

Instruction Sheet – Privatized Transition Economy Companies

The Governance of Privatized Transition Economy Companies

Privatized Transition Economy Companies are the result of the mass privatization programs of the successor states of the former Soviet republics. The “instant corporations” created in the 1990’s experienced a decade of turmoil as controlling stakes changed hands, often through mechanisms less than completely transparent. Many privatized companies have emerged with an ownership structure that includes a controlling shareholder or group of shareholders (sometimes of uncertain identity) as well as a large number of employee or public shareholders with very small holdings, none of whom have made any substantial economic investment in the company. This situation, with controllers who have neither built nor provided capital to the firms and minority shareholders who are not economic investors, combined with an uncertain regulatory and enforcement environment, has resulted in poor corporate governance of historic proportions. Some companies have gone on to list their shares in international markets, subjecting themselves to higher corporate governance standards in the process. It is now possible to identify some corporate governance leaders in these countries, but many have only just begun to consider improving their corporate governance.

Frequent abuses of the rights of minority shareholders in the transition economies have played a large role in limiting portfolio and direct investment, especially foreign investment. Because of their unique history and characteristics Privatized Transition Economy Companies constitute a unique paradigm calling for their own set of tools. The Instruction Sheet, Progression Matrix, Information Request List and Sample CG Improvement Program for Privatized Transition Economy Companies take into account this history and the resultant unclear ownership structures, evolving regulatory regimes and spotty enforcement mechanisms to be found in transition economies. In some transition countries, a two-tiered board model of corporate governance has served as the model for privatizing companies. In many cases, despite a legal structure that points to a two tiered model, practice is developing more along the lines of the Anglo-American unitary board model. For those companies that are strictly following the two-tiered board (Supervisory Board) model, it may be useful to review the information request list developed specially for companies in supervisory board systems.

Using the CG Tools

There are seven key CG Tools that are used for analyzing the governance of potential IFC investee companies. The explanatory note “Why Corporate Governance?”, the Model Independent Director Definition and the Supervision Checklist are applicable across all five paradigms without any adaptations.

- 1) **Instruction Sheet – Privatized Transition Economy Companies** The purpose of this Instruction Sheet is to describe each of the key CG Tools, how they should be used and who should be interviewed in the course of the Corporate Governance Review. (A full description of the Step-by-Step Process for analyzing the governance of companies is provided in the section of the website “Applying the IFC Methodology”.)
- 2) **Why Corporate Governance?** This note explains IFC’s approach as value-added for clients. *This explanatory note should be given to the client at the earliest opportunity in the pre-appraisal.*
- 3) **Progression Matrix – Privatized Transition Economy Companies** The Progression Matrix relates the five areas of governance (Commitment to Good CG, the Board of Directors, Control Environment and Processes, Transparency and Disclosure and Shareholders Rights) to four levels of achievement. The use of a matrix framework emphasizes the importance of ongoing improvements in the governance practices of clients, rather than trying to apply rigid and static minimum standards. In particular, the Progression Matrix allows clients to assess the governance of their own company against a simple framework which is adapted to fit the challenges faced by owners, boards and managers of these firms. *The Progression Matrix should be given to the client at the earliest opportunity in the pre-appraisal.*
- 4) **Information Request List – Privatized Transition Economy Companies** This list of questions and requests for documentation forms the basis for the Corporate Governance Review of an IFC client. The Information Request List is organized along the same lines as the five areas of governance in the Progression Matrix. *The Information Request List should be circulated to the company at least three weeks in advance of the on-site Corporate Governance Review.* The company should identify a single officer who will be charged with responding to the Information Request List by providing brief written answers of one or two paragraphs to each of the questions and deliver these to IFC *prior to* the on-site Corporate Governance Review. Discussions relevant to IFC’s understanding of the governance of a company will arise throughout the appraisal and diligence process. Therefore, IFC staff is encouraged to edit the Information Request List as necessary before sending it to the client, so as to avoid duplication or questions not relevant to the client’s stage of development.
- 5) **Model Independent Director Definition** Perhaps the most frequent governance recommendation is to increase the Board’s independence from both the management and the controlling shareholders. This Model Independent Director Definition is often used during discussions with the client to clarify the assessment of the current Board and its future needs.
- 6) **Sample CG Improvement Programs – Transition Economy Companies** In many cases, the Corporate Governance Review will result in the drafting and negotiation of a Corporate Governance Improvement Program to be implemented by the client. This CG Improvement Program should always be tailored to the circumstances and priorities for the company. However, these Model CG Improvement Programs give a good idea of what has been negotiated with clients in the past and, therefore, they can be used as a reference.
- 7) **Supervision Checklist** The Supervision Checklist provides a list of key issues that should be considered by investment staff while supervising IFC investee companies and, in particular, those companies undertaking CG Improvement Programs.

Corporate Governance Interviewees

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To carry out a thorough Corporate Governance Review, IFC staff need to have direct discussions with people who play a variety of governance roles in the company. A list of the people who would normally be interviewed is provided below. It is important that IFC staff meet with those who, as a practical matter, are responsible for the principal corporate governance functions, irrespective of their job titles.

- Representatives of controlling shareholders
- Representatives of other holders of significant blocks of shares
- Chairperson and members of the Board of Directors, including any “independent” Board members and the chairs of the audit and other special committees of the Board (and where applicable, members of the Inspection/Revision/Audit Committee).
- Chief Executive Officer
- Chief Financial Officer (or senior accounting officer)
- General Counsel (or senior lawyer)
- Corporate Secretary
- Chief of Internal Audit and Internal Controls
- Chief of Investor Relations
- Independent External Auditors
- Independent Registrar
- External Corporate Governance Advisors
- Minority Shareholders (especially those with past or current disputes with the Company)

Some special cases

a) Transition Economy Financial Institutions

With more than a quarter of IFC’s portfolio in financial institutions, the CG Unit has developed a paradigm and CG Tools for these clients. IFC staff working with listed financial institutions should use the Financial Institutions paradigm, rather than the Privatized Transition Economy Company paradigm. Due to their financial complexity and, in most cases, the presence of public depositors, financial institutions pose special governance risks. The failure of financial institutions and, in particular, banking failures, can also have systemic implications.

b) Transition Economy Companies with ADR programs

Transition economy companies with publicly traded ADR programs (NYSE or NASDAQ listings) are subject to most of the requirements of the 2002 Sarbanes-Oxley Act and the NYSE or NASDAQ listing rules. In the past, foreign issuers in the US markets were exempted from many of the governance requirements applicable to US domestic issuers, but from now on, these exemptions will be much more limited in scope. Therefore, companies with (or planning) ADR programs will need to improve their governance practices in a variety of areas, such as the independence of the Board and the role and composition of the audit committee. IFC staff working with companies that have such listings should use the Listed Company paradigm tools though elements of the Privatized Transition Economy Company paradigm may still be useful.

c) Family-Owned Transition Economy Companies

The consolidation of shareholding in many Privatized Transition Economy Companies has given them some of the same corporate characteristics found in family-owned firms around the world. Often, the “family” may consist of a group of business or political partners who work in concert to protect their interests and who are now reaching the age where the next generation is beginning to get involved in the “family” business. In these cases it may make sense to take a look at the CG tools for family-owned firms on the IFC CG website for information on issues such as succession planning, appointing outside directors for strategic business development and employing professional managers in the family firm setting.

d) SMEs in Transition Economies

SME funds and cooperation with smaller, entrepreneurial companies is critical to the development of the transition economies. Where applicable, IFC staff may want to make IFC’s corporate governance resources available to start-ups which are heavily reliant on outside capital in order to aid them in long-term planning towards an eventual public listing. Educating our SME clients about good governance will aid in meeting our goals of long-term sustainable development.

e) State-Owned Transition Economy Companies

In some cases, IFC may participate in the privatization of transition economy companies to help develop the private sector in a member country. In these cases, IFC has a unique opportunity to shape the governance structure at the company being privatized. As these are often high profile deals, the demonstration effect of improved governance being tied to improved access to capital can have a strongly positive impact on the entire market.