
Corporate governance and disclosure in Ukraine

Adam Mycyk*, Elizabeth Cook and Dymtro Fedoruk

Received (in revised form): 14th December, 2006

*Chadbourne & Parke LLP, 11 Mykhailivska Street, 4th Floor, Kyiv 01001, Ukraine; Tel: +380 44 270 7205; Fax: +380 44 270 7206; E-mail: amycyk@chadbourne.com

Adam Mycyk regularly advises multinationals and foreign companies, banks, investment banks and other financial institutions on structuring and implementing debt and equity inward investments (including through privatisations, mergers and acquisitions, and joint ventures), and on complex cross-border commercial and financing transactions in diverse economic sectors. He has worked extensively in complex financing transactions, and advised the lead manager of the first-ever direct Eurobond issue by Ukraine to restructure approximately US\$2.7 billion of its foreign debt. Mr Mycyk counsels clients on various aspects of doing business in Ukraine, including commercial, operational, regulatory, administrative, corporate, labour and dispute resolution matters.

Elizabeth Cook's practice focuses on mergers and acquisitions, commercial and general corporate matters. Prior to joining the firm, Elizabeth was a solicitor at a large international law firm in the United Kingdom. Elizabeth has gained experience in a broad range of commercial work, but with an emphasis on advising clients on the commercial and intellectual property aspects of corporate acquisitions, disposals, funding rounds and flotations. Advising on a range of national (UK) and international transactions has involved undertaking due diligence exercises, drafting and negotiating warranties, provisions in sale agreements and ancillary documents. Elizabeth also has experience in stand-alone commercial agreement (distribution, supply and development arrangements), and advising clients in relation to licensing and exploitation of IP.

Dymtro Fedoruk's practice focuses on cross-border financing, general banking and finance, mergers and acquisitions and oil and gas legislation. He has advised major institutional lenders, foreign investment banks and major international oil companies on various aspects of their activities in Ukraine. Mr. Fedoruk also counsels clients on a broad range of corporate, securities and business-related matters, including mergers and acquisitions, restructurings and joint ventures. He has been directly involved in all phases of such transactions, including initial structuring, negotiation, drafting and implementation. Mr Fedoruk was recently listed among five leading practitioners in PLC Which Lawyer? (2006) for banking and debt finance in Ukraine.

ABSTRACT

KEYWORDS: *Ukraine, corporate governance, disclosure*

This paper aims to provide an overview of the current legislative and regulatory framework in Ukraine in respect of the corporate governance of joint stock companies (JSCs), including a review of recent improvements in legislation. It goes on to highlight the deficiencies of the Ukrainian corporate governance framework itself, as well as to illustrate the widespread failure by Ukrainian JSCs to comply with and implement the existing legislation, resulting (among other things) in the widespread violation of minority shareholders' rights.

International Journal of Disclosure and Governance (2007) **4**, 59–74. doi:10.1057/palgrave.jdg.2050042

INTRODUCTION

The concept of corporate governance in Ukraine remains in its infancy. As recently as



2004, the European Bank for Reconstruction and Development's Corporate Governance Sector Assessment measured Ukrainian corporate governance legislation to be in 'very low compliance' with the OECD's Principles of Corporate Governance.

There is, however, no doubt that in recent years efforts have been made in a number of sectors in Ukraine to develop a corporate governance framework, and to promote awareness of, and compliance with, this framework. A key milestone, in terms of regulatory developments, occurred in December 2003 when the Ukrainian State Commission on Securities and the Stock Exchange (the primary regulator of joint stock companies (JSCs) in Ukraine) (*Securities Commission*) issued a set of nonmandatory corporate governance principles, which are based largely on the OECD Principles of Corporate Governance. On a legislative level, various laws have been introduced and/or amended in the past three years with the aim of simplifying and clarifying the rules relating to the organisation and operation of certain types of companies, and improving shareholder rights. And on a practical level, a number of Ukrainian companies, particularly those preparing for initial public offerings or other forms of foreign investment, have taken steps to improve compliance with corporate legislation, as well as implement corporate governance structures within their organisations.

While steps have been taken, however, to alter the legislative and regulatory landscapes to improve the corporate governance framework, in practice the implementation by Ukrainian companies of these measures to increase transparency and diversification of corporate culture has not yet occurred across the broader Ukrainian corporate landscape. There has been no wholesale acceptance by Ukrainian JSCs of the concept of, or need for, good corporate governance. In general, the corporate governance practices adopted by Ukrainian companies fail to mirror the high levels set by certain other more developed

European market economies and the United States.

OVERVIEW OF UKRAINIAN CORPORATE GOVERNANCE LANDSCAPE — PROGRESS?

Introduction of corporate governance principles in Ukraine

In December 2003, the Ukrainian Securities Commission issued its own nonmandatory corporate governance principles for JSCs (*Principles*), which are based on the OECD Principles of Corporate Governance (among other international codes). The process of developing Ukraine's Principles was initiated and financed by ten Ukrainian companies, each of whom has declared its recognition of the Principles.¹ It is, however, important to note that the implementation of these Principles is not a mandatory requirement for Ukrainian companies. There is no requirement, for example, for companies listed on Ukraine's two main stock exchanges to comply with the Principles (this is in contrast to the position in the UK, eg, where UK incorporated companies listed on the London Stock Exchange are subject to the Combined Code on Corporate Governance albeit on a 'comply or explain' basis, rather than the 'comply or be punished' basis used in the United States). In practice, the fact that adoption of the Principles is not mandatory means that only a limited number of Ukrainian companies have declared recognition of the Principles.

This limited adoption of the Principles among Ukrainian companies exists despite a significant number of companies having responded to the IFC/Corporate Development Project's 2004 survey² stating that, in their view, the adoption of international best practices in corporate governance is a priority activity for the management of their company, with over 40 per cent of respondents stating that they believed that adoption would increase company profits.



Initiatives to promote corporate governance in Ukraine

A number of initiatives have been introduced in Ukraine in the past 10 years with the aim of improving corporate governance relations, and providing a more fertile investment climate in Ukraine. For example, from 1997 to 2002 the 'Ukraine Corporate Governance Project'³ worked to improve the investment climate in Ukraine by laying the foundations for development and implementation of effective corporate governance practices. This involved project consultants providing assistance on corporate governance issues to Ukrainian companies, the Ukrainian government and educational institutions,⁴ and contributing to a number of pieces of legislation. The work of this project continued with a 'Corporate Development Project', launched in the 2002, with the aim of promoting the development of the private sector in Ukraine by introducing international best practices and advising enterprises, government agencies and educational institutions on corporate governance, financial management and financing/investment strategies. The Corporate Development Project states that, as of 5th September, 2005 it had given 86 seminars for JSCs in Ukraine, conducted seminars for 43 educational institutions, assisted with the completion of the Ukrainian Corporate Governance Principles, organised over 20 presentations and public discussions of the Draft Principles, and undertaken two surveys of corporate governance practices at Ukrainian companies.⁵

Improved legislative setting?

The primary sources of law relating to corporate governance in Ukraine comprise the Civil Code,⁶ the Commercial Code,⁷ the Securities Law⁸ and the Business Companies Law.⁹

In the past three years, a number of legislative measures (including the introduction of the Civil and Commercial Codes, and the Securities Law) have been taken by the Ukrainian authorities to try to improve the safeguards attributed to shareholder rights. This has

occurred for a number of reasons, not least because approximately 30 per cent of the Ukrainian population hold shares in JSCs but lack specific expertise and professional advice. The wish to attract new investment into Ukraine, both from domestic and foreign sources, has also been a key driver for these new legislative measures.

In this context, it is worth noting that the Ukrainian legal system is developing rapidly, and some areas of the Ukrainian legal environment remain difficult to navigate. A number of the laws relating to corporate governance have been introduced only recently, and these laws frequently contain ambiguous wording or lack specificity. There are a significant number of inconsistencies between these laws. In addition, a number of regulations contemplated by these new laws have not yet been implemented. There is also a widespread perception among the business community that the judiciary is subject to political interference and corruption. All these factors combine to make an uncertain legal platform in Ukraine, making interpretation and implementation of the new legislation difficult, and detracting from the development and implementation of good corporate governance practices.

Civil code and commercial code

The introduction of the Civil Code and the Commercial Code in January 2004 aimed to improve the corporate framework in Ukraine, and included certain provisions aimed at improving the rights of minority shareholders. These included the introduction of rules giving exclusive power to the general shareholders meeting of a JSC to alter the company's authorised capital, and the possibility of shareholders holding more than 10 per cent of the company's capital being entitled to request an audit of the JSC. There are, however, a significant number of inconsistencies between the Civil Code and the Commercial Code, which causes difficulties for companies and their advisors when trying to interpret and implement specific provisions of each Code. There have



been calls from a wide group of companies, institutions, academics and professionals to introduce a specific law 'On Joint Stock Companies' (*JSC Law*) to address, among other things, these inconsistencies and provide clarity in relation to the activities of JSCs. As further discussed below, it is unclear whether the political and economic climate will permit the introduction of such a law in Ukraine, at least in the short term.

Draft law on JSCs

On 21st March, 2002 a Presidential Decree 'On Measures to Improve Corporate Governance in Joint Stock Companies' was enacted, in response to the growing need for reform of Ukraine's corporate sector. The decree prescribed the preparation and submission to the Ukrainian Parliament of a law designed (i) to regulate the main problems in corporate governance and (ii) to ensure the development and adoption of national corporate governance principles in JSCs. The decree also recommended the preparation of a summary of court decisions regarding enforcement of corporate legislation.

The JSC Law was subsequently drafted, and various key entities within Ukraine have discussed and approved it. All attempts to pass the draft law (in 2001, 2003 and 2005) in Parliament, however, have failed. A new draft was submitted to Parliament on 21st October, 2005, but it failed to receive the requisite number of votes necessary to pass into law. This is despite significant concessions having been made by the draft law's promoters in order to appease its detractors.¹⁰

There have also been suggestions from various sectors that the Civil and Commercial Codes should be amended, both to remove the inconsistencies between the two Codes and also to ensure that any new JSC Law could co-exist without resulting in material inconsistencies. These suggestions, however, were rejected by the Ukrainian Parliament in early 2006. So, while there remains a significant groundswell of support for the new JSC Law

there is currently no clear indication of when (and in what format) the law will be passed by the Ukrainian Parliament.

It appears that these laws are unlikely to change the major principles of Ukrainian corporate governance, such as quorum requirements, major voting rules, etc. This may be because owners of large portions of shares in Ukrainian JSCs are either members of Ukrainian Parliament themselves or are reputed to have a close connection with such members of Parliament. Since large amounts of money have been invested in Ukrainian JSCs based on the existing corporate governance principles, their change is now very unlikely. On the other hand, it has been a recent attempt by the newly formed 'Anti-Crisis Coalition' to introduce amendments to the Business Companies Law lowering the quorum requirement for the general meeting of shareholders of JSC from 60 to 50 per cent. Although such amendments were vetoed by the President, there is no assurance that a further successful attempt would not be made in the near future.

New securities law

New disclosure obligations. The recent introduction of the Securities Law (which entered into force on 12th May, 2006) brings important modifications to the Ukrainian stock market by expanding the obligations of an issuer of securities to disclose information about itself, its main shareholders and matters affecting its securities. This should provide shareholders (and particularly minority shareholders) with an additional degree of protection in relation to the disclosure of information. Further, commentators agree that (at least in theory) the new law constitutes a significant improvement compared to the earlier legislation to the extent that it provides rules which will be clearer to investors, and brings Ukraine's securities and capital markets more in line with Western European legislation. This should result in both foreign and Ukrainian investors being better able to make informed investment decisions.



By way of background, Ukrainian legislation and regulations of the Securities Commission have historically required open JSCs to disclose certain specific information relating to the company on an annual basis (in a company report), and, in certain circumstances, on the basis of one-off reports at other times during the year. Compliance with these disclosure requirements by Ukrainian JSCs, however, has been, and continues to be, low. This is compounded by the Securities Commission's historic reticence to impose significant penalties on companies who violate the regulations. For example, in 2000, approximately 7,500 out of 11,850 open JSCs failed to file annual reports with the Securities Commission. In that year the *total* aggregate fines and penalties imposed by the Securities Commission on all open JSCs for all violations (not just violations in relation to disclosure obligations) comprised only UAH3,961,155 (approximately \$7,150).¹¹

The new Securities Law has consolidated and widened the existing rules and introduces the obligation for an issuer of publicly placed shares (ie *an open JSC*) to disclose information about itself, about material events potentially affecting the price of shares, and about certain classes of shareholders which hold more than 10 per cent of the company's shares. The Securities Law envisages that the Securities Commission will create a database into which this information will be placed and made freely available to the public via the Securities Commission's website.

The new Securities Law draws a distinction between two types of information, which should be disclosed: ordinary information and special information.

'Ordinary information' includes information on the identity of shareholders who hold more than 10 per cent of the company's shares, and information on the company's finances and business. This information must be filed with the Securities Commission annually and quarterly. Annual information includes the name and location of the company, its management, business and financial operations, issued securi-

ties, annual financial reports and an auditor's report. The information required to be filed on a quarterly basis is similar in type to annual information, except that the issuing company must also provide information on the shares and other interests that it holds in other companies (and the financial report will contain information about the previous quarter only).

'Special information' includes information about events affecting the issuing company, which might result in a material change in the value of the company's shares. These events can include: placement by the company of securities of more than 25 per cent of its share capital, redemption by the company of its shares, listing or delisting of the company's shares on a stock exchange, the company obtaining loans in excess of 25 per cent of its assets, a change in the officers of the company, a change of shareholders owning of 10 per cent or more of the company's shares, and reduction in the company's share capital.

The disclosure obligations imposed on JSCs with publicly placed shares by the Securities Law is a long-awaited and welcome development for investors and advisors alike. Not only should these disclosure obligations make the issuing company more transparent to potential investors, but it will also give minority shareholders access to information, which may previously have been unavailable to them. There are question marks over whether these disclosure obligations, however, can be implemented effectively in Ukraine without the introduction of additional subordinate legislation. Given the Securities Commission's past reluctance to impose fines on companies that fail to adhere to its regulations, it will be interesting to see whether the Securities Commission uses its powers to ensure the enforcement of these new disclosure rules.

Additional potential benefits of the new securities law. The new Securities Law also introduces a legally defined concept of 'insider information', with a prohibition on use of insider information to the detriment of other



security holders (discussed in further detail in the section, Right to share in profit below). It also provides investors with legal remedies to protect against fraudulent practices in the securities market.

It is doubtful whether the Securities Law can, however, in practice, provide a sufficient level of protection for minority shareholders across the corporate spectrum, without the additional protections promised by the long-awaited JSC Law. In addition, inconsistencies in the Securities Law have already been identified. For example, the Securities Law includes a number of references to 'the law which regulates the creation, activity and termination of JSCs,' inferring that the JSC Law has already been adopted (which it has not). In addition, there are concerns that the new Securities Law will not be implemented in its entirety.

UKRAINIAN CORPORATE GOVERNANCE IN PRACTICE — AN OVERVIEW OF CORPORATE STRUCTURES

There are a number of corporate forms through which a company may be incorporated in Ukraine. These comprise:

- *JSC*;
- limited liability company (*LLC*);
- additional liability company;
- general partnerships;
- production cooperative; and
- limited partnerships.

Business practice in Ukraine shows that JSCs and LLCs are the corporate forms most commonly used, and in our experience foreign investors, in particular, prefer their subsidiaries or joint ventures to be organised in either of these two forms. The other types of corporate forms are rarely used by either foreign or domestic investors in Ukraine. Such preference is likely to be based on the fact that the applicable legislation *expressly* states that participants in LLCs and shareholders of JSCs are personally liable only to the extent of their participation

interest/shareholding in the declared capital in these types of legal entities.¹²

In terms of corporate governance, JCSs are normally used for joint ventures with a comprehensive corporate governance structure, while the use of LLCs for this purpose is generally problematic. As a result, LLCs are most commonly used either as a Ukrainian subsidiary of a foreign company or, in the case of a joint venture, in those cases where complex corporate governance and control structures are not required and corporate conflicts among shareholders are not expected.

Because of the foregoing, and taking into account the somewhat simplistic nature of corporate governance in LLCs, this paper focuses on the status of corporate governance procedures in Ukraine as they apply to JSCs.

Characteristics of a Ukrainian JSC

A JSC shares common features with a US corporation and a UK limited company, to the extent that it is a legal entity with a share capital divided into a specific number of shares, each of nominal value. The personal liability of shareholders is generally limited to the value of owned shares. Under the recently introduced rule, however, in certain circumstances where the controlling shareholder(s) have caused the company's insolvency as a result of willful misconduct, the debtors of a company may attempt to 'pierce the corporate veil' and sue the shareholders for the company's debts. In such circumstances, controlling shareholders could bear subsidiary liability with respect to the creditors of such company.

A JSC may be either open (public) or closed (private). Shares of an open JSC are freely traded on stock exchanges, with no requirement for the shareholder to obtain the prior consent of other shareholders or the company before transferring his/her/its shares. In contrast, shares of a closed JSC are distributed among co-founders/a predetermined group and cannot be publicly traded. Shareholders of a closed JSC have a pre-emptive right to purchase shares sold by other JSC shareholders.



Corporate governance structures of a JSC

The corporate governance structure of a JSC consists of a General Shareholders' Meeting, a Supervisory Council, a Management Board and an Audit Committee:

(a) *The General Shareholders' Meeting (GSM)* (discussed further below) is the highest body of authority of a JSC, and determines the policy of the Company. Each shareholder is permitted to be present at each GSM.

(b) *The Supervisory Council* may be created to control the activity of a JSC's executive body (the 'Management Board') and to protect the rights of the company's shareholders. A JSC with over 50 shareholders is required by law to establish a Supervisory Council. There are commonly between five and seven members of the Supervisory Council, selected from the pool of shareholders by a vote of the GSM. Since JSCs in Ukraine are commonly controlled by a relatively small number of large shareholders (which often include management), the Supervisory Council frequently does not contain representation from the minority shareholders.

Issues delegated by the JSC's charter to the exclusive competence of the Supervisory Council cannot be transferred by it for decision to the company's Management Board. Members of the Supervisory Council cannot be the members of the Management Board or the Audit Committee. This is designed in order to limit the possibility for abuse by the Management Board members of their powers.

(c) *The Management Board* is the executive body of a JSC, exercising management of its day-to-day operations. It can be a collective (board of directors, directorate) or a single person (director/general director, who has the right to act on behalf of the company without a power of attorney).

The Management Board resolves all issues of the JSC's operations, other than those within the competence of the GSM and the Supervisory Council. The Management Board reports to the GSM and the Supervisory Council, and (in theory) organises the execution of their decisions. It acts on behalf of a JSC within the limits established by its charter and the law.

The Civil Code introduced the concept of fiduciary duties for officers of the Management Board (and the company's other governing bodies) to act in good faith in the company's interests within the scope of their powers.

(d) *The Audit Committee's* members may be elected from among the shareholders and carries out audit control over financial and business activities of a JSC's Management Board. Members of the Management Board or Supervisory Council cannot be members of the Audit Committee. The Audit Committee's authority derives from statute, and, at least in theory, it has fairly broad authority to control the management of the company, to review company documents, participate in management meetings and audit the activities of the company's managers. The Audit Committee also has an investigatory role, to the extent that it is obliged to conduct investigations (eg in case of violations or inaction by the Company's managers) and inspections following a request from either the holders of more than 10 per cent of the company's shares, the GSM or the Supervisory Council.

In order for the GSM to approve the company's annual balance sheet, the Audit Committee is required to prepare an annual report on the activities of the company. There is, however, a view held in some quarters that the preparation of this annual report by the Audit Committee merely serves to rubber stamp the activities of the Management Board and, further, that, in practice, in some cases the Audit Committee tends to be a largely toothless corporate body.



RIGHTS OF SHAREHOLDERS

Pursuant to the new legislative measures discussed in the section Overview of Ukrainian Corporate Governance Landscape — Progress? above, certain key rights of shareholders in JSCs are now established by law, and can be supplemented in each case by a company's charter. The effect is that shareholders in a JSC now, at least in theory, have certain specific rights in relation to decisions regarding the management of the company's operations (including via procedures specified in the company's charter and internal documents), particularly through participation in the company's GSM. These key rights are set out below. It is, however, questionable whether, in practice, these rights are respected by the Management Boards of Ukrainian companies on a consistent basis.

Rights of participation in governance of the company through the GSM

Calling a GSM: A GSM must be convened by the Management Board at least once each year. In addition, the Management Board must convene a GSM (i) if requested to do so by the holder(s) of more than 10 per cent of the voting shares of the company, (ii) upon the company's insolvency and (iii) in cases specified in the company's charter.

Agenda: Only decisions that are included in the GSM's agenda may be voted upon by the GSM. In practice, it is the Supervisory Council who often decide the issues to be voted upon in each GSM, although the law gives shareholders who hold more than 10 per cent of the company's voting shares the right to include issues on the GSM agenda, as long as such shareholder gives notice of its wish to include any such issues at least 30 days before the GSM. Minority shareholders with less than 10 per cent of the company's voting shares are entitled to suggest that an issue is included in the agenda, but there is no legal obligation on the Management Board to include such an issue.

Notification of GSM and agenda: The Management Board must notify each shareholder of

the date of the GSM and its agenda at least 45 days before the date of the GSM. Furthermore, a notice on calling the GSM must be placed in printed media published at the location of the company, as well as in one of the official printed media of the Cabinet of Ministers, Parliament or the Securities Commission, with the specification of a place, date and agenda of the meeting. Any changes to the agenda must be notified to all shareholders at least 10 days before the GSM. Clearly, these rules aim to ensure that shareholders are able to attend the GSM and be involved in the governance of the company.

In practice, it is often the case that the Management Board does not adhere to the notification requirements, and frequently shareholders are successful in challenging the decisions of a GSM on the basis that they were not properly notified of the GSM or a change in the date of the GSM, nor given details of the agenda.

Participation in the GSM, and voting rights: All shareholders, regardless of the quantity and type of shares owned by them, are entitled to participate in the GSM. Shareholders have the right to appoint a proxy to attend the GSM and vote on their behalf. A valid shareholders' meeting is constituted (ie the GSM is quorate) when the holders of more than 60 per cent of the shares eligible to vote are in attendance. Shareholders' voting rights are based on the principle of 'one share, one vote', apart from holders of preferred shares, which do not have the right to vote unless expressly provided for in the company's charter. Members of the Management Board also have the right to participate in the GSM, but with an advisory vote only.

The majority of issues within the GSM's remit require a simple majority (ie more than 50 per cent) of votes present at a quorate GSM. Three types of decisions, however, require a 75 per cent majority vote of those shareholders present at a quorate GSM: (i) amendment of the company's charter, (ii) insolvency/termination of the company and (iii) the creation of subsidiaries, branch offices and



representative offices. Ukrainian legislation does not currently permit companies to alter the voting requirements referred to above, nor alter the quorum requirements for a GSM.

The GSM's exclusive right to determine certain matters: The GSM has exclusive competence to deal with the following matters, which cannot be delegated:

- alteration of the company's charter and change of its authorised capital;
- election of members of the Supervisory Council, as well as establishment and removal of the Management Board and other corporate bodies;
- approval of the annual financial statements of the company and any subsidiaries;
- approval of the manner and procedure of distribution of dividends;
- approval of the opinions of the Audit Committee;
- establishment, reorganisation and liquidation of subsidiaries, branch and representative offices;
- approval of the papers of association and by-laws of subsidiaries, branch and representative offices and
- liquidation of the company.

The company's charter may include further issues that are in the exclusive competence of the GSM. Typically, such additional items may include approval of certain significant corporate contracts, appointment of executive officers, and creation of corporate internal rules.

Right to ownership of shares

The registered shares in a JSC can be either in documentary form (paper share certificates) or in electronic form. Where registered shares¹³ are in documentary form, title to the shares is evidenced by a share register — with the effect that a shareholder's rights to shares vest in him on the date on which his information is entered into the register. The register is commonly maintained by the company itself,¹⁴ unless the company has more than 500 shareholders, in

which case the share register must be maintained by an independent licensed registrar. Where registered shares are in electronic form, title to the shares transfers to a new owner from the moment the shares are recorded on the shareholder's custodian's securities account.

Right to transfer shares

The shares in an open JSC are freely transferable and shareholders have no right of pre-emption. Accordingly, a shareholder of an open JSC may, subject to certain statutory limitations, freely transfer, sell, pledge or otherwise dispose of all or part of his shares to any person or entity at whatever price he/she/it chooses. The statutory limitations on the right to freely dispose of shares include the requirement that the approval of the Antimonopoly Committee of Ukraine is obtained if more than 25 or 50 per cent of a company's shares are being sold and certain financial thresholds are met.

In contrast, while the holders of shares in closed JSCs are permitted to transfer their shares, existing shareholders have a right of pre-emption in respect of any shares to be sold (ie a seller must first offer his shares to the other shareholders before selling/transferring them to a third party).

Right to share in profits

Ukrainian law gives shareholders of JSCs the right to receive dividends, and these may be distributed in cash, in shares or in kind. It is the GSM that has the exclusive right to declare dividends, and this right cannot be delegated to any other corporate body.

Liability of shareholders/participants

The liability of a shareholder in a JSC is limited to the amount of shares held by that particular shareholder (save in limited circumstances, referred to above in relation to the 'piercing the corporate veil' concept).

Right of access to information

The law gives shareholders the right to access information about the activities of the company,



including information relating to minutes of the GSM, the minutes of any Management Board meetings, reports on the company's operations and certain financial information (eg the company's balance sheet). In addition, a JSC's charter may include additional areas where information must be provided to shareholders, and may even provide for formal reviews of such information. The disclosure of information to shareholders (and others) is addressed in more detail in the section Disclosure and Transparency of this paper.

Insider information

Prior to the Securities Law coming into effect there was no legally defined concept of insider information in Ukraine. Nor was there any prohibition on the use of insider information for personal gain. In fact, insider trading has been accepted and relatively widespread in Ukraine for many years.

The Securities Law has finally introduced a concept of 'insider information', and defines it as any information not publicly disclosed about a company with publicly placed securities, or about such company's securities or related transactions, the disclosure of which may materially affect the securities' value. 'Insiders' include persons in possession of insider information resulting from their position as owners of voting shares in the company, officers of the company or persons with access to insider information in connection with their employment or contractual relations (eg lawyers, accountants, consultants, etc).

The Securities Law makes it a criminal offence for an insider to use insider information (i) to enter into contracts on his or her behalf or on behalf of other persons involving the acquisition or transfer of shares which are subject to insider information, (ii) to disclose insider information to third parties and (iii) to make recommendations on the acquisition or transfer of shares before the information is publicly disclosed. The Securities Law places an obligation on securities traders and other members of the securities markets to report to

the Securities Commission any transactions that they suspect are based on insider information.

DISCLOSURE AND TRANSPARENCY

The disclosure of information and transparency in corporate activities is a key tenet of international corporate governance regimes. Historically, the level of disclosure of information by Ukrainian companies (i) to its shareholders and (ii) more widely to potential investors/interested parties within Ukraine and the rest of the world, has been limited — even where specific disclosure requirements were set out by law.¹⁵ In general, Ukrainian companies continue to be reluctant to disseminate information of any real substance.¹⁶ The reasons for the lack of willingness to disseminate information widely may include: the fact that many JSCs have a small number of major shareholders who already have access to company information via the Supervisory Council and/or Management Board; a lack of funds (or alternatively a lack of willingness to expend funds) to disseminate company information to shareholders and other stakeholders; the fact that it is only relatively recently that Ukrainian companies have begun to explore the options available in terms of foreign investment (at least from non-EBRD, IFC or similar sources) and so have had no *commercial* imperative to disseminate information on a wide scale; and a wish to stay out of the 'range' of the authorities (particularly tax authorities).

Recent Ukrainian laws, including the new Securities Law, have gone some way to address this reticence to disseminate information and the lack of transparency in company activities (as discussed in the section New securities law above, and further immediately below). Again, there is, however, doubt among commentators as to whether the provisions of these laws will be implemented and enforced in practice.

Disclosure of information, new holding companies law

The new Law 'On Holding Companies in Ukraine' (*Holding Companies Law*), which came



into effect on 18th April, 2006, imposes new disclosure obligations on 'holding companies', which are defined as open JSCs with control of two or more other companies). The Holding Companies Law makes clear that holding companies must disclose certain specific information in the official printed media of the Securities Commission, and must publish their own and their subsidiaries' consolidated financial reports at least once each year. Failure to file, late filing or filing false information can result in fines being imposed on the holding company and the holding company's chief executive. These fines, however, are currently relatively low: the maximum fine for the holding is up to 1,000 times the nontaxable minimum income (currently UAH 17,000 which is approximately US\$3,700), and the maximum fine for the chief executive is up to 50–100 times the nontaxable minimum income (currently UAH 850–1,700 which is approximately US\$168–337).

Information relating to Directors and key executives

Ukrainian regulations require that an open JSC's annual report must include information on the total number of the company's employees and their *aggregate* remuneration.¹⁷ There is, however, no requirement to disclose the individual remuneration or benefits of any employee (including key executives).

While there is an obligation on the company to disclose the names, addresses, age, education, experience and number of shares in the company held by members of the supervisory council, management, chief accountant and head of the Audit Committee, there is no requirement for the company to disclose any information at all about the remuneration or benefits provided to the company's directors, management or supervisory council. Clearly, the lack of any obligation on the company to disclose information on the remuneration and benefits provided to key executives and, in particular, to Management and the Supervisory Council, leaves significant scope for abuse of

the company's finances often at the direction of majority shareholders, to the detriment of minority shareholders.

Accounting standards

There is currently no general legal requirement for any Ukrainian company to adopt International Financial Reporting Standards (IFRS) or US Generally Acceptable Accounting Principles (GAAP).¹⁸

There is a need for Ukrainian regulators to adopt processes and rules that ensure harmonisation of legal and accounting documents with international standards. Regulators also need to develop effective regimes, where necessary, for ensuring compliance with such new processes.

FAILURE TO IMPLEMENT CORPORATE GOVERNANCE PRACTICES — VIOLATION AND ABUSE OF SHAREHOLDER RIGHTS

Despite improvements in the legislative and regulatory corporate governance framework governing shareholders' rights and companies' disclosure obligations in Ukraine over the past three years, concerns remain that the implementation of the applicable rules by Ukrainian companies, and the subsequent enforcement of such rules by regulatory bodies and/or courts, has not occurred in a significant number of Ukrainian companies. Even in circumstances where minority shareholders are provided with rights by law, frequently these rights are not respected by the company's executive bodies. Since minority shareholders have no automatic right to representation on the company's Supervisory Council or Management Body, the scope for abuse of their rights is significant. Some examples of ways in which Ukrainian companies fail to adhere to the legal regulations and corporate governance procedures are discussed in the next sections below.

Abuse of power/process by Supervisory Council, Directors and/or Management

The members of the Supervisory Council are often appointed by the company's major shareholders. Consequently, and despite the members'



fiduciary duty to act in the company's best interests, these members often perform their duties on behalf of the major shareholders rather than for the company as a whole (and therefore all the shareholders and/or other stakeholders). Similarly, major shareholders may be closely involved in, and represented on, the Management Board of directors. They will therefore have significant impact on the decision-making process of the company, but their activities may not represent the interests of all shareholders (especially minority shareholders).

Furthermore, Ukrainian law does not currently expressly prohibit asset stripping, related party transactions or share dilutions by company officers. Accordingly, it is extremely difficult for a shareholder to mount a successful claim against a company's officer(s) that these activities constitute a violation of the shareholder's rights. A recent example of an alleged failure to protect minority rights in relation to share dilution involved a large Ukrainian industrial company which is listed on Ukraine's PFTS stock exchange, and in which a number of foreign investors had acquired minority shareholdings. In May 2006, the company announced a new share issue, with the purported aim of 'adding transparency to the ownership structure of the factory and streamlin[ing] its operations'. Since the share issue, however, involved the merger of the company with one of its own major shareholders (an entity which itself owned 45 per cent of the shares in the company, but had few other assets of its own), the result of the share issue was that the minority shareholders' rights were diluted. Many minority investors were concerned that (i) they were not involved in discussions leading to the decision to issue shares and (ii) they were not offered the opportunity to participate in the share issue. Indeed, minority shareholders' fears were confirmed when, following the announcement of the new share issue, the price of the company's shares fell (although there are indications from majority shareholders that the minority shareholders' shares will be purchased

at a price that reflects the share price prior to the announcement of the new share issue).

Similarly, in April 2006, Zaporizhstal (a steel company listed on Ukraine's PFTS exchange) announced that its majority shareholders intended to merge the Zaporizhstal mill with a number of export trading houses that have virtually no assets. In this case, the majority shareholders do not appear to have provided any assurances to minority shareholders that they will be compensated for the share dilution.

Failure to comply with requirements for general meetings

A significant number of Ukrainian JSCs still do not comply with the legal requirements relating to the preparation, notification to shareholders and conduct of GSMs. Examples of violations of these requirements include the failure to send notice of the GSM to any (or some only) of the shareholders and/or print such notice in the respective print media; a failure to provide shareholders with the agenda; a failure to provide shareholders with adequate (or any) notice of a change in the time, date or place of the GSM in accordance with the regulations; a failure to register a proxy at the GSM, with the effect that the proxy cannot vote at the GSM.

Disposal of assets

It is common for the charter of a JSC to provide (and Ukrainian law permits) that if the Management Board wishes to dispose of, transfer, encumber or otherwise deal with assets valued at over a certain amount specified in the charter, or to particular persons, then it must obtain the shareholders' prior approval. In practice, this obligation to obtain the shareholders' approval is, however, frequently avoided by the Management Board through methods that, although within the letter of the law, are of a dubious nature in practice. For example, management often employ specific methods of accounting to undervalue or write-off the relevant assets; and assets may be transferred to related parties for a nominal consideration, and therefore do



not reach the threshold for shareholder approval.

Since the majority of these types of transactions are structured so as to fall within the strict confines of the law, there is often very little recourse available to shareholders who wish to challenge the validity of such transactions.

Failure to disclose information

In terms of the general legal obligations of disclosure of company information (as referred to above in the section Disclosure of Transparency), a significant number of Ukrainian companies have historically failed to comply with the legal obligation to disclose information via annual (and quarterly) reports. The level of fines imposed by the Securities Commission in relation to these violations has been insufficient to encourage compliance.

Similarly, in terms of specific requests from shareholders to the company regarding the disclosure of specific information and/or company documents, there are a large number of instances where companies have failed to comply with their legal requirements to supply such information and documentation. Reasons for this unwillingness by companies to disclose information may include a wish to protect allegedly confidential or sensitive information, or a need to prevent the disclosure of information that would evidence abuses by management or officers.

Foreign shareholders

While Ukrainian law does provide certain specific protections for foreign investments in Ukraine,¹⁹ in practice foreign investors no longer have any preferential treatment in terms of taxes, currency control and customs regime as against Ukrainian nationals and legal entities in their capacity as shareholders — as a result of the Law of Ukraine No. 1457-III ‘On Elimination of Discrimination of Taxation of Companies Created with the Participation of a Foreign Capital,’ dated 17th February, 2000. In addition, it is worth noting that Ukrainian law places certain limitations on foreign inves-

tors in relation to ownership of shares in certain types of companies, including media, television and broadcasting companies.

Options for redress for shareholders

The potential options for shareholders seeking redress in respect of perceived abuses of their rights include:

- *Internal recourse to the Supervisory Council for protection of shareholder rights*, for example where a shareholder complains of a particular abuse by a company officer. This method may be, however, unsatisfactory if the members of the Supervisory Council represent the majority shareholders and have themselves carried out the activities complained of.
- *Internal recourse to the Audit Committee*. A shareholder or group of shareholders holding more than 10 per cent of the company’s shares can apply to the Audit Committee to audit the financial and business operations of the company’s management. In such cases, the Audit Committee has wide powers to demand and review company documentation, and to interview company officers. Since members of the Audit Committee cannot also be members of the Supervisory Council or Management Board, it is more likely (at least in theory) that the investigation by the Audit Committee will have an independent aspect and be less influenced by major shareholders. If the Audit Committee finds that abuses have been committed by the company’s officers, or if there is a threat to the company’s key interests, then the Audit Committee must convene an extraordinary GSM.
- *Bringing a complaint to the attention of the appropriate regulatory body* (eg the Securities Commission). Note that the Securities Commission does not have authority to adjudicate cases involving complaints filed by individual shareholders.
- *Notification of activities to law enforcement agencies*, if the act complained of involves



potential criminal liability for the company's officers and/or employees.

- *Bringing a claim in the Ukrainian civil or commercial courts (or such other method of dispute resolution as may be specified in the company's charter/ internal documents).* If a shareholder believes that its rights have been breached by a company body then it can bring a claim for breach of the applicable civil or criminal law. It is important to note in this context that the independence of the Ukrainian judicial system is currently questionable, as is its immunity from economic and political influence. Judicial precedents have no binding effect on subsequent decisions under Ukrainian law, and there is inconsistency in judicial interpretation of Ukrainian law. There is currently no public records system via which all judgments can be accessed by the public (although recent legislation aims to address this).²⁰ Since the judiciary is not immune from manipulation from outside influences, it is possible that a minority shareholder seeking redress against a company's officers or large shareholders may not receive a fair hearing. In addition, even if a shareholder obtains a favourable judgment from the court, the enforcement of court orders and judgments can be difficult in practice in Ukraine. The State Execution Service (a body which is independent from the courts) is responsible for enforcing court orders, but its limited authority, coupled with the complex and time-consuming enforcement procedures, frequently mean that court orders are enforced inadequately, or not at all.

As a general note, although it is a key principle of international corporate governance that all shareholders in the same class should be treated equally, the Ukrainian legal system, being a civil law regime, does not acknowledge the concept of 'equitable treatment' or 'equitable rights' as these may be understood and implemented by common law systems. While shareholders may

seek recourse from the courts in respect of alleged violations of their shareholder rights (as further discussed below), Ukrainian courts are unlikely to consider an action brought by a group of shareholders alleging that, for example, the company's Supervisory Council has acted inequitably (although within the strict limits of the law) towards the claimants as against a larger group of shareholders.

CONCLUSION: PROPOSALS FOR FURTHER REFORM

Progress is being made, but there is still much to be done to lay the foundations for effective corporate governance procedures in Ukraine, and to encourage (if not to oblige) compliance by JSCs with such procedures in practice. Some suggestions for further reform include the following:

Adopt law 'On Joint Stock Companies'

The draft Law 'On Joint Stock Companies' should be reviewed and adopted. In Ukraine Corporate Governance Development Project's 2004 survey of Ukrainian JSCs, over 80 per cent of respondents stated that the adoption of the Law 'On Joint Stock Companies' was the most important anticipated change in the regulation of corporate governance.

Remove inconsistencies in relevant legislation

A significant number of inconsistencies exist between existing legislation, and a concerted effort is required in order to streamline the legislative and regulatory environment, and to remove conflicting provisions.

There is no clear legal procedure for entering into transactions with a conflict of interest or involving the interests of company officers; a lack of clarity in relation to the procedure for calling and holding the company's annual general meeting.

Introduce compulsory adoption of principles

Consideration should be given as to whether compliance with the Ukrainian Securities

Commissions' Principles should be mandatory for JSCs, which are listed on certain key domestic stock exchanges, at least on a 'comply or explain' basis.

Strengthen minority shareholders' rights, and raise shareholder awareness

Further specific reforms are required to address historic deficiencies in corporate laws, for example, to strengthen minority shareholders' rights.

Harmonise Ukrainian accounting standards with international standards

In common with the area of corporate governance, there is a need for Ukrainian regulators to adopt processes and rules that ensure harmonisation of legal and accounting documents with international standards. Regulators also need to develop effective regimes, where necessary, for ensuring compliance with such new processes.

NOTES

- 1 These companies comprise Aval Bank, Galnaftogaz, Delloite, KPMG, Kyivstar, Int'l Ukrainian Airlines, Odesacabel, PriceWaterhouseCoopers, UkrSibBank and UkrSots-Bank.
- 2 Overall, 804 Ukrainian joint stock companies took part in that survey.
- 3 Funded by the Canadian International Development Agency (CIDA) and, through IFC's Technical Assistance Trust Funds Program, by the British Know-How Fund (BKHF), the Agency of the Dutch Ministry of Economic Affairs (Senter), and by the Government of Japan.
- 4 The project worked directly with newly privatised medium and large enterprises, training about 13 percent of Ukraine's active corporations, providing over 5,000 consultations, and advising 67 pilot enterprises on sound corporate governance practices. The Project reports that almost 50 per cent of the pilot enterprises subsequently found greater success in initiating negotiations with investors, attracting investment, finding partners, and

obtaining financing. The Project also trained more than 300 professors and introduced corporate governance topics into curriculae of 23 universities, which now teach approximately 3,500 students a year about corporate governance.

- 5 The surveys were conducted in 2003 and 2004, with 800 companies surveyed — data taken from the IFC/Corporate Development Project at www2.ifc.org/ukraine/ucdp.
- 6 The Civil Code of Ukraine, dated 16th January, 2003, as amended.
- 7 The Commercial Code of Ukraine, dated 16th January, 2003, as amended.
- 8 The Law of Ukraine No. 3480-IV 'On Securities and the Stock Exchange,' dated 23rd February, 2006, as amended.
- 9 The Law of Ukraine No. 1576-XII 'On Business Companies,' dated 19th September, 1991, as amended.
- 10 Such concessions involved the deletion of certain important provisions which the detractors perceived to be inconsistent with the Civil Code and the Commercial Code.
- 11 Figures taken from the OECD's 2004 report on Corporate Governance in Eurasia: A Comparative Overview.
- 12 The only exception is liability of shareholders under the 'piercing the corporate veil' concept discussed in more detail below.
- 13 The rules relating to evidencing ownership of bearer shares are slightly different.
- 14 In such case, the company requires a license to be issued by the Securities Commission.
- 15 This is not the case in certain specific sectors, for example, the banking sector, where the disclosure requirements set out by law are generally adhered to (eg the requirement to provide basic information on the bank's management, activities and financial status are commonly fulfilled via the publication of the bank's annual report).
- 16 It is interesting to note that the use of the internet and/or company websites is still relatively uncommon in Ukraine, as compared to other Western market economies where even the smallest private companies have fairly informative websites.
- 17 There are exemptions for small open JSCs to submit simplified annual reports.



- 18 We understand that, while it is not a mandatory requirement, the majority of Ukrainian banks now adopt IFRS, and have their accounts audited by international accounting firms.
- 19 As set out in the Law 'On Foreign Investment Regime' (the 'Foreign Investment Law') dated 19th March, 1996.
- 20 The recently adopted Law 'On the Access to Court Decisions' dated 1st June, 2006, envis-

ages the creation of a Unified Register of Court Decisions, an electronic database on which every decision of every court in Ukraine will be stored and made available to the public. It is hoped that this law will encourage a greater level of transparency in the judicial process, and enable improved scrutiny of judicial decisions.