

Corporate Governance Code based on the OECD Principles (2004)

Table of contents

Introduction.....	3
CHAPTER I. Ensuring the Basis for an Effective Corporate Governance Framework (new OECD)	7
Commentary on Chapter I.....	7
CHAPTER II. The Rights of Shareholders and Key Ownership Functions (new OECD)	9
Commentary on Chapter II.....	11
CHAPTER III. The Equitable Treatment of Shareholders	15
Commentary on Chapter III.....	15
CHAPTER IV. The Role of Stakeholders in Corporate Governance	18
Commentary on Chapter IV.....	18
CHAPTER V. Disclosure and Transparency	20
Commentary on Chapter V.....	21
CHAPTER VI. The Responsibilities of the Board of Directors and the Supervisory Board.....	26
Commentary on Chapter VI.....	27
ANNEX 1. Compliance with the 1999 OECD Principles of Corporate Governance in the Czech Republic: Evaluation by the World Bank and International Monetary Fund, July 2002	34
ANNEX 2. Corporate Governance Board Committees	36
Introduction.....	36
➤ THE AUDIT COMMITTEE.....	36
Sample Terms of Reference.....	36
➤ THE REMUNERATION COMMITTEE	38
Sample Terms of Reference.....	38
➤ THE NOMINATION COMMITTEE	39
Sample Terms of Reference.....	40
ANNEX 3. A Guide To Best Practice For Executive Boards.....	41
Introduction.....	41
Background.....	41
The Board and Management.....	43
The Performance of the Direction of the Company	44
The Supervisory Board	46
The Organisation and Management of Boards.....	47
Board Members.....	48
Liability of Members of the Executive and Supervisory Boards	50
Accountability of members of the Executive and Supervisory Boards.....	51
The Executive Board's Relations with Associated Parties	52
Conflicts of Interest.....	54
Director's Duties.....	55
Service Contracts	56
Loans to Board Members.....	56
Directors' Shareholdings	57
Standards of Care.....	58
The Statutory Bodies Report.....	58
Annual Accounts and Directors' Report.....	59
ANNEX 4 Pro Forma Code of Ethics	60
Introduction.....	60
Draft Code.....	60
Important contacts.....	64

Introduction

This Corporate Governance Code based on the OECD Principles (2004) (hereinafter the “2004 Code”) was prepared in the light of the need to update the original Corporate Governance Code based on the OECD Principles of 2001 (hereinafter the “2001 Code”) drawn up by the Securities Commission (hereinafter “SEC”) in cooperation with experts of the British Know How Fund. As the work in a team, involving representatives of a great many institutions active on the capital market, proved successful in preparation of the original Code, the working group, which was again entrusted with drawing up the updated code, renewed its activities. The members of the working group included, in addition to employees of the Securities Commission, representatives of the Union of Investment Companies of CR (UNIS CR), the Prague Stock Exchange (PSE), the Czech Institute of Internal Auditors (CIIA), the Association of Pension Funds of CR (APF CR), the Association of Registered Investment Brokers of CR (ARIB CR), ČESKÝ TELECOM, a.s., ČEZ, a.s., the Czech Institute of Secretaries of Commercial Companies, the Czech Institute of Directors, the Czech Association of Investment Professionals, Corporate Governance Partners, PricewaterhouseCoopers, and Newton Management, a.s. The working group is also very grateful for detailed comments on the 2001 Code, provided by Robert Strahota of the U.S. SEC, which were used in the preparation of the 2004 Code.

A majority of ideas used in the 2001 Code were maintained in the 2004 Code; however, the working group decided to strictly follow, not only the contents of the individual OECD Principles of Corporate Governance, as in the original Code, but also their structure; the OECD Principles of 2004 are divided to six chapters. The reason for this closer correlation with the OECD Principles lies in the need for easier communication both with the organization itself, which plays undoubtedly the leading role in the field of international cultivation of the rules of corporate governance, and with other organizations that either use the OECD Principles, such as the World Bank in its analyses of the quality of economic systems of various countries, or recommend these principles, such as the European Commission. The working group decided to also maintain the manner of presenting the OECD Principles, where the document as a whole contains, in addition to the actual principles, “annotations” – i.e. comments that explain and develop these principles and often also contain other recommendations with a less narrow correlation; these annotations thus form an integral part of the principles.

The direct incentive for updating the 2001 Code was very dynamic development both in the area of creation and implementation of the entire set of corporate governance rules and, of course, in the actual operation of companies, which is regulated by the relevant set of rules. This dynamic development has been taking place since early '90s when the infamous Cadbury's report was published; the core of this report remains generally valid and still pertains to the current state of affairs. The driving force of the entire development has been and still is the care for development of the capital market – indeed, it is clear that its growth, as a promising alternative to corporate financing by banks, is critically dependent on whether confidence in healthy operation of companies, which have addressed the general public with a request for capital resources required for their own development, can be ensured, maintained and further strengthened. It is thus natural that the incentives for innovations of the corporate

governance rules also included certain unfavorable events on the capital market, which impaired the essential confidence of the general public.

The 2004 Code includes particularly elements that were adopted from the “OECD Principles of Corporate Governance” of 2004. The above document is an updated version of the OECD Principles of 1999, which were the basis for the 2001 Code. The 2004 Code also contains elements proposed by the European Commission in its document of May 2003 entitled „Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward“. It follows from the title of the Commission document that the development of the corporate governance rules and their implementation is based on an approach combining two specific mechanisms of their enforcement – the mechanism of enforcing written law, which is contained in the Czech Republic particularly in the Commercial Code, and the mechanism of self-discipline and self-regulation, i.e. voluntary compliance with the relevant rules. The working group decided to reflect this extremely serious issue in that it supplemented the rules of the 2004 Code with a note indicating whether the relevant rule has a statutory strength or whether it is “only” a recommendation intended for voluntary compliance. In the text, this difference is expressed by the words “must/shall” or “should”. In this, it took account of the fact that the general tendency on developed markets is gradual inclination to the use of statutory rules. The European Commission also states that the approach to the rules of corporate governance as non-binding recommendations is inadequate and that it will be necessary to adopt at the EU level a certain number of binding rules. The issue of the binding or non-binding nature of the rules is especially sensitive in the Czech Republic with its modern tradition of legal positivism, where there is a danger that nobody would obey rules that are not statutory. A question was raised within the working group whether the 2004 Code should play a role of an incentive for legislative work on the new Commercial Code, as it is clear that the lack of certain rules constitutes a serious impediment for the development of the Czech capital market (e.g. the impossibility of distance voting at general meetings). However, the working group came to the conclusion that the 2004 Code cannot aim at such goals and that it must remain primarily a document intended for companies listed on the regulated market (Chapters II. to VI.) and thus, in Chapter I intended for the Government, it only enumerates the general principles that ensure a base for an effective framework of corporate governance. The role of an incentive for legislative work must be played particularly by the above-cited document of the European Commission of May 2003, with respect to the part containing recommendations for amendments to the law of commercial companies, i.e., in the Czech Republic, the Commercial Code.

From the viewpoint of recommendations of the European Commission concerned with various approaches to improving corporate governance, which are set forth in the above-cited document of May 2003, it is satisfying that the Securities Commission was thus assured that it had previously adopted a correct strategy. Indeed, in 2002, it recommended that companies with listed securities¹ include in their annual reports a declaration concerning the degree of accord of their corporate governance systems with the recommendations of the Code, on the basis of the “comply and explain” principle. In the sense of recommendation of the European Commission to leave European companies with a choice between a one- or two-level model of corporate governance, the working group ceased to prefer the “Anglo-Saxon” model,

¹ According to the terminology of the new Act on Business Activities of the Capital Market, these securities will be designated as quoted securities – Section 44 (1) of the Act on Business Activities on the Capital Market.

which was followed in the original Code of 2001, and, in the 2004, it leaves upon the companies, whether they will choose a German or Anglo-Saxon model.

The OECD and Commission documents were the principal, but not the only, sources from which the working group derived elements for the 2004 Code. The document of the European Federation of Accountants (FEE) of September 2003 played an important role in conceiving the rules providing for the role of audit and auditors. Materials of the Governance Forum, which was active in the framework of the European Union, also provided considerable incentives.

To facilitate comparison between the 2001 Code and the 2004 Code, we underlined the new elements and designated them either “new OECD” or “new EU” according to the source of the relevant provision.

Although it is not possible to summarize the most fundamental issues dealt with in the 2004 Code within this Introduction, nevertheless, we believe that a very important issue from the viewpoint of the capital market should be noted in the Introduction, i.e. the issue of independence of board members. This issue is addressed in more detail within principle E in Chapter VI and also within the commentary on that chapter in articles 5 and 19.

While the 2004 Code is intended predominantly for companies whose securities are listed on the regulated market, this does not prevent other companies from adopting these principles and following them to an appropriate degree. Indeed, the Code contains recommendations that are also intended for entities active on the capital market other than issuers of securities – i.e. rating agencies, custodians, analysts, auditors, securities dealers, issuers of GDRs (Global Depositary Receipts) and, last but not least, institutional investors, etc. These participants in the capital market should also be encouraged to adopt the Code to the extent of recommendations that apply to them. The entire Chapter I. of the 2004 Code is an incentive for the Government to take over the relevant initiative in the area of legislation and law enforcement. Therefore, the Securities Commission believes that the 2004 Code will also fulfill this inspirational role.

Annex 1 documents the state of compliance with the OECD Principles of Corporate Governance of 1999 in the Czech Republic, as described and evaluated by an analysis of the World Bank and International Monetary Fund of 2002. Annexes 2, 3 and 4 are adopted from the 2001 Code, as provided by The Czech Institute of Directors. The Institute is an independent and non-profit organization, whose principal objective is to promote incorporation of the best practice of corporate governance in the activities of the boards of directors and supervisory boards of Czech companies in accordance with the OECD Principles of Corporate Governance and in accordance with the Securities Commission Code based on the Principles.

Doc. Ing. Tomáš Ježek, CSc.
Head of the working group of the Securities Commission
Prague, June 2004

N.B.:

The 2004 Code contains certain recommendations that are currently stipulated as a legal obligation in the laws of the Czech Republic (e.g. in the Commercial Code, the Accounting Act, Act on Business Activities on the Capital Market, Act on Auditors, etc.). In no case does the 2004 Code replace or modify the relevant provisions of the legal regulations. Thus, the rights and duties imposed by legal regulations are not and cannot be prejudiced by the 2004 Code. In various parts, the 2004 Code refers to the relevant legal regulation related to the individual recommendations, if appropriate. In this relation, the authors of the 2004 would like to note that the reference to or enumeration of legal regulations might not be exhaustive.

CHAPTER I. Ensuring the Basis for an Effective Corporate Governance Framework (new OECD)

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

B. The legal and regulatory requirements that affect corporate governance practices should be consistent with the rule of law, transparent and enforceable.

C. The division of responsibilities among different authorities should be clearly articulated and ensure that the public interest is served.

D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

Commentary on Chapter I.

1. A joint-stock company as a form of organization of economic activities is a powerful driving force. The legal and regulatory environment, in which joint-stock companies operate, has thus key importance for the overall economic performance. Policy-makers are responsible for ensuring that there is an adequately flexible framework that will serve for the needs of companies operating a business under various conditions and that will facilitate the creation of new opportunities for development of values and the most efficient utilization of resources. In order for the policy-makers to successfully bear this responsibility, they must concentrate on the most important economic results. When considering various variants of economic policies, policy-makers must analyze the impact of key variables affecting the functioning of the market, such as the structure of incentives, effectiveness of self-regulatory systems and management of conflicts of interest. Transparent and effective markets ensure discipline in the conduct of market participants and promote their accountability. If there is a need for new laws and decrees in response to market shortcomings and failures, these regulations must be formulated so that they can be enforced and applied in the same manner to all players.

2. It is typical for the rules of good corporate governance that they are interconnected with a great many areas of law and legal regulations, particularly the Commercial Code, the Act on Business Activities on the Capital Market, laws regulating procedures in accounting, audit and insolvency, the Civil Code, the Labor Code and tax laws. Thus, there is a risk that the effects of the above various laws will result in unintended conflicts that could limit and hinder the ability to reach key objectives in the area of corporate governance. Therefore, it is important that the policy-makers be aware of this risk and strive to limit it as far as possible.

3. Responsibility for regulation must be entrusted to institutions that can discharge their functions without any conflict of interests and whose decisions are subject to court review. As

the number of companies, events concerning them and the volume of disclosed information constantly rise, the resources of these institutions may not be sufficient. Thus, the policy-makers must provide for their adequate financing. The ability of these institutions to ensure qualified experts under competitive conditions will undoubtedly increase the quality of supervision and enforcement of laws and regulations and its independence.

CHAPTER II. The Rights of Shareholders and Key Ownership Functions (new OECD)

The corporate governance framework should protect and facilitate the exercise of shareholders' rights (new OECD).

A. The basic shareholder rights include:

1. the right to secure methods of ownership registration;
2. the right to convey or transfer shares;
3. the right to obtain relevant and material information on the corporation on a timely and regular basis;
4. the right to participate and vote in general shareholder meetings;
5. the right to elect and remove (new OECD) members of the supervisory board and/or the board of directors; and
6. the right to share in the profits of the corporation and in the liquidation balance;
7. the right to have shares redeemed by the joint-stock company or the majority shareholder in cases stipulated by law;
8. a pre-emptive right to subscribe for newly issued shares.

B. Shareholders shall have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes. The above changes include particularly the following²:

1. amendments to the statutes or articles of incorporation or similar governing documents of the company;
2. the authorization of additional shares;
3. extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

C. Shareholders must have the opportunity to participate effectively and vote in general shareholder meetings and must be informed of the rules, including voting procedures that govern general shareholder meetings:

1. Shareholders must 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;³
2. Shareholders must have the opportunity to ask questions to the board of directors and the supervisory board, including questions relating to the annual external audit (new

² These rules are stipulated in various parts of the Commercial Code; with respect to paragraph 3, cf. e.g. Section 193 (2): "The consent of the Supervisory Board shall be required for concluding a contract, on the basis of which the Company is to acquire or alienate assets, if the value of assets acquired or alienated during a single accounting period exceeds one third of the shareholders' equity according to the last ordinary financial statements or to the consolidated financial statements, if the Company compiles consolidated financial statements. The consent of the general meeting shall be required if the company has issued listed participating securities. The provisions of Section 196a (4) shall apply *mutatis mutandis*".

³ See the regulation of convening the general meeting as stipulated in Section 184 (4) of the Commercial Code and the differences in convening the general meeting with respect to the form of shares (registered and bearer shares).

OECD), and to place items on the agenda of general meetings, subject to reasonable limitations;⁴

3. Shareholder participation in key corporate governance decisions, such as the nomination and election of board members, must be facilitated. Shareholders must be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees must be subject to shareholder approval (new OECD);
4. Shareholders must be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.⁵

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership must be disclosed.⁶

E. Markets for corporate control must 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, must be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions must occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.⁷
2. Anti-take-over devices may not be used to shield management and the board from accountability.⁸

F. The exercise of ownership rights by all shareholders, including institutional investors, must be facilitated.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights (new OECD and EU);

2. Institutional investors⁹ acting in a fiduciary capacity must disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments (new OECD).

⁴ Stipulated particularly in Section 180 (1), (4) and (5) of the Commercial Code and the statutes of each company.

⁵ At the present time, the Commercial Code does not permit that the shareholders vote by means of distance communication, e.g. through electronic means of communication. With respect to the general meeting this is explicitly excluded in Section 66 (5) of the Commercial Code; however, this manner of voting is permitted for other bodies of the company.

⁶ Regulation of the notification duty in Section 122 of the Act on Business Activities on the Capital Market. The voting rights shall be attributable to the person who actually disposes thereof, which is correct, but sometimes difficult to determine in practice.

⁷ This corresponds to the principles valid for take-over bids set forth particularly in Section 183a of the Commercial Code.

⁸ A decision may be adopted on anti-take-over devices pursuant to Section 183a (11) (b) of the Commercial Code only by the general meeting during the binding period of the take-over bid; other bodies must remain neutral.

⁹ In the Czech Republic, institutional investors are defined in Section 5 (1) of the Securities Commission Act as banks, investment companies, investment funds, pension funds and insurance companies, and foreign persons authorized to operate a business in the same fields in the territory of the Czech Republic.

G. Shareholders, including institutional shareholders, must be allowed to consult with each other on issues concerning their basic shareholder rights as defined above, subject to exceptions to prevent abuse of the mutual consultations (new OECD).

Commentary on Chapter II.

1. Shareholders have property rights and, thus, their shares may be bought, sold, or otherwise transferred. In addition, they are entitled to a share of profits of the company. These rights, particularly to participate in the profits and to sell their shares, provide the elements of shareholder value. All shareholders wish to see their shares increase in value and generate good dividends, but shareholders must learn that they have a role to play in ensuring the proper management of the company and the increase of shareholder value. In order to do this, the shareholders must have the right to information about the company and the right to influence the company, primarily through participation in general shareholder meetings and through voting. In its document of May 2003 entitled „Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward” (hereinafter the “EU Plan to Move Forward”, the EU Commission recommends that strengthening shareholders’ rights must be based essentially on the provision of comprehensive information by the company on what the various existing rights are and how they can be exercised (new EU). However, as any other rights, shareholders’ rights may not be misused (Section 56a (1) of the Commercial Code).

2. In order to be informed about his investment, the shareholder must be informed accurately. The usual basis for information consists in annual and semi-annual reports; however, it is essential that the company notifies shareholders of any changes in the company or its business which may materially affect the value of the shares.

3. Companies must ensure that shareholders are informed (by means of a notice or invitation) of holding a general meeting at least 30 days prior to the date of an ordinary general meeting or at least 15 days prior to the date of an extraordinary general meeting,¹⁰ which should provide the shareholders with sufficient time for preparation and consultations. It must be emphasized with respect to the convening and holding of general meetings of companies that there is no justifiable reason or statutory requirement, on the basis of which companies should submit to the Securities Center an order to suspend the right to manage shares several days prior to the date of the general meeting (in practice, usually 7 days) and thus limit the ownership rights of shareholders. On developed capital markets, this approach is not common and is negatively perceived. Effective shareholder participation in general meetings could be improved through development of secure means of electronic communication. SEC will initiate amendment to the Commercial Code permitting distance voting by electronic means. In the EU Plan to Move Forward, the EC Commission recommends that shareholders of listed companies be provided with electronic facilities to access the relevant information in advance of general meetings (new EU).

¹⁰ Section 184 (4) of the Commercial Code.

4. It is also essential that shareholders have an opportunity to attend all shareholder meetings as it is through these that he can hold the boards to account for their actions. The provisions of the Commercial Code must be regarded as the minimum standards required of all companies. Since the shareholders must be able to call the boards to account for the running of the company, they must have proper opportunity to question the boards and to place items on the agenda of the meeting. Thus companies must include an item entitled “debate” on each agenda of the general meeting and afford sufficient opportunity for such debate. The management and controlling shareholders may not attempt to deter the non-controlling and foreign shareholders from trying to influence future orientation of the company. They must listen to all opinions or inquiries of any shareholder and respond to them. Companies must not charge fees for voting. Other impediments including prohibitions of proxy voting and the requirement of personal attendance at general shareholder meetings to vote are also not permitted. In general, no procedures may be adopted that would practically prevent or limit the exercise of the shareholders' rights.

5. The place and time of holding the general meeting must not cause inappropriate costs or impediments for participation in the general meeting. The board may not arrange the agenda of the meeting in a manner to frustrate a valid discussion by the meeting of the questions validly and properly raised by any shareholder. It is understood that there have been some questionable practices used by some companies to reduce the risk of awkward questions and this must be regarded as unacceptable by reputable companies. At the general meeting, the directors must allow enough time for all shareholders attending to raise questions on the agenda items and for the debate of such matters prior to the vote being taken. Each item on the agenda must be the subject of a separate vote and in the case of appointment of members to the supervisory and/or board of directors, each member must also be voted upon separately.

6. The chairman of the supervisory board must arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the general meeting (more details on these committees are provided hereinafter and in Annex 2). It is important that the shareholders can question all members of the committees on their decisions, for example to award substantial pay increases to individual members of the boards or key executives.

7. Companies must strive to build good relations with investors. The general meeting provides an annual opportunity for companies to inform individual investors of the activities, progress and plans of the company and to encourage them to continue their participation in and support of the company.

8. As all shareholders holding shares of the same class have the same rights, it is essential that the members of the board of directors handle them transparently and properly. They may not take any steps, use any tricks or submit proposals that could reduce or conceal profits and prevent their fair distribution to all shareholders, including minority shareholders. It is particularly important that the board of directors of the company set and publish the dates of payment of dividends and payment of interest on bonds sufficiently in advance (Section 178 (9) of the Commercial Code).

9. There may be a number of cases, especially with respect to foreign investment, where shareholders' agreements provide foreign shareholders with a high degree of corporate control. These agreements need not be contrary to good corporate governance, however, they

must be disclosed to all shareholders. All the following facts must be notified to the shareholders:

- Pyramid structures and cross shareholdings which could be used to diminish the capability of non-controlling shareholders to influence corporate policy.
- Shareholder agreements for groups of shareholders, who individually may hold relatively small shares of total equity, to act in concert so as to constitute an effective majority, or at least the largest single block of shareholders. Shareholder agreements usually give the parties to the agreements preferential rights to purchase shares if other parties to the agreement wish to sell. These agreements may also contain provisions that require those accepting the agreement not to sell their shares for a set period of time. Shareholder agreements may also be concerned with the manner of selection of the supervisory or board of directors or the chairman of the board of directors. The agreements can also oblige the parties to the agreement to vote as a block.
- Voting caps limit the number of votes that a shareholder may cast, regardless of the number of shares the shareholder actually possesses. Voting caps therefore redistribute control over the company and may affect the incentives for shareholder participation in shareholder meetings. In the Czech Republic, Section 180 (2) of the Commercial Code permits incorporation of such a rule in the statutes.

10. The rules of the market for corporate control were included in the Commercial Code in 1996; however, they have been effectively enforced only since 2001. The need to enforce such rules was especially urgent in the Czech Republic with respect to the process of concentration of shareholding, which has been taking place after the end of the coupon privatization. The lack of enforcement of rules of the market for corporate control, which continued for several years, seriously hindered confidence in the capital market. Thus, the experience of the Czech Republic confirms the conclusion contained in the EU Plan to Move Forward, i.e. that the approach to the corporate governance rules as non-binding recommendations is inadequate and that certain key rules must have the force of law. The order, which was brought to the functioning of the market for corporate control by amendment to the Commercial Code in 2001, was appreciated by the World Bank by means of the only highest mark granted within its review of compliance with the OECD Principles of Corporate Governance of 2002 (see Annex 1).

11. On a number of developed capital markets, institutional investors hold a majority of shares of listed companies for individuals consisting in participants in pension funds, unit trusts, insurance policies, etc. Thus, the common interest is very strong. Institutional investors must be encouraged not to act as passive investors but rather to take an active role in supervising their investments. Failure to properly exercise the ownership rights could result in a loss for the beneficial holder, who should thus be notified of the policies pursued by the institutional investor. Of course, in the actual performance of ownership rights, the institutional investor will be limited by the costs connected therewith and, therefore, the investor must always take account of the effectiveness of exercise of the ownership rights. This requires an easy access to all information. Additionally, they must have access to the management. They must hold the management to account for its mistakes, including, where necessary, a request for the resignation of responsible executives. This requires the management and the board to adopt an open approach to its institutional investors and to enter into dialogue with them. Institutional investors should disclose their policy with respect to the exercise of voting rights in companies in which they invest and disclose to

their beneficial holders at their request how these rights have been used in a particular case (new EU).

12. In some cases, a shareholder cannot achieve improvements of the company situation. In this case, he must be allowed and indeed encouraged to “vote with its feet” by selling his share and leaving the company. Once companies realize that this is a course of action which shareholders will take, they must pay more heed to the requests and views of the institutional investors.

CHAPTER III. The Equitable Treatment of Shareholders

The corporate governance framework must ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders must have the opportunity to obtain effective redress for violation of their rights.¹¹

A. All shareholders of the same series of a class must be treated equally.

1. Within any series of a class of the same issue (replaceable shares of the same nominal value), all shares must carry the same rights. All investors must be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to voting by the affected shareholders.¹²
2. Minority shareholders must be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress (new OECD).
3. Votes must be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares. This rule applies if the shareholder has given his instructions. If he fails to give any instructions, the custodian or nominee may vote according to his own discretion, however, the voting rights are attributed to him.¹³
4. Processes and procedures for general shareholder meetings must allow for equitable treatment of all shareholders. Company procedures may not make it unduly difficult or expensive to cast votes.¹⁴

B. Insider trading and abusive self-dealing shall be prohibited.¹⁵

C. Members of the board of directors, supervisory board and key executives must be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation (new OECD).¹⁶

Commentary on Chapter III.

¹¹ The regulation of the prohibition of abusing a majority and a minority in the company and the prohibition of placing a partner (shareholder) at an advantage is stipulated in Section 56a of the Commercial Code.

¹² Stipulated in Section 187 (1) (a) of the Commercial Code.

¹³ The nominee principle is not regulated in the Czech Republic.

¹⁴ The principle of equitable treatment of all shareholders is regulated in Section 155 (7) of the Commercial Code.

¹⁵ The use of inside information (the former Securities Act used the term “confidential” information) is prohibited and the duty to maintain confidentiality on this information is imposed by Sections 124 and 125 of the Act on Business Activities on the Capital Market; criminal liability is stipulated in Section 128 of the Criminal Code, the confidentiality duty of the members of the boards of directors and supervisory boards of all joint-stock companies is imposed by Section 194 (5) in connection with Section 200 (3) of the Commercial Code.

¹⁶ This is not explicitly stipulated by law; however, cf. regulation of the ban on competition in Section 196 of the Commercial Code for the board of directors, which also applies to the supervisory board, and also the limitation stipulated in Section 196a of the Commercial Code.

1. The principle of equitable treatment of all shareholders becomes one of critical importance if companies seek to raise additional capital through the capital markets and to encourage institutional investors to invest. At the present time, the Czech Republic is still perceived as a country, where minority shareholders are being harmed.
2. Section 155 (7) of the Commercial Code requires that identical rights be attached to shares of the same class and the recent amendments have strengthened this by requiring companies to treat all shareholders equally and under the same conditions (see Section 178 (1), Section 220 (1) and Section 180 (2) of the Commercial Code).
3. The optimal capital structure of a company can best be decided on by the board or directors, but this should be subject to the approval of the shareholders. In the Czech Republic, some companies can issue preferred shares which have a preference with respect to receipt of the dividends of the company but which normally have no voting rights unless a preferred dividend is declared and paid. This mechanism could be open to abuse as companies are unlikely to issue preferred shares to anyone other than the existing majority shareholders for fear of losing control in the event that the company cannot declare and pay a preferred dividend.
4. Investors should require information regarding their voting rights before they invest. Once they have invested, their rights should not be changed unless those holding voting shares have had the opportunity to participate in the decision on the change. However, proposals to change the voting rights of different classes of shares must be submitted for approval at the general meetings by not less than a 75 % majority of the total voting shares in the affected categories and such resolution must have the form of a notarial record (see Section 186 (3) and Section 186 (6), respectively, of the Commercial Code).
5. Custodians and nominees, such as banks and brokers holding securities for their customers, usually may not vote at general meetings without an explicit instruction of the client. In addition to the possibility to generally authorize the custodian or nominee to vote in a manner corresponding to the interests of the shareholder in cases, provided that the custodian or nominee does not receive a different specific instruction from the shareholder, any attempts to deviate from this standard should be perceived as undesirable. This includes particularly activities where the custodians and nominees are requested to vote in favor of the management.
6. There is a general rule that directors must not take personal advantage of the company's opportunities, allow their personal interests to conflict with those of the company or misapply the company's assets. Most courts internationally expect a very high standard of honesty from all fiduciaries and will apply very stringent tests as to what constitutes impropriety, personal advantage or misapplication.
7. The Commercial Code (Sections 196 and 196a) includes a specific ban on competitive conduct, provided that the statutes or resolutions of the general meeting may impose a stricter ban. In case of violation of the ban, the company may claim reimbursement of the benefits or the right to indemnification. Even in cases where the statutes vary the provision of the Commercial Code, internationally accepted best practice would require that the principle of declaration of interest is observed. It would thus be requested that the directors disclose to the company body, of which they are members, their interest in each contract or draft contract that the company concludes with some other person. Any failure to do so is a disciplinary tort.

Disclosure should be made at the first board meeting he/she attends and where the contract is discussed or at the first such board meeting after he/she has become interested in the contract. Generally, this would include any transaction or arrangement, including loan and guarantee transactions, whether or not constituting a formal contract. Directors and managers should also refrain from voting on such transactions and should also not vote on any other decision that is affected by these interests (as required by Section 196a of the Commercial Code). This relates to situations where these persons have business, family or other special relations to the parties to the transaction or contract. Abusive self-dealing occurs when persons having close relationships to the company exploit those relationships to the detriment of the company and investors. Contracts for the sale of company assets or products to the management, key executives, board members or shareholders, or persons connected with them,¹⁷ should all be undertaken at arms length. Such contracts should be explained together with the relevant connection and approved by a general meeting of the company prior to their execution.

8. The Act on Business Activities on the Capital Market prohibits insider trading and companies should note that the risk of violation of this provision can be reduced if they promptly publish material information in accordance with their notification duty. Insider trading is also usually connected with capital market manipulation, which is also prohibited by the Act on Business Activities on the Capital Market.¹⁸ Pursuant to the Act on Business Activities on the Capital Market, a company whose securities have been accepted for trading on a regulated market in a Member State of the European Union, is obliged to provide for keeping a list of persons who have access to inside information of the issuer and provide the Commission promptly with this list on request.

¹⁷ This connection is defined in Section 2 (f) of the Act on Business Activities on the Capital Market.

¹⁸ Section 126 (4) of the Act on Business Activities on the Capital Market.

CHAPTER IV. The Role of Stakeholders in Corporate Governance

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

A. The rights of stakeholders that are established by law or through mutual agreements (new OECD) must be respected.

B. Where stakeholder interests are protected by law, stakeholders must have the opportunity to obtain effective redress for violation of their rights.

C. Performance-enhancing mechanisms for employee participation must be permitted to develop (new OECD).

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis (new OECD).

E. Stakeholders, including individual employees and their representative bodies, must be able to freely communicate their concerns about illegal or unethical practices¹⁹ to the supervisory board and their rights should not be compromised for doing this (new OECD).

F. The corporate governance framework must be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights (new OECD).

Commentary on Chapter IV.

1. The term stakeholder²⁰ requires explanation. It encompasses a number of parties who are interested in the success and the mode of operation of a company. It includes its employees, members of the local community who are keen to ensure that their environment is not polluted; local government and self-government bodies; local businesses that sell goods and services to the company employees, schools, doctors, etc.; and the businesses which the company does business with, both suppliers and distributors; and, of course, creditors. Thus a company that is a major manufacturer in an area should consider the impact of its decisions on the local businesses. It is in the long-term interest of each company to foster wealth-creating co-operation among stakeholders and it must be recognized that the interests of the company are served by recognizing the interests of stakeholders and their contribution to the long-term success of the company.

¹⁹ The current legislation e.g. provides for employee participation in the supervisory board and various mechanisms for creditor protection (e.g. various notification duties and the duty to secure obligations – e.g. in decreasing the registered capital of the company, etc.), and the meetings of bondholders pursuant to Section 21 of the Bonds Act. The rights of other stakeholders that are specifically related to the issuers of securities are not regulated in the current legislation.

²⁰ N/A.

2. A key aspect of corporate governance is concerned with ensuring the flow of external capital to companies. Corporate governance is also concerned with finding ways to encourage the various stakeholders in the company to undertake socially efficient levels of investment in company specific human and physical capital. The competitiveness and ultimate success of a company is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Thus, it is best practice for the boards to consider the implication of their decisions on the various stakeholders as integral part of the decision making process.

3. At the present time, the relationship between companies and their creditors is especially important in the Czech Republic. Companies must use their best efforts to provide payments to the suppliers and creditors in time and they must not consider late payments or failure to pay to be a manner of arranging their own cash flow. Companies must treat their creditors as important stakeholders and notify them of their inability to provide timely payments, as this could have a serious impact on their economic performance and viability. The best practice in case a company is not able to provide timely payments is to notify the creditor thereof and propose and agree with him a different payment calendar, which reflects the requirements of his business.

4. In most countries, including the Czech Republic, stakeholder rights are established by law, i.e. labor law, business law, contract law, and insolvency law. Even in areas where stakeholder interests are not legislated, many companies make additional commitments to stakeholders, as they are concerned to protect the corporate reputation and corporate performance. This is a new, but developing, concept to many companies in the Czech Republic. Where stakeholder interests are protected by law, however, stakeholders must have the opportunity to obtain effective indemnification for violation of their rights. The legal framework and process must be transparent and must not limit the ability of stakeholders to request and obtain indemnification for violation of their rights.

5. The degree to which stakeholders participate in corporate governance depends on laws and practices, and may vary for different companies. Examples of mechanisms for stakeholder participation include employee representation on boards; employee stock ownership plans (Section 158 of the Commercial Code) or other profit sharing mechanisms or governance processes that consider employees' viewpoints in certain key decisions. Companies may thus considerably profit from the fact that their employees are willing to invest their abilities and knowledge in the company. It is therefore in their interest to involve them in governance. The involvement of creditors in corporate governance in the context of insolvency procedures and incorporation of arbitration clauses in contracts could increase the performance of the company and improve its goodwill. Where laws and practice of corporate governance systems provide for participation by stakeholders, it is important that stakeholders have access to information necessary to fulfill their responsibilities.

CHAPTER V. Disclosure and Transparency

The corporate governance framework must 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.²¹

A. Disclosure must include, but not be limited to, the following material information:

1. The financial and operating results of the company;²²
2. Company objectives;²³
3. Major share ownership and voting rights;²⁴
4. Remuneration policy for members of the board of directors and supervisory board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent (new OECD);²⁵
5. Related party transactions (new OECD);
6. Foreseeable risk factors;²⁶
7. Issues regarding employees and other stakeholders;²⁷
8. Governance structures and policies in this area, in particular, the content of any corporate governance code²⁸ and the process by which it is implemented (new OECD).

B. Information must be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

C. An annual audit must be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board of directors, the supervisory board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects (new OECD).

²¹ This duty is stipulated in a number of regulations – in particular, the Accounting Act, the Act on Business Activities on the Capital Market, the Collective Investment Act, the Act on Auditors, the Commercial Code, the Act on Banks, and a great many secondary regulations.

²² Stipulated in the Act on Business Activities on the Capital Market and the Accounting Act.

²³ This issue is not regulated by law; the laws include only projections based on facts – the expected development – Section 20 of the Accounting Act and newly also Section 118 of the Act on Business Activities on the Capital Market

²⁴ Stipulated in Section 122 of the Act on Business Activities on the Capital Market

²⁵ The Act on Business Activities on the Capital Market requires statement in the annual report of data on accepted consideration by individual members of the bodies and management.

²⁶ This duty is currently not explicitly stipulated by law; however, it can be derived from the general clause concerning the function and contents of annual and semi-annual reports of the issuer of listed securities – Section 118 (3), Section 119 (1) of the Act on Business Activities on the Capital Market – and from the requirement for statement of future projections.

²⁷ This duty is not explicitly stipulated by laws; however, the same shall apply as to the previous paragraph. However, this issue could also have the features of insider information – in that case, there is a statutory duty to promptly publish the information.

²⁸ This duty is not stipulated by law.

D. External auditors must be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit (new OECD).

E. Channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by users.²⁹

F. The corporate governance framework must be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice (new OECD).

Commentary on Chapter V.

1. Public disclosure is typically required, at a minimum, on a half-year basis and more frequently in the case of material developments affecting the company. Companies must be encouraged to make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand. A strong disclosure regime is essential to market-based monitoring of companies and is central to shareholders' ability to exercise their voting rights. It can also significantly influence the behavior of companies and protect investors. Furthermore, it can help to attract capital and maintain confidence in the capital markets. Shareholders and investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship by the board and management, and make informed decisions about the valuation, ownership and voting of shares. By contrast, insufficient or unclear information may hamper the functioning of the financial market and increase the cost of capital and result in a poor allocation of resources.

2. However, it is important that disclosure requirements do not place unreasonable administrative or cost burdens on enterprises. Companies should not be expected to disclose information that might endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading investors. It is essential that such non-disclosure is strictly limited and thus a test of materiality is often used.³⁰ Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information. For example, a pharmaceutical company would be required to disclose that it had patented and was testing a new drug but would not be required to disclose details of the patent. Thus timely disclosure of all material developments that arise between regular reports is considered essential as is simultaneous reporting of information to all shareholders in order to ensure their equitable treatment.

3. Sections 118 and 119 of the Act on Business Activities on the Capital Market require publication of annual and semi-annual reports. The annual report must include an audited balance sheet and, overall, it must give true and accurate picture of the financial situation, business activities and economic results of the issuer. This information must enable appropriate monitoring of the company and provide the basis for appraisal of securities. This information must be accompanied by management's discussion and analysis of operations as

²⁹ Electronic form of disclosure can be considered sufficient pursuant to the Act on Business Activities on the Capital Market – cf. e.g. Section 118, 119 or 125 of the Act on Business Activities on the Capital Market.

³⁰ The situation and conditions, under which the issuer need not disclose insider information or postpone its disclosure are stipulated in Section 125 (2) of the Act on Business Activities on the Capital Market.

this provides light on the future performance of the company. Transactions relating to an entire group must be disclosed to ensure disclosure of the complete situation of the company.

4. In addition to quantitative targets, their time horizons and cost, the objectives of the company must also include policies relating to business ethics, the environment and other public policy commitments which enable investors to evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

5. A major holding of shares and voting rights must be included in information on the ownership structure of the company and the shareholder's rights vis-à-vis the rights of other owners. However, the company must disclose also all data on major shareholders and others that control or may control the company, including information on special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, significant cross shareholding relationships and cross guarantees.

6. Companies must disclose information on related party transactions (Section 66a (9) of the Commercial Code). Similarly the companies must disclose acting in concert (Section 66b (1) and (2) of the Commercial Code).

7. Companies should disclose information on individual board members and key managers to enable shareholders to evaluate their experience and qualifications and assess all potential conflicts of interest.³¹ The disclosure of this information is critical to the achievement of transparency of the company. Since the direction and management of the company is so important, shareholders need information on the qualifications of the board members in order to have confidence in their abilities and to ensure balance of experience available to the company. Only with this information can shareholders call board members to account for their actions and decisions. This recommendation reinforces the requirements for nomination and remuneration (for more details, see Annex 2).

8. In the Plan to Move Forward, the EU Commission recommends that shareholders should be able to appreciate fully the relation between the performance of the company and the level of remuneration of directors, both ex ante and ex post, and they should be able to make decisions on the remuneration items linked to the share price. An appropriate regulatory regime should consist of four key items:

- disclosure of remuneration policy in the annual accounts³²,
- disclosure of details of remuneration of individual members of the board of directors and the supervisory board in the annual accounts³³,
- disclosure of share and share option schemes in which members of the board of directors and the supervisory board participate prior to approval by the general meeting³⁴,
- proper recognition in the annual accounts of the costs of such schemes for the company³⁵.

³¹ However, the legislation does not contain this requirement, only Decree of the Ministry of Finance No. 500/2002 Coll., laying down the contents of the financial statements, requires statement of the name and surname of the board members.

³² No legal regulation stipulates such an obligation.

³³ This duty is stipulated by the Act on Business Activities on the Capital Market.

³⁴ No legal regulation stipulates such an obligation.

9. Companies must disclose information on reasonably predictable important risks including risks that are specific for the given sector and geographic area. These include particularly risks resulting from dependence on commodities, financial market risks, including the interest-rate risk or foreign-exchange risk, risks connected with derivatives and off-balance transactions, and risks of environmental liabilities. Information whether or not the company has a risk monitoring system is also useful³⁶.

10. Companies should disclose information on key issues relevant to employees and other stakeholders that could materially affect the performance of the company. This information may include management/employee relations, and relations with other stakeholders such as creditors, suppliers, and local communities. The World Bank has recently emphasized the importance of relations between companies and their creditors in the Czech Republic. Although this matter is dealt with in more detail in Chapter IV hereof, it is essential that companies treat their creditors properly and transparently, as this could affect their economic viability.

11. Channels for the dissemination of information can be as important as the content of the information itself. Companies should disclose the channels for disseminating their information, i.e. indicate in which paper or website this information can be found, and at what e-mail address it can be requested, etc.

12. It is becoming more and more common that companies also disclose their information in a language other than Czech (most frequently, English). This trend is welcome and must be promoted. However, it must be consistently ensured that all language versions of reports and documents disclosed by the company contain the same information. In this relation, a note should also be made of the statutory duty of companies, whose securities have been accepted for trading on several public markets (in this country and abroad), to publish the same information on all these markets (cf. Section 120 (4) of the Act on Business Activities on the Capital Market).

13. Companies should publish in their annual reports a declaration how they apply in practice the relevant principles of corporate governance contained in this Code. These declarations should be drawn up according to their draft structure, as published on the SEC website³⁷. In the Plan to Move Forward, the EU Commission recommends that the declaration should coherently describe the key elements of their corporate governance structure and practices, which should at least included the following items:

- a. the operation of the shareholder meeting and its key powers, and the description of shareholder rights and how they can be exercised;
- b. the composition and operation of the board and its committees
- c. the shareholders holding major holdings, and their voting and control rights as well as key agreements;

³⁵ This duty is stipulated in Section 118 of the Act on Business Activities on the Capital Market (annual report) (new EU).

³⁶ This duty is currently not stipulated by law; however, it can be derived from the general clause concerning the function and contents of annual and semi-annual reports of the issuer of listed securities – Section 118 (3), Section 119 (1) of the Act on Business Activities on the Capital Market – and from the requirement for statement of future projections).

³⁷ www.sec.cz

- d. the other direct and indirect relationships between these major shareholders and the company;
- e. any material transactions with the other related parties;
- f. the existence and nature of a risk management system;
- g. a reference to a code on corporate governance, designated for use at national level, with which the company complies or in relation to which it explains deviations (new EU).

14. The quality of information depends on the standards under which it is compiled and disclosed. An annual audit must be conducted by an independent auditor³⁸ in order to provide an external and objective assurance on the way in which governance and financial statements have been prepared and presented. The annual audit of the company is fundamental to corporate governance. Directors are required by law to report on their stewardship of the company in the annual reports to all shareholders and this is particularly important in companies where the management is, or is related to, the controlling shareholder. It is thus essential that the audit is objective and true as only such an audit gives reassurance to all those who have a financial interest in the company.

15. According to the recommendation of the World Bank, companies should appoint their audit committee. The Federation of European Accountants (FEE)³⁹ recommends that all companies listed on a stock exchange have an audit committee and that the office of members of the committee is discharged either by non-executive members of the board of directors or the members of the supervisory board, provided that at least a majority of the members of the committee should be independent (for the meaning of independence, see the commentary on Chapter VI). The audit committee should be responsible for submitting a proposal for appointing and recalling external auditors of the company. Such proposals for appointing and recalling should be approved by the general meeting and the external independent auditor should be entitled to present his standpoint at the general meeting prior to voting on each relevant resolution.

16. The competence of the audit committee should be defined by means of an internal regulation of the company, which clearly specifies the powers and responsibilities of the committee. The members of the audit committee should be individually identified in the annual report. The duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee must keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.

17. The audit must be carried out to the strictest international accounting standards. The following should be addressed:

- The members of the board of directors have unambiguously declared their responsibility for preparing the accounts, next to a statement by the auditors about their reporting responsibilities.

³⁸ Cf. in this relation *inter alia* also Recommendation of the European Commission 2002/590/EC of 16 May 2002 - Statutory Auditors Independence in the EU: A Set of Fundamental Principles, published in the Official Journal of the European Union N° L 191, 19.07.02, p. 22 , (to download: <http://europa.eu.int>)

³⁹ www.fee.be in the section Introduction to FEE

- The board of directors have taken into account interim and other price-sensitive public reports and reports to regulators as well as information required to be presented by statutory requirements.
- The board of directors has maintained a sound system of internal control and audit to safeguard shareholders' investment and the company's assets.
- The members of the supervisory board have reviewed the effectiveness of the company's internal control and audit system and have submitted a report thereon to shareholders. This report covered all controls, including financial, operational and compliance controls and risk management.
- The members of the board of directors reported that the business is a going concern, with supporting assumptions or qualifications.
- The executive and supervisory boards have established formal and transparent arrangements for considering the application of the financial reporting and internal control principles and maintaining an appropriate relationship with the company's auditors.

18. Companies that do not have an internal audit function should regularly reconsider its establishment.

CHAPTER VI. The Responsibilities of the Board of Directors and the Supervisory Board

The corporate governance framework must ensure the strategic guidance of the company, the effective monitoring of management by the board of directors and the supervisory board, and accountability of the board of directors and the supervisory board to the company and the shareholders.

A. Members of the board of directors and supervisory board must 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 (new OECD).

B. Where decisions of the board of directors and the supervisory board may affect different shareholder groups differently, the board of directors or supervisory board must treat all shareholders fairly.

C. The board of directors and supervisory board must apply high ethical standards. They must take into account the interests of stakeholders.

D. The board of directors and/or supervisory board must 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. Monitoring the effectiveness of the company's governance practices and making changes as needed.
3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
4. Aligning remuneration of the members of the supervisory board and the board of directors with the longer term interests of the company and its shareholders (new OECD).
5. Ensuring a formal and transparent process of nomination and election of the members of the supervisory board and the board of directors (new OECD).
6. Monitoring and managing potential conflicts of interest of management, members of the board of directors and supervisory board, and shareholders, including misuse of corporate assets and abuse in related party transactions.
7. 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 risk management, financial and operational control, and compliance with the law and relevant standards.
8. Overseeing the process of disclosure and communications.

E. The board of directors and supervisory board must be able to exercise objective independent judgment on corporate affairs.⁴⁰

1. The board of directors and supervisory board must 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 ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of members of the board of directors and supervisory board and key executives, and remuneration of the members of the board of directors and supervisory board.
2. When committees of the board of directors or supervisory board are established, their mandate, composition and working procedures must be well defined and disclosed by the board of directors or supervisory board (new OECD).
3. Members of the board of directors and supervisory board must be able to commit themselves effectively to their responsibilities.

F. In order to fulfil their responsibilities, members of the board of directors and supervisory board must have access to accurate, relevant and timely information.⁴¹

Commentary on Chapter VI.

1. The company must be headed by a well functioning board of directors and supervisory board that manage the company and are responsible to the shareholders. It is important that shareholders understand that, for practical reasons, a company cannot be managed by shareholder referendum. The shareholding body represented in the company's general meeting is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the company's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the company's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations must be placed in the hands of the board of directors and a management team that is selected, motivated and, when necessary, replaced by the board of directors. The shareholder's responsibility is focused on appointing and recalling the supervisory board and/or the board of directors.

2. There is little understanding by the management or indeed the board of directors of many companies of the concept of shareholder value and this requires explanation and development. Currently, the ethos of many companies is to improve the position of the management, through advantageous management contracts, sales of company assets at below market prices and other preferential arrangements. This situation was also prevalent in a number of other countries until management understood and accepted that this approach was unsustainable in the long term and that it was in their interests to improve the company itself, give shareholder value to the shareholders and to benefit personally through approved incentive schemes.

⁴⁰ This does not apply to banks where, pursuant to the Act on Banks, the board of directors of the bank is part of management. For other companies, even regulated companies, such interconnection is not prohibited.

⁴¹ Principles B to F are a basis for regulation of accountability and activities of the board of directors and supervisory board of a joint-stock company.

3. There have been several instances recently in the Czech Republic where management and the boards were held accountable for the management of their companies and were forced to resign. In the Czech Republic, the Commercial Code provides for the personal liability of members, both of the board of directors and supervisory board, for their actions. Again, this is a usual international provision and this liability encourages those who are elected to the board to act honestly and with due care and attention. This culture needs to be encouraged, as it exists in other European countries. Institutional investors play an important role in this relation and must be encouraged to call for the resignation of management and board members where results or performance is weak.

4. The international trend is for the role of directors to become an increasingly specialized profession. Professional courses, examinations and qualification requirements are used for directors on the most developed markets.

5. The best international practice absolutely unambiguously requires that a majority of the members of the supervisory board and board of directors be independent, i.e. that the members of the boards not be related with the executive management or majority shareholders or with persons working for the company, or with a subsidiary or a holding company, or that they not be closely connected entities pursuant to the definition set forth in Section 2 (f) of the Act on Business Activities on the Capital Market. It is also proposed in the OECD Principles of Corporate Governance that a majority of the members of the board of directors and supervisory board be independent. They emphasize that the board of directors must be able to exercise objective judgment on corporate affairs, independent particularly of the management,⁴² as it has a natural advantage with respect to information.

Thus, the requirement for independence of the board of directors and/or supervisory board means in practice that the board of directors and/or supervisory board must have a sufficient number of members who are not employed by the company and are not closely related to the company or its management through significant economic, family or other ties. This does not preclude shareholders from becoming board members as long as a balance is maintained. Even if representatives of employees may be considered independent of the majority shareholder, given their employment, they are nevertheless dependent on the company and, therefore, they should not be included amongst independent members of the supervisory board. We are aware that, in the Czech environment, this requirement for independence could be considered to be overly harsh. Therefore, we recommend a compromise, according to which this requirement would be fulfilled at least for the supervisory board of a company, whose board of directors is executive, i.e. composed of the executive management. In this case, the supervisory board should take over all tasks connected with the control framework of the company: the audit, remuneration and appointment committees should be advisory bodies of the supervisory board, and the company secretary and internal audit should also be subordinate to the supervisory board. All this should be stipulated in the statutes of the company. An important aspect is that an independent member should be capable of exercising independent judgment and thus not be hampered by any conflict of interest. A comparative study of Corporate Governance Codes used in EU (Weil, Gotshal a Manges, 2002) defines independence as lack of close family ties or business relations with the management of the company, with the controlling shareholder or with a group of controlling shareholders. It is critical that these independent directors are not connected in any way particularly to the

⁴² This does not apply to banks where, pursuant to the Act on Banks, members of board of directors of the bank are simultaneously members of management.

majority shareholder as this creates an impression of a lack of independence, even where the individual, as a professional, would be otherwise assumed to be capable of exercising an independence of judgment. In an ideal world, all members of the boards should be appointed for their independence and for their professional skills. It has to be recognized, however, that in the Czech Republic recent tradition has been for the majority shareholder to appoint the board members to follow his bidding. However, attempts should be made to change this unfavorable practice.

6. The board of directors must undertake the following key functions in the management of the company and the supervisory board must effectively supervise such functions:

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 of potential conflicts of interest of the management, members of the board of directors and shareholders and adopting the relevant measures to prevent misuse of assets of the company, causing damage through related party transactions, fraud and unauthorized alienation of assets of the company.
5. Ensuring the integrity of the company'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. Overseeing the process of disclosure and communications.
7. Presenting a balanced and understandable assessment of the company's position and prospects. (For more details on the role of the board of directors see Annex 3 – A Guide to the Best Practice for Executive Boards in the Czech Republic).

7. The situation that prevails, according to our information, in many companies, where the supervisory board meets only once or twice each year and the board of directors, which is only in effect a supervisory board, meets the same number of times and delegates the direction of the company to a general manager who appoints his own management board is entirely unacceptable under the OECD standards. Until recently, the general manager was only an employee and as such was not accountable to the shareholders. Under the Labor Code, the general manager's liability was limited to four and one half times his salary and this was a loophole used by several companies. The Commercial Code amendment introduced through Section 66 (6) special liability of true leading persons. Thus, any person, who has a substantial influence on the activities of the company, i.e. particularly the general manager, is accountable to the same extent as the members of the board of directors, i.e. without any limitation. This should ensure greater transparency of the decision-making process.

8. Separation of the office of general manager and chairman of the board of directors should be considered part of the "best practice" even if this is not obligatory (new OECD). A decision to combine the role of general director and chairman of the board of directors should

be explained. In either case, whether the offices are discharged by different persons or by the same person, there must be a strong and independent non-executive element on the board, with a recognized senior member other than the chairman. These individuals should be identified in the annual report. It is essential that the power of the company should not be concentrated in one person and that the individuals holding these roles should be capable of being questioned and held accountable for their actions and inaction by shareholders.

9. Together with creating the corporate strategy, the board of directors is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the company. The supervisory board is responsible for the effective supervision of the activities of the board of directors and is accountable to all the shareholders for such supervision. This is especially important where there is a controlling shareholder.

10. Another important board responsibility is to implement systems designed to ensure that the company obeys applicable laws, including tax laws, laws in the area of competition, labor, environment, health and safety, etc. In addition, both the executive and supervisory boards are expected to take due regard of, and deal fairly with, stakeholder interests including those of employees, creditors, customers, suppliers and local communities. This is particularly important where the company is the key company in a region and has attracted smaller manufacturers and suppliers to establish nearby. Other stakeholders would include local residents affected by environmental standards implemented by the company (for more details, see Chapter IV).

11. The statutes must formally define matters reserved for decision-making by the board of directors. The roles of the board of directors and the supervisory board must be clearly identified and the boards must be careful to ensure that they follow these roles. There must be an agreed procedure for members of the board of directors and the supervisory board in the furtherance of their duties to take independent professional advice if necessary, at the company's expense. It is clear that members of the boards may need to take external professional advice in certain circumstances in order to properly discharge their functions. They must be able obtain this advice at the company's expense so that the cost thereof does not deter the members from taking such advice.

12. All members of the board of directors and supervisory board must have access to the advice and services of the company lawyer, who is responsible to the boards for ensuring that board procedures are followed and that applicable rules and regulations are complied with. As the members of the two bodies are personally liable, it is essential that they have access to a lawyer and are able to obtain advice from him, if they are concerned that the company does not comply with laws, valid rules and directives.

13. To ensure proper and effective administration of the process of corporate governance, particularly the activities of the board of directors and supervisory board, the office of company secretary has proved successful in a number of national corporate governance models. In Anglo-Saxon countries, the duty to appoint a company secretary is even imposed by law. The company secretary has a great many duties, whose scope differs according to the size of the company and the objects of its business. The company secretary is responsible for administration of the governance processes, provides for preparation of meetings of the boards and their committees, provides the chairmen of the boards and their members with support and advice, provides for administration of the meetings of the boards, coordinates

their activities and monitors the fulfillment of tasks imposed by the boards. The secretary ensures conformity of the performance of duties and responsibilities of the boards with the valid legislation, statutes of the company and its ethical principles. He participates in meetings of the board of directors and supervisory board and usually also fulfills the role of a secretary of board committees.

In Anglo-Saxon models of corporate governance, the secretary is considered to be the principal partner or non-executive board members, to whom he provides comprehensive and impartial information and advice concerning the rules of procedure of the boards and their committees, and the requirements following from laws and good corporate governance. He acquaints new members of the boards with activities of the boards and with the process of corporate governance. The company secretary is accountable to the board of directors/supervisory board and is appointed and recalled by these boards. Therefore, due attention should be paid in his selection to his professional qualities and integrity. In the Czech Republic, the development of the profession of secretary of boards is ensured by the Czech Institute of Secretaries of Commercial Companies. It is considered the best corporate governance practice to incorporate in the statutes of the company the duty to establish the office of secretary of boards and define his duties and responsibilities in the statute of the secretary.

14. The managers of the company have an obligation to provide the board of directors with appropriate and timely information, but information volunteered by management is unlikely to be enough in all circumstances and, thus, particularly members of the non-executive board of directors must make further enquiries where necessary. The chairman must ensure that all members of the board of directors are properly briefed on issues arising at board meetings. Since the directors have a liability it is essential that they are properly informed. Only if they receive and read all the critical information and are able to question management and evaluate their answers will they be able to properly discharge their duties and thus defend themselves against charges of failing to exercise due care and attention.

15. It is important that the board of directors and the supervisory boards meet regularly in order that they can properly discharge their duties. Ideally, the board of directors should meet no less than once each month and the supervisory board no less than 10 times each year. Once it is recognized that members of both boards have a liability, they must also recognize that they can only defend themselves from any charge of negligence if they meet regularly and properly perform their functions, namely in the case of the board of directors to direct the company and, in case of the supervisory board, to supervise the direction and management of the company. The number of times each board meets need not be exactly as hereby recommended provided that the meetings are sufficiently frequent to be appropriate for the particular company.

16. Participation in too many boards can interfere with the performance of board members and this should be a feature considered by the company in putting forward the potential board member. In this relation, the general meeting must be provided with detailed biographical data. Whilst there has been a suggestion that the Code should recommend a maximum number of board appointments, this approach is considered too prescriptive – it would encroach on what should be the decision of the shareholders. Clearly, if a member works in too many boards, this limits the amount of time he/she can devote to any of them and this in turn weakens any defense he/she may have against charges of failing to discharge his/her functions

with due care. Thus, board members should perceive that it is in their own interest not to accept too many appointments.

17. Members of the board of directors and/or supervisory board should be appointed by the general meeting for specified terms of office and reappointment should not be automatic. They could be subject to re-election thereafter at intervals of no more than five years. The names of members of the supervisory and board of directors submitted for election or re-election should be accompanied by full biographical details. Since the members of the boards must be accountable to all the shareholders, it is essential that their appointment is more than a simple formality. Thus, the shareholders must be able to be informed as to the qualities of all the proposed members of the boards. It is critical that the shareholders can replace any board member, whose performance is considered inadequate. Contracts that secure the tenure of the board member generally act as a barrier to their replacement.

18. The company should establish three separate committees responsible for the independent audit of the company and the remuneration (including other financial incentives) and nomination of directors and key executives. A majority of members of these committees should be independent persons (new EU) (for more details, see Annex 2, for the audit committee, see also commentary on Chapter V.) Unless the company is a small company, as defined by the Commercial Code, a nomination committee should be established to make recommendations to the supervisory board on all new appointments to the supervisory and board of directors. The chairman and members all committees should be identified in the annual report. In the near future, the EU Commission will issue a recommendation which will define the minimum standards for these committees.

19. In the Plan to Move Forward, the EU Commission recommends that in key areas where executive directors clearly have conflicts of interests (i.e. remuneration of directors, and supervision of the audit of the company's accounts), decisions in listed companies should be made exclusively by non-executive or supervisory directors who are in the majority independent. With respect to the nomination of directors for appointment by the body competent under national company law, the responsibility for identifying candidates to fill board vacancies should in principle be entrusted to a group composed mainly of executive directors, since executive directors can usefully bring their deep knowledge of the challenges facing the company and the skills and experience of the human resources grown up within the company. Non-executive directors should, nonetheless, also be included and specific safeguards should be put in place to deal with conflicts of interests when they arise, for example when a decision has to be made on the reappointment of a director. These requirements should be enforced at least on a "comply or explain" basis (new EU).

20. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors, independent directors and key executives. No director or key executive should be involved in fixing his or her own remuneration. Shareholders should be invited specifically to the general meeting to approve all new long-term incentive schemes (including share option schemes) whether payable in cash, in kind or shares in which members of the board of directors and supervisory board and senior executives will participate (Section 66 (2) and (3) of the Commercial Code).

21. The annual report of a company should include a declaration on the policy of remuneration of board members and publish data and their remuneration and on all other

financial consideration provided thereto, including share options, bonuses, pension insurance and “golden hellos and handcuffs” that could have an impact on the performance of a member of the board and thus also the company, and shareholders must therefore be notified thereof. Board members should declare that they will voluntarily forfeit any remuneration in case of bad financial performance of the company as defined in the Section 66 (3) of the Commercial Code.

22. The company should have its own Code of Ethics (see Annex 4), disclose the Code publicly and continuously acquaint all employees with its principles. The board members and the company management must be an example for employees with respect to their conduct and behavior, and must prove their respect for the provisions of the Code of Ethics.

ANNEX 1. Compliance with the 1999 OECD Principles of Corporate Governance in the Czech Republic: Evaluation by the World Bank and International Monetary Fund, July 2002

Evaluation scale:

- 1 compliance
- 2 fair compliance
- 3 partial compliance
- 4 non-compliance in fundamental aspects
- 5 non-compliance

Principle	Evaluation
Chapter I. Rights of Shareholders	
A. Basic rights of shareholders	2
I.B. The right to participate in decisions on fundamental corporate changes	3
I.C The right to be duly informed of general meetings, participate therein and vote thereat	3
I.D Disclosure of capital structures and arrangements enabling a degree of control disproportionate to equity ownership	3
I.E Effective and transparent functioning of markets for corporate control	1
I.F The requirement for weighting costs and revenues from exercise of voting rights	5
Chapter II. The Equitable Treatment of Shareholders	
II.A The equitable treatment of all shareholders of the same class	3
II.B Insider trading and abusive self-dealing should be prohibited	4
II.C Disclosure of material interest of the board members and managers in transactions or matters affecting the company	4
Chapter III. The Role of Stakeholders in Corporate Governance	
III.A Respect for statutory rights of stakeholders	4
III.B. Indemnification for infringement of rights	3
III.C. Performance-enhancing mechanisms with participation of shareholders	3
III.D. Access to relevant information	2
Chapter IV. Disclosure and Transparency	
IV.A Timely and accurate disclosure of material information	3
IV.B. Preparation of information, audit and	4

disclosure in accordance with the highest standards of accounting, disclosure and audit	
IV.C. Annual audit performed by an independent auditor	2
IV.D. Channels for dissemination of information providing for timely and cost efficient access to information by users	2
Chapter V. The Responsibilities of the Board of Directors and the Supervisory Board	
V.A. Informed action, action in good faith, with due diligence and care, in the best interest of shareholders	3
V.B. Fair treatment of each group of shareholders	3
V.C. Compliance with law and respect for interests of stakeholders	3
V.D. Fulfillment of key functions, such as formulation of corporate strategy, selection and monitoring of the management, nomination of board members, monitoring of conflicts of interest including misuse of corporate assets and abuse in related party transactions, integrity of procedures in accounting, audit and corporate governance, and supervision over disclosure of information and communication	3

ANNEX 2. Corporate Governance Board Committees

Introduction

To make effective strategic decisions management needs accurate and up-to-date knowledge of the business. Knowledge is based on information, which can be defined as data provided in a useful way and delivered to the right person at the right time.

In order to assist directors to properly shoulder their responsibilities and be in a position to inform shareholders knowledgeably about activities of their company it is recommended that **Boards include the adoption of committees which review the audit, nomination and remuneration functions** of the company. The establishment and functioning of each of these three committees should follow an unemotional style and consequently it is better that they are composed mainly, if not wholly, by independent directors.

Each committee should have Terms of Reference which clearly delineate their tasks and establish a protocol for their fulfilment. They should meet regularly (in the case of the audit committee), annually (in the case of the remuneration committee), and as required (in the case of the nomination committee). All meetings should have formalised agendas.

The prime purpose of these committees is to provide transparency for shareholders and to ensure that undue and unfair influence is not exerted by executive directors against the interests of shareholders and other stakeholders.

Relation to the board reports required by law

- The board report should name the members of these three committees
- The board report should review the work and achievements of these committees

➤ THE AUDIT COMMITTEE

This committee will usually have 3 to 5 members, mainly or wholly independent directors, who will meet at least four times a year.

Sample Terms of Reference

To provide an independent capability to advise the board on the quality of the financial management of the Company by way of review and oversight of financial reporting arrangements, corporate governance and internal controls.

An audit committee could typically:

- examine the management's procedures for ensuring the appropriateness and effectiveness of systems and controls
- examine the arrangements made by management to ensure compliance with requirements and standards under the regulatory system
- oversee the functioning of the internal audit function (if applicable)
- provide an interface between management and the external auditors.

With an effective audit committee the Board can be responsible for the group's system of internal control and for reviewing its effectiveness. Such a system, however, is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable, and not absolute, assurance against material misstatement or loss.

Its main responsibilities can be stated in four categories. They are to be fulfilled by designing and monitoring the activities of the internal audit department and by co-ordinating with the external auditors and the management of the company.

1. Supervision of Internal audit

- Review internal controls, performance tests of compliance with internal controls, suggestions for improvement
- Review risks, accepting degrees of risk and concentrating on the most serious risks which affect or could affect the business
- Review of compliance with legal requirements and with internal code(s) of procedures
- Recommendations for improvements of any sort
- Performance of special examinations (including those designed for misappropriation of funds), find conflicts of interests, test compliance with code of ethics (if it exists)
- Verify accounting data (accounting principles and procedures)
- Evaluate and approve the financial statements
- Ensure effective information flow

2. Recommend (as appropriate) external auditors and/or the renewal of their existing mandates; co-ordinate with external auditors

- Recommend and select the independent external auditors (usually with the recommendation of the Executive Board). This selection is then ratified by shareholders' meeting.
- Members of the audit committee should participate in audit meetings (together with the management and the external auditors) about the scope of external audits, and the results of those external audits.
- Co-ordinate with external auditors

3. Protection of assets and supervision of internal controls

- Establish systems for the protection of assets and other internal controls
- In co-ordination with the internal audit department, the audit committee should supervise major risks such as financial misappropriation, technological and natural risks, including health hazards and environmental risks. It should review monitoring methodologies and make recommendations to improve the effectiveness of established safeguards.
- Establish (with the executive financial director and his department) adequate controls for financial operations

4. Evaluate all special financial operations with significant consequences for the company

- Regularly review specific financial operations to ensure their effectiveness
- Assess cash flow controls to ensure that funds will be available to meet all short term commitments
- Assess contingent liability transactions especially where the accounting procedures do not automatically evaluate the mark to market liabilities

➤ **THE REMUNERATION COMMITTEE**

This committee usually has 3 to 5 members, mainly or wholly independent directors, who meet annually but may need ad hoc sessions as well.

Sample Terms of Reference

To recommend to the Board a broad policy in relation to all aspects of directors' and senior executives' remuneration.

The most important role for this committee is to ensure that the company can attract, retain and motivate its directors and senior staff. However, such rewards for their tasks should be reasonable in relation to individual responsibility, knowledge and performance.

It is possible that company's remuneration policies will from time to time lead to tensions between the ability of the company to meet the requirements and standards under the regulatory system and the personal advantage of those who act for it. Where tensions exist, these should be appropriately managed.

The results should be able to demonstrate accountability and transparency. Compensation and performance-related pay should be reasonable and not excessive.

This committee's tasks can be listed under two key headings:

1. Attract, retain and motivate directors

- Be sensitive to the wider picture, particularly salary levels elsewhere in the firm and in the relevant market area
- Research minimum and maximum market levels
- Evaluate relative responsibilities, performances, motivations and targets per each individual
- Balance quality against cost

2. Consider performance elements carefully

- Set main board and senior managers salaries and other remuneration, including “perks”
- Perks should be relevant, functional and not excessive
- Always consider pension costs in relation to salary awards particularly for directors nearing retirement
- The committee should always consider taking outside advice
- Balance business expansion/increase in profitability/ increase in assets and per share values against risks to business both in terms of efficiency and capabilities
- Ensure that bonuses in some areas are not at the expense or disadvantages of other areas

3. Special considerations

- Always consider the remunerations from a fairness point of view of shareholders. In particular remember that performance payments will usually be made in the year following the achievement and may reflect adversely on following year profit relationships
- When awarding percentage increases to directors consideration should be given to the relative rate of inflation and the awards made to staff
- Share options should not vest for at least three years and should be encouraged to be held for further periods subject to necessary financing arrangements
- New long-term schemes should be approved by shareholders.
- Contracts should be no longer than one and at most two years, however, where they need to be longer to attract the right person such terms should revert to no more than one year after the initial period
- Compensation following departure from poor performance should be fair but not excessive.

➤ THE NOMINATION COMMITTEE

This committee usually consists of 3 to 5 members, mainly or wholly independent directors, who meet as required.

Sample Terms of Reference

To make proposals to the Board for the appointment of directors and senior staff responsible to shareholders or directly to the chairman or a managing director and to consider issues of succession planning within the company.

The purpose of this committee is to ensure that the make-up of the Board meets with a broad range of skills, experience and expertise relevant to the business and that it has a high proportion of independent directors who have no potential conflicts of interest within the business.

This committee's tasks can be listed under three headings:

1. Evaluate the skill sets necessary for the board to function fully

- Review the balance of the range of necessary skills
- Ensure a range of knowledge of business, operational, social and specific market functions
- Ensure a reasonable level of independence at board level

2. Establish and disclose the applicable criteria

- Required level of experience of candidates of management, social and technical ability
- Required level and types of qualifications of candidates
- Relative responsibilities necessary for the available positions
- Required numbers without any potential conflicts of interest
- Required knowledge of specific operational functionality
- Required level of shareholder specific representation
- Should the board have a senior non-executive director and should he be of sufficient calibre to be deputy chairman?

3. Select candidates

- Differentiate between potential executive and non-executive posts required
- Determine on basis of established criteria only
- Consider relevant costs of appointment
- Consider number of other such posts held and experience
- Research details of experience and past history
- Check if "fit and proper" to act in this capacity (i.e. financial standing, integrity, competence)
- Check personal and commercial references
- Check age and relative community standing

ANNEX 3. A Guide To Best Practice For Executive Boards

Introduction

This guide for boards does not seek to provide a summary of the law relating to directors but is designed to illustrate what is generally accepted best practice for directors of publicly tradable/registered companies in those areas where the law permits the company to address procedures in the statutes. Whilst the focus is on the standards of conduct of Executive Boards there are some references to Supervisory Boards and in any event the members of Supervisory Boards should be familiar with these guidelines as they describe best practice of those Executive Boards they supervise. Many of the functions that directors must perform, the responsibilities they must accept and the liabilities to which they are exposed are common to those in charge of any type of organisation. These guidelines are, however, primarily addressed to the directors of joint stock companies incorporated in the Czech Republic under the Commercial Code.

Background

The Executive Board is the governing body charged with the task of determining the company's strategic objectives and policies, appointing and controlling its operational management, and monitoring its progress towards objectives and its compliance with policies and not least to be accountable for its activities to the shareholders.

The nature of a company director's functions and responsibilities and public attitudes to them are so heavily influenced by the special legal status of a company that it is important to understand the nature and functions of the company in the interest of which directors have a duty to act. A company enjoys corporate status and, as such, has the legal capacity to act as an entity distinct from the persons who hold the capital. Additionally, the shareholders have limited liability and thus the shareholders can limit their liability for the company's debts to the amount they have agreed in advance to make available to it. However, it is only the liability of a shareholder for the company's debts that is limited. There is no limit to the damages for which a director may be held liable if he breached any of his duties, whether to the company or a third party and the amendment to the Commercial Code extends this to those persons who, based on contract or shareholding or otherwise, substantially influence the behaviour of the company. This appears to cover a wide range of persons, including a major shareholder and a general manager.

Recently there has been increasing emphasis internationally placed on the relationship between a company and associated parties. A company holds together a complex web of economic relationships. Since such relationships are directed to the pursuit of mutual advantage in a competitive environment, they are, like those involved, in a game conducted within a framework of rules. In business many of the rules are set by the players themselves - for instance the terms of an individual contract - but some are imposed on all players everywhere by the application of the general law, either in the interest of society as a whole or

to take account of actual or perceived inequalities in the bargaining power of different interests.

In respect of two groups of interests, a company's legal status as a corporation creates a need for special treatment. These two groups are shareholders, who would not exist if there were no company, and creditors, whose normal legal right to be paid out of the whole of the assets of the proprietor of a business is diminished by the limitation of the shareholders' liability. A company's obligations to its customers, suppliers and employees, or its wider public obligations in respect of such issues as the protection of the environment, are not affected by its corporate status.

A company, then, has associated with it a number of interests, sometimes called "stakeholders", including customers, suppliers, employees, lenders and other creditors. These have a relationship with the company that is based on contract but heavily modified by statute. It has a further and most important relationship with its shareholders and potential shareholders who enjoy, or hope to enjoy, property rights in the company and it must work within the legal, social and political requirements of the environment in which it operates.

To be successful, a company must adopt policies for its dealings with these interests which embrace both the economic and the legal aspects of its relationship with them.

Shareholders have a special relationship with the company which is different from those of the other parties (being based on property rights) and they play a formal part in the decision-making structure of the company and need therefore to be considered in this light also. It is inaccurate to regard the shareholders and the company as being identical or indeed to describe them simply as the "owners" of the company. Even collectively, they do not own the company or its assets outright. What they do own is a bundle of rights on which a monetary value can be placed. The extent and nature of these rights depend very largely on the constitution as expressed in the statutes of the company. These rights will normally include the following main elements but many of them may be excluded or modified in the case of a particular company or class of shareholder:

- a financial return, normally in the form of a proportion of the company's distributable profits (i.e. a dividend)
- the right to transfer their interest to another person
- a right to vote in general meetings, enabling them to participate in decisions on the size, shape and scope of the company and in particular in decisions to:
 - dismiss and appoint the directors
 - change the company's constitution
 - liquidate the company and distribute the value of the assets among themselves.

Many of the provisions of the Commercial Code are designed to protect the interests of shareholders on the assumption that their knowledge of and involvement with the company will be minimal. Shareholders' rights to information about a company are limited to those provided for by law. Companies and their directors must comply with these disclosure

provisions. However, there is a wider obligation for the disclosure of information under the guidance provided by the Securities Commission and shareholders can benefit also from this disclosure.

It is not possible to overstate the significance of customers in a business context. The free enterprise system depends fundamentally on the ability of individuals and organisations to choose to spend their money on the products of one business rather than those of another. At the company level it is customers alone who produce revenue and every other party associated with a company through the market produces costs. Thus nothing brings a business to disaster quicker than failure to take account of its customers' requirements and interests in the widest sense and nothing is more calculated to bring free enterprise in general, or any particular company, into disrepute than an unwillingness to take adequate account of, or provide adequate compensation for, possible dangers to health or safety inherent in a particular product or service, or attempts to secure unfair advantages over customers, whether by price fixing or collusive practices, by failure to disclose information relevant to the customer's choice, or by attempts to set aside statutory safeguards for customers' economic interests.

There are a formidable number of laws designed to protect the health and safety of customers. It applies to both companies and directors, and is backed by powerful enforcing agencies in the shape of local Trading Standards Officers, the Competition Office and the Securities Commission (in its role as supervisor of mergers and take-overs).

It is essential for any well-run company to take account of its relationship with its employees. Employees are rightly as concerned about such factors as the security of their employment, the capacity of their employer to recognise and reward their individual contributions to the business, the physical conditions in which they work and the inherent interest of the job, as they are about their wages. Whilst it is true that employees sell their labour, collective bargaining over terms and conditions of employment is still an expression of this contractual relationship. However, as the emphasis in modern economies has shifted from manual to mental skills the idea that labour can be treated as an undifferentiated mass loses even the limited validity it might once have possessed. It has had more effect in the Member States of the European Union and wider involvement of employees in company management remains a major objective of the EU.

Finally, the relationship between the company and its creditors is important. There are many features of companies and insolvency legislation which stem from a desire by legislators to compensate creditors for the reduction in their rights that the limitation of shareholders' liability involves. A company's liabilities to creditors may create substantial personal liabilities for its directors if the company becomes insolvent.

The Board and Management

The general meeting of shareholders, together with the Executive Board, and the Supervisory Board are the bodies with direct responsibility for shaping the company's future. The

relationship between these bodies is given formal expression in the company's statutes. Every member of the Executive Board (“director”) and of the Supervisory Board should, before accepting his/her appointment, obtain copies of these documents, which, together with any resolutions of, or agreements between, shareholders constitute the company's written constitution, and read them carefully to identify the formal powers and duties of each body. The directors may do only that which the current constitution and the law permit them to do.

The statutes will not give much of a guide to how the relationship, which depends more on the business environment and history of each individual company and on the personalities of the individuals concerned, works in practice from day to day. It is nonetheless possible to assign broad areas of responsibility to each body and to be reasonably sure that if one body steps outside its proper area, trouble is likely to ensue.

The general meeting of shareholders holds what is in effect a power of life and death over the company and over its boards. It is also the guardian of the company's constitution, since it alone has power to alter the company statutes.

The Performance of the Direction of the Company

In the case of publicly tradable/registered joint stock companies, the Executive Board's function is directed primarily toward making strategic decisions and there should be a clear distinction between direction, management and ownership. The directors of publicly tradable/registered companies operate under a tighter regime and must comply with the requirements of the Commercial Code in areas such as maintenance of capital, distribution of profits, payment for share capital, accounting requirements and the maintenance of the reserve funds. The need for greater protection arises from the need to protect the public who invest in such companies. If the company is listed on The Prague Stock Exchange, the obligations imposed on the company are even stricter and the provisions of the Exchange's "Listing Rules" must be met. In addition to these the Czech Securities Commission has published rules on continuing disclosure obligations and these also must be met.

In between the general meeting and management stand the executive and Supervisory Boards. The Executive Board is responsible for governing the company, for its long-term strategic direction as contrasted with its short-term operational management and the Supervisory Board is responsible for overseeing the activities of the Executive Board and representing the company in actions against the directors.

In summary the Executive Board takes responsibility for:

- Determining the company's strategic objectives and strategic policies.
- Appointing the company's top management.
- Monitoring progress towards the achievement of objectives and compliance with policies.
- Giving an account of the company's activities and its financial position to the Supervisory Board and to the shareholders in the general meeting.

The strategic function is generally taken to involve:

- The determination of the business activities in which the company should
- Engage
- Ensuring that the company has adequate long-term objectives and strategies, expressed in both physical and financial terms.
- Balancing the interests of shareholders, employees, customers, suppliers, creditors and the community at large with those of the company and ensuring that the company and its shareholders clearly understand the policies in relation to these interests consistent with the achievement of its strategic objectives.
- Ensuring that the company reviews its business plans in the wider context of the current and likely local, national and international environment and with adequate intelligence as to the activities of its major competitors and developments in technology.
- The approval of the budgets presented by the management and ensuring that they are compatible with short-term and long-term objectives.
- The determination of the extent and priority of the company's investment in relation to the opportunities and threats ahead, having regard to the resources available.
- The approval of specific major investment and policy proposals and making recommendations on dividend policy.

The appointment of the top management generally involves:

- The selection of the general manager and the determination of the terms of his/her contract.
- Ensuring that the company's management structure and resources are appropriate and sufficient for specific and general tasks. The planning of management motivation, development and succession.
- The approval of the top management remuneration, and directors' expenses (subject to oversight by the remuneration committee if there is one).

The monitoring function generally involves:

- Ensuring that the company's information systems are adequate to monitor performance and to provide for sound decisions by board and management.
- Identifying vulnerabilities in the company's financial position, short term and long term, with particular reference to expected profitability, liquidity and solvency.
- Monitoring management performance against strategic objectives and compliance with strategic policies and initiating appropriate corrective action if failures are revealed.
- Ensuring the fullest communication with shareholders and the company's identification with their interests.
- Ensuring that the company complies with its legal obligations as to the disclosure of information and maintains an appropriate level of transparency about its

business.

The Supervisory Board

The Supervisory Board is charged under the Commercial Code with overseeing how the Executive Board exercises its range of powers and how the business activity of the company is conducted. In order to do this the members of the Supervisory Board have the right to inspect all documents relating to the company's activities and to review the annual financial statements and the proposed distribution of profits.

Whilst the Commercial Code does not specify the number of times the Supervisory Board should meet, best practice requires it to do so once each month in order to effectively supervise the Executive Board. Furthermore, to ensure a sufficient level of independence under which the supervisory function can be performed, at least twenty five percent of the members of the Supervisory Board should be independent of the company. These members should have no contractual relationship with the company and should not be under the control or influence of any other director or group of directors.

It is extremely important to be clear what the proper contribution of Supervisory Board members is to a company. Their legal duty is to act bona fide in the interests of the company. However, their independence has further contributions to make including:

- Taking responsibility for monitoring management performance and the extent to which the management of the company is achieving the results planned when strategy was determined.
- Ensuring that the board has adequate systems to safeguard the interests of the company where these may conflict with the personal interest of individual directors.
- Exercising a duty to the company in such areas as board appointments and remuneration.
- Ensuring the presentation of adequate financial information, whether or not a formal audit committee exists.

Whilst not a member of the Supervisory Board the chief executive should be available to be called to the meetings of the Supervisory Board to explain any actions of the Executive Board and the members of the Supervisory Board should expect the same level of access to company information as described below.

To enhance the company's sense of general responsibility, and to widen its strategic horizons, it is good practice that the supervision of the Executive Board is undertaken by a Supervisory Board which should contain a proportion of suitable independent members with a minimum of three or twenty five percent of the total for larger companies and two or one-quarter of the total for smaller companies.

The independent directors should be of sufficient number and calibre for their views to carry significant weight in the board's decisions. It is good practice that all members should be

selected through a formal process and that this process and their appointment should be a matter for the board as a whole. The use of a nomination committee (composed of a majority of independent directors) is good practice to carry out the selection process of independent members and to make proposals to the board.

The Organisation and Management of Boards

Unless the statutes of the company provide otherwise the members of the Executive Board are appointed and recalled by the general meeting and are thus directly accountable to the general meeting and its constituent shareholders. The Commercial Code however also permits the use of the German model, namely the appointment of the Supervisory Board by the general meeting and the empowerment of that body to appoint and recall the members of the Executive Board.

Whichever model is followed there are some common themes. First it is essential that an Executive Board accepts and implements the concept of collective responsibility. The Executive Board should seek to achieve a common view about an uncertain future and reach decisions by which all its members agree to be bound. This is particularly important where there is a dominant shareholder. The development of a collegiate spirit amongst the Executive Board members is highly desirable, particularly in the light of the liability of directors under the Commercial Code.

All directors are entitled to any information they require in order to perform their functions. So long as they have no grounds for suspecting that it is misleading or wrong, they are entitled to rely on the information supplied by management. As the time available for board meetings is limited, they need complete and accurate information and they need it sufficiently in advance of a meeting to have time to study it. If critical information is given to board members within insufficient time for their consideration before a board meeting, best practice should dictate that the subject is deferred to a subsequent meeting, even if a special meeting has to be called to discuss a subject which is urgent.

Meetings of the Executive Board and Supervisory Board should take place at least once each month, although depending on the business, a meeting in August may be deemed by the board as unnecessary.

It is good practice that the statutes of the company specify that every member of the board is entitled to call a meeting of the board and to have notice of a meeting. Likewise the proceedings of a meeting where all members have not had proper notice of such a meeting should be void. The notice need not be in writing to be valid, but the period of notice must be reasonable having regard to all the circumstances. It is good practice that a list of prearranged dates is circulated.

The quorum requirements necessary for the meetings of the Executive Board should be set out in the statutes of the company. A meeting cannot proceed to business unless a quorum is present, as this would run counter to the concept of collective responsibility.

The agenda is normally combined with the notice of a meeting but there is in fact no legal requirement to give notice of the business to be transacted when calling a board meeting. The constructive use of the agenda, to ensure that the various proper functions of the board are performed on an appropriate cycle and that items appear in the best order, can make a considerable contribution to the efficiency of the board. This practice also gives the members of the board an opportunity to request relevant information and to be prepared.

It is also good practice for the board papers to include minutes of the previous meeting which members of the board will be asked to agree as a true record, though minutes can be prepared and signed before the meeting to which they refer breaks up. Once agreed and signed by the chief executive they are evidence of the proceedings to which they relate. On the whole it is unreasonable to expect minutes to chart discussion as opposed to recording decisions for the topics to be considered.

Papers relating to the business of the meeting should normally accompany this documentation. These should include:

- The management accounts and statistical returns which should not be in a form in which the key information is obscured in a mass of data more suited to use by the management rather than the board. Boards should insist on this as it is extremely important for board members to have the clearest possible picture of the expected profit and cash position of the company.
- The business plans and budgets. Boards should ensure that they have adequate information about underlying assumptions and particularly about the sensitivity of profits and cash flow to variations in assumptions as even the slightest variation may wipe out any expected profits.
- Information supporting proposals by management for new projects which seek authority to commit funds to new investments or major changes in policy. It is essential that the boards expect information which clearly demonstrates that the project has been properly evaluated, especially the following information that:
 - demonstrates how an investment relates to the company's objectives
 - addresses all the factors which ought to be covered
 - sets out a realistic range of options for achieving a particular objective
 - has measured everything that can reasonably be measured, and which draws attention to those factors of which the management is doubtful or where measurement is not possible.

Board Members

Whilst the responsibility of all directors of a company is equal, some play a special role. Thus the Chief Executive is often appointed by the board to preside over the board and will normally, under a provision in the company's statutes, also take the chair at general meetings of the company. In practice, however, the Chief Executive is not only seen as being the

chairman of the board, but is also expected to act as the company's leading representative, presenting the collective views of the board to the outside world. The distinctive features of the Chief Executive role are:

- To chair the general meetings and the meetings of the board, including in this function not only the orderly conduct of meetings, so that everyone who should have a say can have a say, but also the allocation of time to different items, the determining of the order of the agenda, directing discussion towards the emergence of a consensus view, and adequately summing up decisions so that everyone understands clearly what has been agreed by way of policy and action.
- To act as the company's leading representative in its dealings with the outside world.
- To play a leading role in determining the composition of the board and any substructure of committees, so as to make the board an effective team, working with a high degree of harmony.
- To take whatever decisions are delegated by the board to him or her to take between meetings of the board.

Executive directors are members of the board who carry out executive functions in the company in addition to their board duties and are remunerated separately for them. It is good practice that the majority of the Executive Board members work full time for the company and are thus aware of the key issues affecting it. Often department heads are appointed as directors but the reasons for these appointments are sometimes confused. A directorship should not be some sort of prize for long service with a company. The only criterion for appointment to the board should be a recognisable capacity to contribute to the board's proper function. This cannot be the case if an executive does not recognise that his/her responsibilities as, say, head of product development are quite distinct from his or her responsibilities in the boardroom. Such a specialist may carry only a specialised view into the boardroom and tend to shrug off the other problems of the company as not being matters to which he/she should devote much thought or express an opinion. The executive director is not there just to press the views of a particular side of the company, but should contribute to all policy decisions of the board and, if he/she has special skill and knowledge, present to the board this essential information in language that the other members can understand.

There is a tendency in some companies to describe as "Directors" individuals who do not sit on company boards. Often the title is given to enhance the status of the individual concerned either within the company or in dealings with other companies. It is usual to state in the statutes that a special director does not possess any of the powers of a full and normal director and has no right to attend board meetings. But the Commercial Code provides that this has limited effect against third parties. If special directors are held out to the outside world with the title of "Director", without qualification, they cannot expect wholly to escape the responsibilities which go with that office. They may not indeed have those responsibilities but if something went wrong with the company which meant a legal penalty, local or special

directors might have some difficulty in denying that they were "Directors" within the meaning of the Commercial Code and particularly the recent amendment.

An Executive Board is normally permitted by the statutes to delegate its functions further, either to committees or to management. Delegation to committees can cause certain problems, most acutely where an executive committee is formed to carry on the board's business between meetings. The danger is that the creation of committees may create, in the mind of members of the board, the idea that because some members' responsibilities are enhanced thereby, those of the others are diminished. This is not the case; indeed the purpose of committees is to go, in greater depth than is possible in full board meetings, into certain issues for which the full board retains responsibility.

Other than executive committees and committees with a more or less administrative function, the three which should be considered seriously are the nomination, remuneration and audit committees.

As a matter of good practice, executive directors should not be responsible for fixing their own remuneration but rather this should be subject to the recommendation of a remuneration committee made up wholly or mainly of independent members of the Supervisory Board. The use of a remuneration committee therefore provides the opportunity for independent members to assist the chief executive in the sensitive task of deciding the pay and conditions of service of their executive colleagues in a manner which is demonstrably fair to them and to the company. A director should not be present when his/ her own remuneration is under discussion.

The establishment of audit committees is also considered best practice. They should comprise of at least three independent directors with written terms of reference which clearly deal with its authority and duties. Audit committees provide a link between the board and the auditors, independent of the company's management which is responsible for the accounting system that is the subject of the auditor's scrutiny. The primary purpose of such a committee is to assist the board in the proper discharge of its responsibility with regard to the validity of published financial statements. It can also provide an appropriate vehicle for reviewing prospective external auditors (who should report to the shareholders), for any discussions the auditors may wish to initiate on the scope of external audit and its relationship with internal audit, and for negotiating the audit fee.

The Chairman of the Supervisory Board is another key person, particularly where the employees have elected him to the Supervisory Board, or where he is independent of the main shareholders and thus is seen as truly independent. In either case his status will be enhanced and he may take part of the role of representative of the company to the outside world.

Liability of Members of the Executive and Supervisory Boards

The Commercial Code provides that members of both the Executive and Supervisory Boards are personally liable, jointly and severally, for any damage to the company resulting from a

breach of their legal duties. Since the same section charges the directors with exercising their range of powers with due diligence, this may well in time become a stringent provision. Furthermore, the recent amendment to the Commercial Code provides that this liability may extend to any person, who, either based on contract or through a shareholding substantially influences the behaviour of the company. This may be seen as a significant change for those general managers who whilst not being members of the Executive Board were the effective directors and managers of the company and whose liability was previously limited to a maximum of four and one half times their annual salary. Additionally, a majority shareholder who uses his/her influence over the Executive Board to take a course of action which is damaging to the company will also be liable under this provision.

Directors should not only be concerned about the information which they receive, they must be responsible for the information given to those who rely on it. As such, they are personally liable to such individuals if they have not exercised due diligence to ensure that it is accurate and not misleading.

The members of the Executive Board should also observe their obligations for ongoing disclosure under the Securities Act and the requirements of the Czech Securities Commission.

Accountability of members of the Executive and Supervisory Boards

It is important that the members of the Executive and Supervisory Boards understand the concept of accountability, which is distinct from their liability discussed above. Their liability is a legal liability which requires enforcement by the courts whereas the members are also accountable to the company as represented by the shareholders in the general meeting and can be sanctioned by being removed from their positions. There is a move internationally whereby institutional investors are increasingly playing a more active role in calling members of the boards to account and members of the boards should be aware of this.

It is increasingly becoming good practice that companies and their directors should be more widely "accountable", not merely in terms of the strict accountability which directors already owe to the company, nor simple discharge of their duties relating to accounts and disclosure created legislation, but a willingness to provide adequate information about the company's affairs to any party with an interest in the company. An example of this is the recent controversial SEC regulation regarding disclosure. Reasonable transparency is a pre-requisite for satisfactory relationships with all the parties associated with a company; if companies do not make adequate voluntary disclosure they will undoubtedly face further ill-considered attempts to secure changes by legislation.

It is important to accept that it is not the job of each individual member of the Executive Board to be an equally competent expert in all fields of the company. However, it is a member's task to understand that unless each field is functioning adequately the company may fail and, furthermore, that if he/she possesses particular expertise in any of these fields, or in any other branch of knowledge relevant to the company, he/she should deploy that expertise

in the company's interest. A formal code of ethics should outline the approach board members should adopt.

The Executive Board's Relations with Associated Parties

In formulating company policy toward the various interest groups, members should regard seriously their position as the collective conscience of the company. To the extent that the interests of parties are protected by law it is likely that the company's compliance with the law will be enforced by imposing penalties on its directors. To the extent that they are matters of agreement, directors should remember that the board is the guardian of the good reputation of the company. Increasingly this becomes important, especially as companies look over time to raise capital from the international capital markets.

The company needs to maintain good relations with a number of categories:

- Shareholders
- Employees
- Creditors.

Under the Commercial Code the general meeting has the power to appoint directors or if the statutes provide this can be the role of the Supervisory Board. In practice they confirm appointments made by the board between annual general meetings. It is a requirement of the Commercial Code that a person appointed by the directors of a listed company to fill a casual vacancy, or as an additional director, must retire from office at the next annual general meeting. He or she will then be eligible for re-election.

Where the directors are appointed by the general meeting, his/her relationship with the shareholders may be terminated either by vote, or in the market place as the normal way, namely the shareholders of a public company express their dissatisfaction by selling their shares, which, if continued long enough, may well lead to a bid or a change of directors. In addition, and in extreme circumstances, the shareholders have collectively the power to terminate the relationship by exercising their right to liquidate the company.

The main justification for shareholders appointing the board through the general meeting is that the shareholders' relationship with the company is through their property rights. Once they have subscribed the capital, then they surrender any detailed control over how the funds are to be used. It is argued that having control over the appointment of the company's governing body compensates them for this loss of direct control over their property. Also the shareholders, ranking last in order for their income and taking the greatest risk of irrecoverable loss of their assets, are a definable group with the greatest interest in the company's success. They cannot be satisfied without the company having first satisfied the customers and then all the other parties in terms both of the amount and the security of their income. Clearly where the statutes provide that the Supervisory Board appoints and recalls the Executive Board, this link and compensation is diluted but nonetheless remains since the shareholders appoint the Supervisory Board.

It is a matter of good practice for directors to maintain regular contact and to keep their institutional investors well informed. They can be a potential ally in the face of a hostile takeover, and can also prove a powerful enemy where they consider an action taken by the board to be ill conceived. Indeed, the recent development of an association of investor relations firms in the Czech Republic underlines the importance some companies attach to this aspect of their relations with their shareholders.

The duty directors owe to the company to have regard to the interests of the employees arise, quite apart from legislation, from the fact that they cannot direct a company successfully unless they have regard to the interests of employees. What this means in practice is directing the company in such a manner that every individual employee perceives that he/she is getting a good bargain in terms of pay, security and general welfare at work, to set against the opportunities he/ she surrenders of working elsewhere or not working at all. Thus, like most board considerations, it ultimately rests on commercial, as well as social, criteria.

Best practice dictates that, as a minimum requirement, boards of directors should:

- Keep under review their arrangements for determining pay and other terms and conditions (e.g. the degree of centralisation and recognition of trade unions) bearing in mind the need to link pay as closely as possible to productivity as well as the general factors affecting the labour market.
- Review the systems which exist within their companies for consultation with employees before decisions are taken, for communicating relevant decisions and general information about the company, for involving all employees as effectively as possible in the making of those decisions which will directly affect them at the work place and for enabling them to participate in the company's equity.
- Ensure, whether or not collective bargaining arrangements exist, that clear guidelines have been set for the company's management before negotiations about pay and other terms and conditions of employment take place.
- Review the company's health and safety policies and record, bearing in mind the provisions of the relevant health and safety legislation relevant to the company which relate to the physical well-being of employees.

The board should be responsible for the company's relationship with its creditors and for creating and monitoring compliance with the company's policy on terms of payment. It is extremely damaging to a company to get a reputation as a poor payer and attempts by larger companies to fund their working capital needs at the expense of their smaller suppliers are probably self defeating as the terms on which small companies can borrow are usually worse than those available to large companies and this is ultimately reflected in the prices of supplies.

Members of the boards can also be liable under the bankruptcy laws for any trading undertaken whilst they are aware that the company has no reasonable prospect of avoiding insolvency.

Furthermore, under the recent amendment of the Commercial Code, a director of an insolvent company is automatically disqualified from being a director of another company for a period of three years from the conclusion of the bankruptcy proceedings. The court is empowered to grant an exemption if the member concerned proves that he/she has made every effort to prevent the bankruptcy. However members of both boards must keep a weather eye at all times on the solvency or otherwise of the company.

Conflicts of Interest

There is a general rule that directors must not use their powers for an improper purpose, take personal advantage of the company's opportunities, allow their personal interests to conflict with those of the company nor misapply the company's assets. Most courts internationally expect a very high standard of honesty from all fiduciaries and will apply very stringent tests as to what constitutes impropriety, personal advantage or misapplication.

The Commercial Code provides specifically for a prohibition on competitive conduct (unless otherwise permitted by the statutes or by a resolution of the general meeting) and in the event of a breach the company may seek the transfer of any benefit gained or rights acquired and may seek damages.

Even where the statutes vary the provision of the Commercial Code, internationally accepted best practice would require that the principle of declaration of interest is observed. Thus directors would be required to disclose to the board their interest in any contract or proposed contract with the company and failure to do so becomes a disciplinary offence. Disclosure should be made at the first board meeting he/she attends at which the contract is discussed or at the first such board meeting after he/she has become interested in the contract. Generally, this would include any transaction or arrangement, including loan and guarantee transactions, whether or not constituting a formal contract.

If a director makes a personal profit through the use of the company's property without it being disclosed to the company, that profit belongs to the company and the director is under a duty to account for it to the company. Good practice extends this to profits arising from the directors' making use of a corporate opportunity. It makes no difference that the profit is one which the company could not itself have made if the director had not deployed his/her own resources to making it, nor that he/she acted in good faith. The required elements are simply that what was done resulted in a profit to the director concerned, was not disclosed to, nor permitted by, the company and related to the company's affairs in such a way that it could be said to have been done in the course of the director's management by virtue of his/her opportunities or special knowledge as a director.

A director may be under no duty to account for such a profit if he/ she has disclosed to the company the profit and the circumstances in which it was obtained and his/ her retention of that profit is sanctioned. It is also possible for the statutes to include a provision permitting a director to retain a disclosed profit in certain circumstances without the need for the sanction of a shareholder's resolution. If, however, the profit has been obtained through misapplication of the company's property or involves dishonesty on behalf of the director it will not be capable of ratification.

It is good practice that directors disclose to the board their interest in any contract or proposed contract with the company, and whereby failure to do so becomes an offence for which a fine can be imposed. The areas where conflicts of interest are most likely to arise are contracts between a director and a company, loans by a company to a director, and dealings by directors in their company's shares.

Director's Duties

In most countries there is no specific list of director's duties as they tend to be set out in various pieces of legislation, the Commercial Code, the Bankruptcy Act, the Competition Act and so forth. However they can be classified as:

- Direct - where a director is required to act in a particular way for the benefit of the company or of a third party.
- Indirect - where the company is required to act in a particular way for the benefit of third parties or in the general public interest and an obligation is placed on the directors to ensure that it does so.
- Incidental - where other people as well as directors are required to discharge a duty, but where the nature of directors' functions means that it is particularly likely that they will have to discharge it.

Directors owe a fiduciary duty to their company. This means that they must show it the highest loyalty and act in good faith in its interest. They must act honestly and diligently. As the company's agents, directors must use their discretion, but whatever decisions they take must be within the company's objectives and in the interests of the company and not for any collateral purpose, nor for a personal motive. The benefit of the company can be taken to mean the interests of its members present and future and thus the directors may balance a long-term view against the short-term interests of present members.

What is in a company's best interests is sometimes hard to define and is generally a matter of opinion, and the courts will no doubt recognise this. Generally the test will be whether a reasonable director could have concluded that a particular course was in the interests of the company.

Directors have a duty of care as regards property of the company which is in their hands or under their control. They must ensure that it is not misapplied. The term property is wide and includes not only tangible assets, such as cash at bank, but also items such as trade secrets and know-how. A misapplication would include any disposition of the company's property which ought not to have been made. As soon as it is demonstrated that a company's asset has been applied by the directors for purposes which the company cannot sanction, the directors become personally liable for its reinstatement, however honestly they may have acted.

Service Contracts

Despite the shareholders' nominal control over an individual's appointment and removal as director, executive directors are often protected by long-term employment contracts as employees of the company. The high cost of compensation on removal can act as a deterrent, and make it expensive for the shareholders to exercise their powers. It is good practice to obtain the express approval of a company in the general meeting for any arrangement (whether formal or informal) which would enable a director's employment to continue beyond five years in such a way that it could not be ended by the employer, or only by notice in specified circumstances.

Employment includes not only employment with the company of which the individual concerned is a director but also, where a director is a director of a holding company, employment with any company in the group. Where a director of a holding company is employed by a wholly owned subsidiary, approval is required from the shareholders of the holding company.

The international trend is moving also towards the requirement to obtain formal approval of contracts with directors where there are favourable conditions for early departure.

Loans to Board Members

The Commercial Code contains rules regarding the grant of loans and similar transactions in favour of directors and, in certain cases, connected persons. These, together with the transfer of property free of charge, require the prior approval of the general meeting and must be undertaken under the customary conditions of business.

It is generally accepted good practice that a company should not make a loan to a director or enter into any guarantee or provide any security in connection with a loan made by any person to a board member. Also companies should not:

- make (or take part in an arrangement to make) a loan, or a quasi loan, to a director or a person connected with a director
- enter into a credit transaction for a director or a person connected with a director
or

- enter into any guarantee or provide any security in connection with a loan, quasi-loan or credit transaction for a director or a person connected with a director.

However, it is accepted that where a company provides a director with funds which he/ she uses exclusively for the purposes of the company's business, and which are not mixed with the director's own money, this funding would not be counted as a loan to the director. Similarly, the use by a director of a company credit card exclusively for company business would not constitute a quasi-loan.

Directors' Shareholdings

It is generally accepted practice (and indeed often encouraged) for the directors to hold shares in the company, provided they are held as a long-term investment. Indeed, the statutes of some companies require directors to hold qualification shares. Directors should not, however, use their special knowledge to deal in their company's shares; if they do so they are likely to be in breach of their duties to the company and in the same position as a director making a secret profit.

Because such dealings may be concealed, for instance behind nominees, it is important and good practice to monitor and control them. A director should, on appointment, notify the company in writing of any interest of his/her in shares or debt of the company or any other company in the group. Subsequently he must notify the company of any dealing or any other change in such interests (including entering into a contract to sell any such interest).

The company must keep a register of directors' interests and, on receipt of any notification of an interest or change, must record it in the register. Where the company has allotted shares or debt to a director or granted him an option to subscribe for shares or debentures, the director is not required to notify the company but the company is obliged to enter the resulting interests in the register without notification from the director. Where the directors' interests are in shares or debentures which are listed on a recognised exchange, the company should notify that exchange of the interests recorded on the register. The obligations of disclosure and notification should extend to the interests of a director's spouse and minor children.

Insider dealing is not only a breach of directors' duties; it is also regulated which makes a number of activities based on the use of inside information criminal offences. Briefly, individuals, whether directors or not, must not deal on their own account on a regulated market (i.e.: most stock markets in the developed world), or in certain cases, off-market, in securities of any company if they have, by virtue of their position or employment (whether with the issuer of the securities or not), confidential, unpublished, price-sensitive information relating to those securities. The prohibition also extends to individuals who have knowingly obtained, directly or indirectly, information from such individuals. Insiders with confidential, unpublished, price-sensitive information are also prohibited from encouraging others to deal in the relevant securities and, generally, from passing on such information.

Although it is possible that, in the case of insider dealing, a person to whom shares have been transferred may in some circumstances be able to claim rescission of the contract on the grounds of misrepresentation or fraud, the new provisions do little to make it easier for the company, its shareholders or third parties who may suffer, to recover their loss.

Standards of Care

The standards of skill and care which directors must bring to their duties and the manner in which these duties are to be performed have been significantly developed recently. A director of a company is generally expected to have (and to exercise):

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
- the general knowledge, skill and experience that director has.

In other words, a director must comply with both an objective standard (namely one expected of a person in his/her position) and, if he/she has higher skills, a subjective standard (i.e. one expected of him/her personally).

It is generally established practice that, in respect of duties that may properly be left to some other official of the company, a director is, in the absence of grounds of suspicion, justified in trusting that official to perform such duties honestly.

The Statutory Bodies Report

Directors of every company are required to prepare a report for each financial year. The matters to be included are set out in the Commercial Code and the Guidance note on Disclosure Obligations published recently by the Czech Securities Commission and include:

- a fair review of the development of the business of the company and its subsidiary undertakings during the financial year and of their position at the end of it
- the amounts of any recommended dividends or sums proposed to be carried to reserves (if any)
- the names of all persons who at any time during the year in question were directors, and their shareholdings and other interests
- the principal activities of the company and its subsidiary undertakings any changes in them and in asset values
- details of acquisitions of the company's own shares or charges on them
- employee health, safety and welfare.

Companies listed, or applying for a full listing, by the Prague Stock Exchange must satisfy the basic conditions for listing and comply with the relevant listing rules and the directors have a duty to meet these on an ongoing basis.

Annual Accounts and Directors' Report

A company's annual accounts should be approved by the Executive and Supervisory Boards and signed on the balance sheet by a director. A copy should be sent to the Securities Commission and the Commercial Registry. The directors' report must be approved by the board and signed on their behalf by a director and a copy sent to the Securities Commission and Registrar. Copies of both documents which are laid before the general meeting or otherwise published must carry the names of the persons who signed them.

If accounts are approved which do not comply with the law's requirements, every director who is party to their approval and who knows that they do not comply with the law, or is reckless as to whether they comply, is guilty of an offence. Every director of the company at the time the accounts are approved is taken to be "a party to" their approval unless he/ she shows that he or she took all reasonable steps to prevent them being approved.

If the directors' report fails to comply with the law's requirements about preparation and content, every person who was a director immediately before the end of the period for laying out and delivering accounts and reports for the financial year in question is guilty of an offence, unless he or she can prove that he/she took all reasonable steps for securing compliance with the requirements.

ANNEX 4 Pro Forma Code of Ethics

Introduction

All business activities are increasingly assessed by investors, employees, customers and the entire society according to their approach to business and trustworthiness.

Good business relations always depend on the reputation, i.e. on the opinion of the individual stakeholders on the company (enterprise). All types of companies require good reputation – both public and private, and both profit and non-profit companies.

When promoting the best corporate governance, a number of companies, as well as commercial associations, ministries, etc., adopt their codes of ethics, which they then disclose to their customers and shareholders, as well as all stakeholders, if appropriate; the aim is to improve the reputation of the company and inform the public of the overall approach of the company to business activities. Although a majority of companies have their own codes of ethics, the following text summarizes the main principles that should be followed by codes of ethics of a majority of companies and institutions.

Draft Code

➤ MANNER OF UNDERTAKING BUSINESS

Define the main values of the business; these values should also include the obligation not to accept or offer bribes and not to misuse personal relationships for obtaining business opportunities, as well as the obligation not to provide false or misleading information. *Your customers, shareholders and other stakeholders must be aware that, when dealing with them, you will act honestly and openly; otherwise, you will not persuade them to deal with you.*

If you want to improve the reputation of the company, follow your business values and act accordingly. *If the stakeholders are convinced that you take seriously the adopted ethical principles, as well as statutory duties, they will trust your opinions on the benefits of long-term cooperation with the company.*

If you undertake business in cooperation with other partners or use risk capital, ensure that your partners share your vision and values. *It is necessary that you trust your partners; the same is true for customers - they need to be assured that you will not deviate from your standards and values and give preference to lower standards of other partners. Lack of trust in partners results in further and needless business risks.*

Do not criticize your competitors. *Criticizing competitors brings no benefit. The only important thing is what your company pursues and how well it does its job. The need to criticize competitors is often perceived as camouflaging one's own mistakes.*

➤ APPROACH TO CUSTOMERS

Develop your relations with customers, answer their questions without delay, as your relationship with them does not cease at the instant of sale. *On-going business activities are much more valuable than one-time sales. Companies operate in a long term, in spite of e.g. changes in their personnel, and business success never comes immediately. Profitability is always obtained after a certain period of time.*

Comply with the agreed payment conditions and other business terms and conditions. *It is extremely important that customers can count on your reliability, as it can substantially affect their own business. Quality control and maintaining delivery dates is extremely important for the reputation of your company. Customers very negatively perceive any additional or hidden costs, as they chose your product, amongst other things, on the basis of its quality and price; therefore, they feel cheated, if any of these factors changes between the order and delivery (payment). Note: you can always make more profit on repeated trading and faithful customers, than on one-time transactions.*

➤ APPROACH TO EMPLOYEES

Ensure that employee satisfaction is a priority goal of the company. Provide them with appropriate training, inform them of matters of the company, and provide them with safe and adequate working conditions for performance according to their best abilities. *If your employees feel like an important and valued part of business, their motivation and accordingly also performance substantially increase.*

Ensure also that employees are fairly remunerated and motivated and that they are fairly treated according to their performance and without respect to their sex, age, race, or religion or political orientation. *Employees who are convinced that they are inadequately remunerated or that they are subjected to discrimination, could become a disintegrating element within the organization; they could harm the reputation of the company with customers and undermine all business activities of the company. The same effect on employees could also be caused by belief that the management tolerates misuse of company funds or otherwise behaves inappropriately.*

Remember that employees will probably consider the conduct of the management as an example, which will ultimately affect perception of the company by customers and shareholders. *Any conduct of yours that is seen by employees will probably be imitated. They will consider your behavior to the standard of working morals in the company.*

In case of a complex ethical issue, where the management or employees are not sure about its resolving, use external and independent assistance. *Ethical issues have often emotional or other consequences affecting profit. In that case, independent consultancy is suitable; this*

consultancy is not affected by emotions and direct orientation on profits, i.e. a conflict of interests.

➤ **APPROACH TO PUBLIC ADMINISTRATION**

Keep records of all financial transactions in accounting books and do so transparently. *Where this is not done, someone is always cheated – shareholders, employees or authorities. Incidentally – where authorities obtain clear and accurate information, they are usually more flexible and affable. However, in each of the above-mentioned cases, the ultimate losers are the managers, as the long-built reputation of the company can be lost over a short period of time and the guilty person is always ultimately found. Correct corporate governance is possible only if managers have both control of all facts and support and trust of all owners.*

Comply with all laws and regulations in jurisdictions where you operate a business, while complying with your own code of ethics. *All stakeholders must be assured that neither the company nor its employees breach the code of ethics, in order to use opportunities in a country where the statutory framework and business culture is less developed than in their own country.*

➤ **APPROACH TO LOCAL COMMUNITY**

Seek good relations with the local community in the place of your business through support of educational, health-care, ecological, cultural or other activities. *The local community belongs amongst the stakeholders of your business. It could be your supplier of human resources and provide your company or its employees with other services. Good relationships with the local community in the place of business are important for permanent development of business.*

➤ **PROPOSED STEPS FOR IMPLEMENTATION**

1. Design and implement a strategy to integrate the Code into the running of the business when it is issued.
2. Permit all company management and staff an opportunity to respond to the contents of the Code.
3. Ensure the Code is endorsed by the Supervisory Board, Board of Directors and the Company management.
4. Ensure that all members of management and staff become familiar with the Code, so that good ethical practice permeates throughout the business.
5. Provide advice on what to do when faced with an ethical choice.

6. Regularly review the Code and update where appropriate.
7. Consider making compliance with the Code a term of employment and link breaches of it to disciplinary procedures.
8. Provide training on ethical problems and circumstances.
9. Issue copies of the Code to suppliers and customers and expect their compliance also.
10. Provide a copy of the Code with the annual report so that shareholders and a broader public audience understand the company's stance.

Important contacts

Komise pro cenné papíry (Czech Securities Commission)

Washingtonova 7, P.O. Box 208

111 21 Praha 1

Tel: +420 221 096 111

Fax: +420 221 096 110

Email: podatelna@sec.cz

www.sec.cz

Asociace penzijních fondů České republiky (Pension Funds' Association of the Czech Republic)

Rumunská 1

120 00 Praha 2

Tel.: +420 224 266 561

Email: apfcr@apfcr.cz

www.apfcr.cz

Asociace registrovaných investičních zprostředkovatelů České republiky (Association of Registered Investment Intermediaries of the Czech Republic)

Rumunská 25

120 00 Praha 2

Tel.: +420 222 515 567

Fax: +420 222 515 568

E-mail: sekretariat@arizcr.cz

www.arizcr.cz

Burza cenných papírů Praha, a.s. (BCPP) (Prague Stock Exchange)

Rybná 14

110 05 Praha 1 – Staré Město

Tel.: +420 221 831 111

Fax: +420 221 833 040

Email: info@pse.cz

www.pse.cz

CG Partners, s. r. o.

V Tišíně 3

160 00 Praha 6

Tel.: +420 233 371 106

Fax: +420 233 371 161

Email: info@cgp.cz

www.cgp.cz

www.governance.cz

Czech Association of Investment Professionals

Tišmická 13/610

100 00 Praha 10

Tel.: +420 602 265 813

E-mail: info@caip.cz

www.caip.cz

Český institut interních auditorů (ČIIA) (Czech Institute of Internal Auditors)

Karlovo náměstí 3
120 00 Praha 2
Tel.: +420 224 920 332
Fax: +420 224 919 361
Email: ciia@interniaudit.cz
www.interniaudit.cz

Český institut tajemníků obchodních společností (ČITOS)

V Tišíně 3
160 00 Praha 6
Tel.: +420 233 371 106
www.citos.org

Fond národního majetku ČR (National Property Fund of the Czech Republic)

Rašínovo nábřeží 42
128 00 Praha 2
Tel.: +420 224 991 111
Email: info@fnm.cz
www.fnm.cz

Institut členů správních orgánů (Institute of Board Members)

V Tišíně 3
160 00 Praha 6
Tel.: +420 233 371 170
Fax: +420 233 371 161
Email: monika.zahalkova@ciod.cz
www.ciod.cz

Komora auditorů České republiky (Chamber of Auditors of the Czech Republic)

Opletalova 55
110 00 Praha 1
Tel: +420 224 212 670
Fax: +420 224 211 905
Email: kacr@kacr.cz
www.kacr.cz

Ministerstvo financí ČR (The Ministry of Finance of the Czech Republic)

Letenská 15
118 10 Praha 1
Tel.: +420 257 041 111
E-mail: podatelna@mfc.cz
www.mfc.cz

Ministerstvo spravedlnosti ČR (The Ministry of Justice of the Czech Republic)

Vyšehradská 16
128 10 Praha 2
Tel.: +420 221 997 111
Fax: +420 224 919 927
E-mail: posta@msp.justice.cz
portal.justice.cz

Ministerstvo průmyslu a obchodu ČR (The Ministry of Industry and Trade of the Czech Republic)

Na Františku
110 15 Praha 1
Tel.: +420 224 851 111
Email: mpo@mpo.cz
www.mpo.cz

RM-SYSTÉM, a. s.

Podvinný mlýn 6
180 18 Praha 9
Tel.: +420 266 198 111
Fax: +420 266 198 607
E-mail: rmsystem@rmsystem.cz
www.rmsystem.cz

Společnost pro strategické řízení, inovace a podnikatelství

Klub tajemníků správních orgánů akciových společností (Society for Strategic Management, Innovation and Entrepreneurship; Corporate Secretaries' Club)

Starostrašnická 25
100 00 Praha 10
Tel.: +420 274 782 158
Fax: +420 274 782 458
Email: mailto:ssrip@ssrip.cz
www.ssrip.cz

Unie investičních společností České republiky (UNIS ČR) (Union of Investment Companies of the Czech Republic)

Štěpánská 16
110 00 Praha 1
Tel: +420 224 919 114
Fax: +420 224 919 115
Email: unie@uniscr.cz
www.uniscr.cz