxies to management. Doing in such way, executives obtain corporate control with no costs. This is a management dictate.

Please, assess the degree of efficiency of executives in solving conflicts with their subordinates at the company you control	Companies under control of (structure of responds in per cent)			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
Strongly efficient	10	16	21	15
Efficient	21	21	33	27
Weakly efficient	60	49	40	46
Not sure	9	14	6	12
Total	100	100	100	100

Efficiency of outside executives in solving conflicts with subordinates is much higher than that performed by inside executives (see *table 7.4*). Probably outside executives perform well in solving conflicts because they are free of entrenchment. Coming at the company outside executives try to use as much their skills as possible to make appropriate decisions in transparent manner. Transparency of decision making during solving conflicts with subordinates lets outside executives create a positive image within a company.

Table 7.4. *Efficiency of outside executives in solving conflicts with their subordinates*

Please, assess the degree of efficiency of Executives in solving conflicts with their subordinates at the company you control	Companies under control of (structure of responds in per cent)			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
Strongly efficient	19	31	46	35
Efficient	34	30	38	24
Weakly efficient	36	32	12	28
Not sure	11	7	4	13
Total	100	100	100	100

Therefore, the fifth hypothesis, i.e. *all groups of shareholders are sure that outside executives are much better equipped with knowledge how to make decisions effectively than inside executives*, is approved. For

the first time it is a paradox when shareholders are sure that outside executives are much more efficient in decision making than inside executives but at the same time, the number of inside executives is much higher than the number of outside executives.

According to *table 7.5* the paradox can be explained by the nature of shareholders controlling a company. Thus, the higher level of knowledge on corporate governance of shareholders the higher number of outside executives in the company. The most qualified shareholders of Ukrainian joint stock companies are foreign institutional investors. The least qualified owners of Ukrainian companies are employees.

Table 7.5. *Ownership structure and origin of executives*

	Majority of shareholders is represented by			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
2001				
Share of companies headed by "intracorporate" executives, per cent	96	84	79	89
2002				
Share of companies headed by "intracorporate" executives, per cent	98	81	52	76
2003				
Share of companies headed by "intracorporate" executives, per cent	96	83	54	72

So, the sixth hypothesis, i.e. *ownership structure is the key factor in creating an efficient system of mechanisms for executive decision-making at Ukrainian joint stock companies*, is approved.

The critical factor in composing the executive board

Under asymmetry of information and low level of knowledge of shareholders in the Ukraine, an ownership structure is one of the most important factors influencing efficiency of decision making by executives. Bounded rationality and managerial opportunism contribute to worsening the problem of developing the system of mechanisms for efficient decision making. Under such circumstances outside executives

are more efficient than insiders in decision making. Outside executives are not characterized by bounded rationality and managerial opportunism.

From this perspective, an ownership structure plays an important role in hiring the outside executives. We concluded that the higher level of knowledge on corporate governance of shareholders the higher number of outside executives in the company. The most qualified shareholders of Ukrainian joint stock companies are foreign institutional investors. The least qualified owners of Ukrainian companies are employees.

At the same time, all groups of shareholders are sure that outside executives are much better equipped than inside executives with knowledge how to make decisions effectively. All shareholders, despite their type are sure that the degree of accountability and transparency of insider executives is very weak and does not meet requirements of all shareholders. Obviously, the critical factor in composing the executive board of outside members is ability of shareholder to behave in the way of looking for outside executives, nominating outside executives, electing outside executives and evaluating performance of outside executives. At this time, foreign institutional shareholders behave the most effectively in the manner above.

CORPORATE GOVERNANCE IN TRANSITION ECONOMY
ALEX KOSTYUK
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DIRECTOR AND EXECUTIVE COMPENSATION SYSTEMS IN UKRAINE

Supervisory Board: compensation system

In Ukraine compensation system for members of the Supervisory Board is set by shareholders according to the volume of work, every member execute. There some elements of the compensation system. These are:

- setting a certain compensation for participation of a member in a meeting of the Supervisory Board;
- setting an extra compensation for participation of a member in the commetes of the Supervisory Board;
- setting an extra compensation for execution a work of the Head of Supervisory Board, Deputy-Head of Secretary of the Board.

There are no still advanced methods to measure an efficiency of work of members of the Supervisory Boards in Ukraine. Development of efficient compensation system in Ukraine is hampered because of uncertain relations between corporate performance measures and financial stability of the companies. Thus, even such financial measure, as profit, can not be used to measure efficiency of work of members of the Supervisory Board. A lot of Ukrainian companies report losses. That is possible to do after establishing a lot of daughter firms within a mother company. In such way a mother company may hide a profit from an eye of the State taxes authorities.

Moreover, such corporate performance measures as earnings per share, relation of market to book value of share, volume of sales per share and finally a stock price, which are widely used in the world to measure an efficiency of work of members of Supervisory Board, can not be used in Ukraine. The reasons of that situation are:

- absence at the Ukrainian stock market the real, the State regulated free, market mechanisms of stock price setting;
- sufficient pressure of the market for corporate control at the market for equity;
- small number of owners, who purchase shares of Ukrainian companies to contribute to equity liquidity in the future.

If to get to those corporate performance measures, which are widely used in the world, then it would be possible to conclude that efficiency of compensation system of members of Supervisory Boards in Ukraine remarkably increased during 1998-2002 (see *fig. 8.1*).

Considering a compensation system in Ukraine from the point of view of linking a work of members of Supervisory Board to stock price, it should conclude that Ukrainian compensation system is far from using those incentives, which are used in the USA or Canada - countries, where Anglo-Saxon model of corporate governance use. Thus, there is no any evidence of use by Ukrainian companies such element of compensation system as stock option.

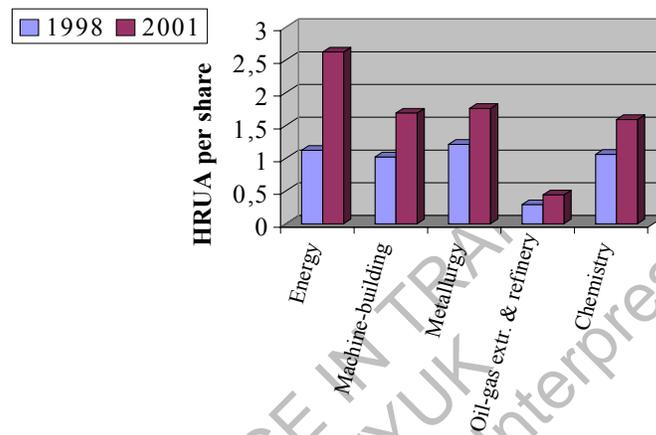


Fig. 8.1. *Dynamic of change in earnings per share at Ukrainian companies*

Compensation system, based on use of shares, is wide-spread in those countries where structure of corporate ownership is spread too. This concerns such countries as the USA, UK, Brazil, Canada and countries of the Southern Asia (*Murphy, 1999*).

In those countries, where structure of corporate ownership is concentrated, for example Germany and France, compensation system, based on use of shares is not popular. Controlling shareholders, who are rather controllers than investors, do not intend to lose the control levers through stock options and other stock based compensations.

In Ukraine a structure of corporate ownership is concentrated too. That is why, a compensation system in Ukraine is not based on use of shares. Strong controllers, such as Ukrainian financial-industrial groups, have already obtained enough shares and stock options, which can increase their share even more, do not attract their attention.

Management Board: compensation system

Level and structure of executive compensation system in Ukraine

Efficiency of work of members of Management Board depends on a compensation system. Compensation system can be based on use of salary (a fixed element), bonuses, stock option (as incentive elements) and other forms of compensation.

Around the world base salaries for executives are typically determined through competitive "benchmarking", based generally on general industry salary surveys and supplemented by detailed analyses of selected industry or market peers. The surveys, which report a variety of pay percentiles, typically adjust for company size either through size groupings or through simple log-linear regressions of Log (salary) on Log (size). Size is traditionally measured using company revenues or market capitalization.

Executives throughout the world devote substantial attention to the salary-determination process, even though salaries comprise a declining percentage of total compensation. First, base salary is a key component of executive employment contracts (which typically guarantee minimum increases in base salaries for the subsequent some years). Second, since base salaries represent the "fixed component" in executive contracts, risk-averse executives will naturally prefer a dollar increase in base salary to a dollar increase in "target" bonus or variable compensation. Finally, most components of compensation are measured relative to base salary levels. Abroad, target bonuses are typically expressed as a percentage of base salary, while option grants are expressed as multiple of base salary.

In Ukraine a structure and principles of development of executive compensation plans differ from those, which are widely used abroad.

Ukrainian companies do not use shares in a form of compensation to members of management boards although stock options provide a direct link between managerial rewards and share-price appreciation, since the payout from exercising options increase hryvna for hryvna with increases in stock price. Stock options are prohibited by the legislation.

Compensation system at the companies, under control of Management is pictured below.

It should be mentioned that there is a factor, which can a little justify negative relation of management to shares of the companies they control and manage at the same time. This is a weak liquidity of Ukrainian stock market. Using stock options under conditions of weak liquid stock market is very problematic.

Meanwhile, executive compensation system at the companies under control of foreign investors differ from those which are used by companies, controlled by management.

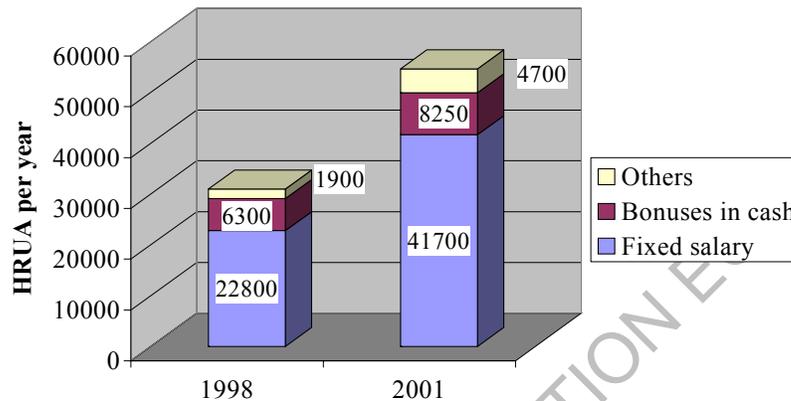


Fig. 8.2. Compensation system at Ukrainian companies, under control of management

Foreign shareholders come to Ukraine not only with money. They bring with them a lot of knowledge about modern principles of development of efficient executive compensation system. Thus, a share of bonuses in cash, paid to executives in companies under control of foreign investors in total amount of compensation is equal to 34 % in comparence to 15.6 % at the companies under control of management.

Companies under control of Ukrainian financial-industrial groups are inclined to follow principles of incentive based compensation system. They are going to develop a compensation system based on bonuses. Thus, at the end of 1998 a share of bonuses in cash, paid to executives in companies under control of Ukrainian financial-industrial groups in total amount of compensation was equal to 12 %. At the end of 2001 a share of bonuses in total amount of compensation got up to 25.2 %.

Table 8.1 contains a data about structure of executive compensation systems at the companies, controlled by various groups of shareholders.

Probably, a perspective use of stock options at the companies where the control is held by two large groups of investors - management and Ukrainian FIGs - would lead to further violation of rights of minorities. Moreover, under such ownership structure a use of option would lead to sharpening conflicts between management and Ukrainian FIGs. The fight between them for grasping an absolute corporate control would burn up with a new energy.

Table 8.1. *Structure of executive compensation systems at the companies, controlled by various groups of shareholders*

Controllers	Structure of executive compensation system			
	salary	bonuses	options	others
Management	75.9	15.6	0	8.5
Ukrainian FIGs	68.6	25.2	0	6.2
Foreign investors	58.7	34.0	0	5.1
Employees	80.5	12.3	0	7.2

At Ukrainian companies where Management and Ukrainian FIGs are controllers, a Management Board is composed of just executives-shareholders. At the same time a Supervisory Board is composed as a rule of representatives of only Ukrainian FIGs. Thus, in the case of intensive use of stock options, this instrument of executive compensation system will turn into an instrument of market for corporate control. Large shareholders will aspire to increase an option compensation to increase a corporate control. Such behavior of large shareholders will violate rights of shareholders minorities and it is not correspondent to a principle of balancing interests of shareholders.

The following hypothesis should be issued here.

Under conditions of conflicts between large shareholders, stock options turn from an instrument of compensation system to an instrument of corporate control. That leads to violation of rights of shareholders minorities and provokes a further development of the conflict.

A presence of conflicts between large shareholders at the companies in Ukraine is a strong barrier on the way to efficient use of a stock option as an instrument of executive compensation system. Probably, a comparative absence of conflicts between shareholders in other countries, not only developed, lets the companies in these countries use stock options much more frequently and far more effectively.

With reference to the above figure it is possible to conclude that executive compensation system in Ukraine remarkably differs from those, used in other countries.

First of all, executive compensation systems in Ukraine have a larger share of salary which is set taking into account previous achievements of executives and their experience. Salary is weakly linked to performance of executives in the future. It is a weak instrument of compensation system.

Second, executive compensation systems in Ukraine are very narrowed in the part of "other" instruments. In Ukraine share of other

instruments in a total amount of compensation is equal to 6 %. Abroad this number is equal to 15-25 %.

Explanation of such remarkable difference in use of other beyond salary, bonuses and options instruments of compensation system in Ukraine and abroad is in the part of composition of other instruments.

In Ukraine executives are granted a limited number of social compensations. For example, one of such compensations is obtaining from the companies paid recreation services in the Black Sea coast or paid trips abroad.

Other forms of compensation are not used in Ukraine. This concerns such instruments as restricted stock, long-term incentive plans (LTIPs) and retirement plans.

For this time no company in Ukraine uses long-term incentive plan. Meanwhile, there is no any evidence of use of this form of compensation. Abroad, in addition to bonuses plans, based on annual performance, many companies offer long-term incentive plans, typically based on rolling-average three- or five-year cumulative performance. For example, approximately 27 % of the S&P 500 CEOs received LTIP payouts in 1996. These payouts for 5.5 % of 1996 total compensation (and 20 % of compensation for those CEOs receiving payouts).

Other form of compensation - restricted stock - is not spread in Ukraine too. The main reasons are weak liquidity of stock market in Ukraine and absence of knowledge of executives in the field of investment management. So, restricted stock can not perform a function of incentive of executives in Ukraine.

Abroad restricted stock is more popular. Approximately 28 % of the S&P 500 firms granted restricted stock to their CEOs in 1996. These grants accounted for an average of 6.1 % of total compensation (and 22 % of compensation for CEOs receiving grants). The grants are "restricted" in the sense that shares are forfeited under certain conditions (usually related to employee longevity). The forfeiture possibility allows favorable tax treatment (executives do not pay taxes on the shares until the restrictions lapse) and accounting treatment (the "cost" is amortized over the vesting period, are recorded as the grant-date stock price even if prices have increased since the grant).

Despite remarkable tax treatment, restricted stock is not spread in Ukraine. It is hardly possible to hope for use of restricted stock in the country where the process of separation of corporate property still lasts and where the market for corporate control hampers development of the stock market.

Abroad, in addition to participating in company-wide retirement programs, top executives routinely participate in supplemental executive retirement plans (SERPs). SERPs are non-qualified for the tax purposes and can take a variety of different forms, including defined benefits based

on "credited" years of service (which can deviate substantially from "actual" years of service) or variable benefits based on inflation or company performance.

Abroad, it is difficult to collect a data on supplemental executive plans because of a lot of reasons. First of all, it is difficult or ultimately arbitrary to convert the future payments into current annual compensation.

Second, payouts from SERPs are not disclosed, because the retired recipients are no longer company executives.

Third, the discussion of retirement plans in publicly available proxy statements is insufficient to calculate the actual value of these plans. Indeed, the vagueness of disclosure, coupled with anecdotes of high payouts in a few publicized cases, have led some observers to call SERPs the ultimate form of "stealth compensation".

Ukrainian companies are still not experienced in use of SERPs. Executives do their utmost to maximize their wealth within a short period of time. The reason is very common. This is an absence of belief of executives in the future market opportunities of the companies. They are going to maximize their wealth as fast as possible before their companies go bankrupts or before coming to the companies other shareholders, who would be unsatisfied with a quality of managerial services, provided by executives.

Executive compensation system and size of the companies: looking for sensitivity

Abroad, it is surprising that compensation increases with company size. Larger firms may employ better-qualified and better-paid managers (Rosen, 1982; Kostiuk, 1990). More surprising has been the consistency of the relation across firms and industries. Baker, Jensen and Murphy (1988) summarized Conference Board data on the relation between CEO cash compensation and firm sales from 1973-83 and document pay-sales elasticities in the 0.25 to 0.35 range, implying that a firm that is 10 % larger will pay its CEO about 3 % more. Rosen (1992) summarized academic research covering a variety of industries and a variety of time periods in both the US and the UK, concluding that the "relative uniformity across firms, industries, countries, and periods of time is notable and puzzling because the technology that sustain control and scale should vary across these disparate units of comparison".

In Ukraine sensitivity of level of compensation depends strongly on a size of companies. Under a word "size" we understand volume of annual sales of the companies. Sensitivity of level of compensation of executives

of Ukrainian companies to volume of sales of companies, where they are employed is equal to 0.742.

The above mentioned strong sensitivity does not differ sufficiently across companies under control of various groups of shareholders (see fig. 8.3).

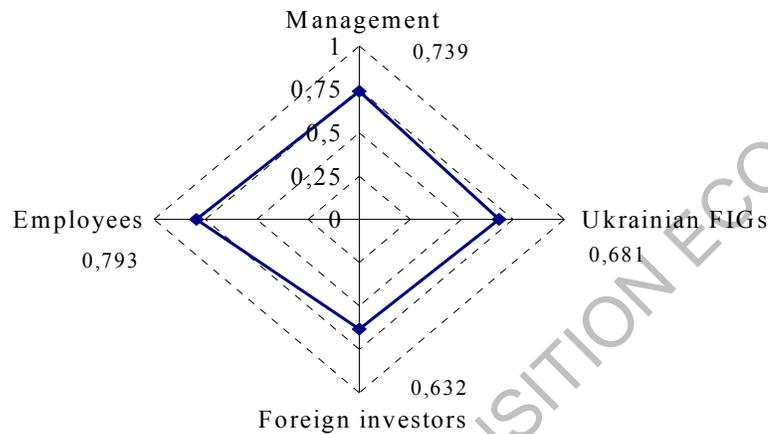


Fig. 8.3. Sensitivity of level of compensation of executives of Ukrainian companies to volume of sales of companies

Common sensitivity trend is explained by the following:

- increase of volume of sales at the companies under control of Management leads to increase of level of executive compensation because increase in volume of sales gives Executives an excellent chance place larger salary, shadowed by large sales, despite very low correlation between sales and earnings obtained;
- increase of volume of sales at the companies under control of foreign investors leads to increase of level of executive compensation because increase in volume of sales is strongly correlated with earnings. Thus, increase in level of compensation happens because of growth in bonuses, linked to earnings;
- increase of volume of sales at the companies under control of Ukrainian financial-industrial groups leads to increase of level of executive compensation because increase in volume of sales, like in a case of companies under control of foreign investors is strongly correlated with earnings;
- increase of volume of sales at the companies under control of employees leads to increase of level of executive compensation because increase in volume of sales, like in a case of companies under control of Management gives executives an excellent chance, using administrative levers of influence of employees, obtained larger payouts.

CAPITAL STRUCTURES AND CORPORATE GOVERNANCE PERFORMANCE

Introduction

Process of privatization of the State property in Ukraine is followed with transformation of relations between participants of corporate governance, especially between management and owners. Difference in level of knowledge about investments and financial management which shareholders and management possess, can have a negative impact on relations between them. That is why, the most important criteria of the corporate governance performance is an absent of asymmetry of information and conflicts between shareholders and managers.

Asymmetry of information exists in a case if management of the company and its shareholders possess information about the company market opportunities of different content and volume. The most evident results of existence of asymmetry of information is under-valuation of the company market value and increase in cost of shareholders equity.

Changes in capital structure can be used to monitor asymmetry of information (*Jensen M., W. Meckling, 1976*).

R. Stulz, a famous expert in the area of corporate governance, noticed in his fundamental paper "Globalization of world stock markets" that corporate governance performance under asymmetry of information directly relates to the capital structure.

By the point of view of *R. Stulz* the problem of asymmetry of information which happens as a result of process of concentration of corporate ownership, makes management finance the company activity with equity, which costs grows sufficiently under asymmetry of information, or with debt, which leads to increase in financial leverage and worsening in the company financial stability.

That is why, under asymmetry of information, the most important features of efficiency of corporate governance, deriving from capital structure are:

- reduce in costs of equity;
- reduce if financial leverage.

Capital structure in Ukraine

Applying data, gathered as a result of investigation of 270 Ukrainian joint stock companies it is possible to conclude that a lot of enterprises have a low-levered capital structure (Fig. 9.1).

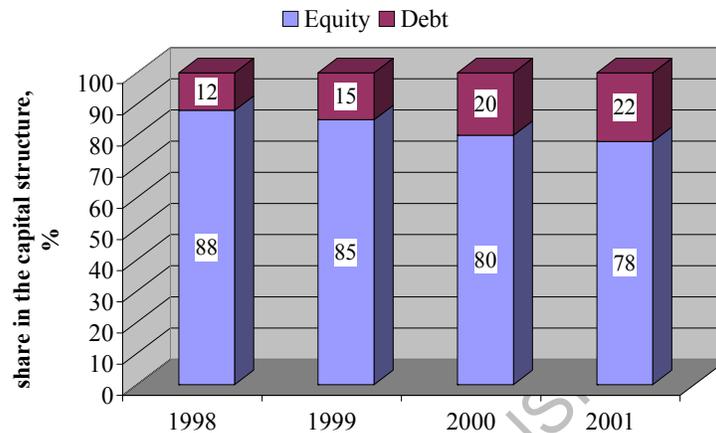


Fig. 9.1. Capital structure of Ukrainian companies

With reference to *fig. 9.1* it is possible to conclude that remarkable changes happened in the capital structure of Ukrainian joint stock companies over 1998-2001. The most sufficient change is an increase of share of debt in the capital structure from 12 to 22 %. The above mentioned trend can be explained by some reasons.

First of all, over the above mentioned period of time liquidity of alternative markets of corporate capital - market for banking loans and equity market - improved but scales of these changes were various. Thus, cost of loans dropped down from 60 to 35 %. Thanks to reduce in costs of corporate borrowing, volume of loans, issued by banks to the companies in Ukraine increased for 74 %.

In comparison to the market for banking loans, situation at the equity market of Ukraine can not be taken for prospective. Thus, despite sufficient increase in capitalization of the secondary stock market of Ukraine from HRUA 2.1 to 3.8 bil. and increase in stock market turnover for 86 %, cost of equity increased too.

For the second, trend of increase of share of debt in the capital structure was followed by concentration of the shareholders equity in the hands of managers of the companies and institutional investors.

Taking into account numbers, containing in table above it is possible to conclude that performance of capital structure management in Ukraine sufficiently dropped down.

Table 9.1. *Cost of equity of Ukrainian joint stock companies, whose shares are listed at PFTS*

Industries	Cost of equity by years, %			
	1998	1999	2000	2001
Energy	13	16	11	13
Metallurgy	21	19	29	31
Chemistry	29	18	17	19
Oil-gas refinery	24	22	26	24
Machine building	14	24	21	26
The rest	21	28	31	33
Average:	21	23	26	28

Tight connection, found between concentration of shareholders equity, its costs and capital structure (financial leverage) gives a right to conclude that at the markets under asymmetry of information structure of corporate ownership directly influences liquidity of shareholders equity, and as a result, cost of equity and capital structure. Generally said, the higher degree of concentration of corporate ownership the higher cost of equity and higher financial leverage.

Capital structure and types of owners

It should remark that managers-owners and institutional investors who compose a core of insiders of the most of investigated 270 companies in Ukraine have different points of view on what capital structure of the companies is an optimal.

Managers, who are shareholders at the same time, are much less inclined to use equity to finance activity of the companies. Only 26 % of controlled by managers-owners companies issued new equity during 1998-2001.

Over the same period of time companies under control of institutional investors were much more active in financing its activity through secondary stock issuing. About 42 % of the above mentioned companies issued equity.

The same activity was performed by the companies with separated structure of ownership. About 44 % of them effected secondary stock issuing during 1998-2001.

Despite a high activity of institutional investors in financing activities of the companies controlled by them through equity issuing, some groups of institutional investors were passive in the way.

Fig. 9.2 shows a dynamic of change in number of the companies controlled by various groups institutional investors which issued new equity.

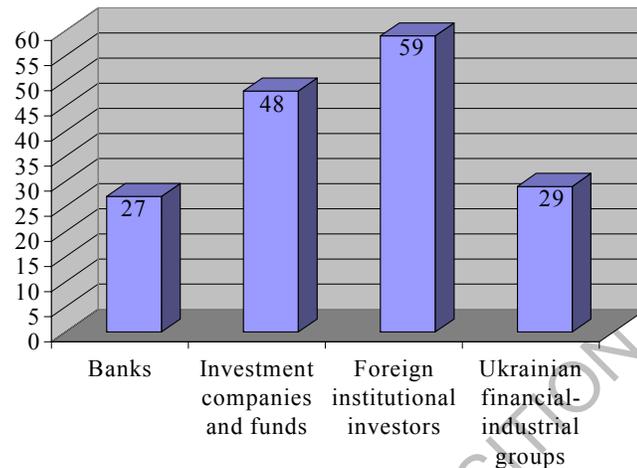


Fig. 9.2. Dynamic of change in number of the companies controlled by various groups of institutional investors which issued new equity during 1998-2001

According to fig. 9.2 it should conclude that the foreign investors were the most active group of institutional shareholders in financing the companies activities with new equity. Over 1998-2001 more that a half of companies controlled by foreign institutional investors issued new equity. In contrast to foreign investors, Ukrainian financial-industrial groups and banks were the groups of institutional investors which were the most passive in new equity issuing. Only every fourth of the companies under control of Ukrainian financial-industrial groups and banks issued new equity during 1998-2001.

Different behavior of the above mentioned groups of institutional shareholders concerning making a decision about new equity issuing can be explained as follows.

First of all, foreign institutional investors are much more active in new equity issuing because they are much more skilled in stock liquidity management than Ukrainian institutional investors such as financial-industrial groups or banks.

Second, foreign investors use more advanced investment strategy which is not narrowed only to obtaining a corporate control but and to having a return as a result of deals with shares.

Foreign institutional investors are inclined to obtain stock return rather as a result of trading shares at the stock exchange than in the form

of cash dividends to which Ukrainian financial-industrial groups and banks aspire. Such behavior of foreign investors facilitates process of earnings investing. As a result a combination of two factors - aggressive strategy in new equity issuing and inclination to reinvest gained earnings - leads to reduce in the cost of equity at the companies under control of foreign investors (see table below).

Table 2. *Cost of equity at the companies in Ukraine controlled by various groups of institutional investors*

Groups of institutional investors	Cost of equity by years, %			
	1998	1999	2000	2001
Ukrainian banks	26	29	32	34
Ukrainian financial-industrial groups	28	33	31	36
Ukrainian investment companies and funds	24	22	25	23
Foreign investors	21	19	18	20
Average:	25	27	28	30

Applying findings of *R. Stulz* it is possible to conclude that exactly foreign investors, having a corporate control, compose a corporate governance system in the most efficient way to avoid provoking such problems of corporate governance as asymmetry of information and conflict of interests.

In conclusion of conducted research of capital structure as an element of corporate governance system the following should be underlined.

First, capital structure of Ukrainian companies is an efficient indicator of corporate governance performance. That means the higher cost of equity and higher financial leverage the sharper a problem of asymmetry of information.

Second, foreign investors are the most active in new equity issuing and the most efficient in capital structure management which leads to reduce in cost of equity and terminating a problem of asymmetry of information.

Third, managers of Ukrainian companies who are shareholders at the same time are the most inefficient in managing capital structure. Evidences of their inefficiency are a high cost of equity and high degree of asymmetry of information.

CREDIT MARKETS

A function of corporate governance

Credit markets in Ukraine does not still perform efficiently a function of structural element of the corporate governance system in contrast to credit markets of such countries in transition as Poland, Czech Republic or Hungary (*Frydman Roman, Cheryl W. Gray, Andrzej Rapaczynski, 1996*). First of all volume of bank loans issued to real sector of economy of Ukraine is only 8-10 % of real GDP. Second, cost of credit for enterprises is still very high. It is equal to 30 % per year. Third, solvency of borrowers is very weak. By results of 2001 about 25 % of loans issued were delayed and about 15 % of loans were not covered by borrowers at all. Probably, exactly weak solvency of Ukrainian borrowers is one of the most important reasons of high cost of credit. The most remarkable feature of credit market in Ukraine is extremely weak market for corporate bonds. Within 1998-2001 relationship between volumes of loans, borrowed by Ukrainian enterprises and volumes of issues of corporate bonds in Ukraine was equal to 240/1.

One more remarkable feature of credit market in Ukraine should be noted. The most active lenders at the credit market are one of the most active participants of market for corporate control. Moreover, commercial banks are more active in lending those enterprises where they are shareholders. Under such circumstances both terms of credit agreement and cost of borrowing are more acceptable for borrowers.

The best sample of the above mentioned relations is JSC "Balzem" - one of the biggest manufacturer of cement in Ukraine. JSC "Privatbank" - one of the most stable commercial banks in Ukraine - owns 20 % of shareholders equity of JSC "Balzem". Having bought shares of the company in 1999, JSC "Privatbank" has already issued to JSC "Balzem" almost HRUA 100 mln. of loans by interest rate which was lower than standard loan interest rate which was used by JSC "Privatbank" to lend financial resources to other borrowers. It was possible to do thanks to availability of JSC "Privatbank" to have an access to insiders information within JSC "Balzem".

Exactly thanks to access of JSC "Privatbank" to insiders information within JSC "Balzem", which is not available to other participants of the market, the commercial bank upgraded its trust in prospects of investing in JSC "Balzem", both like lender and shareholder. As a result, JSC

"Privatbank" announced its intentions to lend HRUA 30 mln. to let JSC "Balzem" develop its export business.

That is why it is possible to suppose that too high cost of lending in Ukraine is explained by asymmetry of information between lenders and borrowers.

Asymmetry of information and corporate governance

The problem of asymmetry of information at the credit markets of the countries in transition was thoroughly investigated by *J. Stiglitz* who made a conclusion that the main cause of phenomenon of too high costs of lending in the countries in transition is asymmetry of information that means situation, when lenders have lack of information about market opportunities of borrowers of the appropriate contents and of needful volume.

Probably, one of the most efficient ways to solve the problem of asymmetry of information is an increase of attention of commercial banks to shareholders equity of Ukrainian companies as object to invest, and obtaining corporate control over their activity which is accompanied by getting an access to confident information about activity of the companies.

- Numer of commercial banks, which are shareholders of Ukrainian companies
- their share in total number of commercial banks in Ukraine

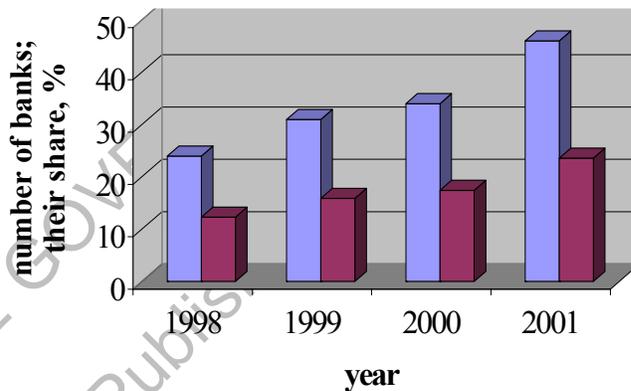


Fig. 10.1. *Commercial banks as shareholders of Ukrainian joint stock companies*

With reference at *fig. 10.1* it should be noted that commercial banks in Ukraine increased their attention to the markets of shareholders equity

and corporate control at 1999. During 1998-2001 number of commercial banks in Ukraine was almost unchanged (195 commercial banks in 1998 and 194 banks in 2001), but number of commercial banks which were shareholders of 270 investigated Ukrainian joint stock companies increased from 21 to 44 commercial banks. The most active participants at the markets for shareholders equity and corporate control were such Ukrainian banks as JSC "Privatbank", JSC "Prominvestbank", JSC "Aval", JSC "Nadra" and JSC "Ukrsibbank".

Commercial banks as participants at the markets for shareholders equity and corporate control as a rule are inclined to buy big blocks of shares, at least 10 % of shareholders equity.

Besides that, investment strategy of commercial banks in Ukraine has common objective. This is an obtaining additional prospects in the field of lending expansion toward the enterprises, controlled by them. The most attractive features of enterprises where commercial banks want to have a share are:

- export specialization of the companies;
- high share of markets for products and services controlled by the companies.

Export specialization of the company where commercial bank is one of shareholders, gives to the commercial bank a chance to obtain its currency accounts for serving. If the commercial bank obtains currency accounts of the company which is controlled by commercial bank then financial performance of the bank improves, number of clients of the banks increases and the cost of capital for the bank gets down.

Regrettably, having obtained a corporate control over the companies and access to serving their currency accounts some commercial banks were not active in lending to these companies.

This can be taken for phenomenon because the following question arises: "Why is commercial banks not active in lending to those enterprises where the bank became a shareholder confirming an availability of market opportunities for the company?".

Probably, the above mentioned behavior is shown by those commercial banks which balance sheet is very small, and they are not successful at the market for bank loans for enterprises. Having obtained an access through purchasing shares of the company to the levers of corporate control, commercial bank can obtain its money spent for purchase of shares back through getting rights to serve accounts of the company. Moreover, at the market of Ukraine there were cases when the above mentioned role was played by very weak commercial banks, whose assets were in ten and higher times lower than assets of the company under control of the bank.

Commercial banks prefer to buy shares of those companies having in balance sheets huge fixed assets. Such behavior can be explained by

aspiration of banks to secure investment risks in whole and credit risks in particular. Wide spread in Ukraine way to minimize the above risks - real estate mortgage - makes lenders give a favor to those companies which have a lot of fixed assets in their balance sheets.

Meanwhile, a lot of commercial banks which are shareholders of Ukrainian companies, having become a status of shareholders, become more active in lending to the companies, where they have a share.

Fig. 10.2 illustrates a dynamic of change in volume of loans, issued by commercial banks to those 89 of 270 investigated companies, where commercial banks plays role of shareholders.

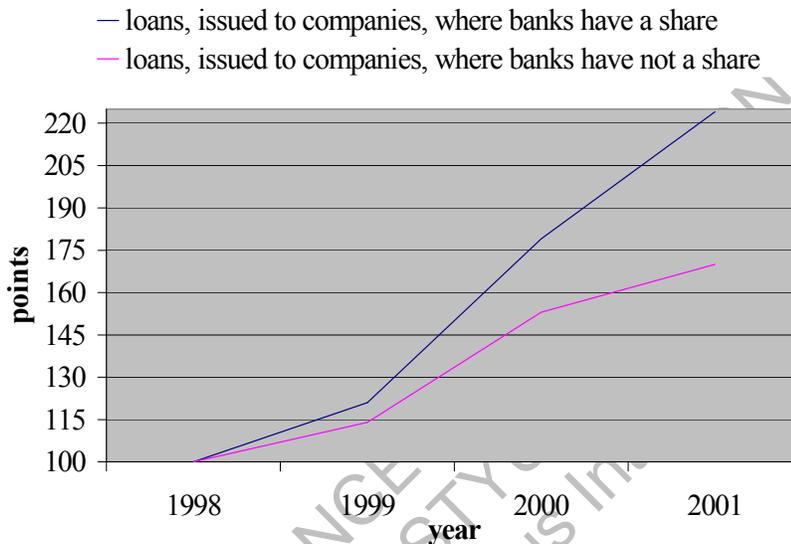


Fig. 10.2. *Dynamics of increase in the loans, issued to those companies controlled by banks as shareholders*

With reference to fig. 10.2 it is possible to conclude that those companies where commercial banks are shareholders, obtains much more loans than those without commercial banks among shareholders.

Probably, problem of asymmetry of information at the credit market of Ukraine forces commercial banks buy shares of Ukrainian companies to obtain an access to the confident information about recent financial performance and market opportunities of the companies. Access to the confident information lets commercial banks be efficient in securing credit risks, which were secured earlier through increasing interest rate.

That is why the credit market in Ukraine performs its disciplinary function just partially. Thus, drop in cost of borrowing for enterprises, increase in volume of borrowings and improve of the terms of the credit agreements as a result of high reward of efforts of management of the

companies by commercial banks happen only in a case if commercial banks are shareholders of those companies to which they issue loans.

Disciplinary function is performed by credit market in Ukraine just within a those segment of the market, where shares are in ownership of commercial banks.

According to the investigation of the author, commercial banks play role of shareholders in 89 of 270 investigated joint stock companies in Ukraine. Within 1998-2001 the above mentioned number was getting up remarkably. In 1998 commercial banks were shareholders only of 48 of 270 investigated companies. In 2001 number of joint stock companies where commercial banks were shareholders increased up to 89 enterprises.

The above mentioned trend gives a chance to hope for decrease in cost of borrowing for enterprises which can facilitate actualizing all market opportunities of the companies. Taking into account increasing activity of commercial banks on the market for shareholders equity, it is reasonably to suppose that model of corporate governance in Ukraine will be more and more closer to continental model, which allows a high level of participation of commercial banks in shareholders equity of enterprises.

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BANKRUPTCY SYSTEM

Bankruptcy system and corporate governance

As it is pointed by one of the main theorists of institutional economics, *Douglass North (1999)*, “The key to sustained economic growth is adaptive rather than allocative efficiency”. This, in turn, requires nation to promote the maximum possible number of trials so that country could learn and adapt to all possible opportunities that were found and proposed by entrepreneurs. Promotion of the maximum possible number of trials in its turn supposes development of economic institutions that will both promote incentives for economic agents and will reduce the transaction costs that entrepreneurs bear with trials (e.g. reduce costs and routines of entering and quitting business).

The notion of allocative efficiency suggests that with the assumption of perfect competition market forces will generate the most efficient allocation of resources as inefficient producers will not survive in price competition. Nevertheless, economists do argue that the model of perfect competition do not necessarily brings the most efficient outcome as there are externalities and public goods, competitive markets cannot guarantee the optimal allocation of incomes. In addition, it is argued that competitive market system may not facilitate the fastest technological progress as enterprises do not earn profit substantial for advanced research activities, besides, lack of profits limits the products’ variety as product differentiation may require additional investments.

The concept of allocative efficiency is most heavily attacked for the lack of dynamics, as *Douglass North (1999)* says in his words: “The criteria for realizing allocative efficiency are seldom if ever specified in terms of the institutional framework, but implicitly they assume secure property rights and enforcement of contracts. But just how would the rules be balanced between the security of existing organizations and the encouragement of innovation and displacement-- in effect the creative destruction in Schumpeter's vision? It is not obvious that the ideal rules for current allocation are the ideal rules to encourage the conditions for adaptive efficiency in a world of positive transaction costs.”

In this light the bankruptcy law may be viewed as an institution that brings dynamics and provides mechanism for restructuring and liquidating the inefficient businesses. Bankruptcy procedure performs the

role of identifying enterprises that are subtracting value from the economy – i.e. “consume” its assets or resources of the creditors. At the same time, properly designed bankruptcy law creates incentives for management which is penalized in case of bad performance and it also creates incentives for creditors which thus reduce their risks and are more likely to release loans. Another dynamic effect that bankruptcy procedure provides is the learning effect: it offers the opportunity to learn on the past and/or current failures in order to prevent future failures. When the failures have systematic nature (which may have roots to existing ideology of economic policy design) their critical mass may promote generation of the political will to overcome these systematic patterns.

Researches (Lizal, 2002) distinguish three main reasons why the firm may go bankrupt:

1. Neoclassical view – the inappropriate allocation of assets. Bankruptcy is a mean of assets re-allocation and is a natural way of allocating resources efficiently. Amount and size of bankrupted firms may provide *the evidence on the speed of economic restructuring*.

2. Financial reason – the right structure of assets but bad financial structure with poor liquidity. (The firm may go bankrupt in the short-run while it is financially viable in the long-run).

3. The firm has good assets structure but is badly managed – xinefficiency. It is natural to expect that in explaining bankruptcy in transitional economies like Ukraine any of these reasons may be present.

1. Price and international trade liberalization which ensure right market signals to producers are the forces that stimulate re-allocation of pre-transition production resources of a planned economy for their more productive use in a market environment.

2. The break-down of a planned-economy links, negative externalities of hyperinflation and lack of developed financial markets put a lot of enterprises that are competitive and efficient in the market environment in a long-run into severe financial insolvency.

3. Lack of managerial experience of working in a competitive environment as well as managers’ dubious incentives often result in inefficient managerial decisions that also put viable enterprises into financial insolvency.

For the general aim of providing efficiency to the whole economy, as it was described earlier, bankruptcy law has to perform certain economic functions that facilitate the best use of economy’s resources:

1. Bankruptcy law has to provide mechanisms of liquidating inefficient enterprises;

2. Bankruptcy law has to provide incentives to management to maximize the best use of resources. There should be clear mechanism of changing ineffective managers;

3. Bankruptcy law has to guarantee rights of lenders and provide mechanisms for debts repayment and thus to facilitate investments;

4. Bankruptcy law shall be an instrument of financial restructuring for potentially solvent in the long-run enterprises.

In fact if the debtor and creditor would be able to design contracts that could specify what happens in the case of default there would be no need for bankruptcy procedure. Nevertheless in practice parties usually have difficulties in concluding such contracts, as some debtors' assets may not serve as adequate collateral for the loan. And more problems arise if there are several creditors that may not be willing to coordinate their moves.

In contrary, the bankruptcy procedure is designed to maximize the general ex post outcome taking into account interests of all involved parties. At the same time bankruptcy procedure has to solve the collective action problem in a way that the value that may be obtained by both creditors and shareholders will be maximized. As *Hart (2000)* argues about three important goals of the bankruptcy procedure: 1) *Ceteris paribus*, a good bankruptcy procedure should deliver an ex post efficient outcome; 2) managers and shareholders shall be penalized adequately in bankruptcy states; 3) bankruptcy procedure should preserve the absolute priority of claims². As for the third goal it is argued that something shall be left to shareholders, otherwise the managers controlled by shareholders, will do any actions to delay bankruptcy that will have adverse effect on efficiency.

The problem of efficient litigation among the participants of the bankruptcy procedure has also drawn the views of economists. Indeed the bargaining process of participants over the liquidation/reorganization pie may be costly, time-consuming and may have inefficient outcome as each party maximizes its own outcome. In this context *Bebchuk (2000)* proposes that bankruptcy procedure should be designed in a way that each participant in reorganization "would receive a set of rights with respect to the securities of the reorganized company." These rights are designed so that, whatever the reorganization value, the participants will never end up with less than the value to which they are entitled.

There is also a debate whether it is more efficient to liquidate enterprise and sell out its assets or it is more efficient to restructure it. Fast liquidation may reduce time cost to participants especially to creditors which may not have enough resources and information to look for more efficient outcome.

Besides that liquidation will facilitate faster transferring of resources to its more efficient use. This argument would be weaker in a situation of transition economies as resources released by liquidation procedure may not find the immediate use in other economic activities. Due to underdeveloped markets idle capital, land and labour resources may be

unutilised for a long period as it is discussed later in this paper. Existence of a developed capital market is a necessary condition for the efficiency of the bankruptcy law, otherwise the most efficient potential buyers that do evaluate the enterprise properly are willing to acquire it and know how to revoke it from the financial distress may not find in time sufficient resources.

On the contrary, arguments for reorganization argue that the company's assets may potentially have higher value as a going concern. Also, at the required point in time, there might be no buyers that could accurately evaluate and have sufficient resources to buy the assets. In this case it might be more efficient for participants to retain enterprise as a going concern thus ending up with higher value than they may get from the liquidation of insolvent enterprise.

Bankruptcy law and transition economy

Transitional economy may be different in how firms became insolvent. As it was mentioned earlier this insolvency may come not due to bad management that is not used to work in the market economy environment or lost of competitiveness, or even structural adjustments of the economy, but due to temporal macroeconomic shocks like high inflation, sudden lost of contractor due to break-down of linkages, etc. Thus transitional economies have the problem of preserving potentially viable and productive enterprises from being liquidated in any manner due to severe financial insolvency.

Another linked argument is that immediate liquidation of inefficient and/or insolvent enterprises do not necessarily faces the best needs of society.

Unlike economies with developed markets where resources relatively easily flow from less efficient businesses toward their more productive use, in transitional economies where labour and capital markets are only at initial stage of development, massive liquidation and restructuring of enterprises is likely to produce severe social problems as released workers often might not have other employment opportunities. The resulted social distress may erode the peoples support of reforms, slow-down the overall transformation process and produce long-run adverse effects on the country's economic performance.

Thus the bankruptcy procedure in transitional economy like Ukraine has to pay especial attention to possibilities of retaining potentially viable enterprises in the business restoring their solvency.

Yet another role for which bankruptcy procedure may be used in transitional economy is capturing of the state property by private sector in situations when traditional official privatisation is slowed-down due to

political reasons or if it is badly designed. In this case the efficiency outcome for the society is ambiguous.

From one point, if potentially more efficient owner captures productive assets from the state ownership (assuming that state cannot be considered as an efficient owner), finds better use of productive resources that state would not identify and thus raises general economic welfare of the society.

From another point, the state budget could have not received revenues that it could get in the process of official privatisation of these enterprises. Thus general public has not obtained and used substantial financial resources that are so valuable during economic transformation. In addition, this “shadow privatisation” does not necessarily bring the most efficient owner as

the successful outcome of the capturing move heavily depends on the availability of insider information about the enterprise as well as on political support of the private owner from the politicians in the central or local power bodies. We also may argue in this case that badly designed political institutions may make impediments to the bankruptcy procedure as well as to privatisation at some enterprises, as officials may prefer to have private rents from state-controlled enterprises rather than to facilitate their transferring into private hands.

Evolution of bankruptcy procedure in Ukraine

The first Ukrainian bankruptcy law was enacted in 1992. This law was a first attempt of providing the economy with the tool of liquidating inefficient enterprises. Nevertheless this law was criticised for providing small incentives for enterprise restructuring. According to the statistics provided in the article by Helen Kryshchalowych and Smith Greig in the year 1997, there were 32 decisions authorising financial restructuring versus 4,107 declarations of bankruptcy; in 1998 - nine restructurings versus 4,525 bankruptcies; and in 1999 there were 21 restructurings versus 6,244 bankruptcies⁵.

In 1995 the effort of reforming bankruptcy legislation was made when a group of scholars and arbitration judges developed few Explanations that provided rules for clarification of the difficult and controversial items in the bankruptcy procedures. These Explanations were approved by the Highest Arbitration Court of Ukraine in 1997. As Dr. Biryukov points out: “until 1998, bankruptcy reform was achieved not by passing a law through the Parliament but through the court system, specifically Ukrainian arbitration courts”.

The new draft law of bankruptcy which contained only minor changes to the law of 1992 has passed the first reading in the Parliament

in 1996, and unfortunately there was no any further progress for about 2 years as preparation to the second reading started in 1998. And in June 1999 an almost new version of the law was adopted and came into force in 1 January 2000.

The new Bankruptcy law was designed to meet the requirements of Ukraine's transition namely the need to pay extra attention for providing set of flexible opportunities in reviving potentially viable enterprises. Even the name of the new Law was now "On restoring the debtor's solvency and declaring him a bankrupt".

One of such provisions is contained in Article 53 of the Law provides the *debtor with the option to initiate* the bankruptcy procedure by himself which is based heavily on the US bankruptcy law (see: Wolfe and Glinka⁶). Another important attribute of the new law is an *automatic stay provision (moratorium)* that prohibits the debtor from paying any pre-petition creditors (Article 12-4). These two provisions allow insolvent enterprise to avoid fast capturing of indebted enterprise by a strong creditor, thus providing the owners and management with a time and opportunities to restore enterprise financial viability. The moratorium on repaying creditors claims remains in stay until the sanation procedure is started or the enterprise is declared bankrupt and liquidated or an amicable agreement is concluded (Article 12-3). To secure the interests of creditors in the bankruptcy process the court assigns an external manager which is licensed by the state agency on the bankruptcy issues⁷ (Article 13-2).

Bankruptcies of state-owned enterprises in Ukraine

As the *Table 11.1* shows there is indeed a much higher number of bankruptcy suits to the enterprises with the state ownership in the years after 2000 when the new Bankruptcy Law came into force. That means that the bankruptcy procedure started to be applied to the state-owned enterprises more frequently than it was before.

The dynamics, however does not corresponds with the overall dynamics of the bankruptcy cases in the economy: as it is seen in the table below in the year 2001 after the introduction of the new bankruptcy law the number of bankruptcy cases has grown only insignificantly comparing to the year 1997 and has declined sharply comparing to the year 1999 (see *Table 11.2*). That means that the share of bankruptcy cases filed against the enterprises with state shares has grown.

Table 11.1. Dynamics of bankruptcy cases with state-owned enterprises

	1996- 1997	1998	1999	2000	2001	2002-3
Total bankruptcy cases	17	20	30	35	113	118
liquidation	9	6	13	15	38	23
In-court procedure	8	14	15	14	50	71
Sanation			2	6	24	24
Amicable agreement					1	
<i>In % of total:</i>						
Liquidation,	56%	33%	39%	31%	30%	17%
In-court procedure	50%	78%	45%	29%	39%	52%
Sanation			6%	13%	19%	18%
Amicable agreement						1%

Table 11.2. Dynamics of bankruptcy cases reviewed in Ukrainian arbitrage courts

Year	1997	1999	2001
Total number of bankruptcy cases	7 082	9 539	7 277

There might be several explanation to these tendencies. One is that the outcome of the bankruptcy procedure to the creditors of the state enterprises became more attractive than it was before. The evidence in confirmation of this hypothesis may be supported by the observed increase in the bankruptcy cases filed against the enterprises of particular industries. About half (38 of total 96) of the bankruptcy cases filed against enterprises with state shares in food industry were initiated over the sugar-producing enterprises. Nowadays, the sugar industry in Ukraine is the industry that loses its competitiveness and generated severe debts. Thus in this case the bankruptcy law performs its economic function of reallocating inefficiently used resources. Again we admit that all bankruptcy cases toward sugar industry were initiated after the new bankruptcy law came into force.

Table 11.3. Estimated value of the state-owned stakes in the enterprises in bankruptcy

Year	Value of the state stakes by statutory fund for the enterprises in bankruptcy	Actual privatisation receipts
1996	0.0	0.01
1997	13.5	78.1
1998	40.7	360.8
1999	33.2	694.6
2000	46.0	2075.5
2001	1131.8	2132.0
2002	2686.0	576.11

From another point of view among the bankruptcy cases there are a lot of enterprises of the industries that show remarkable performance during last few years. This concerns metallurgy and metal-working industry, construction industry, chemical industry, etc. Some of these enterprises indeed went to bankruptcy due to their ineffective structure and deteriorated competitive position, and some indeed may fall into bankruptcy due to the capturing activities of private investors.

There are two sets of explanations to the phenomena of these enterprises bankruptcies that may be called external and internal ones. The one possible explanation, which may be referred to as external, is the slow-down of official privatisation. The reason is that with the lack of attractive enterprises that are available through privatisation the big Ukrainian financial groups may concentrate their efforts on capturing state-owned enterprises by other methods. Moreover, in bargaining for these enterprises using alternative methods they may have higher success than in official privatisation due to political affiliation or economic impact on the particular company. To consider the political aspect, it might be possible that even potentially efficient capturer which could be a winner of competitive bids through the official privatisation scheme may be in a hurry using alternative methods expecting the possibility of developing unfavourable political balances for him in the short- or medium-term and expecting more ambiguous results in more inconvenient future.

Among other reasons, that we call internal ones there could be strategies of big financial and industrial groups that might be willing to acquire enterprises that are crucial for secure functioning of their other enterprises (like power generating facilities or ore refining for metallurgy). We may say that in this way big owners are aimed at fast capturing of the enterprises complement to their businesses or are aimed to get more control over the markets where they have solid presence. Some evidence on these propositions might be obtained from observing the Table 11.4 where the biggest enterprises in terms of statutory fund are shown.

As it is seen these enterprises belong mostly to the industries that experience the higher growth: chemical industry, metallurgy, ore-refining, etc. The most visible example is metallurgy sector that experience stable growth during last years and which gains substantial amount of export revenues.

The phenomena of capturing the state property with the tools of bankruptcy procedure has attracted attention not only of the mass media but also by the President, who argued about “necessity on revealing and fighting the misconduct behaviour related to artificial bankruptcies”¹¹ in his message to the Parliament.

Table 11.4. Enterprises with highest statutory fund that went bankrupts

Enterprise code	Enterprise	State Share	Statutory fund (thous. UAH)	Branch of industry	date	Bankruptcy stage
5743160	OJSC "Oriana"	100	806 000	chemical industry	2002	procedure
5393043	OJSC "Dniprovsky Metal Works n.a. Dzherzhynsky"	99	594 136	metallurgy	2001	procedure
5761318	OJSC "Svema"	100	488 072	chemical industry	2002	procedure
5393108	OJSC "Nikopol south-pipe plant"	96.67	364 751	metal-working industry	2002	procedure suspended
191170	OJSC "Malaiivskii metallurhijnyj kombinat"	61	354 160	metallurgy	2002	sanation
5800159	OJSC "Krasitel"	85	304 254	chemical industry	2002	sanation
191023	OJSC "Nothorn ore-refining plant"	36	242 869	ore-refining	2001	procedure
23343582	"Donbasenergo"	86	236 443	energy		procedure
5393056	OJSC "Dnipropetrovsk metallurgy plant n.a. Petrovskiy"	42	212 338	metallurgy	2001	procedure
191827	OJSC "Komsomol'ske rudoupravlinnia"	100	111 768	ore-refining	2002	sanation
130872	OJSC "Dniproenergo"	76	98 100	energy	2002	procedure
191164	OJSC "Donetsk metallurgy plant"	16	90 560	metallurgy		procedure
5441447	OJSC "Alchevsk metallurgy plant"	25	77 525	metallurgy	2001	procedure
14310997	"Znamia"	100	70 542	electronics	2002	sanation
152269	OJSC "Rosava"	75	69 246	rubber-processing industry	2002	procedure
5389942	OJSC "Lysychansk rubber products plant"	50	62 744	rubber-processing industry	2001	procedure
21841896	OJSC "Luhanskoblenergo"	60.06	52 031	energy	2001	procedure
306650	OJSC "Teksterno"	25	48 710	light industry	2002	procedure
131587	OJSC "Lvivoblenergo"	26.98	48 493	energy		procedure
5396155	OJSC "Kvartssamotivty"	100	45 012	jewelry	2002	sanation
857290	COJSC "Agriplant "Kalita"	47.5	43 032	agriculture	1998	procedure
14313033	OJSC "EKMA"	99	41 271	electronics	2001	liquidation
5758948	OJSC "Luhansk aldkumulators"	50	37 549	machine-building	2001	sanation
187381	OJSC Debaltsevo metallurgy machine-building plant	99.5	33 069	machine-building	2002	sanation
204895	OJSC "Sloviansk soda plant"	100	32 923	chemical industry	2001	procedure
18201	AXK "Ukrmaftoproduct"	50	30 544	trade	1999	procedure
5393062	OJSC "Dnipropetrovsk metallurgy plant"	61	25 926	metallurgy	2001	procedure
213196	OJSC "Pivdennelektromash"	75.01	24 957	machine-building	2001	sanation
165646	OJSC "Krasnohul'sk machine-building plant"	50	21 592	machine-building	2002	procedure

To conclude we may say that it could be proposed that there are the following reasons for capturing state-owned enterprises by alternative to official privatisation methods:

- slow-down of official privatisation;
- current political sustainability of big financial industrial group;
- need to capture complement productions;
- desire to capture higher market share at particular market.

The usual way of capturing assets is creation of a new clone company usually in a form of a closed joint stock company to which the interested enterprise transfers its productive assets leaving debts and non-productive asset to the "old" company. This "old" company is usually the subject to

the bankruptcy procedure. Sometimes a new enterprise plays a role of an investor during sanation procedure¹².

The capturing of attractive assets from the state-owned enterprises requires support of the regional administrations and/or branch ministries. For example the inter-branch working group that was ordered¹³ to investigate the transferring of state property at state enterprise “Luhans’k machine-tool plant” concluded that the artificial bankruptcy of this plant was made by a concerted action of Luhans’k regional administration, arbitrage manager of sanation, investor, regional bankruptcy Agency and even by the Ministry of Industrial Policy and state tax administration¹⁴. As a result the President issued special Degree to investigate these cases of misbehaviour¹⁵.

Certainly there are other cases that also have drawn attention of the public but we have to admit that the nature of such misbehaviour of state power bodies and certain responsible officials has rather systematic nature. As it was already mentioned few times in this text, one reason is the slow-down of privatisation that stimulates entrepreneurs to look for other methods of acquiring state property. In addition big financial and industrial groups that posses political influence find alternative privatisation schemes cheaper with more manageable outcome.

In fact an interested capturer gets opportunity to be involved in some kind of enterprise restructuring deciding which assets are not useful for production. And that opportunity may be of a particular attraction for investor as from another side the official privatisation tenders usually require investor to retain cumbersome social sphere and ask for particular investment obligations. Besides, official tenders usually apply questionable qualification criteria that prevent potentially efficient investors from participation in privatisation process. These additional tender requirements are in fact intervention to the private economic activity and certainly limits transparency and efficiency of official privatisation.

The design of the bankruptcy procedure itself, where a substantial decision power is granted to the creditors committee and court can hardly be blamed for the state property capturing. On contrary it is more apparent to say that the capturing of the state property is conducted by applying the political influence over court itself or over the body responsible to manage the state corporate rights. This behaviour is possible only due to the current design of political and market institutions.

As the main reasons of intensified state property capturing we would highlight:

- *the slow-down of official privatisation and its insufficient transparency*
- *the decentralised management of state corporate rights*

As for the last item some reforming measures in managing corporate rights are being undertaken. Until recently the Cabinet of Ministers was delegating the right to manage state corporate rights either to corresponding branch ministries or to local power bodies¹⁶. However, in early 2003 President issued an Order¹⁷ about transferring of all state corporate rights to the State Property Fund of Ukraine. The concentration of state corporate rights within one body is a positive result however the implementation of this decision is still in question mainly due to insufficient SPFU expertise in certain industries' specifics. Moreover the process demonstrates reverse tendency as Head of SPFU¹⁸ said that SPFU proposes to transfer management of state shares in energy companies to the Ministry of Fuel and Energy.

The wide practicing of capturing the state property has also drawn attention of the Parliament which adopted a Law "On moratorium on the compulsory sale of the property"¹⁹, that postpones compulsory sale of the property of enterprises where the state share exceeds 25% till the mechanism of the sale of state property will be improved (Article 1).

The state property capturing is also challenged in the draft State Privatisation Programme for the years 2003-2008. In particular it stipulates that the property of state-owned enterprises that is under the pledge can be sold only through the privatization procedure. In this way it is supposed to discourage artificial capturing of the state property through pledged credits.

However this proposed mechanism does not solve all the problems. Still the pledged property transfer may remain as inefficient way of restructuring that can reduce attractiveness of state-owned enterprises. Another point that needs clarification is the who shall be recipient of sale proceeds in case these proceeds exceed the pledged sum. Alternatively it also shall be clarified who will compensate lender the rest if the proceeds are smaller than the pledged value. In addition the credit market may react by raising interest to state-owned companies as the probability of fast credit recovery declines.

12 CASE STUDIES

MINORITY SHAREHOLDERS VS. THE STATE: THE CASE OF JSC "UKRNEFT"

Introduction

The joint-stock company "Ukrneft" is a good example for understanding the role of asymmetry of information in the corporate governance. Corporate ownership structure is characterized by high enough concentration. The state is the largest stockholder, owning 50%+1 company stock, i.e. controlling block. Besides the state, there are some large shareholders in the structure of corporate ownership of the joint stock company "Ukrneft". They are represented by Pryvatbank, Ukrsybbank and Wotford Groups. The consolidated shareholding of these shareholders is 41 % of voting shares. The remaining 9 % of shareholder equity belong to the rest minority shareholders.

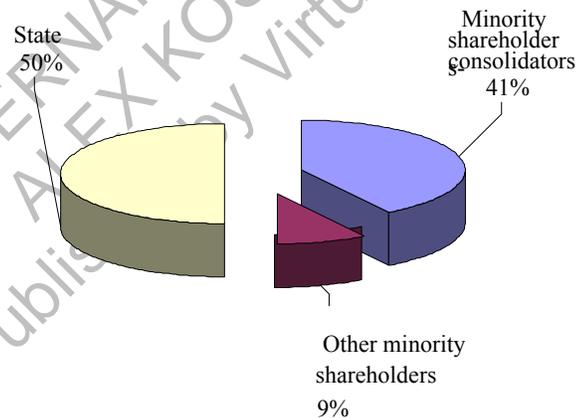


Fig. 12.1. Joint-stock company "Ukrneft" ownership structure

In general, about 35.800 individuals and 200 legal entities, of which about 50 are not residents, are the shareholders of the enterprise. Private shareholders aggregate 49% of shareholder equity. The JSC "Alpha-Capital Ukraine", incorporated bank

"Societe General' Ukraine", joint-stock bank "ING Bearing Ukraine", "Raznoeksport", companies "Oksydental Management Company Ltd", "Ukrainian Capital Management Ltd, "Optyma", "Synkom", "Zdobutok" and "Wood & Company Management" are the largest owners.

The reins of the corporate governance are at the hands of the state. This concerns not only the approving the strategic decisions at the shareholders' meeting, but also the implementing the control for its execution by the Supervisory Board. Before the next shareholders' meeting, which was planned on August 28, 2001, the state was represented in Supervisory Board by 9 members.

The first round of conflict

A few questions, which became the reason of the agent conflict between the state and the consolidated shareholders, were included on the agenda of the shareholders' meeting, i.e.:

- reelections of the Supervisory Board and the Chairman of the Supervisory Board;
- question about the redistribution of the income, which the corporation has earned in 2000 and the dividend payment;
- the Board's report on the financial activity for the year 2000;
- some changes in the charter and internal corporate statements;
- establishing the new structural units, divisions, etc.

As a result of the enterprise activity for the year 2000, book income was generated at the volume of HRUA1 billion. It was planned to spend HRUA76 million to the dividend payments, i.e. about 7 %. On the assertion of the Supervisory Board and the Executive Board, the remaining amount was reinvested during the year. Thus, the minority shareholders confirm that neither the efficiency of the investment projects, nor its advantages for the shareholders of the company are obvious. In addition, the minority shareholders would like to get an answer at the question about the reason of the unprofitable gas sales by JSC "Ukrneft' to the national oil-gas joint-stock company "Neftegaz of Ukraine".

To find an answer to these questions, the minority shareholders consolidated their interests and suggested to an existent majority in the person of the state before the shareholders' meeting on August, 28, 2001, to discuss the possibility of the acceptance of some suggestions, which would protect the rights of the minority shareholders and were

instrumental in the diminishment of the asymmetry of information between two groups of the shareholders - majority and minority shareholders.

The minority shareholders suggested to the majority shareholders to support the following suggestions at the shareholders' meeting:

- to increase the number of minority shareholders on the Supervisory Board from 2 to 5 persons;
- to approve some amendments and changes to the corporate charter. According to these amendments, the shareholders' meeting, instead of the Supervisory Board, should elect the Chairman of the Supervisory Board.

The first suggestion of minority shareholders was aimed to getting an access to the control of the Board's activity. For the state, the suggestion of minority shareholders, who wanted to have 5 their members on the Supervisory Board, was unacceptable, because of the fact that the meetings of the Supervisory Board can be valid only for a seven members quorum. Thus, having five members on the Supervisory Board, the minority shareholders would get a good possibility to compel the majority shareholder – the state - to consider the minority interests.

Unfortunately, the majority shareholders did not accept the minority suggestion. As a result, the minority shareholders were not at the shareholders' meeting on August 28. Only 52,47% of the shareholders were registered at the shareholders' meeting (in accordance with Law of Ukraine "On Enterprises", a quorum at the shareholders' meeting is considered as attained, if no less than 60 % of shareholders are registered). Thus, the shareholders' meeting of JSC "Ukrneft", that was planned for August, 28, 2001, had not happened.

The second round of conflict

The next shareholders' meeting of JSC "Ukrneft" was appointed for November 15, 2001. The minority shareholders stayed on the steady positions concerning the redistribution of the seats on the Supervisory Board of the company. The subject of the confrontation between the "consolidators" and the main shareholder – national gas-oil JSC "Neftegaz of Ukraine" - remained unchanged. Mr. Galyev, vice-president of incorporated bank "Ukrsybbank", noticed that "questions of the redistribution of corporate control and access to insiders' information about company's activity between the state, as the owner of controlling block, and companies, that are owners of the consolidated block at 41 % of shares, still are not resolved". In this case, there is a question about the proportional representation on the Supervisory Board.

The requirement of the minority shareholders about the proportional distribution of seats on the Supervisory Board of JSC "Ukrneft" does not contradict with the current legislation of Ukraine, but also it is not ratified as obligatory.

According to the Galiev's statements, the minority shareholders can not protect their interests directly, i.e. in legal order, namely, to require appointing on the Supervisory Board five representatives, because of the current legislations. The principle of cumulative presentation on the Supervisory Board, which appeals to defend the minority rights, works in many countries of the world, but in Ukraine, unfortunately, is still absent.

In such situation, the owner of controlling block of shares receives a good possibility to consolidate all information about the company's activity in his hands and limit the minority shareholders in getting it. It leads to the appearance of asymmetry of information and as a result, to the conflict of interests of the owners of the company, i.e. to the agent conflicts.

Obviously, the problem can be solved through the transparent reporting and communication policies to reflect current situation and the prospects of the company development at the market. The information about an economic activity of the joint-stock company, which is presented every year to all shareholders at the meeting, is rather common. So, before the meeting, the financial reports, that had the formal status and informed the owners, for example, about the profit which company has received at a size of HRUA1 billion was presented to the shareholders. As the minority shareholders noticed, this amount must be somewhere accumulated - at accounts or in highliquid assets, before shareholders' meeting makes a decision about its use. There was a far less amount of income at the company accounts before the moment of holding a meeting. The Board explains this fact by the realization of some actions, related to the renewal of fixed assets, new field development, etc. Minority shareholders find the majority shareholders guilty because they do not allow them to take part in developing of the company investment strategy, and only put them before the fact of the decisions accepted by the Supervisory Board. A. Dubylet, Chairman of incorporated bank "Pryvatbank" says: "It is strange, what the main point of this investment decision is, why a huge amount of money goes there, and there is no control from the side of the shareholders. There are many questions, connected with that fact that the company did not get a necessary income in 2000, in spite of such a serious jump of oil prices. May be, this is one of the most important questions".

The audit conclusion about the financial position of the company in 2000 was made about its stability, and coming from liquidity ratio, the company has a good position. But, the audit conclusion cannot contain

the estimation of the loss of profit, as a result of the incorrect choice of investing.

Galyev on this occasion noticed that formally, documents, which are spreading at shareholders' meeting, must not contain the detailed information about the choice criteria of the objects of company's investing. So, they must not contain the statement of account, settlement account balance, etc. To get such information, it is necessary to be on the Supervisory Board. "If I were a member of Supervisory Board, - Galyev noticed, I would ask to explain, where the HRUA1 billion of income was. If it was not reinvested, it means that the money have been paid to the shareholders. If it was reinvested, the question is in what projects and what the return period. And in general, was this period calculated?"

In spite of the justified desire of shareholders to have five representatives on the Supervisory Board, the majority shareholders did not accept any suggestion of the minority. Only four seats on the Supervisory Board were offered to the minority shareholders. Having such number of seats, they would not be in a position to influence the investment decisions of the company. Besides this suggestion, majority shareholders did not offer concrete methods for solving the agent's conflict. V. Kopylov, Chairman of Management Board of joint-stock company «Neftegaz of Ukraine» who is the owner of the controlling block of shares of JSC «Ukrneft», explains that the private shareholders were not allowed to be on the Supervisory Board of the company because of their not large investments in comparison with the company value. A. Dubilet noticed that if US\$100 million investments mean nothing for the management and the welfare of the company, what it should say about the Ukrainian pensioners, whose stake in the company makes about UAH100, and whether it means, that they are not of interest for the state as co-owners of the Ukrainian enterprises.

The minority shareholders used a popular method of protest, i.e. ignoring shareholders' meeting, which had not happened on November, 15, 2001 again because of absence of the decision of the arising conflict. One of the minority shareholders, M. Wotford, Head of Wotford Groups, declared that the most painfully an agent conflict influences the market value of enterprise.

As we can see at the figure, the share price of enterprise did not suffer sufficiently as a result of the agent conflict. A high price of "Ukrneft" shares is explained by the fact that a block of shares at 51%+1 share belongs to the state. That's why, the final owner has not been determined and fight for the company control is coming.

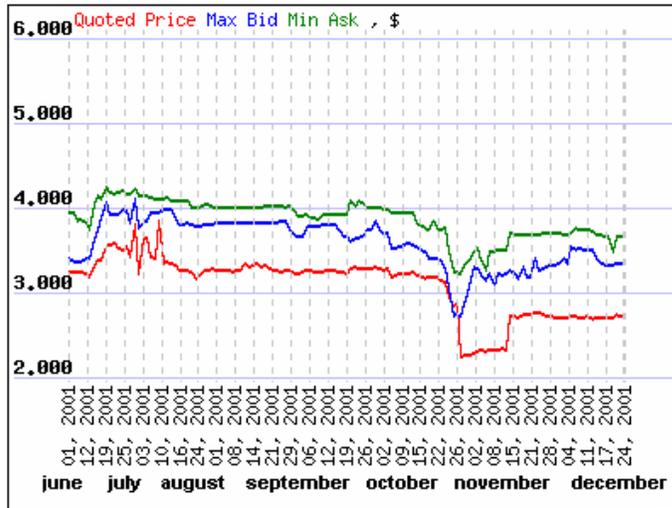


Fig. 12.2. Dynamics of share prices of JSC "Ukrneft"

In addition, the reason of such stability is the statement, made by Mr. Galyev after the shareholders' meeting, which was to be undertaken on November 15, 2001. The Vice-president of incorporated bank "Ukrsybbank" declared that nobody of minority shareholders-consolidators is going to sell the company shares belonging to them.

Moreover, minority shareholders became more active to increase their share in the ownership structure. Obviously, increasing their participation in the shareholder equity, their requirement to get 5 seats in the Supervisory Board would be more and more convincing.

That is why, before the shareholders' meeting on November 15, 2001 there was an evidence of increasing the price of shares of "Ukrneft". A large transaction (25.000 shares) which took place on November, 7 on OTC market is a proof of this fact. This transaction went beyond the scopes of current market corridor (the bid quotations were HRUA22.66, the asked quotations were HRUA22.669). Analysts are sure that the protection strategy of minority shareholders rights is aimed to buy shares of those outsiders who own 9 % of the registered equity and do not join the group of consolidators.

Probably, after that, minority shareholders would remind Mr. Kopylov, Chairman of the Supervisory Board, about his promise to give one seat in Supervisory Board to the owners of this 9 % block of shares. If they bought this block, shareholders -consolidators could require giving this seat to them. As a result, this seat and the other four seats, which the majority shareholders are ready to give to the minority

shareholders, will give the possibility to the majority to influence the company work. This strategy would correspond to the principles of a honest fight for the corporate control.

The consolidated commercial banks just tried to purchase shares of JSC “Ukrneft” at the secondary market. The State responded quickly to deprive commercial banks of funds to finance purchases. The strategy was the following.

The State as a shareholder of JSC Ukrneft, decided to attack consolidants, represented by commercial banks. Thus, at the end of the year 2002, the Ukrainian government wanted to finance an activity of National JSC “Naftogas” through issuing corporate bonds. It was very strange initiative to allow a company with only HRUA 60 mln. assets, to issue corporate bonds at amount of HRUA 800 mln. The reason of such initiative was understood only by those, who knew how this issue of corporate bonds relates to commercial banks. The link was obvious, i.e. commercial banks will have (forced by the Ukrainian government) to buy corporate bonds. In the case of success of this strategy, commercial banks would lost their liquid positions and they would have to get rid of a plan to purchase shares of JSC “Ukrneft” at the secondary market.

The National Bank of Ukraine, as a regulator of the banking sector in Ukraine, has not supported an initiative of the Ukrainian government (in Ukraine, the National bank is quite independent). The conflict between the Ukrainian government and the National Bank of Ukraine was settled at the Ukrainian parliament, where parliamentarians rejected the strategy, i.e. the issue of bonds was prohibited.

After this, local victory, minority shareholders chose another strategy, instead of purchasing shares of JSC “Ukrneft” at the secondary market. Political blackmail became the key element of this strategy.

In 2002, the Ukrainian government decided to attract the investments of the Russian oil-extracting companies in the oil processing industry of Ukraine. Negotiations with Yukos, Sybneft, Lukoyl and TNK were initiated. The above mentioned Russian companies really wanted to come to Ukraine to invest huge funds. The prospects of these relations were examined by the Russian companies through the prism of the role in these relations of one of the largest Ukrainian financial and industrial groups – Privat-Invest¹ (see the figure below) and UkrSibBank, which are shareholders of JSC “Ukrneft”.

For the moment of the beginning of negotiations, Privat-Invest actively co-operated with the Russian oil-extracting companies in the area of import of oil and petrol to Ukraine.

¹ One of the biggest financial and industrial groups of Ukraine. The book value of assets of the companies owned by Privat-Invest is HRUA11,5 bln. (USD 2,18 bil.) The largest FIG is «Industrial Souz Donbasa» (USD 12,5 bil.).

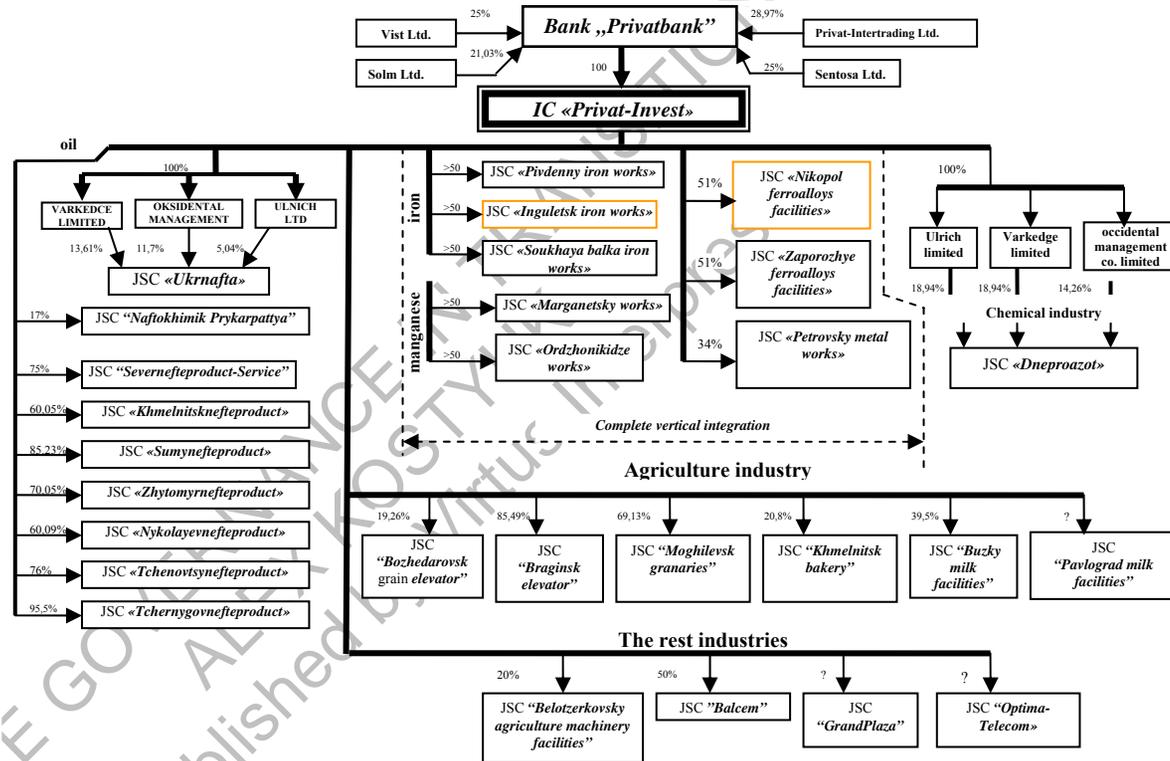


Fig. 12.3. Financial-industrial group "Privat-Invest"

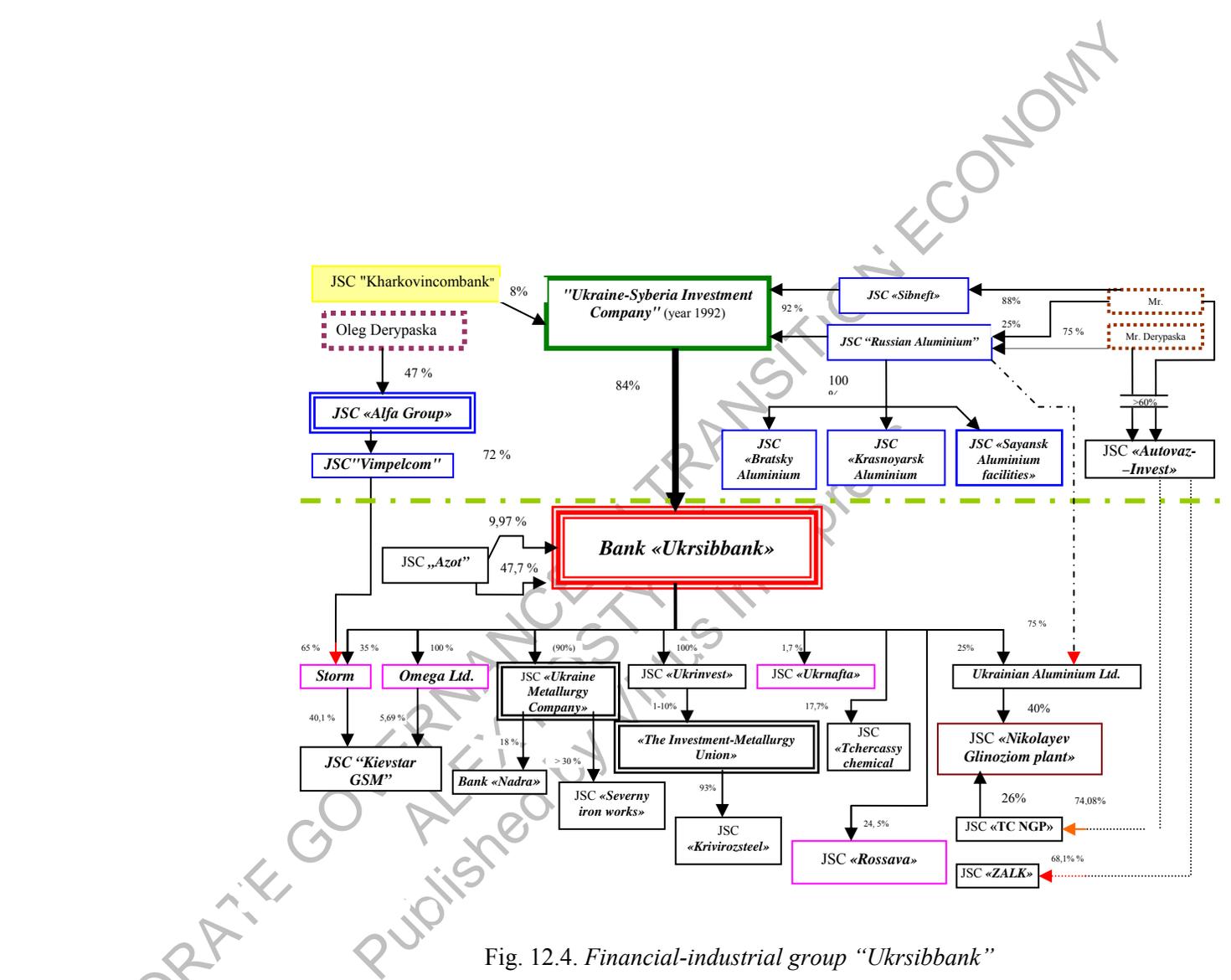


Fig. 12.4. Financial-industrial group "Ukrsibbank"

Moreover, Privat-Invest was successful in establishing a vertically-integrated structure in the oil sector. Therefore, Russian oil companies considered Privat-Invest as a serious partner at the market. It is interesting, that the commercial bank "Privatbank" is the financial kernel of the Privat-Invest group. In this situation the state had to choose between saving of corporate control in JSC "Ukrneft" and realization of investment projects in oil industry of Ukraine.

UkrSibBank represents interests of Mr. Abramowich who is an owner of Russian JSC "Sibneft" (see the figure above). Therefore, JSC "Sibneft" will come to Ukraine to invest only if the Ukrainian government gives a guarantee that the rights of UkrSibBank as shareholder of JSC "Ukrneft" will be protected.

As a result of numerous negotiations the decision was accepted. First, the state, as a shareholder, gives the position of a Chairman of the Management Board of JSC "Ukrneft" to the representative of Privat-Invest². Secondly, the state promises in the near future to sell a part of the shares of JSC "Ukrneft", i.e. to lose the corporate control. Thus, the circle of participants of shares tender sale is already defined - the Russian oil-extracting companies and financial and industrial groups "Privat-Invest" and UkrSibBank. Interestingly, interests of other consolidators are not taken into account.

Thus, as the result of the fight for corporate control of JSC «Ukrneft» - the leading corporation at the market for oil and gas in Ukraine, the State is going to give corporate control to other large investors who behave in not transparent manner. Rights of minority shareholders, under such circumstances, are an excellent target to violate. Probably, the State prefers to find a mutually advantageous way out with participation of a small number of large shareholders to keep the process of transfer of corporate control under shadow. The state men suppose that it is much easier to find a compromise with a narrowed circle of discusants than try to find the best decision for all minority shareholders – consolidants.

Such kind of perspective for the market for corporate control development is a step back from the principles of corporate governance, i.e. principle of transparency and accountability.

S.L.Tigibko is the former CEO of «Privatbank». He was the leader of the former President of Ukraine L. Kuchma fraction «Trydovay Ukraina». On December 2002 he was elected on the post of Chairman of National Bank of Ukraine, at the end of November of 2004 he left the position.

² On January, 30, 2002 a representative of "Privat-Invest" was elected on the post of Head of the Management Board JSC «Ukrneft». Before that he hold apposition of Head of the Management Board of JSC «Galichina».The controlling block of shares belongs to FIG "Privat-Invest".

P.S. After the inauguration of the new President of Ukraine Mr. Yuschenko, the President of Ukraine placed a lot of emphasize to such issue as transparency and acountability of corporations. He underlined that the State will do its utmost to create a system of incentives to drive owners toward the best principles of corporate governance. This is not an issue of regulation. This is an issue of liberalization, when the State takes a position of guarantee of rights of minority shareholders.

CORPORATE GOVERNANCE IN TRANSITION ECONOMY
ALEX KOSTYUK
Published by Virtus Interpress

CONCLUSIONS

Ukraine, as a transition economy, made a choice in the favor of the concept of corporate governance, popular in the USA - monistic concept. This is very surprising conclusion, taking into account a fact that the most corporate governance practices are close to those, popular in Germany, mainly regarding the supervisory and management board practices. At the same time, we need to declare that the Ukraine monistic concept is modified very much. Interests of shareholders are primary for the company, and the company is considered by shareholders as a personal instrument to earn money. But, in contrast to the USA, where shareholders use the stock market as an instrument to earn money, shareholders in Ukraine use another instrument to enrich themselves - political lobbying, corporate blackmailing, assets and cash tunneling.

Agency conflicts erode the mutual trust of participants of corporate governance. Shareholder activism that could be a way out for Ukraine is still not popular. It is because of a weak legislation base and weak degree of knowledge of minority shareholders in the area of corporate governance. Ukraine still has not a separate law on joint-stock companies. The draft of the respective law is in the Parliament during last years, but it is not adopted because of the lobbying interests of the Ukrainian parliamentarians.

Supervisory board that could be logically taken for an instrument of protection of the rights of minority shareholders and balancing interests of all shareholders is out of the situation. Members of supervisory boards in Ukraine are inclined to be lobbyists of interests of large shareholders. As a result, the motivation to be an independent director is very weak in Ukraine.

Executives consider themselves as dictators who are able to ignore interests of employees and minority shareholders. Executives got used to make employees pass them the voting rights. As a result, executives have excellent chances to run the companies as they want, without investing in the company.

We need to conclude that corporate ownership structure, whether it is concentrated or dispersed, is much more disputable factor, affecting corporate performance, than nature of the owners. Shareholders, who are well-motivated to own shares and well-equipped with knowledge how to do this in the interest of society in whole, are ideal owners.

If the companies are not fortunate to be owned by ideal shareholders, ownership structure just specifies those participants of corporate governance, who will likely follow only their own interests. If the ownership structure is concentrated, it is expected that those "foul

makers" are block holders. They will not be inclined to care about interests of minority shareholders. If the ownership structure is dispersed, there is an expectation that management of companies will violate rights of shareholders. Executives will behave in their own favor and follow their own interests.

So, what is the best way out for the companies - concentrate or disperse ownership structure? Whatever you answer, it will be a wrong choice. The right question must be constructed not around concentration of ownership structure. It must be constructed around an ideal shareholder - a well-motivated and equipped with knowledge owner, who is responsible not only for his own stake in a company, but for the company in whole, not only to shareholders, executives or employees, but to society in whole.

The Ukrainian corporate governance practice says that this type of owners is represented by foreign institutional shareholders. The Ukraine's state authorities and the President make their utmost to attract attention of foreign institutional shareholders to Ukraine. But foreign shareholders will come only if executives and Ukrainian institutional shareholders take a code of best practices that should be developed in Ukraine, for a bible of corporate governance. The code could be a documentary evidence of transition of the Ukrainian corporate governance from chaos to a well - disciplined state, named a system.

CORPORATE GOVERNANCE IN TRANSITION TO A FREE ECONOMY
ALEX KOSTYUK
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