

# **REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)**

## **Corporate Governance Country Assessment CZECH REPUBLIC**

**July 2002**

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The Corporate Governance Assessment was completed as part of the joint World Bank IMF program of Reports on the Observance of Standards and Codes (ROSC). It benchmarks the country's observance of corporate governance against the OECD Principles of Corporate Governance and is based on a template developed by the World Bank. This assessment was undertaken on the basis of the template and report prepared by Romana Cervinkova, analyst with ASPEKT Central Europe Group, a.s. Acknowledgements are due to the following stakeholders who participated in the diagnostic assessment: Ministry of Finance, the Securities Commission, UNIVYC, lawyers and accountants, Association of Pension Funds, Prague Stock Exchange, Institute of Directors, Union of Investment Companies, Securities Centre, Czech Society of Economics, Chamber of Auditors, Federation of Accountants, Czech Telecom, CS, and CEZ. The final report was drafted by Olivier Fremond and Warren Gorlick of the Corporate Governance Unit, Private Sector Advisory Services of the World Bank. The ROSC assessment was cleared for publication by the Ministry of Finance on June 16, 2002.

## I. EXECUTIVE SUMMARY

The Prague Stock Exchange (PSE) is the Czech Republic's only stock exchange. An off-exchange trading system, the RM system (RMS), also exists. In April 2002, 95 issues of shares and participating certificates and 83 bond issues were traded on the PSE. By January 2002, the total market capitalization of the Czech securities markets reached CZK 364.3 billion (USD 10.3 billion),<sup>1</sup> or 17.3 percent of GDP. The Czech securities markets are rapidly evolving under political and commercial pressures. However, shortcomings remain that undercut their role in price discovery, and limit their value as risk diversification, as a source of finance and a mechanism for good corporate governance. Ownership concentration resulting from privatization in the early 1990s was accompanied by opaque deals and price manipulation, and owners often exploited control and acted against the interests of enterprises, creditors and minority shareholders.<sup>2</sup>

The policy recommendations may be grouped into three broad categories: legislative reform, institutional strengthening, and voluntary/private initiatives. In 2001, the Czech Republic instituted broad financial regulatory reforms. However, related party transactions, insolvency and more technical issues, such as voting by mail and shareholder meetings, still require more attention. Institutional strengthening is also vital to improve enforcement. The judiciary, Securities Commission, and other institutions that oversee financial market participants should be strengthened. Finally, in the area of voluntary/private initiatives, this report recommends enhanced training opportunities for Czech directors.

## II. CAPITAL MARKETS OVERVIEW AND INSTITUTIONAL FRAMEWORK

The three primary forms of business enterprise in the Czech Republic are joint stock companies, limited partnership companies, and limited liability companies.<sup>3</sup> Each type of entity requires a different level of capitalization.<sup>4</sup>

The Prague Stock Exchange (PSE) was founded in November 1992. It is a joint-stock company subject to Czech Securities Commission (CSC) oversight. Shareholders, mainly securities traders and banks, elect and remove members of the Exchange Chamber, the PSE's supervisory body. Members serve three-year terms but may be re-elected. The Chamber imposes sanctions on members for breach of securities laws or exchange rules. Sanctions include reprimands, fines up to CZK 1 million (USD 28,350) or temporary or permanent exclusion from the exchange. The CSC has final say on certain disputes, such as cases where the PSE denies listing or where sanctions are involved.

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<sup>1</sup> All exchange rates are as of January 3, 2002; 1 USD = 35.27 CZK.

<sup>2</sup> *Czech Republic: Capital Market Review*, A World Bank Country Study, The International Bank for Reconstruction and Development/The World Bank, Washington, DC, 1999, p. 7.

<sup>3</sup> Joint stock company requirements are set forth in Com. Code Sec. 162; those for limited partnerships appear in Com. Code Sec. 97a; and those for limited liability companies appear in Com. Code Secs. 108-09.

<sup>4</sup> Joint stock companies are the legal form used for privatized companies. A joint stock company must have minimum basic capital of CZK 2 million (USD 58,207) and CZK 20 million (USD 582,070) if it offers shares to the public. Owners have limited liability. Shares can be registered or in bearer form. A limited liability company must have basic capital of CZK 200,000 (USD 5,820) and minimum CZK 20,000 (USD 528) per partner and a maximum of 50 shareholders. It cannot trade on the stock exchange. Limited partnership companies must have minimum capital of CZK 5,000 (USD 132) per partner.

In 1993 and 1995, a total of 1629 share issues were floated on the PSE from the first and second waves of voucher privatization. In 1997, following capital market regulatory changes, 1,301 illiquid share issues were withdrawn from the PSE Free market.<sup>5</sup> In 2001, another 70 issues were withdrawn.

Investment funds played a role in post-privatization restructuring. Their introduction into the privatization program was a response to concerns that voucher distribution would lead to excessively dispersed ownership structures. Excessive portfolio concentration was also a concern, and restrictions on the amount an investment fund could invest in one company were introduced. In practice, the restrictions were often circumvented. In addition, the corporate governance of investment funds was poor, and asset-stripping occurred at the expense of fund shareholders. These concerns led to the 1998 Investment Fund Act, which mandated conversion of closed-end funds into open-ended funds, a process slated to be completed by 2003. The Act also reduced the maximum holding in a single company to 11 percent. The rationale is to place the interests of investors leaving such funds on par with those of new and remaining investors. The CSC expects a new CIS law to be ready by 2003, in time to comply with the mandate on EU member countries to implement the EU UCITS<sup>6</sup> directive by mid-2003. To avoid the stricter regulatory framework, some funds were converted to a holding structure. The conversion resulted in assets being managed without adequate regulatory oversight, and many small shareholders were left without a real exit strategy. Conversions were associated with asset stripping and fraud, as, for example, in the case of Investiční a Poštovní banka (IBP), where managers siphoned off assets through a complex network of holding companies. Another characteristic of the Czech economy is the large percentage of foreign owners in Czech enterprises and banks. Of the 41 banks licensed by the Czech authorities in 2000, 27, including foreign subsidiaries and foreign branches, were foreign-controlled.<sup>7</sup>

Trading on the PSE is divided according to the liquidity of securities on the Main, Secondary and Free markets. To maintain Main market listing, a security must have a daily mean trading volume of CZK 1 million (USD 28,350). In 2000, 35 securities traded on the Main market, 71 on the Secondary and 139 on the Free. However, by the end of April 2002, the number of shares and participating certificates on the PSE had declined to 95 (five on the Main, 46 on the Secondary and 44 on the Free market), in part due to some issuers deciding to delist. This has led to a decline in the PSE market capitalization, which was CZK 364.3 billion as of January 2002 (USD 10.3 billion). The RMS is a joint stock company that allows customers to access its market without intermediaries, through real-time online trading and with same-day settlement.

The Czech Republic has harmonized most of its company and capital market laws in preparation for EU accession, with few details still unresolved. Still, further work is needed in collective investment and clearing and settlement. Once the Czech Republic is an EU member, EU

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<sup>5</sup> 1996 saw the failure of six major banks, setting off a fear of a domino effect throughout the economy; a monetary crisis followed shortly thereafter, forcing the government to enact structural reforms. These included privatization of state-owned businesses (including banking and telecommunications), the creation of the CSC, the passage of Glass-Steagall type legislation to ban "incestuous" relationships between banks and companies, and currency devaluation (but under strict measures to combat speculation).

<sup>6</sup> Undertakings for Collective Investments in Transferable Securities.

<sup>7</sup> Figures from the Czech National Bank show that the amount of foreign direct investment rose from CZK 23.1 billion (USD 654 million) in 1993 to CZK 176.4 billion (USD 5 billion) in 2001. Foreign portfolio investment (equity) was CZK 21.8 billion (USD 617 million).

passporting provisions should expose issuers and market participants to greater competition, which may further raise standards.

The Commercial Code was amended in January 2001. The changes enhanced minority shareholder protection. They included rules allowing shareholders to call special shareholders' meetings and to ask a court to name an expert to examine a company, provided certain ownership thresholds (three or five percent, depending on company size) are met. The 2001 revisions also lowered the threshold for invoking mandatory tender offer provisions to 40 percent and contained other protections, such as the right to review a merger proposal 30 days prior to the shareholder meeting, and to have two independent experts review the agreement.

In April 1998, the CSC became the securities market regulator, assuming a role held by the Ministry of Finance (MOF). The CSC supervises broker/dealers and their employees, organized stock exchanges, clearing and settlement, securities issuers, collective investment schemes, pension plan investments and shareholders required to make public disclosures. Further statutory changes would permit the CSC to supervise rating agencies. The CSC can suspend or remove a person's authorization to operate on the capital market and can impose fines. The CSC's jurisdiction over public unlisted companies is limited to reviewing the prospectus before a public offering and reviewing takeover bids. Parliament sets the CSC's budget, and fees collected by the CSC go to the MOF. The Securities Center was established in 1993 to keep a unified register of dematerialized securities and their owners and act as a depository for such securities.

### III. REVIEW OF CORPORATE GOVERNANCE PRINCIPLES

This review assesses the compliance of the Czech Republic to each OECD Principle of Corporate Governance, which are set out in Annex A. Description of practices and policy recommendations may be offered whenever a principle is less than fully observed. **Observed** means that all essential criteria are generally met without any significant deficiencies. **Largely observed** means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the OECD Principle, practices and enforcement diverge. **Materially not observed** means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means that no substantive progress toward observance has been achieved.

#### Section I: The Rights of Shareholders

##### **Principle 1A: Largely observed**

*Description of practice:* The Securities Center maintains a register of shareholdings in listed companies. Shareholders may obtain details only about their own holdings or about holdings that exceed five percent of the issued shares. They may freely transfer shares either on the PSE or RMS. Registration of transfers is suspended for seven days prior to an Annual General Meeting (AGM) to allow for production of a shareholders' list. An issue of concern is the fact that the Czech entity providing settlement services (Univyc) is not the custodian for dematerialized securities. Accordingly, there is a bifurcation of functions between the Securities Center, which provides custodial services (and which may not legally act as a settlement agent), and Univyc,

which provides settlement services. Such bifurcation makes it hard for the Czech Republic to eliminate principle risk in settlement through the adoption of the principle of delivery versus payment (DVP).

Czech courts maintain a company register accessible to all, and shareholders may make copies. The Company Register includes company bylaws, annual reports, and other significant company documents.<sup>8</sup> The Securities Act requires listed companies to publish semi-annual and annual financial statements, as well as the board of directors' annual report on company operations.<sup>9</sup> In 2002, the threshold for a mandatory external audit of the annual financial statements was lowered, as discussed in Section IV. PSE rules require that companies listed on the Main market also file unaudited quarterly reports. All information materially relevant to investors must also be disclosed, unless the CSC determines publication to be contrary to the public interest or the company's financial health.

Joint stock companies are governed by supervisory and management boards elected each year at the AGM by shareholders, although the right to select the management board can be bestowed to the supervisory board. In practice, this is rarely done. Cumulative voting is not permitted. Dividends approved by the AGM are sent directly to large shareholders. Small shareholders may obtain their dividends through banking institutions.

*Policy recommendations:* Although there are no indications of abuse, the rule allowing companies to withhold “damaging” information should be subject to clear criteria, issued by the CSC. Policymakers should introduce changes to allow DVP settlement.

#### **Principle IB: *Partially observed***

*Description of practice:* The Commercial Code protects minority shareholders with respect to fundamental corporate changes such as changes to bylaws, authorization of additional shares, and extraordinary transactions resulting in the sale of a company. Changes to company bylaws and capital increases must be approved by a two-thirds majority of shareholders attending a general meeting. Shareholders have pre-emptive rights with respect to share issue, though they can be waived at a general meeting with 75 percent majority approval. Despite statutory protections, some PSE listed companies have gained a bad reputation for fraudulent transactions that have resulted in the sale of company assets at prices that were disadvantageous to their shareholders. Some of these transactions involved the use of off-shore centers in the Cayman Islands and other banking centers with weak financial regulation. A 1997 post-privatization scandal concerned the investment fund CS Fondy, which purportedly tunneled away CZK 1.22 billion (USD 36.2 million) to foreign bank accounts. Another high profile case in 2000 involved IPB, once the third largest Czech bank. Allegations were made contending that the bank's assets were stripped and transferred to Cayman Island banks and other locations through a maze of ownership structures. (See Annex C).

*Policy recommendations:* Recent Commercial Code amendments, including enhanced provisions for minority shareholders to call meetings, name experts to review the contract fairness, mandatory tender offer provisions, and merger proceedings, provide stronger statutory protections to minority shareholders. However, enforcement of the provisions remains an issue,

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<sup>8</sup> Com. Code. Sec. 27a.

<sup>9</sup> Securities Act Sec. 80a.

and insufficient time has passed to judge their efficacy. Progress in enforcing shareholder rights must still be demonstrated.

**Principle 1C: *Partially observed***

*Description of practice:* Shareholder meetings must take place at least once a year, and no later than six months after the close of the company’s fiscal year, with a 30 day notice provision.<sup>10</sup> As of January 2001, the Commercial Code requires that, at the request of holders of five percent or three percent of issued shares for companies depending on their size, a special general meeting may be held in order to discuss “proposed matters.”<sup>11</sup> Those shareholders may also place additional items on the agenda of the general meeting. There are no statutory or regulatory restrictions on shareholders’ ability to attend and vote at company general meetings. However, shareholders continue to report difficulties in gaining access to meetings or establishing their right to vote. There are a number of instances where shareholder meetings were called in remote geographic areas. Shareholders are entitled to appoint a proxy to vote their shares at the meeting, though companies have been reported to use technicalities for refusing to allow proxies to vote the shares of beneficial owners. Voting by mail or electronically is not permitted. The quorum requirement for the AGM is 30 percent of the company’s issued share capital, unless the bylaws stipulate a higher percentage.

*Policy recommendations:* Shareholder meetings should be held in accessible locations at company headquarters or nearby, and shareholders should be able to cast votes without difficulty; these measures should be ensured through regulatory oversight by the CSC or through statutory changes. Shareholders should be permitted to vote by mail, and electronic voting should be considered in the medium term.

**Principle 1D: *Partially observed***

*Description of practice:* A shareholder whose holdings have reached five percent of the issuer’s share capital must disclose this within three days to the company, the CSC and the Securities Center.<sup>12</sup> Disclosure is also required at each additional five percent threshold and at one-third and two-thirds levels. The Securities Center publishes such disclosures on its website no later than nine calendar days after receiving the announcement or from the day the Securities Center learns of the event.<sup>13</sup> The Commercial Code presumes control at 40 percent.<sup>14</sup> When this threshold is reached, an action by the controlling party that causes loss to the company will trigger a right of compensation to the company or minority shareholders. An independent expert must also review the fairness of arrangements providing distributions to controlling shareholders.

*Policy recommendations:* The Commercial Code amendments that provide a broad definition of a controlling person are a clear advance. While many past abuses by controlling shareholders were due to weaknesses in existing legislation, the issue was and largely remains one of enforcement (See Annex C). A higher score in this area will require demonstrated progress in achieving full compliance with relevant legal provisions.

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<sup>10</sup> Com. Code Sec. 184.

<sup>11</sup> Com. Code Sec. 181.

<sup>12</sup> Com. Code Sec. 183d paragraph 1.

<sup>13</sup> Com. Code Sec. 183d, Paragraph 10.

<sup>14</sup> Com. Code Secs. 66(5) and 66a.

**Principle 1E: Observed**

*Description of practice:* Takeovers are governed by Section 183a of the Commercial Code,<sup>15</sup> which is modeled on the London Takeovers and Mergers rules. The offeror must notify the target company of the offer and supply the target and CSC with full information. The target's management board must review the offer and notify the offeror and the market of its views within five days. The target may not adopt measures that could prevent shareholders from reviewing the offer in full possession of the facts or from doing anything to frustrate the offer. The Commercial Code precludes "creeping" takeovers by requiring that once a shareholder, or several acting together, have acquired 40 percent of issued shares, an offer must be made to all shareholders at a fair price based on average share price over the previous six months. Once a shareholder holds a 95 percent stake in the company, the CSC may, at a minority shareholder's request, require the controlling shareholders to buy out the minority shares.

**Principle 1F: Not observed**

*Description of practice:* Institutional investors are neither required to vote their shares, nor to consider the costs and benefits of doing so. It is not common practice to disclose voting policies, and few institutional investors attend AGMs. In discussions with various institutional pension plan managers, asset managers were unable to cite a single instance where shareholders voted against a management recommendation, or where shareholders requested an extraordinary general meeting. Asset managers generally do not believe that the costs of pursuing remedies are worth the potential benefits.

*Policy recommendations:* Consideration should be given to requiring pension funds, investment funds and holding companies to disclose their voting policy as a fiduciary duty. In addition, while pension funds do not consider mandatory voting to be appropriate (given relatively low stakes in many large companies), greater awareness of international experiences in shareholder activism is desirable, particularly in light of previous abuses.

## Section II: The Equitable Treatment of Shareholders

**Principle IIA: Partially observed**

*Description of practice:* Joint stock companies may issue only common and preferred shares. The former typically carry one vote per share. The bylaws may allow a cap on voting rights, but without discriminating between shareholders. Preferred shares carry a fixed dividend payable in priority to dividends on common shares or distribution of liquidation proceeds. The Commercial Code requires that changes in voting rights attached to shares be approved by a 75 percent majority of the shareholders of that class attending the general meeting. Custodians are not legally required to obtain the consent of the beneficial owner prior to voting the owner's shares. In practice, most custodians seem to enter into contracts with institutional shareholders that allow the beneficial owner to send directions before voting shares.

*Policy recommendations:* A legal requirement on the custodian to obtain the beneficial owner's consent before voting shares should be considered. More specific procedures appear necessary, either by law or regulation, in order to ensure that shareholder meetings be held in reasonably convenient locations. Consideration should also be given to permitting shareholders to vote by mail, with electronic voting a possibility at a later date.

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<sup>15</sup> Com. Code Sec. 183a.

**Principle IIB: *Materially not observed***

*Description of practice:* Self-dealing and insider trading have been reported and appear to be pervasive (See Annex C). In 2001, the Czech Commercial Code was revised to address some issues related to self-dealing. Under the new provisions, the supervisory board's approval is required for any contract providing for the acquisition or disposition of assets worth more than one-third of the company's equity capital.<sup>16</sup> Also, if a company uses more than ten percent of its subscribed registered capital to pay for an acquisition, the transaction must be backed by an independent valuation; if the transaction occurs within three years of incorporation, shareholder approval is required.<sup>17</sup> A separate provision of the Commercial Code states that a contract is invalid if it provides for preferential treatment for a shareholder or a shareholder group.<sup>18</sup> This last provision is broadly worded, and does not appear to be limited with respect to any particular type of contract or particular parties.

Securities laws prohibit the use of inside information for personal benefit. Breaches of the law are punishable by fines up to CZK 20 million (USD 567,000). The CSC's monitoring unit watches for abnormal trading and investigates potential insider dealing activities. However, with only 130 employees, CSC's human resources are insufficient to fully monitor for insider trading and other abuses. The CSC has never successfully prosecuted an insider trading case. Under the Law on Auditing, a listed company's external auditor must report any breaches of law, including insider trading, of which he becomes aware during the audit. However, sanctions on external auditors for failure to report are unclear. Section 80c of the Securities Act requires the company to submit to the PSE – albeit within no specific timeframe - all information needed to protect shareholders interests or to ensure the public market's normal functioning. The PSE may require the company to publish the information, or may do so itself if the company fails to. PSE listing rules also require companies to make timely disclosure of material or price sensitive information.

*Policy recommendations:* The latest statutory provisions were written so as to reflect past abusive practices, but are so narrow that they may provide loopholes for those willfully choosing to evade particular self-dealing provisions. For example, a transaction involving over ten percent of the company's equity capital only requires shareholder approval (and, therefore, disclosure), if conducted within three years of company start-up. In addition, most existing provisions on potentially abusive self-dealing are written in the context of asset disposition, but do not address other types of self-dealing – e.g., leases or loans. For both self-dealing and insider trading, additional enforcement capacity is necessary, particularly at the CSC, to assure that there is a greater likelihood that fraudulent conduct is detected through enhanced market surveillance, and that resources exist to prosecute such cases. The role of auditors to report illegal activity could also be enhanced, pursuant to statutory provisions already in place.

**Principle IIC: *Materially not observed***

*Description of practice:* In the event a board member or manager purchases substantial corporate assets, the company must seek an independent review of the transaction's fairness and, if this occurs within three years of start-up, obtain prior shareholder approval.<sup>19</sup> Shareholders may

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<sup>16</sup> Com. Code Sec. 193(2).

<sup>17</sup> Com. Code Sec. 196a(3).

<sup>18</sup> Com. Code Sec. 178(11).

<sup>19</sup> Com. Code Sec. 196(3).

claim damages if approval procedures are not followed. Directors may be liable in a civil action for company losses. Shareholders with five percent or more of the shares (three percent for companies with issued share capital of 100 million CZK (USD 2.8 million)) may require the supervisory board to launch the civil action on the company's behalf.<sup>20</sup> If the board fails to do so, shareholders may sue directly. Besides the purchase of substantial company assets, there is no requirement that board members and managers disclose material interests in transactions entered into by the company. Moreover, as discussed in IIB, many of Czech legal provisions relating to disclosure are only applicable in the first three years. After that, while supervisory board approval is still necessary, shareholder approval is not required.

*Policy recommendations:* As in IIB, while recent amendments to the Commercial Code enhance the duty to disclose, there is still no overt requirement for all material interests involving a director or manager to be disclosed. In addition, substantial enforcement capacity should be added to ensure that companies comply with statutory provisions and regulations. Enhancement of the auditor role is also desirable.

### **Section III: The Role of Stakeholders in Corporate Governance**

#### **Principle IIIA: *Materially not observed***

*Description of practice:* In areas like equal opportunities for men and women, co-ordination of social security schemes among EU-member countries, health and safety measures, and labor law and working conditions, Czech workers have rights similar to those in EU countries.<sup>21</sup> As in Germany, employees of companies with over 50 employees may elect one third of the firm's supervisory board members.

Actions have been taken to enhance creditor rights, which in the past were not well respected. In 2000, a law facilitating foreclosures on security interests through public auctions was passed. In the case of a merger, the firm is obliged to publish information on the merger and draw creditors' attention to their rights; creditors may demand various assurances to protect their rights in the merged company. While there has clearly been progress, creditor rights reform is still needed. As in many EU countries, despite several amendments to bankruptcy law since 1991, the law still does not provide for a procedure allowing insolvent, but viable businesses to survive. Without such a reform, there is no practical alternative to liquidation of a debtor's assets. Such a procedure would hold off creditor claims while a restructuring plan is devised by a trustee, firm management, and a committee of creditors. Creditors have little say as to how a bankruptcy is conducted, by, for example, being able to select the administrator of the debtor's property. The current system also fails to differentiate well between large and small creditors, leading to misplaced priorities in a bankruptcy. The commercial register is not computerized. Finally, judicial reform is needed to ensure the enforceability of creditor rights. Cases are reported to last up to two years, and there are relatively few specialized bankruptcy judges. Moreover, courts operate under civil procedure rules, not specialized bankruptcy proceedings.

*Policy recommendations:* To enhance creditor rights, further amendments to the bankruptcy laws and/or regulations are needed to support reorganization of potentially viable businesses; ensure

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<sup>20</sup> Com. Code Sec. 182(2).

<sup>21</sup> Czech Republic – Toward EU Accession, at 90.

that court procedures upholding key creditors' rights; and support enhancements to the judicial process to ensure cases are efficiently reviewed.

**Principle IIIB: *Partially observed***

*Description of practice:* Employees, creditors and other stakeholders can exercise their rights in court, albeit within the framework of a legal system that is slow, inefficient and costly. Czech firms providing credit stress the practical difficulty of obtaining redress of their rights. Such creditors have frequently added cumbersome, otherwise-unnecessary contract provisions to ensure protection of their claims.

*Policy recommendations:* Further work is needed to enhance judicial resources to ensure that there are efficient, effective and not unduly costly mechanisms to enforce legal rights. Statutory or regulatory provisions may also need to be refined to address certain weaknesses.

**Principle IIIC: *Partially observed***

*Description of practice:* The Czech Republic permits stock options and similar mechanisms to align employee and management interests. However, such mechanisms do not seem widespread, and the lack of liquidity in all but the largest firms may make stock options an unattractive way to reward employees. Any movement to increase stock option use would need to take into account the lessons learned from other jurisdictions.

**Principle IIID: *Largely observed***

*Description of practice:* In larger companies, where employees elect one third of the supervisory board, employees have broad access to material information. In addition, banks often serve on the supervisory board of companies with which they have commercial relations. While employees do not elect supervisory board members of smaller companies, problems concerning disclosure to employees and other stakeholders do not raise particular concern among market participants.

## **Section IV: Disclosure and Transparency**

**Principle IVA: *Partially observed***

*Description of practice:* Recent Commercial Code amendments ensured that Czech disclosure requirements substantially conform with the Fourth and Seventh EU Company Law Directives. Listed companies must submit an annual report to the CSC<sup>22</sup> and shareholders within four months of the fiscal year's end. The report must provide a true, fair view of the company's financial status, business activities and economic results, as well as future prospects. The report must disclose aggregate director and manager remuneration, and board member and executive shareholdings. Semi-annual audited statements must also be issued by listed companies.

Companies are required to disclose major share ownership by informing the CSC and the Securities Center of a five percent shareholding acquisition and subsequent five percent increments, along with blocking stakes of one-third and two-thirds. Disclosure of corporate governance structures and policies is not required. While companies must disclose all material information, practices appear uneven among Czech companies with respect to dissemination and

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<sup>22</sup> Companies that are not listed must still issue a report, but need not file it with the Securities Commission.

analysis of material foreseeable risk factors, as well as long-term company objectives, such as in the case of IPB and others.

*Policy recommendations:* Current regulations on financial disclosure appear adequate, but enforcement remains a question. Providing greater resources to the CSC to review semi-annual and annual filings would motivate companies to comply with both the spirit and letter of the regulations and would promote consistency in disclosure across industries. Particular scrutiny should also be paid to disclosure of material risk factors and company objectives. Informal guidance by the CSC to issuers may help in clarifying the type of information needed in company reports. Czech regulators should also consider requiring outlining of governance structures and policies in company reports. Consideration should also be given to mandatory quarterly reporting for all listed firms, rather than relying on PSE rules, in accordance with recommendations made by European securities markets regulators.

**Principle IVB: *Materially not observed***

*Description of practices:* Financial reporting is based on Czech accounting principles as defined in the Accounting Law and regulations issued by the MOF. Czech Accounting Standards conform broadly to the EU Fourth and Seventh Directives and with International Accounting Standards (IAS). However, tax compliance is still emphasized over full, accurate reporting for shareholder, employee and creditor benefit. The MOF controls the preparation of changes to accounting principles which Parliament must approve. Changes are thus slow and influenced by fiscal, rather than business, considerations. However, given a general transition to IAS, which will be mandatory for EU listed companies in 2005, it is unclear whether great resources should be devoted to developing national standards. As of January 2001, PSE listing rules require listed companies on the PSE's Main market to complete their financial statements in accordance with IAS. Even before the PSE rule change, most large companies had begun to utilize IAS. In general, the movement towards IAS is coming from companies, rather than the government. It should be noted that, while differences exist between the IAS and Czech GAAP (e.g., segment reporting is undeveloped, the lack of detailed rules on consolidated reporting), the primary issue is one of enforcement and actual practice. To the extent that the implementation of IAS is voluntary and not mandatory (at least, not until mandatory EU adoption in 2005), a question remains about the ability of regulators to sanction for non-compliance.

Czech Auditing Standards comply with International Standards on Auditing (ISA), although consistent application is not assured. The Chamber of Auditors has statutory licensing powers and a disciplinary function. The Chamber has so far not been proactive in monitoring its members' activities, but changes are expected in this area. Current fines are too low (CZK 500,000 (USD 14,174) for individuals, and CZK 1 million (USD 28,350) for firms), to serve as a real deterrent. The Chamber does not yet have a professional body of full-time overseers. Between 1994 and 2000, about 100 complaints about auditors were filed, and of those, about 30 are still in progress, with another 34 resulting in a fine and 36 in a warning. While the Act on Auditing provides for the concept of auditor independence, independence may be eroded by the common practice of leaving appointment and removal of external auditors to management. An auditor's removal mid-year often signals strong disagreement as to the audit function or the completeness of reporting. In the case of IPB, the auditor was fired during the audit, and another auditor brought in who issued an unqualified report, notwithstanding major problems that later led to the forced administration and sale of the bank. Auditors can be sued by the company or by

shareholders if the auditors improperly conduct the audit and a loss to the company or shareholders results. Auditors must insure against liability claims; there is no cap on liability. The Union of Internal Auditors is trying to raise awareness of the internal auditor role and to encourage better practices in selection and work of internal auditors.

*Policy recommendations:* As the transition to IAS accelerates prior to mandatory adoption in 2005, steps should be taken to enhance compliance with the new standards. A stronger judiciary in this regard is critical. While, in some cases, auditors have been sued for improper examinations, no case has yet been resolved. The Chamber of Auditors appears to be progressing with respect to oversight of the profession, but it still needs to buttress its discipline and enforcement functions, partly by hiring full-time staff to engage in enforcement. The severity of fines that the Chamber imposes should be increased, perhaps according to the size of the enterprise involved.

**Principle IVC: Largely observed**

*Description of practice:* Changes to the Accounting Act lowered the threshold for conducting an annual audit, and audits are now required when two of three criteria are met: (i) net revenues exceed CZK 80 million (USD 2.3 million) in the current and prior year, (ii) firm aggregate capital of CZK 40 million (USD 1.1 million) and (iii) the average number of employees over the last two years is more than 50. The company may select any licensed auditor. The supervisory board need not include an auditing committee, although there is a tendency among larger public companies to have one.

As of January 2001, auditors of banks, pension funds, mutual funds and insurance companies must inform the regulator of a breach of law, the existence of a tangible threat to the company's viability, or of circumstances that may lead to the issuance of a qualified audit opinion.

*Policy recommendations:* In the past, managers sometimes removed auditors who reported unfavorable financial information. An auditor's removal should require shareholder approval in the general meeting, in addition to supervisory board approval.

**Principle IVD: Largely observed**

*Description of Practice:* In general, disclosure practices appear satisfactory. In addition to annual reports, listed companies must also submit a half-yearly report to the CSC and shareholders. Companies are required to publish the reports in the form of an announcement in one or more nationally distributed daily newspapers or in an abridged form provided free of charge by the issuers. The Securities Center and the CSC also have copies of the annual reports, which are accessible to the public. Company information is available through the publicly accessible company register, though access is not always easy.

## **Section V: The Responsibilities of the Board**

**Principle VA: Partially observed**

*Description of practice:* Supervisory and management board duties are enumerated in the Commercial Code<sup>23</sup> and are also included in laws relating to investment funds, investment companies, pension plans and banks. The supervisory board must have at least three members,

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<sup>23</sup> Com. Code Secs. 191-201.

and thereafter, in multiples of three. Employees of companies with over 50 workers elect one third of the supervisory board. The supervisory board is concerned with overall company framework issues, such as checking compliance with the legal and regulatory framework. It must ensure that the management board carries out corporate policies and decisions in areas like strategy, corporate finance and risk management. The management board's duties focus on implementing corporate policy, selecting company managers, carrying out day-to-day management, and preparing decisions for the supervisory board and/or attendees of the general shareholder meeting to consider. Management board directors must act in the company's interests; the company may sue them if they fail to.<sup>24</sup> Minority shareholders representing at least five percent of the issued capital, or three percent for companies with capital of at least CZK 100 million (USD 2.8 million), may demand that the management board take action. If the board does not, the shareholders may initiate an action, although such actions are infrequent.<sup>25</sup> Cases have been reported where directors looted company assets for personal gain, or permitted others to "tunnel" assets.

*Policy recommendations:* The score is based on practice, rather than formal requirements, which generally appear to be consistent with Germany's and those of other EU countries with dual-tier board structures. While instances of directors failing to prevent misappropriation of corporate assets appear to be declining, such failures still appear to be occurring.

#### **Principle VB: *Partially observed***

*Description of practice:* Shareholders elect both supervisory and management board members, although the Commercial Code permits the supervisory board to select the management board if the bylaws grant such powers.<sup>26</sup> However, minority shareholders have little say over the appointment or removal of board members, a process dominated by majority shareholders, such as in the case of CEZ and other companies (See Annex C). Cumulative voting for directors is not permitted. For this and other reasons, there are some situations in which a majority shareholder, through his board representatives, has dominated companies and management decisions, at the expense of minority shareholder interests. In addition, exercising rights in the courts is reported to be slow and costly. Yet, there have been cases where minority shareholders unnecessarily delayed important corporate proceedings, such as in the case of IBP, where a minority shareholder was able to prolong a firm's restructuring after it was clearly insolvent.<sup>27</sup>

*Policy recommendations:* While cases of minority shareholder rights abuses seem to be declining, further efforts to enhance minority shareholder rights is suggested. This could include removing the prohibition on cumulative voting, at least for directors for which the employees do not vote directly. Better judicial enforcement is also needed. However, to prevent minority shareholders from blackmailing management with protracted delays, limits could be imposed on very small shareholders to prevent their imposing unwarranted obstacles to basic corporate decisions. Special attention should also be paid to the CSC's corporate governance code's (CSC

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<sup>24</sup> Com. Code Sec. 193.

<sup>25</sup> Com. Code Sec. 181 (3).

<sup>26</sup> Com Code Sec. 194.

<sup>27</sup> This problem has been highlighted in contrast to the experience of some other transition economies, such as Romania. See, for example, OECD Policy Brief, "Economic Survey of the Czech Republic 2001," *OECD Observer*, 2001 and Victor Kaznovsky, "Implementation of the EC Directives Regarding Capital Markets in Romania and the Czech Republic," March 2001.

CG Code) emphasis on independent supervisory board members “whose authority arises from their election by the minority shareholders.”<sup>28</sup>

**Principle VC: *Partially observed***

*Description of practice:* Company directors appear to generally respect employee rights, although cases have been reported where directors have not taken into account creditor interests.<sup>29</sup> Management board directors failing to act in the company’s interests may be liable to the company<sup>30</sup> and to shareholders representing at least five percent of the issued capital, or three percent for companies with a capital of CZK 100 million (USD 2.8 million).<sup>31</sup> As of January 2001, persons who can substantially influence the company bear the same liability as directors. It is unclear how well this new liability feature is enforced.

*Policy recommendations:* Based on concerns raised in Section III, efforts should be made to help directors properly understand stakeholder rights, particularly creditor rights. This means training in the importance of seeking legal counsel, an issue highlighted in the CSC CG Code. However, since at times the problem is not one of absent knowledge but willful disregard, improvements in court system efficiency may also be needed, as this would encourage private parties to enforce their rights in court.

**Principle VD: *Partially observed***

*Description of practice:* The management board prepares the financial statements (including ordinary, extraordinary, consolidated, and if relevant, interim financial statements) of the company and sends them to the shareholders at least 30 days prior to the general meeting<sup>32</sup>. However, directors often include insufficient information on risk factors and company objectives to give investors a comprehensive view of the company’s medium and long-term potential. Regarding management selection and monitoring, the supervisory board often lacks sufficient independence from management and makes it difficult for the board to fulfill its fiduciary duties. It is not yet the norm in Czech companies for the supervisory board to establish a nominating committee, although the practice has begun in some larger firms. There appear to be no formal processes within boards for reviewing management and board remuneration. With respect to monitoring and managing potential conflicts of interests, as discussed in IIB, while the Commercial Code has been amended to prohibit certain types of self-dealing by directors, other transactions are not covered. There appear to have been cases where directors permitted the misuse of corporate assets. Concerning auditing and accounting, at this time most companies lack audit committees. Directors do not now routinely monitor the effectiveness of governance practices. Awareness of the importance of disclosure and communication has increased, and it appears that in many companies, directors fulfill their fiduciary duties in this regard.

*Policy recommendations:* Supervisory and management board directors must be better trained to help them fulfill their fiduciary duties, particularly with respect to non-financial statement

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<sup>28</sup> Securities Commission CG Code 2.7. The CSC finalized a Corporate Governance Code based on the OECD Principles and the Combined Code of the London Stock Exchange in February 2001. Czech Institute of Directors (IOD) representatives participated in the working group that drafted the Code, which is recognized as having superseded an earlier Code drafted directly by the IOD.

<sup>29</sup> The mission team’s discussions with a number of issuers, such as Ceska Sportelna, revealed that creditors feel obliged to write in very strict stipulations and conditionalities into their contracts to protect themselves.

<sup>30</sup> Com. Code Sec. 194(5).

<sup>31</sup> Com. Code Sec. 181(5).

<sup>32</sup> Com. Code Sec. 192.

disclosure, governance practices, and supervisory board duties in properly monitoring, hiring and firing management. The routine establishment of nomination, remuneration and audit committees within the supervisory board is desirable (*see* VE below), along with appropriate training programs for directors selected for such positions.

**Principle VE: *Partially observed***

Description of practice: The concept of assigning duties like nomination, remuneration and audit to specific board members is fairly new and not yet standard practice. The amount of time that boards devote to their duties varies among companies, but this is not seen as a problem. The CSC CG Code recommends organizing the supervisory board into various committees, including audit, nomination and remuneration committees, and calls for audit committees to be comprised *solely* of independent directors. While larger Czech companies have increasingly sought to place independent directors on their boards, many others have not yet met the Code's recommendation for 25 percent independent directors.

Policy recommendations: Adoption of the Czech CG Code proposals for audit, nomination and remuneration committees, as well as adoption of the Code's recommendations for the overall level of independent directors.

**Principle VF: *Largely observed***

Description of practice: As discussed above, management board members prepare company financial statements and comprise key members of management. Supervisory board members do not appear to have trouble obtaining access to relevant information.

#### IV. SUMMARY OF POLICY RECOMMENDATIONS

This section summarizes policy recommendations to improve listed companies' compliance with the OECD Principles of Corporate Governance. The next step is the development of a detailed action plan. The action plan should be formulated in close cooperation with the Czech authorities and in consultation with the private sector and other stakeholders.

Legislative reform: The 2001 changes to the Czech Commercial Code signal major progress. Still, opportunities for improvement remain. With respect to related party transactions, legislative changes should address various types of self-dealing not covered under current rules. Similarly, as regards creditor rights, despite several bankruptcy law changes, further reforms are needed to facilitate reorganization of insolvent companies, as well as procedural reforms to enhance creditor rights (e.g. allowing creditors to select an administrator of the debtor's property). Regarding shareholder voting, companies should be required to hold shareholder meetings at reasonably convenient locations. Institutional investors, including pension plans, investment funds and holding companies, should disclose their voting policies. Corporate governance structures and policies should be required to enhance shareholder review of these issues. Consideration should be given to permitting cumulative voting to strengthen the influence of small shareholders in the selection of supervisory board members. Shareholder approval at the AGM, as well as supervisory board approval, should be required for an auditor's removal.  
*Priority: high*

Institutional strengthening: While changes to legal regimes are critical, an equally important task is to ensure enforcement of existing laws and regulations. Court proceedings are reported to be

inefficient, slow, and costly, an issue that is especially problematic with respect to creditor rights. In addition, lack of judicial enforcement leads to a widespread belief that corporate misdeeds will go unpunished. Measures to be taken include speeding up the process and reducing the cost of court proceedings, and reassessing salaries for court officials, particularly judges.

Although the CSC now has added powers to impose fines, it is short-staffed and has never been able to close any insider trading cases. It needs more resources to deter and detect various securities violations. In addition, with respect to auditing, the Chamber of Auditors has insufficient powers to perform credible oversight of its members, it should be able to impose higher fines, and it needs staff exclusively dedicated to oversight of the profession. *Priority: high*

*Voluntary/private initiatives* – The CSC CG Code highlights the fact that many Czech directors do not fully understand the concept of shareholder value. The Czech IOD seems ready and able to conduct substantial training to raise awareness and understanding among Czech directors and those potentially destined to become directors, but needs more resources to implement comprehensive programs. It would also be desirable for the Czech IOD to cooperate with relevant organizations in other transition economies in the region. Finally, it would be desirable for firms to adopt voluntarily audit, remuneration and nomination committees. *Priority: medium*

## **ANNEX A: OECD PRINCIPLES OF CORPORATE GOVERNANCE**

### **Section I. The Rights of Shareholders**

*The corporate governance framework should protect shareholders' rights.*

- A. Basic shareholder rights include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect members of the board; and 6) share in the profits of the corporation.
- B. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorization of additional shares; and 3) extraordinary transactions that in effect result in the sale of the company.
- C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:
  - 1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
  - 2. Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.
  - 3. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.
- D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.
- E. Markets for corporate control should be allowed to function in an efficient and transparent manner.
  - 1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.
  - 2. Anti-take-over devices should not be used to shield management from accountability.

- F. Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

## **II. The Equitable Treatment of Shareholders**

*The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.*

- A. All shareholders of the same class should be treated equally.
  - 1. Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.
  - 2. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
  - 3. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.
- B. Insider trading and abusive self-dealing should be prohibited.
- C. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

## **III. The Role of Stakeholders in Corporate Governance**

*The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.*

- A. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.
- B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.
- C. The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.
- D. Where stakeholders participate in the corporate governance process, they should have access to relevant information.

#### **IV. Disclosure and Transparency**

*The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.*

- A. Disclosure should include, but not be limited to, material information on:
  - 1. The financial and operating results of the company.
  - 2. Company objectives.
  - 3. Major share ownership and voting rights.
  - 4. Members of the board and key executives, and their remuneration.
  - 5. Material foreseeable risk factors.
  - 6. Material issues regarding employees and other stakeholders.
  - 7. Governance structures and policies.
- B. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.
- C. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.
- D. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

#### **V. The Responsibilities of the Board**

*The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.*

- A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
- B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
- C. The board should ensure compliance with applicable law and take into account the interests of stakeholders.
- D. The board should fulfill certain key functions, including:
  - 1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring

implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
  3. Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
  4. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
  5. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.
  6. Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
  7. Overseeing the process of disclosure and communications.
- E. The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.
1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.
  2. Board members should devote sufficient time to their responsibilities.

In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

## ANNEX B: OECD PRINCIPLES-ASSESSMENT MATRIX

### Section I: The Rights of Shareholders

Principle IA. Basic shareholders rights:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IB. The right to participate in decisions on fundamental corporate changes:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IC. The right to be adequately informed about, participate and vote in general shareholders' meetings (AGM):

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle ID. Disclosure of capital structures and arrangements enabling control disproportionate to equity ownership:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IE. Efficient and transparent functioning of market for corporate control:

(a) Observed	<input checked="" type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IF. Requirement to weigh costs/benefits of exercising voting rights:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input checked="" type="checkbox"/>		

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### Section II: Equitable Treatment of Shareholders

Principle IIA. Equal treatment of shareholders within same class:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IIB. Insider trading and abusive self-dealing should be prohibited:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input checked="" type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IIC. Disclosure by directors and managers of material interests in transactions or matters affecting the company:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input checked="" type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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### Section III: Role of Stakeholders in Corporate Governance

Principle IIIA. Respect of legal stakeholder rights as established by law:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input checked="" type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IIIB. Redress for violation of rights:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IIIC. Performance-enhancing mechanisms for stakeholder participation:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IIID. Access to relevant information:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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### Section IV: Disclosure and Transparency

Principle IVA. Timely and accurate disclosure of material information:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IVB. Preparation of information, audit, and disclosure in accordance with high standards of accounting, disclosure and audit:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input checked="" type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IVC. Annual audit by independent auditor:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle IVD. Channels for disseminating information allow for fair, timely, and cost-efficient access to information by users:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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### Section V: The Responsibilities of the Board

Principle VA. Act on an informed basis, in good faith, with due diligence and care, in the best interest of the company and shareholders:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle VB. Fair treatment of each class of shareholders:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle VC. Compliance with law and taking into account stakeholders' interests:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle VD. Fulfillment of key functions, including corporate strategy, selection and monitoring of management, remuneration, board nomination, monitoring of conflict of interest including misuse of corporate assets and abuse in related party transactions, integrity of accounting ,audit, governance practices and overseeing disclosure and communication:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle VE. Objective judgment on corporate affairs independent from management; devotion of independent time:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input type="checkbox"/>	(c) Partially observed	<input checked="" type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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Principle VF. Access to accurate, relevant, and timely information:

(a) Observed	<input type="checkbox"/>	(b) Largely observed	<input checked="" type="checkbox"/>	(c) Partially observed	<input type="checkbox"/>
(d) Materially not observed	<input type="checkbox"/>	(e) Not observed	<input type="checkbox"/>		

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*This table attempts to summarize the current provisions in the country, benchmarked against the items set out in the **OECD Principles of Corporate Governance**.*

**Observed** means that all essential criteria are generally met without any significant deficiencies. **Largely observed** means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability

and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the OECD Principles, practices and enforcement diverge. **Materially not observed** means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means that no substantive progress toward observance has been achieved.

*Any comments are welcome*

## ANNEX C: Cases of Corporate Governance Abuse in the Czech Republic

### Box 1: Transparency, Disclosure and Asset-Stripping in the Banking Sector: The Case of IPB

The collapse of the Investment and Postal Bank (Investiční a Poštovní banka or IPB) caused a major corporate governance scandal in the Czech Republic in 2000, highlighting the precarious economic and financial structures resulting from the country's path to privatization. IPB, then the country's third largest bank, held a portfolio across numerous sectors totaling a quarter of GDP, and the collapse caused ripple effects throughout the economy. Since 1998, when privatization of the banking sector began, IPB's Board of Directors allowed reserves to fall short by CZK 40 billion and in early to mid 2000 alone, diverted funds of CZK 57 billion through a complicated network of offshore holding companies for personal benefit. In addition to making misleading statements about the bank's position, they granted loans without assessing risks, lending, in some cases, to some of the Czech Republic's poorly-managed companies. The lack of transparency and IPB's poor disclosure practices were bolstered by its financial interests – also under murky ownership structures - in the Czech media, particularly Nova TV, which underreported abuses and covered IPB in glowing terms.

Poor disclosure also allowed IPB to manipulate auditing and accounting results. When a 1997 Coopers & Lybrand audit yielded poor findings, IPB hired Ernst & Young, whose results painted a rosier picture. IPB also transferred bad debts off its books to those of subsidiaries offshore, where more relaxed banking regulations prevail.

Some problems had been apparent to national banking authorities for some time, and they tried to curb abuses and improve IPB's financial prospects by selling a 36% share to Japanese bank Nomura; Nomura, however, treated it as a portfolio investment and soon exited – by transferring its IPB shares to Saluka, a Dutch “special purpose vehicle” - with a tidy profit from the sale of two IPB-owned breweries, as the bank slid further into insolvency. After reports of IPB's dealings began to become public, there was a run on deposits, and the Czech National Bank placed the bank under receivership before finally selling to a Belgian owner.

By IMF estimates, banking system restructuring has probably cost Czech taxpayers CZK 430 billion, although only a third of it has been written off in the government's budget.

In June 2001, after most of its bad debts had been expunged, IPB was sold to Ceskoslovenska Obchodni Banka (CSOB), the fourth-ranking former Czechoslovak Foreign Trade Bank, making CSOB, the largest Czech bank. (Interestingly, even CSOB did not have an opportunity to review the details of IPB's books before the sale.) KBC Group, CSOB's Belgian owner, received a state guarantee against any further inherited IPB loan losses.

The long delay before subjecting the Czech Republic's principal banks to strong corporate governance is largely why the banking bailout has been so costly. Former premier Vaclav Klaus, who pushed through the country's pro-market reform program, has since stated that bank privatization was put off because it would have reduced the credit flows depended upon by most Czech companies.

#### Sources:

*“Czech Republic - Better Late Than Never,” The Banker, January 2, 2002.*

*Jan Culik, “Dodgy Bankers.” Central Europe Review, Vol. 2, No. 25-26, June 26, 2000.*

*Lisa Gronderinger, “Picking Up the Pieces,” The Prague Post/Business and Finance, December 7, 2000, p. 2.*

*Marek, Loula, “PSE Still Reeling from IPB Fallout,” Prague Business Journal, June 26, 2000, p. 23, Capital Markets.*

*Lisa Gronderinger, “Assessing the Blame,” The Prague Post/Business and Finance, June 21, 2000, p. 2.*

*Ray Furlong, “Heads Roll in Czech Bank Scandal,” BBC News Online, February 4, 2001.*

**Box 2: Transparency, Hostile Takeovers and Abuse of Minority Shareholders: The Case of Motoinvest**

In October 1995, an anonymous organization embarked on a high-powered television ad campaign directed at scaring small shareholders into believing that their shares, acquired through voucher privatization, would become worthless due the dealings of unscrupulous managers and major shareholders at privatized companies. The advertiser, later identified as private investment firm Motoinvest, achieved its goal, encouraging small investors to dump their shares quickly and cheaply, despite attempts by other investors and analysts to allay market fears. (Motoinvest has also attempted to gain significant influence in the banking sector through hostile takeovers of some banks' investment funds.)

At the time, there were low barriers to entry into the broker dealer market, leading to the proliferation of over 400 such firms, which eagerly facilitated the buy-up of these shares. The ad campaign had several important consequences: 1) it led to a rapid concentration of ownership in a small number of highly opaque owners; 2) it led to further leveraging of Czech businesses, since many of the buy-outs were leveraged by easily-obtained bank loans; 3) it precipitated a process whereby oligopolies could gain quick control of a given company. In most cases, the controlling stakes were sold and purchased at prices above company NPV.

The event helped speed amendments to capital market legislation in the Czech Republic in 1996, including the Law on Investment Funds and Investment Companies, the Securities and Exchange Act and the Commercial Code. However, this did not occur before great costs had been incurred by taxpayers and some privatized companies had suffered irreparable damage to their liquidity.

*Sources:*

*Jana Matesova, The World Bank Group, Visiting Scholar, Development Economic Research Group. "Banking Turbulence in the Czech Republic and the "Bad Boys" from Motoinvest," Transition Newsletter, September-October 1996, The World Bank Group, based on reports of news agencies, the Open Media Research Institute, and Oxford Analytica, an Oxford, U.K.-based international research group.*

**Box 3: The Government as Major Shareholder and Minority Shareholder Abuse: The Cases of Ceske Energeticke Zavody and Others**

In 1998, the Czech government embarked on an attempt to align government and company interests within the framework of privatization. The intervention of the government as a major shareholder has led to apparently arbitrary changes at the upper levels of company governance, much to the dismay of minority shareholders. The government's stake, represented by the National Property Fund (NPF), takes control by calling special shareholder meetings without announcing their purposes and replacing managers and even entire boards with their own personnel.

Once case in point in January 1999 was that of monopolist electricity vendor Ceske Energeticke Zavody (CEZ). When the NPF called a meeting, company directors and managers could learn little about the agenda, despite submitting an official request for details. At the time, the NPF Fund held 67% of the company. When the meeting was convened, NPF representatives dismissed five of seven supervisory board members and all seven management board members, replacing at least some with government officials.

Over the next two months, the NPF made similar moves against oil producer Unipetrol, the country's first and second largest banks, Komerčni Banka and Ceska Sportitelna, and communications company SPT Telecom.

The results of such moves by the government majority stakeholder has often been less than favorable. The new directors are generally politicians with little business or governance experience, and government objectives vis-à-vis company performance are often at odds with profit motive. For example, with utilities, the government directors often favor strategies aimed at helping consumers over the company.

*Source:*

*Joseph Sargent, "No Way to Privatize," Global Finance, New York, April 1999.*