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SHAREHOLDER RIGHTS, EQUITABLE TREATMENT AND THE ROLE OF THE STATE

*Corporate Governance Upside-Down
How the pieces (and lemons) fit after the mass privatization*

By

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We can't solve problems by using the same kind of thinking we used when we created them.

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Albert Einstein

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When the Berlin Wall fell, the first economic advice given to the former Soviet block countries was decentralize, deregulate, Mass Privatize. Often multilateral institutions, even the IMF, would set objective privatization goals for each country to achieve before obtaining the next tranche of aid or financing. The donor agencies also sent consultants to help countries meet their set privatization goals by distributing privatization vouchers to the public and running the voucher auction centers. Now those consultants are often criticized for focusing on distribution of shares and failing to address how the corporations would be governed. Consequently, the Communist centrally planned economies were replaced not by the free market, but by kleptocracy. Control over the assets, not ownership mattered in the new economy. This led to two negative results: First the much-touted investments did not materialize, as no one wanted to invest in a kleptocracy. Second, the population, who were sold on the idea of market economy and private ownership, were disillusioned as their shares became worthless.

The focus of multilateral institutions had changed from mass privatization in the nineties to corporate governance today. The IFC, USAID, CDA, OECD are all actively pursuing corporate governance projects in the mass-privatized economies. The USAID web site now states that as the mass privatization stage is finished, one of the main focuses is corporate governance. Armed with a box of corporate governance cures, consultants are now talking accounting reform, independent boards, company law, and minority shareholder rights. **But are the consultants keeping an eye on the big picture, or are they overlooking something again? Could it be that the region's regulatory, judicial and corporate capacity will not be able to support the proposed cures for a long time to come?** This paper will attempt to put the pieces together into a big picture for a comprehensive program in post-mass-privatization corporate governance. It will expand the work in Krakovsky (2000)¹ and attempt to expand on the analytical framework for after mass privatization, discussed in Dyck (99)² and Ellerman (2001)³ by suggesting specific program, target specific laws and providing some empirical evidence to support the claims herein.

So what is the big picture?

The free enterprise system is based on the premise that businesses are too complex for the central planners to control and run efficiently. Instead, individuals, allowed to freely choose and in pursuit of their own self-interests are better equipped to run businesses because their performance is directly linked to their individual utilities. In doing so, they produce goods and services and pursue cooperative networks based

¹ Alexander Krakovsky, 2000 "Corporate Governance After Mass Privatization – Ukrainian Perspective" Proceeding of International Finance Conference.

² Alexander Dyck 1999 *Privatization and corporate Governance: Principles Evidence and Future Challenges* Harvard Business School Working Paper. Provides a very good analytical framework for policy makers and advisors, including a description of CG mechanisms and economic fundamentals of corporate governance.

³ David Ellerman 2001 *From Sowing to Reaping: Improving the Investment Climate(s)* World Bank Provides a conceptual framework for focus on economic principles for investment climate over pre-supposed dogmas that might be out of date and place.

on the free exchange of goods and services. Collectively this creates an “invisible hand” of free economic activity that maximizes the social utility much more efficiently than the central planner. “*The pressures of the marketplace direct the selfish activities of individuals as if by an Invisible Hand (to use Smith’s wonderful phrase) into socially responsible paths*” (Heilbroner and Thurow).

“*It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest.*” Observed good old Adam Smith.

Of course, Adam Smith did not explain many things, such as the observability and feasibility of perfect contracts. Additionally, Adam Smith observed individual entrepreneurs in his time. As a consequence of those networks that people form and necessitated by specialization, the butcher, the baker and the brewer are now large corporations. Consequently, corporate governance is a component of modern economics. **Just as the classical economics deals with the non-benevolence of the butcher, brewer and baker toward the customer, corporate governance has become a vital component of modern Economics, taking things one step further to deal with the non-benevolence of the corporate CEO’s, board members and other agents toward the corporation and its stakeholders.**

To be sure, if it was possible to have full costless information or the ability to make perfect contracts that span every possible state of the world (complete markets), then the society could contract with a central planner, just as well as with the butcher, just as well as with a CEO. It would make no difference. But life is not so simple. That is why modern economic theory tries to balance the motivating factor of free enterprise with the government’s role and other mechanisms to bring about efficient outcome.⁴ Equivalently, corporate governance tries to address the separation of ownership and management to bring the behavior of the management as close as possible to the interests of its constituency (shareholders).⁵

The World Bank defines corporate governance as “*That blend of law, regulation and appropriate voluntary private sector practices which enable the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interest of stakeholders and society as a whole.*”

This is a great definition because it captures the “blend,” fully recognizing that good corporate governance is a carefully crafted balance between the motivational forces and forces that constrain or direct certain types of behavior. However, the voluntary portion is too often overlooked and scuffed in favor of regulatory because a) lawyers usually deal better with law and regulation, b) many often make the mistake of thinking of voluntary practice as benevolent practice. **That was not the thinking behind this definition.** Just as with “*the butcher, the brewer and the baker,*” it is not through the benevolence of any CEO that we expect good management. CEO would impose constraints and hard work on himself only if he had self-interest, such as enabling the corporation to attract more finance, which would allow him to take on more profitable projects and earn money for himself in stock options, bonuses, etc.

Governance of a corporation is a mechanism of many components. One group is the country’s regime, made up of the company law, corporate law, securities law and regulations, commercial code, tort law, criminal law, labor law, other laws, regulatory capacity and even the unwritten law of the old boy’s

⁴ The best theoretical proof that incomplete market should be regulated probably came from O. Hart 1975 “*On the optimality of equilibrium when the market structure is incomplete.*” *Journal of Economic Theory* December, 418. Hart shows that in an incomplete market, removing the ability to make certain transaction may actually increase the utilities of market participants. The question, however, of who, how much and how should be entrusted with regulation is an infinitely more complex issue, discussed and cited further in this paper.

⁵ The historic work on that topic was: Berle and Means 1932 “*The Modern Corporation and Private Property*” New York: Macmillan. This work points out to potential expropriation by insiders (management) of outside claimants in a corporation.

network. The other part is internal and voluntary component; made up of the market capacity for monitoring, the charter, bylaws, debt contracts, management contracts, labor contracts and possibly a variety of other contracts affecting governance AND the firm's capacity for controls and information.

Just as the free enterprise system relies first on the voluntary, self-serving actions of the "butcher, brewer and baker," a well-structured corporate governance regime must also first of all harness the voluntary behavior of corporate agents and stakeholders. Regulations need to enable the invisible hand to work, not hinder it, and not enable the "grabbing hand"⁶ of the regulators. That is why the idea of simply cramming the OECD (or any other) principles of corporate governance into a couple of laws or regulations only turns the Government into a central planner, not a facilitator.

Regulation, Legislation and Capacity

Unfortunately, even after this clarification, some international development professionals tend to flatly reject the idea that private contracting, driving motivation and self-interest of agents is the primary component of corporate governance. A new argument uses the Enron case as the example why regulations need to "be increased." However, the Enron case shows that even in arguably the best-regulated market, there are breaches and lack of capacity. No amount of laws or regulations can eliminate problems like Enron if there is no corporate, market, regulatory and legislative capacity to implement them. With lower regulatory capacity in transitional economies, such breaches are more likely unless private mechanisms can be found to supplement the regulatory capacity.

An answer to this has been that the countries simply have to "build regulatory capacity." This was reflected in summaries of OECD Corporate Governance roundtables. This was also reflected in the USAID web page. After all, that was the criticism of mass privatization in the first place – poor regulatory and legal environment⁷. **But building regulatory capacity is not the same as popping out institutions.** Ukraine now has five stocks exchanges, a Securities Commission and a super-regulator of non-bank institution. No country in the world has both a securities commission and a super-regulator, but Ukraine does! So, Ukraine must be completely institutionalized, right? Maybe so, but in the wrong sense. This is because regulatory capacity requires things that take time and patience, like developing human capital, like instituting controls and substitutes for corruption. But since one cannot quote Smith without quoting Keynes, "*in the long term, we are all dead,*" and especially the mass privatized companies.

Public or private

The choice between having a public or a private company is a perfect example of balance between the need to regulate and the need to allow as much free choice as possible. However, many use the ambiguity between public and private companies, created by mass privatization to point to the need to resort to pre-packaged regulation instead of market-driven solutions.

A public (sometimes called publicly listed) company is a company that at some point issued securities for the distribution to the public without the regard to the ability of those acquiring such securities to

⁶ Shleifer, A and Vishny, R. W., (1998), *The Grabbing Hand: Government Pathologies and their Cures*, Harvard University Press. This book characterizes the danger that state or public officials would hold onto their power over the enterprise because they get the benefits of control without ownership rights. That emphasizes the need to limit the power of regulators and rely first on market mechanisms. However, the other way of looking at it is a much older classic one-liner by Lord Acton: "All power tends corrupts, and absolute power corrupts absolutely." Regulation and market mechanism has to be a careful blend, as the World Bank definition of corporate Governance suggest.

⁷ Dyck (99) reflects this. Other examples are:

Coffee, John C. Jr. 1999 *Privatization and Corporate Governance: The Lessons from Securities Market Failure* Columbia Law School The Center for Law and Economic Studies. Working Paper 158

understand, evaluate or control the enterprise. Further, public securities are usually sold to the diversified investors, holding a relatively small portion of personal wealth (and little stake) in each enterprise to make it worthwhile to defend their rights on their own. **Note that public and private does not refer to state-owned and non-state-owned.**

It is because of the same Adam Smith observation about the non-benevolence, but this time of the CEO, that the securities commissions regulate public companies and their corresponding organized exchanges. (Note that not all public companies are listed on organized exchanges). National laws usually define public companies as companies where securities were distributed to either more than a certain number of shareholders (100 in the US) or to unsophisticated investors, reflecting the public nature of the companies. Regulations of public companies usually focus on clarity of public vs insider information, proper disclosure of public information and proper use of insider information, leaving the freedom to choose the bylaws and interpret the disclosed information to the market. This is a perfect example of balance between the free market need to allow people to choose and the need to address inefficiencies of an incomplete market through regulation.

By tapping a public market, the entrepreneur can get the lowest possible cost of capital, afforded by a large competitive pool of diversified investors, investing along their efficient frontier. On another hand, the entrepreneur must make a rational choice: Can the lower cost of capital justify the added expense and constraints, associated with the regulation and disclosure? For one, “*when a firm goes public, it does not rise like Venus from the sea; most firms going public have been in business for some time...*”⁸ On another hand, the disclosure methodology and structure of privately financed companies (by venture capital funds) is entirely subject to agreement between the parties. Sophisticated investors are best suited to develop contract, tailored to their understanding how and the ability to control their investments.

Again, Enron is a good example: in congressional hearing on Enron, the static nature of accounting was criticized. However, if a smart entrepreneur had private power over Enron, they would have gone beyond accounting numbers and insisting on knowing “what’s at risk” by obtaining the management information on riskiness of contracts and guarantees to special entities. The real question with Enron is where were the institutional investors, who own large stakes in Enron and are supposed to be motivated and diligent fiduciaries of the public. While the congressional hearings focused on analysts, only the AFL-CIO representative correctly mentioned institutional investors. This once again demonstrates how even the most sophisticated capital market systems break down. It seems this time, the The famost Stiglitz question “*Quis Custodiet Ipsos Custodes? (Who Is Guarding The Guards Themselves?)*”⁹ should be asked of the US market, not just transitional market. If this issue is overlooked in transitional markets, Enrons will be the norm.

So what’s the deal with mass-privatized companies?

The first problem with the mass privatized companies is that the only participants who influenced the creation of corporate contracts were the general directors and the bureaucrats. There were no underwriters and no particular interest in attracting shareholders because shareholders or debt holders did not form the capital base of the corporations. Potential shareholders merely traded in their vouchers and had no freedom to choose any kind of alternative. There was no self-interest on the part of the bureaucrats or the directors to collect more vouchers, thus no interest to constrain themselves or even to form viable businesses of the corporations. Instead, they did everything possible to free their hands and perpetuate their entrenchment in collecting rents from the enterprises.

⁸ Richard Brealey and Stewart Myers PRINCIPLES OF CORPORATE FINANCE P 300 of second edition.

⁹ Stiglitz, J. 1999 *Quis Custodiet Ipsos Custodes? Corporate Governance Failure in Transition* ANNUAL BANK CONFERENCE ON DEVELOPMENT ECONOMICS-EUROPE Keynote Address. Paris, June 21-23, 1999

Equally, there was no rational choice to go public. In Ukraine, all 30,000 enterprises without selection were corporatized, and shares were distributed to the public in exchange for vouchers. Although the enterprises received no financing for the shares, the public traded their vouchers (share of ownership stake in all state-owned companies) for shares of one particular one. By that virtue, in principle, the public deserves corresponding protection of their investment. In Ukraine, roughly 3,000 were called closed joint stock companies, while 27,000 were called open joint stock companies, irrespective of the composition of the shareholders. In Romania, roughly 3,000 companies were created this way. In Bulgaria, 1,057 companies were created in mass privatization. 828 companies are considered open.

According to the IFC Corporate Governance Manual for Ukraine, “*Ukraine has its own forms [of companies], not necessarily related to Western Public and Private.*” True, but that should not imply that Ukrainian (or Romanian, Russian, Georgian, etc.) forms are merely some kind of reflection of the local culture and tradition. **Instead, this implies a schism in basic economic principles that needs correction.** The shares were distributed to the public in all companies. So long as the public owns securities in these enterprises, they cannot effectively control the companies. Without appropriate protections, the public will be forced to rely on the benevolence of the insiders, which is fundamentally not very free-market. At the same time, virtually all companies in Ukraine have appeared “*Like Venus From The Sea*” as a collection of state assets without any kind of internal capacity to provide even the most basic protection for shareholders. Having the position of collecting rents, the insiders are surely unwilling to volunteer to constrain themselves. Clearly, no international capital flow will be attracted to these companies (though investors like Mark Rich happily invest in parallel structures). This leaves regulators with an awful task: try to protect the interest of shareholders in a vast number of companies that do not even have the internal structure to provide proper disclosure. **Even the US or European regulators would not have that kind of capacity, while institutional investors would only bring another level of moral hazard as the Enron case is an example.**

Of course, the securities regulator can bring back Soviet era controls, as J Brown¹⁰ suggests, but besides simple impracticality, that converges all the economic and social thought since Juno in opposition: First is the “*grabbing hand*” issue by SLV. “*Quis Custodiet ...*” question applies to the Commission now. One cannot skip Lord Acton’s famous quote: “*All power tends to corrupt and absolute power corrupts absolutely.*” Equivalently in Smith’s view, we would simply be relying on the benevolence of the Securities officials.

The only name for this so-called Ukrainian form of company is perverse. **These companies are beyond lending themselves to being regulated because regulations alone without the internal capacity for disclosure, regulatory capacity and the beneficial motivating behavior of corporate agents can only shift the grabbing hand, but not solve the problem.**

Market for Corporate Control

One of the private solutions for bad corporate governance of public companies is the market for corporate control. If a company is poorly governed, an entrepreneur would buy-up shares of minority shareholders to take control and govern the company through private means. Coasean theory of private choice, often touted in support of mass-privatization, states that initial distribution is irrelevant, so long as there are clear property rights and an efficient market that would allow the property rights to be transferred. Certainly, investors saw the market for corporate control as the most viable. For example: Michael Blayezzer, the principal of Sigma-Bleyezzer investment funds, one of the largest Western investors groups in Ukraines, states “*We have stopped investing in minority stakes, focusing on acquiring company control. This*

¹⁰ Brown, J., Skouropi, K. *Corporate Governance in The Former Soviet Union* University of Denver College of Law working paper.

eliminates the corporate governance problems.” Author’s own work in Ukraine with NCH Capital and private clients focused on the market for corporate control.

However, there has been a lot of debate as to the thickness of market for corporate control, which is important to evaluating the legal and regulatory focus on the market for corporate control. We have done two light empirical studies¹¹ in Ukraine to gage the market for corporate control. Complete results of this study are in Appedix 5. Here is the summary:

Broker Survey:

We have surveyed ten out of twenty five largest brokers in Ukraine that agreed to be surveyed with the following question, posed to the top management: *What percentage of your trading volume on the buy side for the past six months was: acquisition of control, do not know, portfolio purpose. To be sure, acquisition for immediate resale to the strategic buyer, such as building a swing vote between two entities vying for control should be considered control acquisition, while portfolio acquisition is where the buyer wants to hold a minority stake for investment portfolio.*

The results were as follows:

Securities Dealer	Control Acquisition	Do not know	Portfolio
Privat Bank	85%	5%	10%
Tekt	99%	0%	1%
ITT Invest	99%	0%	1%
Sokrat	50%	50%	0%
Dragon Capital	75%	0%	25%
Alpha Capital	95%	0%	5%
Foyle Securities	99%	0%	1%
Prospect Invest	99%	1%	0%
Liberty Markets	99.5%	0%	0.5%
Interregional Financial Company	100%	0%	0%
Average	90%	6%	4%

Clearly, at least 90% of market activity is definitely for the purpose of control.

Company Survey

We have studied the Securities Commission filings of sixty largest mass-privatized companies and public banks in Ukraine for the evidence of consolidation for the purpose of control. Some adjustments were made based on companys’ clarifications, described in Appendix B. Here are some results. The rest are in Appendix B:

Sample Summary						
	Workers 98	Workers 99	Shareholders 98	Shareholders 99	Shareholders 2000	Turnover US 000
Total	508,103	479,674	2,785,515	2,236,757	2,134,731	5,889,227

¹¹ I thank Financial Markets International and Demir Yener of USAID for their assistance. All the mistakes and absurd ideas in this paper are mine, not theirs. I thank everyone who contributed for the good ideas.

Maximum	26,059	25,605	529,817	234,402	234,402	538,920
Minimum	10	8	1	1,250	687	190
Mean	8,612	8,130	47,212	37,911	36,182	99,817
Median	7,985	7,402	27,891	16,251	17,731	56,418

Note that the company with 1 shareholder in 1998 is 100% state-owned and is not the same as the company with least shareholders in 1999 and 2000. Each company had to have at least 1,000 shareholders in either of: 1998, 1999 or 2000. The least shareholders also do not correspond to the least workers and the lowest turnover. Note also that the decrease in the maximum number of shareholders is due to consolidation. Note that this period is accompanied by mass privatization, thus driving the increase in the total number of shareholders, while consolidation was causing the decrease. Therefore, the actual minimum and maximum numbers of shareholders were in reality more extreme than this data could capture. Note also that 2.8 million shareholders represents 6% of Ukrainian population and 16% of all shareholders, registered in Ukraine.

Private control summary:

The number of companies, in 1999 and 2000 where majority shareholders **as a group** owned more than 50%. Note: a majority shareholder is the owner of at least 5%.

Year ↓	State owns 50%	Private group owns 50%	No 50% Concentration	Total companies
1999	28	20	12	60
2000	22	29	9	60

Controlling ownership by a single entity (the majority owner did not use multiple entities to own the company) -- Number of companies:

Percent ownership ⇒	40%	50%	60%	75%
Year ↓				
1999	4	1	1	0
2000	7	3	2	1

Note that private investors concentrated only five companies that were state-controlled in the previous year. The remaining concentration came from companies that were not state-controlled in the prior year.

An assumption that a group of major shareholders in a particular company probably constitutes a related group makes the argument about concentration stronger. It is certainly difficult to determine objectively which companies with concentration actually are concentrated by a single group, and which just have several large shareholders. Arguably, the major shareholders could or could not be related entities. An example in Appendix B, however, reveals that it is both difficult to ascertain, but more often than not a pattern emerges that points to relationship of the entities. For example, in some cases offshore entities can be identified as belonging to a particular group by market insiders, as with Interpipe. In other cases, each shareholder owns exactly the same percentage or bought shares on almost the same date as the others. Reader can also study the data in Appendix B to draw a conclusion for yourself about the extend of relationship between the entities that own each company. Unfortunately, it is difficult to generalize. Further, it could be that 50% is not enough for control, and that sixty percent are required. However, we have been able to identify many owners as either Oligarcial structures or management. In case of management, for example only 35% to 40% is needed for control. In case of Oligarchs, it could vary. Oligarchs might control a company with 10% and many contracts. However, if competing against other

Oligarchs, it may be difficult for them to control the company at all. Therefore, the assumption that majority ownership of 50% is a good approximation of control, and therefore 29 out of 60 large companies were majority controlled is a good one. Without assumptions, the above table conclusively shows a watershed of concentrations.

Here is a summary of ownership by type of control in 2000:

Type of Controlling Owner	Method of determining	Quantity of Companies
State	Ownership 50% or more (if 50% is owned by a single private entity, then non-state)	14
Russian	Clearly identified Russian Company is Tumen Oil (Ownership 50% or more of Lisichansk Naftoorgsintez)	1
Oligarch	Subjective: entities known to the author to be owned by Oligarchs have major involvement with no other investor	12
Not Identified	There is a fifty percent major shareholder ownership, but identity of the type of investor could not be made	15
Management	Ownership 40% or more	8
Local government	Ownership 50% or more	1
Undetermined	No major or controlling owner	2
Foreign	Known foreign investor with 50% or higher ownership.	3
Bank	Target company is a commercial bank. We assume that all commercial banks are associated with Oligarchs.	4
Total		60

From the empirical study, some clear conclusions can be drawn:

- The focus of the Ukrainian market is with corporate control, not portfolio investing.
- Even the largest mass-privatized companies have either been acquired or are in play for being acquired by a majority investor. It can be concluded that smaller companies are in an even more robust market for control.
- Very few investors use transparent entities to own shares, preferring to break-up ownership between seemingly unrelated entities. While some such entities can be identified by a market insider, it is obviously difficult to make an objective identification in most cases.
- The private owners of large companies are Oligarchs, management, but also foreign investors.
- Despite the market for corporate control, there are currently millions of very small shareholders. In combination with the prevalence of insider-sided corporate contracts and lack of regulatory, judicial and corporate capacity in the foreseeable future create a problem where million of shareholders are expropriated. **This doesn't only make the market unfriendly to any possible good companies, but also creates a social problem of disappointment with the free market.** Solution to the corporate governance problem of this magnitude and weight needs to provide for a workable mechanism for these shareholders to sell shares to majority owners, who cannot be objectively identified.

Unfortunately, however, as can be seen here, market for corporate control had not resolved the institutional problem either. Coasean Theory of Public Choice that requires clear property rights and an efficient market was simply taken out of context in justifying mass privatization. First the property rights of the wrong commodity were considered because ownership of a share does not translate to the proportional ownership of control. Control, however, is the valuable commodity in poorly structured companies, not minority share. Second, without a clear tendering process, transactions became too costly and non-optimal Nash equilibria arose. For example, an aggressive buyer would only need 60% to control the company and expropriate minority. Small shareholders rush to sell to such buyer at any price, knowing that if left in

minority, their shares would be worth nearly nothing (hold-in equilibrium). A strategic investor might promise to restructure the company and be good to all shareholders. The minority shareholders then would holdout from selling, wanting to free-ride on the work of the strategic investor¹². In all, instead of public choice, this situation creates adverse selection, where an investor promising to expropriate minority would be able to buy, but an investor promising to be good would not be able to buy. This point is also well developed in Dyck (99).

The entire exercise in mass privatization, arguably the most Smith-Coase-Freidman-free-market-argument-driven exercise, did not follow the principles of free market in forming corporations and executing the privatizations. The forest (the free market) was lost in only a few trees (distributing vouchers and running auction centers). And that is why “*mayemo sho mayemo*” (What we have is what we have) (Ukrainian President Leonid Kuchma 1997).

So what now?

Do not lose the forest in the trees again and make lemonade.

In implementing the corporate governance reform, it is time to step back from the cliché remedies that seem to work because they are in the book of good practices and to first look at the economic principles. We are trying to achieve a viable free market, not just implement reforms for reforms' sake.

A lot of talk about corporate governance reform focuses on a list of institutional and legal remedies. Without a question they are important, but they cannot exceed the institutional and judicial capacity. **If proposed laws or regulations exceed the judicial and legal capacity, they should be postponed for later.** To demonstrate this point, here are some examples how even the most common sense remedies, proposed today for transitional markets, would actually **damage, not help**:

DO NOT Require that all publicly listed companies keep IAS accounts. There are 27,000 public companies in Ukraine, something less in other countries outside Russia. In 2000 there were 50 IAS certified accountants in Ukraine. Other countries with mass privatization fared no better. Suppose this year there are 200. However, accountants who are actually qualified to be controllers or audit managers need to have roughly 10 years of experience. Let's say the countries can legislate the requirement that shareholders appoint auditors, that they hire qualified controllers, that they implement internal controls – who is going to do it? Without the motivation of the insiders to cooperate, without the institutional and human capital base, the presence of this law will simply reduce IAS accounting to the lowest common denominator. An industry will develop to certify IAS based on nothing more than an IAS looking form of accounts, not the substance. The qualified controls and audits will not be there. Without such controls and audits, the insiders will still be able to run parallel structures without transparency.

Consequently, instead of transparency, such a requirement now will institutionalize complacency and poor practices, but under the IAS name. If there were poor practices, IAS should not be associated with them. It would be much more effective to select a few companies that the current institution can handle for true and proper IAS accounting. The remaining companies would probably not be able to deliver the most rudimentary disclosure that IAS provides, but they should have never been public in the first place. The best deal for shareholders in these companies is some negotiation power to sell their shares.

DO NOT Impose strict personal liability on board members and managers and provide for class action suits (as proposed in the JSC Bill). Despite an inefficient market for corporate control, this market is obviously very thick. Any acquisition is eventually followed by a radical restructuring effort.

¹² Stiglitz points this out in “Quis Custodiet...” Additionally, Krakovsky (2000) describes from personal experience the buy-out process.

Restructuring mass-privatized companies is even more perilous, however, than buying them. Restructuring usually means stripping away the illegitimate stakeholders, such as parallel structures, unfair suppliers, customers and rent collectors who have been bleeding the company. Such restructuring efforts are rare without a major conflict with these entrenched structures, even if a well-connected group carries out such restructuring. Suppose now the opponents of restructuring had another pretence to use the corrupt judicial system. What havoc they could raise by focusing their lawsuits on the individuals involved in the restructuring! By paying a bribe to the judge, they could surely find a violation worth jailing the bastards trying to make their feeding pan into a company! Bottom line -- neither the judicial capacity, nor the state of companies are ready to handle lawsuits against the directors.

DO NOT Require proper notice of the meeting and its agenda without exception (as it is done now) A newly-formed majority shareholder currently needs a 65 day notice to fire a manager in Ukraine. This gives the management to take all kinds of extraordinary measures to entrench. Management in JSC Hotel Lybid in Ukraine stayed in power so far for four years this way. It would better empower the private sector to stipulate that if the majority of shareholders (as opposed to the majority of the meeting participants) actually votes for change in management, change in board, change in audit committee or change in auditor, then this meeting would be legal without any notice, so long as the remaining shareholders are informed about the decision. This way, shareholders can take quick actions when they witness unsatisfactory actions by company officials.

DO NOT Require that majority shareholder offer a buy-out to the minority shareholders. DO NOT Require a 60-day notice to the company before control can be acquired (as proposed in the Ukrainian JSC bill). As all well-meaning proposals, it is based on essentially a good principle, but as proposed right now, it is a bad idea. It is a good principle because in the presence of a majority shareholder, whose ability to expropriate is costly to control, some companies are more efficiently governed privately. It is a bad idea because of inadequate institutional capacity for this particular formulation: 1. How would an objective price be obtained? Most majority stakes were acquired in a less than transparent manner, with brokers making a huge margin. Further, some large sums may have been paid for swing votes. In Romania, for example, it is very common for the same shares to be transacted several times at different prices before reaching the final destination due to poor market structure¹³. 2. Many control acquisitions were made through several, seemingly unrelated companies, as could be seen from Appendix B. At the same time, acquisitions by more honest investors were probably made in a transparent or an arm-length manner. This would create adverse selection against honest investors and transparency, while give more reason for untransparent means, while no practical enforcement is available. (See Appendix B for a case example and more study). 3. There is no mechanism to tender a purchase, making it difficult to prove that the majority investor observed the law and made an offer to each minority shareholder. This would muddle property rights. 4. Providing a sixty-day notice to the company, gives management sixty days to take actions against the acquisition. They can even call a shareholder meeting and strip the company. Certainly, the law provides that the company may not take actions against acquisition, but the law in my state also says that one cannot exceed the speed limit. Everybody does because the consequences are minute. 5. The incumbent management or supplier will have the opportunity to use lack of clarity on what constitutes a proper notice to exploit the lack of judicial capacity. Bribing the judge is all it takes to further entrench in their positions, muddle property rights and make investment more risky. 6. Combining all five, these two rules would provide another venue to apply extraordinary pressure on any majority investors trying to restructure a company. Additionally, it would create adverse selection in investors, favoring those who would happily hide their ownership.

One argument in favor of this law was that the regulators, such as the antimonopoly organ and the securities commission, should investigate and police against untransparent ownership. However, this

¹³ See for example F. Pogonaru. Romanian Capital Markets; A Decade in Transition. Creditanstalt, Romania working paper.

brings us back to the issue of regulatory capacity and the grabbing hand issue. Given broad powers and monumental task, under the current state of affairs, the regulators have more capacity to extort bribes than bust oligarchic trusts. Regulators can develop such capacity in the next ten or twenty years, but this would not be the argument for adopting such a law now. However, if the regulators were helped by a market-driven solution instead of more power, they would have less capacity to extort bribes and would begin developing real capacity to serve their functions sooner.

Another argument by a consultant, recommending this law, is that he was concerned with the joint stock company law. It was not his job to consult on economics, or to consult on the securities market law, which would be more appropriate for a tendering methodology. However, this is exactly what happened with mass privatization, as consultants insisted that they are concerned with implementing mass privatization, not with corporate governance or discussing such esoteric things as how mass privatization fits in the big picture of economic reforms. **This is losing the forest in the trees that got us in trouble in the first place.**

DO NOT Legislate specific limits on the authority to sign contracts by managers and boards, such as 50% of firm's asset value for boards and 25% for managers, (as proposed in the JSC Bill). Again, this is a good principle, but bad idea. This should be done, but by companies, not law. Law cannot reflect company specifics, but merely "gets the average temperature of the patients." **Such law can functionally incapacitate some companies, while giving the managers of others the legal framework to expropriate.** In transitional economies, it would be a good idea to require that the formula for authority limits be explicitly stated in charters or bylaws. This will force the managers to open this issue to discussion at the shareholders meetings.

It is not so vital to teach red directors about corporate governance and try to convince them that it is good for them because through good corporate governance they will get more financing. Stupid they are not. The red directors are the ones who most likely designed the corporate governance system in their companies, not the owners or underwriters. They did it with the aim to protect their jobs and their rents, not raise finance. Improving the corporate governance system in their companies now might eventually help raise capital, but surely it will prevent them from collecting rents now or even cost them their jobs. They eagerly study corporate governance not to improve companies, but to perpetuate their position. Corporate governance is best taught to entrepreneurs, who create new businesses. Part of creating new businesses is often taking over and restructuring mass-privatized companies.

DO NOT Declare the Coasean approach a failure and focus on developing the institutions as a pre-requisite to free market solutions. First, the Coasean approach was not a failure. It was taken out of context and misused, as discussed earlier in this paper. Second, developing institutions is important, but it would take a lot of time. For example, to develop an audit profession, it would probably take a generation. In the first ten years, Ukraine was able to produce 50 IAS accountants. With exponential growth, it would take another ten, maybe twenty years to produce 100,000 or so the country needs. What about the corruption-ridden judicial and regulatory capacity? Stamping out corruption and building institutions edict brings us back again to "who is guarding the guards?" question. Without the appropriate market substitute for corruptions¹⁴, the

¹⁴ One way to examine substitutes for corruption is in the elements of economic reform that actually worked, possibly because those elements were least affected by the format of privatization – food distribution. It used to be in the good old days of the Soviet Union that to buy any goods, especially food, one had to go to the back door of the smelly *gastronom* (food shop) and bribe the manager to get anything worth eating. Mass privatization and decentralization turned things around as suppliers of poor quality products flooded the stores by bribing or pressuring the managers to sell their goods. However, as *novae* private supermarkets develop, most of the privatized *gastronom* operations are dying out or are being taken over (Thank Coase for that). Controls instituted by truly private operators make it very

new market oligarchs will do everything possible to preserve corruption. Institutional development cannot take place in a vacuum. It must go hand-in-hand with the market solutions to the corporate governance problems.

The same goes for institutional development that is not related to corporate governance. Many people say that the tax system (certainly, very confusing and arguably draconian) needs to be reformed before corporate governance can change. However, First, as powerful business groups are required to own their factors of production, not just control them, they will be at more risk from a draconian tax system and will have to use their power to lobby to improve the system. Second, the IMF appears to be very proud of what has been achieved in developing the Ukrainian tax system. (Another example of losing the forest in the trees). Third, many privately founded Ukrainian companies are operating in Ukraine, working the tax system now. This reflects that no matter how draconian the system is, it is also somewhat manageable by entrepreneurs. Changing the tax system is not a condition precedent to changing how mass-privatized companies are governed.

DO NOT Only limit institutional and regulatory reforms only on the large, “truly public” companies or any other select group. Krakovsky 2000 did call for separating companies “destined to be truly public” from those that are better off being private. Certainly, the economy needs to separate those companies that can benefit from being public (raising finance in the market) from those that are better off private (raising finance internally or privately while restructuring). The institutional resources can then be directed to the truly public companies. However, currently, almost all mass-privatized companies have the public as the shareholders. This public deserves some kind of protection in all companies. **Failing to protect the public would only create social problems as people become more and more disillusioned with the free market.** Further, who is to decide which companies are “truly public?” Regulators? Consultants? Multilateral agencies? Or the market? The answer is obvious: a market solution needs to be developed to select companies that can benefit from being public from those that should go private.

So what is the solution?

First, the solution cannot come from a box of tricks, so intuitive, but inappropriate for the regulatory and judicial capacity. It also cannot come from the unqualified creativity of the wheeler-dealers and politicians in the new economy. It has to be an approach that is outside the box of basic tricks, but based on solid knowledge of local business and economic, legal and business principles. The solution has to be that right “mix” of voluntary (market-driven), legal and regulatory that the World Bank definition prescribes, but with all the pieces fitting together.

The primary focus needs to be a market-driven solution to completing the market for corporate control, placing inefficiently governed companies in private hands. It is an off-take of the requirement to buy-out the minority, but more market-oriented and pragmatic. Mass privatization and concurrent development of the securities market did not take into account the impracticality of pure share trading to accommodate the mass transfer of controlling stakes.

much perilous for employees to take kickbacks (though this can not be eliminated entirely anywhere). A trip to a Ukrainian supermarket now does not include the back-door tour. At the checkout there are sophisticated registers with scanners, and the selection of merchandise is well chosen for the shopper, not for the supplier. What's more, these supermarkets are located in the “bedroom areas” of block apartment houses, not just in the upscale Lypki section.

Lack of a tendering mechanism creates economic inefficiencies in the cost and time of consolidating shares and multitude sub-optimal Nash equilibria, preventing consolidation of control or sale of residual minority shares. Dyck (99) pointed out correctly that Coasean justification for mass privatization does not fly because of the high transaction costs. Then he went on to other explanations. However, a tendering mechanism will drastically reduce transaction costs and should take care of many of these issues:

1. It should provide for the ability to communicate a tender offer to all shareholders.
2. All shareholders should have the option of selling shares at the conditions presented, but also to vote collectively to accept or reject the offer.
3. An independent body should control shareholder communication, clearing and certifying that the tender has been completed.
4. Finally, the successful completion of the tender would make the company non-public. This should mean that many of the corporate governance rules that exist and proposed in a variety of initiatives would be lifted to give the owners a free hand in restructuring the company. This puts a useful function on strict company law: it compels, but does not require the buy-out. For example, the rules, criticized above in this paper, can be beneficial if allowed to be lifted should the buy-out tender take place. The company law can be developed in this context, indicating how rules would be different after a tender. Equivalently, there can be a specific law on mass-privatized companies. The exact lists of provisions that would be lifted for a company that has been bought out through a tender can be worked-out by a working group in each country. Such law would both protect the minority shareholders' ability to sell and enable entrepreneurs to restructure mass-privatized companies. Problems associated with required buy-out would be replaced by market-oriented solution.

Even without point four, the tendering mechanism is a useful tool to make buy-outs more efficient. At the same time, this could persuade the legislature to take a serious look at the solution to the problem they know exists. Unlike hard provisions of proposed company law, the mechanism stated in point four actually allows some rules to be lifted. The legislators would see this as something that could help their financial constituency, who see a strict company law or securities commission as an impediment to their business.

Appendix A describes this tendering system in the context of the document sent out by IFC, Ukraine, tabulating the disparity between the preferred Joint Stock Company bill and the alternative proposed by some MP's.

Some of the arguments I heard against the tendering mechanism are:

- *The tendering system will destroy the fledgling capital markets in transitional countries by encouraging the market for corporate control.*

Nothing could be further from the truth. The tendering system will save the fledgling capital markets by injecting some confidence in the fairness and completeness of the system. It will take the companies from being public that should not be public and merely pollute the market, leaving the focus and regulatory capacity to deal with capital formation instead of control formation. This paper has shown that the market for corporate control exists without the tendering system, but it has no semblance of a functioning capital market. The tendering system is the missing link to make the capital markets, not to destroy them. Slowing the market for corporate control will only leave shareholders with worthless pieces of paper and the economy full of companies with perversely incentivized management. Additionally, it will exacerbate social problem of people disenchanted with free market reform.

There is more: Most economists (Dyck (99) and Ellerman (2001) in particular) have given up on the economic justification for mass privatization, focusing instead on the political reasons, such as play between one group of nomenclature against another. A tendering system will inject some economic consistency in the post-mass-privatization economy by reducing transaction costs and completing the

market for corporate control because love it or not, mass privatization is fait-a-complete. Now it's time to make lemonade.

- *The oligarchs and their cronies in the [national Parliaments] do not want this as it provides more transparency.*

One thing is clear now: the Rada (Ukrainian Parliament) has frozen the proposed JSC Bill for the real reasons stated above. Certainly, they are not a council of angels, but if things are so bad, what is the point forcing the existing JSC bill on them anyway? There is another side: the transitional countries have largely gone through the initial private capital formation. The tendering system reduces transaction costs for Oligarchs too. Why would they oppose that? Finally, the Oligarchs now need some law and order to secure their property rights and attract capital. Given them a workable, pragmatic solution and see them take it!

- *The mass-privatized companies are all trash anyway. We need to focus on individual companies and new enterprises.*

First the sixty companies in our sample alone are not irrelevant to the economy and social structure. They have 2.7 million shareholders, 480,000 workers and \$5.8 billion in annual turnover. They may be perverse, but they have productive tangible and intangible assets. Otherwise they would have gone bankrupt. Bankruptcy system in Ukraine is probably even a little too vibrant. However, leaving these companies in the never-never land would perpetuate social and economic problems. Besides, who is to decide what is trash anyway? Certainly, not the regulators or the “technical assistants.” The market should. So let it.

Here are other components of the solution:

- Monitor the tendering process and assist the exchanges in implementing it.
- With regard to the Ukrainian JSC Bill and the legislative proposals in other transitional countries: Rewrite to make it more market-oriented and less regulation-oriented, as proposed above and in appendix A. In Ukraine, this should be done in consultation with the opponents, in the Rada as a compromise between the two versions.
- Assist the exchanges (PFTS in Ukraine) and a few select companies to become truly public companies. This should include IAS audits, internal controls, management incentive systems and special listing levels to separate them from the rest. This worked in Russia. Help this process in other countries and help develop a true capital market.
- Non-managerial wage arrears should have absolute priority over all other debt. This paper does not discuss bankruptcy, but social problem of unpaid wages is great as workers have little leverage against companies. Fairness has to be established. Independent labor organizations should be a part of institution building program to provide them a constructive role in corporate governance.
- Certainly, institution building should continue, but this is a long-term task and immediate results should not be expected.

When this author had proposed to a mass privatization contractor in 1995 that a private tendering system should be created, she said that this idea is a creation of an aggressive business mentality. She explained that they were trying to make an equitable privatization system and a liquid securities market (and Ellermann and Dyck thought it was politics – Ha!). The corporate control mentality was contrary to her goals. She even showed me the promotional materials. One of those was a poster (later displayed all over Ukraine) of a beautiful pregnant woman. The woman was saying, “Privatization is my future.” I surveyed several Ukrainians what they thought of this poster. With few exceptions, they all said, “Who knocked her up?” This only proves that the right thing needs to be done, not something that merely reflects the ad-hoc perception of a parachuted functionary.

At that time, however, this author realized that he was making more money with a fund, buying privatized companies than trying to prove what privatization implementers thought was a crazy idea anyway. Realizing the special nature of privatized companies, maybe it's time to listen to reason that may be a bit outside the box of old tricks, but is based on the full body of the economic and social knowledge we have today. The answer is not in the trees -- quantity of institutions, regulations and legislation that enable the grabbing hand. **The answer is in the forest -- smart policies that empower the private sector to restructure the enterprises now**, combined with the long-term program for real capacity building. Incentivize and it's not entirely too late to make lemonade.

Corporate Governance Upside Down
Alexander Krakovsky
Appendix A

The comparative table reproduced below was prepared by the International Finance Corporation's Ukraine Corporate Governance Project. The text in **Times New Roman** is pasted from the IFC compilation, including comments. The text in **Arial** is author's comments.

This paper or the author's comments in the appendix does not represent the beliefs of IFC, but only those of the author.

Comparative table

as to the resolution of corporate governance problems
by the draft law on joint-stock companies submitted by the Cabinet of Ministers of Ukraine, registration No. 6300 and the
draft law on joint-stock companies submitted by People's Deputies D. Kostrzhevsky and S. Moskvina, registration No. 8050 (hereinafter—"Alternative Draft Law")

2. Regulating the procedure for acquiring the majority stake of shares in a company:

2.1. Determining the price at which a buyout will take place of shares from minority shareholders who do not wish to remain in a company controlled by another person:

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
The person who buys the majority stake of shares must offer to buy shares from other shareholders at the price determined by this Draft Law. This is an average weighted price at which the person in question has been buying company shares during the past six months (Art. 64).	It is provided that the buyout price will be determined by the person who buys the majority stake of shares and is obliged to buy shares from other shareholders (Art. 64).

Comments:

The Alternative Draft Law gives the person who bought the majority stake of shares an opportunity to set any price (which may not always be fair). It is important to note that the existing worldwide general pattern of regulating the procedures for ownership concentration in joint-stock companies provides that if a majority stake is bought in a joint-stock company, the purchaser must offer to buy the shares of other shareholders at a fair price. To this end, it is important that the fair price at which the shares will be bought be determined by legislation. National legislation in different countries sets the following requirements for a fair price: in Britain, for example, this price may not be lower than the highest purchase price at which the person has been buying such shares during the past 12 months. In Germany, the purchase price may not be more than 25% less than the price at which the person has been buying the company's shares during the six months before the majority share was reached. In Russia, it is an average weighted price of the most recent six months preceding the date on which the majority stake was bought. Departure from the practice of setting the fair price by law could lead to the deterioration

of the regulatory mechanism for ownership concentration in a joint-stock company and result in violations of minority shareholders' rights if one person gains control over the company.

Author's comments:

There are extensive comments in the body of the paper why mandatory buyouts would not be beneficial in Ukraine. Propose to replace this draft with the following draft provision:

"If a successful buy-out tender was carried out according to the procedures determined by [this Draft Law,] the company becomes non-public. "

The companies with non-public status will thus enjoy less regulation, as in examples herein.

3. Regulating conflict of interest in joint-stock companies:

3.1. Determining the scope of application of the norms regulating conflict of interest in joint-stock companies:

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
Provisions of Chapter XIV regulate the procedure for entering into any agreements where a conflict of interest exists.	Due to the change in the title of Chapter XIV, the scope of application of its provisions to regulation of conflict of interest has been narrowed to cover only significant agreements.

Comments:

The proposition to narrow the scope of application of the norms regulating conflict of interest on entering into agreements contradicts generally accepted corporate governance principles, according to which company officers must always disclose their conflicts of interest and act in the best interest of the company and of persons who contributed their financial resources to the company, not only in the case of significant agreements.

Author's comments:

Apply the Draft Law of the Cab.Min to the public companies. For non-public companies, the procedures for entering into any agreements where a conflict of interest exists can be determined by the company charter.

Directors of private companies often have a formal conflict of interest, but they are usually well known to the partners. Going through procedures to establish it every time is burdensome. It should be up to participants in a public company to decide freely about their relationship. Very few countries actually require such procedures in private companies. That is why if a company is taken private, the owners should not be burned with this formality, unless they choose it. It also compels majority shareholders to offer to buy-out minority and remove formalities, such as this.

3.2. Imposing the obligation on persons with conflicts of interest to provide the supervisory board with information about agreements in which they have a conflict of interest:

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
The obligation of persons with a conflict of interest is stipulated, along with the procedure for informing the supervisory board about agreements, in which said persons have a conflict of interest (Art. 72).	No obligation of persons with a conflict of interest to disclose information is stipulated. The general procedure for approving agreements where conflicts of interest exist lacks the step at which information required to make a proper decision is disclosed.

Comments:

The exclusion of the step requiring complete disclosure of information when approving agreements where conflicts of interest exist makes the provisions of this chapter purely declarative and impossible to apply.

Author's comments:

Same as 3.1

4. Engaging independent appraisers to determine the market value of assets

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
It is necessary to engage an independent appraiser to determine the market value of assets when the founders buy shares and pay for them in non-cash form, if an open joint-stock company places its shares, and in the event of a company reorganization (Article 6).	It is provided that an independent appraiser may be hired to determine the market value of assets in situations delineated in the company charter (Article 6).

Comments:

Having a law that specifies situations where an independent appraiser must be hired to determine the market value of assets is a reliable guarantee of safeguarding the property interests of company shareholders and creditors.

Author's comments:

First, "founders" is not the right determination. The founder of mass privatized companies is the State Property Fund. The correct determination should be "insiders," but that is difficult to define in Ukraine.

As above, non-public companies should be exempt from this provision.

5. Regulating issues concerning shareholders exercising their right of first refusal to buy additionally issued shares:

5.1. Procedure for exercising the right of first refusal

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
The procedure for shareholders to exercise their right of first refusal to buy additionally issued shares is regulated in detail (Article	The procedure for shareholders to exercise their right of first refusal to buy additionally issued shares is regulated by the company charter

28).	(Article 28).
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Comments:

Practices that existed in Ukraine from 1991 to 2000 show that if normative acts do not regulate the procedure for shareholders to exercise their right of first refusal, this leads to numerous violations and dilution of shareholders' stakes in the company's charter capital upon the additional issuance of shares.

Author's comments:

Cab.Min. law is good for public mass-privatized companies. Exempt non-public companies for this law. Additionally, may want to consider exempting any privately founded public company from this law, giving the company more freedom to establish their charter. The violations that took place in Ukraine (DniproKisen, DniproShina, etc.) were a result of poor contract formation in mass privatization by perversely interested insiders. Market company formation should eliminate the need for this restriction.

6. Issuance of bearer shares by the company

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
The Draft Law does not give joint-stock companies the option of issuing bearer shares (Article 21).	It is possible to issue bearer shares (Article 21).

Comments:

Issuing bearer shares allows the identity of their owners to be concealed and makes it impossible to control compliance with antimonopoly legislation and minority shareholders' rights during a company takeover. It is also worth mentioning that current legislation in Ukraine does not permit closed joint-stock companies to issue bearer shares.

Author's comments:

Unfortunately, it is too easy to avoid antimonopoly legislation and minority rights during takeover just by spreading the shares among seemingly unrelated entities. Nonetheless, bearer shares are not a good idea in Ukraine as it will provide additional venues for shenanigans and add nothing positive to the economy.

7. Stipulating the minimum number of members on the company supervisory board

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
Companies having over 1,000 shareholders (holders of ordinary shares) must have no fewer than seven persons on their supervisory board, and companies having over 10,000 shareholders (holders of ordinary shares) must have no fewer than nine persons on their supervisory board (Article 52).	The number of supervisory board members is stipulated in the charter or the bylaw on the supervisory board (Article 52).

Comments:

Stipulating the minimum number of supervisory board members at the level of company bylaws makes it impossible to implement cumulative voting — a mechanism which helps to reduce the

majority shareholder's monopoly when electing the supervisory board and provides minority shareholders with an opportunity to be represented on the supervisory board.

Author's comments:

First, where are we going to find so many qualified independent board members in Ukraine? There are very, very few wealthy professionals in Ukraine. Further, almost all companies in Ukraine do not compensate properly their existing board members. Eighteen could actually be a significant expense if the company were to compensate and assemble them properly. Without proper compensation and assembly, the boards will be ineffective. Certainly, many companies in the US have eighteen board members or more, but those companies are capitalized at billions of dollars and can afford to have large boards. In Ukraine, large boards would most likely end up being filled with employees, selected by management, even if there is cumulative voting. Further, there has been a lot of academic work, showing that large boards would slow down restructuring^{A1}. It would be better if minority shareholders could have a venue for communicating and have the opportunity to pool their votes for one or two board members.

Despite all of the above, large board requirement for mass-privatized public companies would be a strong impetus for majority owners to conduct public tenders and make the company private. There should be no legal size requirement for boards of private companies or for market-established public companies. For mass-privatized public companies, this norm should go into effect after one or two years to prevent chaotic election of completely unqualified boards, **and this should only be in the context of the tendering mechanism.**

8. Disclosure

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
<p>Joint-stock companies are required to operate according to principles of openness and transparency.</p>	<p>The Draft Law does not require disclosure concerning:</p> <ul style="list-style-type: none"> • persons who buy a majority stake of shares in a company (Article 64); • affiliated persons of the company (Article 79); • persons from whom the company will be buying out shares (in the case of a stock buyback by the joint-stock company) (Article 65). <p>The norm regarding disclosure of conflicts of interest by interested parties prior to approval of agreements has been deleted (Article 71).</p> <p>The list of documents to which shareholders have access has been limited (Article 79).</p> <p>Potential investors are not given the right to review the charter and internal corporate documents of the company before making</p>

^{A1} There is a wealth of knowledge on board effectiveness in general. It is well summarized in Kose J and Senbet L. 1998 "Corporate governance and board effectiveness." Journal of Banking and Finance. 371. On the issue of board size, they point to works by Lipton and Lorsch and by Jensen that "the benefits of larger boards are outweighed by the incremental cost of poorer communication and decision-making associated with larger groups." Interesting also is a study by Yermack, D., 1996. Higher market valuation of companies with a small board of directors." Journal of Financial Economics 40, 185. Yermak finds empirically the inverse relationship between valuation and board size and that smaller boards are better at disciplining and stimulating management.

	investment decisions, that is, before buying shares of the company (Article 79).
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Comments:

Timely and accurate disclosure of information on all of the most important issues concerning the joint-stock company is one of the conditions under which public companies exist, and one of the main principles of effective corporate governance stipulated in the OECD's Principles of Corporate Governance. As such, the provisions of the Alternative Draft Law contradict international principles of effective corporate governance.

Author's comments:

Take the Cabmin version for public companies and the Rada version for non-public (with the exception of limiting documents to which shareholders have access). Again, this makes logical sense in differentiating between public and private and provides impetus for takeover tender.

9. Form of paying dividends

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
Companies must pay out dividends in cash (Article 30).	The Draft Law does not specify the form in which dividends are paid (Article 30).

Comments:

The Alternative Draft Law allows companies to pay dividends in kind (company products, assets), which can cause a number of problems. Practices existing in Ukraine show that not requiring payment of dividends in cash results in the violation of the main property right of shareholders, such as the right to receive a portion of company profits, and in the unequal treatment of shareholders (it is worth noting that dividends on the state's share in the charter capital are paid in cash only, regardless of the situation).

Author's comments:

Mass-privatized public companies must pay dividends in cash. Take the alternative draft law for private companies.

11. Stipulating the exclusive powers of the supervisory board

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
The exclusive powers are laid down in the Draft Law (Article 51)	It is provided that the exclusive powers are to be specified by the charter (Article 51).

Comments:

Not specifying the exclusive powers of the supervisory board in legislation allows the possibility of delegating the adoption of a number of important decisions related to the overall management of the company to an executive body, which, in turn, significantly weakens the position of the

supervisory board within the company's corporate structure and does not promote protection of shareholders' interests.

Author's comments:

Take the Cabmin law for public companies, the alternative draft law for non-public companies.

12. Defining significant agreements and the procedure for signing them

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
<p>An agreement is recognized as significant if the market value of the assets or services to which it relates comprise 25% or more of the company assets (Article 1).</p> <p>The Supervisory Board shall approve significant agreements, if the market value of assets or services to which they relate ranges between 25% and 50% of the value of company assets. If the market value of assets or services in the agreement is over 50% of the company assets, such an agreement shall be approved by the General Shareholders' Meeting, on a motion by the supervisory board (Article 70).</p>	<p>An agreement is recognized as significant if the market value of assets or services to which it relates is more than the amount specified in the company Charter (Article 1).</p> <p>The Supervisory Board shall approve significant agreements. If the Supervisory Board does not approve a significant agreement, it may resolve to submit the significant agreement for consideration by the General Shareholders' Meeting (Article 69).</p>

Comments:

The Alternative Draft Law suggests a definition of significant agreements and establishes a procedure for their approval, which allows the management board to freely dispose of company assets and prevent the shareholders from participation in and control over the process of the distribution of a company's financial resources. This is facilitated by the following:

First, it would be possible to set the value of a significant agreement in the company charter at such a low level that all agreements approved by the management board will not be classified as significant.

Second, the Draft Law weakens the position of the supervisory board by setting out less favorable terms for shareholder representation (see Comment to item 7) and restricting its powers (see Comment to item 11). For example, the Alternative Draft Law allows the supervisory board to delegate the approval of significant agreements to the management board.

Author's comments:

This Cabmin provision can also stifle any investment program or even the raising of debt financing, especially if combined with big boards. Additionally, this law "takes the average temperature of the patient" in determining what is a significant agreement. In most cases, a different definition would be appropriate and law could in some cases stifle normal company operations, while in other cases give the management the tools they need to expropriate. It would be wiser to require that charter or bylaws have significant transactions provision. This would force the management to bring this issue to discussion at the AGM, but AGM should decide, not the self-appointed central planner.

13. "Floating" quorum

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
Quorum is determined once, before the beginning of the General Shareholders' Meeting, at the end of shareholder registration (Article 41).	It is provided that the quorum for General Shareholder Meetings is determined at the end of shareholder registration and before voting on each question (Article 41).

Comments:

A “floating” quorum may cause significant inconvenience in holding General Shareholders' Meetings and will allow unethical shareholders to disrupt General Shareholders' Meetings by leaving the room when they don't want certain resolutions to be adopted. (Moreover, the closer the number of votes of the shareholders who registered to participate in a General Shareholders' Meeting is to the quorum stipulated by law, the smaller the block of shares it would take to disrupt the General Shareholders' Meeting. In theory, it would be possible to do this with a 1% block of shares). Therefore, the stipulation of a “floating” quorum could encourage the development of corporate blackmail.

Author's comment:

By far, the Cabmin version is superior. The alternative version allows a quorum buster to come to the shareholder meeting to vote on some issues, but walk out if they do not like the possible outcome of vote on other questions. The purpose of the quorum is to assure that enough shareholders can be represented at the meeting, not to give someone the ability to blackmail a company. There is no relevance to the tender process here. The proposed Cabmin law also drops the quorum threshold for the second meeting if the quorum was not achieved in the first meeting.

14. Regulating the procedure for a stock buyback by a joint-stock company

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
Joint-stock companies are prohibited to buy back more than 20% of their own shares (Article 67).	The portion of shares that may be bought back by joint-stock companies is not restricted (Article 66).

Comments:

Stock buyback by joint-stock companies is a very dangerous tool with regard to protection of property rights of company shareholders and creditors. Thus, it is no wonder that the OECD's General Principles of Company Law for Transition Economies pay great attention to this issue. In particular, item 102 of this document recommends that joint-stock companies be allowed to buy back only a certain percentage of their own shares that make up the company's charter capital. For example, in Russia joint-stock companies are not allowed to buy back more than 10% of their placed shares.

Author's comments:

Alternatively, limit the allowed buy back to 10% and allow the buy back of more than 10% only if the offer is made to all shareholders and the company would buy shares of anyone who wants to sell (allowing the tender process to be done through the company). Further, there is no need for any restrictions in non-public companies.

1. Setting the amount of the open joint-stock company's charter capital

Draft Law of the Cabinet of Ministers of Ukraine	Alternative Draft Law
May not be smaller than the equivalent of 1,250 minimum [monthly] wages (Article 15)	May not be smaller than the equivalent of 100 minimum [monthly] wages (Article 15)

IFC Comments:

The charter capital amount suggested by the Alternative Draft Law is the same as that presently set in Ukraine for limited-liability companies. However, this amount should not be considered appropriate for the charter capital of a joint-stock company because it is too small. It is worth mentioning that Article 6 of the Second EU Council Directive of 13 December 1976 sets the minimum amount of subscribed capital for open joint-stock companies of EU member states at no less than 25,000 European Currency Units. At the national level, for example, in Germany it is 100,000 marks, in France it is no less than 1,500,000 francs, and in Russia it is no less than 1,000 minimum [monthly] wages.

Author's Comments:

First, charter capital is not the same as subscribed capital. Charter capital is merely a nominal amount that does not include paid in capital. It would still be beneficial to have a minimum charter capital at inception for public companies. After inception, however, the minimum wages can change and the company might fall out of compliance. While this can serve as impetus for a takeover tender, it can also put undue pressure on companies that do not have a buyer or a way of financing the increase in the charter capital. If this law read "at inception," then it would prevent market-founded open joint stock companies from being too small. That's good. Special care should be taken with respect to on-going mass privatization, however. This may give the excuse to the SPF to found non-public companies, but distribute shares to the public. Therefore, the definition of public and non-public should be defined for the purpose of regulations and tendering and not necessarily correspond to the Ukrainian open or closed.

Corporate Governance Upside Down

Appendix B

Empirical Evidence.

IN PROCESS

Company Data

Data:

Filing reports provided by the State Securities and Stock Market Commission on sixty largest companies on the following basis:

- Had to have at least 1,000 shareholders at the end of at least one of: 1998, 1999, or 2000.
- Ranked each company by the largest reported number of shareholders, 2000 revenue and 2000 employee in descending order. Summed each rank and selected sixty lowest ranks.
- Excluded seven companies where data was not available and substituted four out of 26 regional electricity distribution companies and three largest remaining food companies.

The following adjustments were made to the data:

Ukrnafta: based on the statement from Ukrnafata shareholder relations office, added Privat Bank as the owner of 35% stake in 2000.

Ukrriichflot: based on statements of PFTS, added Ukrriichflot management as the owner of at least 40% in 2000.

There a few additional cases of missing data and some additional research and assumptions had to be made. We do not believe that these assumptions affected the outcome.

Ownership:

Owners with 5% or more of charter capital shares had reported to the SSMC. These are called Major shareholders. There were 132 such instances at end of 1999 and 173 at end of 2000, including state.

State ownership is considered ownership by all state entities, for example: the State Property Fund, ministries, state owned companies (such as Ukrnaftahas, NPO Druzhba, etc), state-owned investment companies (such as Derzhinvest), local government. We did not research foreign state ownership, though there are some known instances outside our sample.

Private beneficial ownership is not so transparent. Most registered owners are special purpose entities. Usually, to hide the ownership fact, most beneficial owners use several entities to break-up their total ownership. Therefore, it is impossible to determine exactly who owns what. However, it is evident that accumulation by large (major) shareholders is an accumulation for control, not portfolio. This is supported by the fact that most activity according to brokers is in the market for control, and by the ever shrinking number of shareholders in companies. The following examples will illustrate this point and support the assumption further.

Moreover, there are offshore entities that are beneficially locally owned and local entities that are beneficially foreign-owned. Further, there are cases when a foreign beneficial owner is a bonofied operating company, controlled by Ukrainian citizens. Therefore, there is no relationship between the registered nationality of the registered owner and the nationality of the beneficial owner. When we

determined the designation of beneficial owner (foreign, domestic Oligarch, management,) we only relied on clearly identified entities. Here is an excerpt from the data as an example:

Enterprise name	Holding Entity	1999%	2000%
OJSC Nizhnedneprovskiy Tube-rolling Plant	Interpipe Small Private Enterprise	10.15	7.98
OJSC Nizhnedneprovskiy Tube-rolling Plant	Interpipe Corporation, the Scientific and production investment group	0	9.26
OJSC Nizhnedneprovskiy Tube-rolling Plant	"ALLIED STEEL HOLDING B.V."	0	24.34
OJSC Nizhnedneprovskiy Tube-rolling Plant	ING Bank Ukraine	6.29	9.97
OJSC Nizhnedneprovskiy Tube-rolling Plant	WOOD &Co	10.38	0
OJSC Nizhnedneprovskiy Tube-rolling Plant	Bail&Co Ukrainian and Cyprus company with foreign investments	35.48	0
OJSC Azovstal Metallurgical Combine	Azovstal Trading House (CJSC)	43.85	43.85
OJSC Azovstal Metallurgical Combine	State Property Fund of Ukraine	45.56	25
OJSC Azovstal Metallurgical Combine	Server Management Limited	0	10.28
OJSC Azovstal Metallurgical Combine	Leman Commodities S.A.	0	13.91
Dnipropetrovsk Pipe Plant	Daughter Enterprise MRKS Holding Ukraine	0	16.57
Dnipropetrovsk Pipe Plant	Forte Trading s.r.o. (registration № 63073510)	0	15.51
Dnipropetrovsk Pipe Plant	Joint-Stock Company Timoko AG (registration № CH-170.3.020-245)	0	11.36
Dnipropetrovsk Pipe Plant	US Steel&Tubes Corporation (registration № 2000-00402130)	0	7.96
Dnipropetrovsk Pipe Plant	Easting Holdings Limited (registration № 371194)	0	7.96
Dnipropetrovsk Pipe Plant	Broad Hurst Investments LTD	9.6	0
Dnipropetrovsk Pipe Plant	LINSELL ENTERPRISES LIMITED	9.6	0
Dnipropetrovsk Pipe Plant	Minuz Enterprise LTD	7.8	0
Dnipropetrovsk Pipe Plant	Option Yug LTD	6	0
Dnipropetrovsk Pipe Plant	Region LTD	7.2	0
Slavutich Brewery	Baltic Beverage Holding AB Sweden Company	74	77.77

Nizhnedneprovsk pipe (see a special case review of Nizhnedneprovski, separately):

It is well publicized that Viktor Pinchuk, President Kuchma's son-in-law is the president of Interpipe Small Private Enterprise (SPE). It is also easy to guess that the Interpipe Corporation is related to Interpipe SPE. However, what about Allied Steel Holding B.V., holding just under the reporting minimum of 25%? Anyone care to guess? Even if the shares held in custody by ING are not allied with Interpipe, we do not know how many unreported stakes of less than 5% is beneficially owned by Interpipe group. Care to guess how many shares ultimately belong to Viktor? Do you think any of the civil servants care to investigate? At least in this case, it is easy to see the name Interpipe.

One might also guess that the second Interpipe has something to do with R&D, as well as legal rights to some intellectual property. One might guess that Allied Steel has something to do with supplying steel.

OJSC Azovstal'

The Azovstal Trading House, Closed JSC is a special purpose entity to trade steel. It is supposedly owned by all workers, but controlled by the management.

What about the other two entities that own shares in Azov? One is believed to be owned by the management, while another is believed to be owned by an oligarch group from Donetsk who opposed the management, but now negotiating to sell their shares. Objectively, however, there is no information either way.

OJSC Dnipropetrovsk Pipe.

Statically, it looks like the entities that own large blocks of shares are unrelated. If only the transaction from one group of shareholders to the other was not so obvious. These kinds of indications are everywhere. However, it is difficult to capture them in a statistical model.

The author had some familiarity with this particular transaction, so he labeled that this company is controlled by management. Again, however, there is no objective way to determine.

Slavutych Brewery

This is one of only about four companies, where the beneficial controlling shareholder is obvious.

In addition to the results in the body of the paper, here are some more:

Ownership By Industry					
Industry	Quantity		Private Majority Ownership	State Ownership	Free Float
Transportation	1		40	0	60
Paper	1		73.8	0	26.3
		Average Percentage Ownership	55.1	32.2	18.2
		Minimum Percentage Ownership	30	0	1.6
		Maximum Percentage Ownership	85.2	85.7	51.2
Oil, including Ukrnafta	4	Count Over 50% Ownership	3	1	
		Average	49.6	32.2	18.2
		Minimum	0	0	1.6
		Maximum	88.4	85.7	51.2
N atural Resources (excluding Ukrnafta)	6	Count Over 50% Ownership	3	1	
		Average	41.2	41.4	17.4
		Minimum	0	0	1.2
		Maximum	84.9	98.8	48.4
Metalurgy	17	Count Over 50% Ownership	9	6	
		Average	38.2	27.5	33.5
		Minimum	0	0	13.6
		Maximum	72.8	65.4	66.5
Heavy Industry	7				

		Count Over 50% Ownership	3	3	
Hotel	1		44.4	0	55.6
Food	6	Average	63.5	0	36.5
		Minimum	50	0	33.34
		Maximum	77.8	0	50
		Count Over 50% Ownership	6	0	
Financial Services	6	Average	46.8	14.8	38.5
		Minimum	0	0	14
		Maximum	85.9	78.9	89.9
		Count Over 50% Ownership	3	1	
Energy	7	Average	18.7	63.3	18
		Minimum	0	50	5
		Maximum	40	85.8	39.3
		Count Over 50% Ownership	0	7	
Chemical	4	Average	52.4	18.5	29.1
		Minimum	12.7	0	14.6
		Maximum	85.4	58.8	87.3
		Count Over 50% Ownership	2	1	

Industry ⇒ Control ↓	Metallurgy	Heavy industry	Energy	Transport	Financial services	Hotel	Food	Oil (including Ukrnafta)	Chemical	Paper	Natural resources	Total
State	4	2	6		1		0	0			1	14
Russian								1				1
Oligarch	7		1					4				12
Not ID	2	2			1		2		3	1	4	15
Management	3	2		1		1					1	8
Local gvt							1					1
Undetermined		1							1			2
Foreign	1						2					3
Bank					4							4
												60

State Control			
	Free Float	State Ownership	Majority Private Ownership
Minimum	1.19%	50%	0%
Maximum	39.35%	98.81%	40.08%
Average	17.20214	73.81071	8.620714
Oligarch Control			
Over 50%		5%	5 Companies
Minimum	5.09	0	12.89
Maximum	36.13	75	85.23
Average	13.59818	38.11273	49.19818
Beneficial Owners / Control Could Not Be Determined			
Minimum	0	0	31.45
Maximum	49.61	53.86	88.45
Average	20.56333	15.57933	63.84867
Management Control			
Minimum	1.19	0	37.95
Maximum	60	60.86	68.04
Average	36.04875	11.9825	51.96875
Foreign Strategic or Fund			
Minimum	22	0	64
Maximum	36	0	78
Average	28.5	0	71.5
Commercial Banks Associated with Oligarchs			
Minimum	16.06	0	0
Maximum	89.86	10	83.94
Average	50.22	2.5	47.4525

Appendix C