REVISED CORPORATE GOVERNANCE CODE
BASED ON THE OECD PRINCIPLES
/a final version corresponding with the Czech version – February 2001/

INTRODUCTION:

The following is the draft Corporate Governance Code which was discussed at a series of roundtables hosted by the KCP in September. Following these many very helpful and constructive comments were received and the attached document reflects the majority of these comments. The document will be available on the KCP corporate governance website together with other important material regarding corporate governance, including material provided by the Czech Institute of Directors which is referred to in this Code. The Website also includes background material on the development of corporate governance in Europe prepared for the Czech Institute of Directors and other information from the field.

The Code has been designed to set out the best practice for companies in the Czech Republic. The focus is on transparency and accountability as these elements are essential to encourage investor confidence. Therefore, the emphasis is on encouraging companies to sign up to the Code and adopt some of the provisions now and to explain to shareholders in the annual report why they are not adopting other provisions and when they anticipate being able to do so. It is hoped that companies will be able to progressively implement those provisions of the Code which they are not able to implement immediately leading to full compliance within the next few years.

All statements by the companies regarding the Code should be the subject of independent verification and thus companies are encouraged to instruct their auditors to undertake this verification exercise as part of the annual audit.

It has been suggested that the only way to improve practices in this area is by legislative changes. However, it is thought that at this stage it would be too onerous to incorporate the provisions into legislation as then they would apply to all companies, large and small and this could prove costly at a difficult time for companies in the Czech Republic. This does not preclude some of the provisions of the Code from incorporation in subsequent legislative amendments.

The KCP has established a further working group to identify the means of implementation of the Code. Representatives of all the following participated in the first meeting: the Prague Stock Exchange, RM. System, the Associations of Banks, Insurers, Internal Audit and Pensions Funds, the Union of Accountants, the Czech Rating Agency and the Czech Institute of Directors. UNIS and the Association of Auditors have indicated support for the work of the group.

It is expected that banks, insurers, pension funds, investment companies and other institutional investors will sign up to the Code and progressively implement its provisions in their own companies.

Additionally, it is anticipated that they will actively encourage those companies in which they invest, insure or to which they lend, to also sign up to the Code and to progressively implement its provisions. Thus it should be anticipated that the provisions will become accepted best practice soon.

BACKGROUND:

The Code is based on the OECD Principles but reference has also been made to other materials including the Combined Code of the London Stock Exchange. The Code is intended as a set of standards of best practice to be adopted and implemented in the Czech Republic without recourse to the introduction of legislation. This is the approach adopted in other countries, most notably in the United Kingdom, which is seen by many as the standard bearer of good corporate governance practices in Europe. The principles on which the code is based are those of openness, integrity and accountability. Openness on the part of companies, within the limits set by their competitive position, is the basis for the confidence which is essential between business and those who have a stake in its success. An open approach to disclosure of information contributes to the efficient working of the market economy, encourages boards to take effective action and allows shareholders and others, particularly shareholders, potential investors and bankers, to scrutinise companies more thoroughly. Integrity means straightforward dealing and requires that all financial reports should be honest and present a fair and balanced view of the company. The acceptance of these concepts will do much to remove some of the more unethical behaviour and practices currently prevalent in various parts of the Czech business world and will do much to restore an environment conducive to both strategic and portfolio investment.

The OECD Principles were intended to assist governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. They also were intended to provide guidance and suggestions for stock exchanges, investors, companies, and other parties that have a role in the process of developing good corporate governance. They primarily focus on publicly traded companies but might also be considered a useful tool to improve corporate governance in non-traded companies i.e. privately held and state-owned enterprises.

Good corporate governance is particularly important in the Czech Republic and other transition countries where there was no long term and continuous experience of non state ownership of companies and the attendant corporate practices. Thus it provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Additionally it should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

The degree to which companies observe basic principles of good corporate governance is an increasingly important factor for domestic and foreign inward investors, both institutional and strategic partners. If countries are to reap the full benefits of the global capital market, and if they are to attract long-term capital, corporate governance arrangements must be credible. Currently, in spite of the hope that things will turn for the better after recent amendment to the Commercial Code, one of the major problems in the Czech Republic has been the treatment of shareholders, particularly minority shareholders, including institutional investors and this has severely damaged the reputation of the market. Those foreign investors who have made investments, concerned by the experiences of so called "tunnelling", have sought to protect their investments through active involvement in the management of the company and in some cases this has further damaged good corporate governance arrangements. Furthermore the Commercial Code by allowing alternative models for board structure and appointment has confused the situation further. The adoption of good corporate governance standards should do much to improve investor confidence and thus attract more investment, both of a FDI and portfolio nature.

As owners of equity, institutional investors are increasingly demanding (and should be encouraged to do so) a voice in corporate governance in some markets. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. It should be said that in many countries, it is through the voice, and indeed votes of the institutional investor, that the individual minority shareholder is best protected. Thus the active participation of the institutional investor is critical to the improvement of standards. Creditors, particularly Banks, play an important role in some governance systems as they seek to reduce the credit risk of their customers and thus have the potential to serve as external monitors over corporate performance. The other stakeholders as well, especially employees, can act on improvement of corporate governance standards.

Following the approach adopted by the London Stock Exchange in supporting a similar initiative in the United Kingdom several years ago, the Prague Stock Exchange has agreed that it will recommend each the companies listed on its first market to accept, adopt and implement the final version of this draft Code by 1st January 2003 and to include a statement to this effect in its annual report for that year. Additionally, it will encourage all companies listed on the second market to do the same.

The RM System, recognising its potential role in the improvement of corporate governance standards will ensure that all companies who adopt the final version of this draft Code, are noted as such on its markets and are readily distinguishable from those companies which do not adopt the Code.

The Czech Securities Commission has included the issue of Corporate Governance into its Activity Plan, in spite of the fact that its powers cover only a minor part of the set of companies which should apply the Code. The Czech SEC underwrites the conclusions of the recent World Bank study which indicate that the poor performance of several Czech companies (as reflected by the volume of bad loans and by their arrears in taxes and social security contributions amounting to 32.5% GDP) is to be explained by a low standard of Corporate Governance.

I. The Company should be headed by an effective board of directors and supervisory board which should lead it and account to the shareholders. The board of directors should meet no less than once each month and the supervisory board should meet no less than ten times each year.

It is important that shareholders understand that as a practical matter, however, the 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 is typically 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 board and management team.

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 prevalent in 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 acceptable incentive schemes. In many countries, including the United Kingdom and Italy, this coincided with the privatisation of former state owned companies. The following principles involve the acceptance and development of practices which lead to improvements in shareholder value.

The shareholders have certain rights to influence the company on certain fundamental issues, such as the election of board members and amendments to the company's statutes. It is essential that all shareholders, particularly institutional investors, appreciate the significance of participation in the election of board members and continue to hold them to account for their actions and the performance of the Company.

There have been several instances recently in the Czech Republic where management and the boards have been held accountable for the management of their companies and have been forced to resign. This culture needs to be encouraged, as it exists in other European countries. Once again institutional investors play an important role and should be encouraged to call for the resignation of management and board members where results or performance is weak.

The international trend is for the role of directors to become increasingly professional. Indeed the Institute of Directors in the United Kingdom has recently introduced a professional course, exams and a qualification for directors. In the Czech Republic the Commercial Code provides for the personal liability of directors, 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.

The supervisory board should consist of not less than 25% of independent members who are not related to the executives or shareholders or who work for the company or any subsidiary or holding company or are connected persons within the definition of the section 45, par.7 of the Securities Act. It is accepted that the concept of "independence" is difficult to define, particularly in the Czech Republic. The critical aspect is that the "independent" member should be capable of exercising independent judgement and thus not be hampered by any conflict of interest. Thus it is critical that these independent directors are not connected in any way to the 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 judgement.

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 (the statutes and a resolution can make it more strict).

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. This is explained in more detail in Annex1 in the Guidelines for best practice for Boards which was prepared for the Czech Institute of Directors.

These independent directors should form the majority on the audit, nomination and remuneration committees to be established pursuant to this Code. (Described later in this Code) Additionally these independent directors shall monitor the company's performance and management and represent the interests of the minority shareholders.

1.1 The board of directors should meet ideally no less than once each month and the supervisory board should meet ideally no less than 10 times each year.

It is critical that the board of directors and the supervisory boards meet sufficiently regularly in order that they can properly discharge their duties. Once it is recognised that members of both boards have a liability, they should also recognise 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 the case of the supervisory board to supervise the direction and management of the company. The number of time each board meets need not be exactly as recommended by the Code provided that the meetings are sufficiently frequent to be appropriate for the particular company.

1.2 The board of directors and supervisory board should have a formal schedule of matters specifically reserved to it for decision defined in the statutes.

The roles of the board of directors and the supervisory board should be clearly identified and the boards should be careful to ensure that they follow these.

1.3 There should 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 to do this at the company's expense so that the cost does not deter the members from taking such advice.

1.4All members of the board of directors and supervisory board should 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.

Since the members of the boards are personally liable it is essential that they have access to a lawyer to advise them where they are concerned that the company is not correctly following the law and applicable rules and regulations, whether for example, of the Prague Stock Exchange or the Office of Economic Competition or the Securities Commission.

In some jurisdictions companies have the benefit of a company secretary, whose role is to ensure that the company complies with all laws and rules and regulations but this is not the case in the Czech Republic at present. It would be regarded as best practice for companies to amend their statutes to provide for the employment of a company secretary, who should have an appropriate legal background, to ensure such compliance.

1.5 All members of the board of directors and supervisory board members should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.

In an ideal world all members of the boards should be appointed for their independence and for their professional skills. It has to be recognised however that in the Czech Republic recent tradition has been for the majority shareholder to appoint the board members to follow his bidding. This should be encouraged to change as the regulatory and legal environment improves.

1.6 An individual should receive appropriate training on the first occasion that he or she is appointed to the executive or supervisory board of a company listed on the first or second market.

This should be the rule for all directors but as a first step it is suggested that since the role of directors of companies listed on the first or second markets of the Prague Stock Exchange is more critical as they are companies in which institutional investors can invest on behalf of their clients, the code addresses these companies first. In time the rule should apply to all companies.

1.7 A decision to combine the role of general director and chairman of the board of directors should be explained. In either case, whether the posts are held by different people or by the same person, there should be a strong and independent non-executive element on the board, with a recognised 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. This is all part of the effective supervision and accountability to all shareholders and underpinned the UK Combined Code.

1.8 The supervisory board should include members of sufficient calibre and number for their views to carry significant weight. As stated previously,no less than 25% of members of the supervisory boards should be independent of management and free from any business or other relationship, whether with the majority shareholders or the company, which could materially interfere with the exercise of their independent judgement. Members of the supervisory board considered to be independent should be identified in the annual report.

The OECD principles of good corporate governance suggest a majority of independent members however this proposal should be seen as a first step towards such approach and those companies which can achieve a higher percentage of independent members should be encouraged to do so. The OECD Principles emphasise the importance that the board should be able to exercise objective judgement on corporate affairs independent, in particular from management. Board independence is therefore generally accepted as requiring sufficient numbers 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 struck.

1.9. 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 members of the board of directors should make further enquiries where necessary. The chairman should 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.

1.10 . The board of directors has an obligation to provide the supervisory board with appropriate and timely information and to respond to all questions and requests for further information from the supervisory board.

The above comments apply equally here.

1.11 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. A majority of the members of this committee should be independent directors. The chairman and members of the nomination committee should be identified in the annual report.

The Czech Institute of Directors has arranged for the preparation of some terms of reference for the nomination, remuneration and audit committees and have kindly agreed that they can be published together with this Code as Annex 1. They will be available on the KCP corporate governance website [address].

1.12 Members of the supervisory board should be appointed by the general meeting for specified terms and reappointment should not be automatic. The members should 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 should be accountable to all the shareholders it is essential that their appointment is more than a simple formality. Thus the shareholders should 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 thought to be performing badly. Contracts which secure the tenure of the board member generally act as barrier to their replacement.

1.13 The company should establish three separate committees the majority of whose members should comprise of independent members and these committees shall be responsible for the independent audit of the company and the remuneration (including other financial incentives)and nomination of directors and key executives.

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.
The Czech Institute of Directors has arranged for the preparation of some terms of reference for the nomination, remuneration and audit committees and have kindly agreed that they can be published together with this Code as Annex 1. They will be available on the KCP corporate governance website [address].

1.14. Shareholders should be invited specifically at 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 executive or supervisory board and senior executives will participate (Sec.66, para. 2 and 3 of the Commercial Code).

The company's annual report should contain a statement of remuneration policy and publish data on director's remuneration and all other financial incentives provided. Comments have been made that this should be restricted to remuneration however other financial incentives, such as share options, bonuses, pension plans and "golden hellos and handcuffs" can all impact on the performance of the director and thus the company and shareholders should therefore be informed. 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, para.3 of the Commercial Code.

2. *The Company should protect shareholders' rights.*

Shareholders have property rights so that their shares can be bought, sold, or transferred. Additionally they are entitled to participate in the profits of the company, with liability limited to the amount of the investment. 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 to accept 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 a right to information about the company and a right to influence the company, primarily by participation in general shareholder meetings and by voting.

It is therefore essential that:

The Company should ensure that each shareholder has the following rights:

2.1 to a secure method of ownership registration;

It is essential that the registration of shares is properly and securely conducted. This is not a concern in the Czech Republic.

2.2 to convey or transfer registered shares in a prompt manner and without unreasonable objection or obstacle by the Company;

It is essential that the company cannot refuse to register the transfer of the ownership of shares unreasonably as this would detract from the shareholder's ownership rights. Again, it is considered that this is not a problem in the Czech Republic.

2.3 to obtain all relevant information on the company (including its annual and semi-annual reports and all information which is likely to materially impact the price of the shares), its activities and its management on a timely and regular basis;

In order to be informed about his investment the shareholder must be properly informed. The usual basis of the information are the annual and half year reports but it is essential that the company informs shareholders of any changes in the company or its business which may materially affect the value of the shares. This information duty is generally satisfied by disclosure to the regulator and the KCP has issued a consultation paper on the disclosure obligations of issuers.

2.4 to receive 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 of all general meetings of the company to enable it to participate, whether in person or by proxy, to be informed of the rules, including voting procedures that govern general shareholder meetings and to vote in all general shareholder meetings. The general meetings should be held during working hours and on working days in the Czech Republic and should not be at a location or time of day which involves any shareholders in any unreasonable expense or inconvenience in attending.

It is essential that the shareholder has 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.

2.5 to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.

Since the shareholders should be able to call the boards to account for the running of the company, it is essential that they have proper opportunity to question the boards and to place items on the agenda of the meeting. Thus companies should include an item entitled “debate” on each agenda of the General Meeting and afford sufficient opportunity for such discussion and debate.

2.6 to submit questions in advance and to obtain replies from management and board members. The directors and board members should 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. What is especially important is that the board of directors decides on and discloses early enough the data on dividend and coupon payment (Sec. 178, para. 9 of the Commercial code);

Again, since shareholders must be able to hold the board members to account it is essential that they are able to question their actions. 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.

2.7 to elect members of the board;

The boards should be elected by the general meeting which then can call the members to account. **.** It follows that the Code does not recommend the so-called German model, where general meeting elects supervisory board only. Thus all shareholders who chose to exercise their rights should be able to participate in such election. This is especially critical in the case of the independent members whose authority arises from their election by the minority shareholders.

2.8 to share in the profits of the company and the directors should not take any steps or put forward any proposals which may reduce, conceal or prevent the fair distribution of profits to all shareholders including minority shareholders on a fair and equitable basis.

Since all shareholders with the same class of shares have equal rights it is essential that the directors treat them in a transparent and fair manner and do not employ any devises to conceal the true financial status of the company and thus the ability to pay dividends.

2.9 to require that in order for shareholder-proposed resolutions to be placed on the agenda, they are supported by those holding a specified number of shares and to ensure that such shareholder proposed resolutions are given a fair hearing at the general meeting.

The commercial code addresses this aspect and thus the law should be observed both in the letter and the spirit.

2.10 to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia, whether electronically or not.

2.11. The company should also ensure that shareholders have the right to participate in, and to be sufficiently informed on the following decisions (Sec. 178, para. 1 of the Commercial code):

- ***amendments to the statutes,***
- ***the authorisation of additional shares; and***
- ***any extraordinary transactions that in effect result in the sale of the company.***

The increased importance of foreign shareholders suggests that on balance companies ought to make every effort to enable shareholders to participate through means which make use of modern technology. Effective participation of shareholders in general meetings can be enhanced by developing secure electronic means of communication and allowing shareholders to communicate with each other without having to comply with the formalities of proxy solicitation. Pending the introduction of the new law on voting by electronic means where all the shareholders agree to allow voting by electronic means such method of voting should be permitted. As a matter of transparency, meeting procedures should ensure that votes are properly counted and recorded, and that a timely announcement of the outcome be made.

3. The Company should ensure disclosure of all capital structures and any arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership. Some capital structures allow a shareholder to exercise a degree of control over the company disproportionate to the shareholders' equity ownership in the company:

There will be many cases of foreign direct investment through privatisations or joint ventures where the shareholders agreements allow high levels of control to the foreign shareholder. These may not in themselves be contrary to good corporate governance but must be disclosed to all shareholders. All of the following should be disclosed to shareholders.

- Pyramid structures and cross shareholdings which can 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. This is often the case of those companies which were either established or privatised with shares being sold to the previous management. Shareholder agreements usually give those participating in the agreements preferential rights to purchase shares if other parties to the agreement wish to sell. These agreements can also contain provisions that require those accepting the agreement not to sell their shares for a specified time. Shareholder agreements can cover issues such as how the supervisory or board of directors or the Chairman will be selected. The agreements can also oblige those in 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 may actually possess. Voting caps therefore redistribute control and may affect the incentives for shareholder participation in shareholder meetings.

4. The company should ensure that all shareholders, including minorities and foreign shareholders, are treated equitably.

This principle becomes one of critical importance if companies seek to raise additional capital through the capital markets and to encourage institutional investors to invest. At present the Czech Republic is regarded as abusing minority shareholders and it was for this reason that so much international portfolio investment withdrew from the country. Until this issue is addressed it is unlikely to return. The recent amendments to the Commercial Code contain some notable improvements and have the force of law. However the greater the understanding of the underlying principles the more likely that the spirit as well as the letter of the law will be observed and enforced by companies and shareholders alike.

4.1 All shareholders of the same class should be treated equally. Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.

Section 155(7) of the Commercial Code requires that identical rights must be attached to shares of the same class and the recent amendments have strengthens this by requiring companies to treat all shareholders equally and under the same conditions (see Section 178, para.1, Section 220, para.1 and Section 180, para.2 of the Commercial Code).

The optimal capital structure of the firm is best decided by the executive and supervisory boards, but this should be subject to the approval of the shareholders. In the Czech Republic, some companies can issue preference shares which have a preference in respect of receipt of the dividends of the company but which normally have no voting rights unless the preferred dividend is declared and paid. This mechanism could be open to abuse as companies are unlikely to issue preference 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 preference dividend.

Investors should expect to be informed 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. Proposals to change the voting rights of different classes of shares should 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 should be recorded by a notarised record of the minutes of the meeting (see Section 186, para.3 and 6 of the Commercial Code).

4.2 Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

Custodians such as banks and brokerage firms holding securities as nominees for customers are sometimes required to vote in support of management, which is in contradiction with the Section 186d, para.1, let. b of the Commercial Code. Shareholders may elect to delegate all voting rights to custodians. Alternatively, shareholders may choose to be informed of all forthcoming shareholder votes and may decide to cast some votes while delegating some voting rights to the custodian. It should be considered best practice that custodians can split their votes in order to reflect the wishes of their customers.

Custodians should disclose to the shareholders that, if no instruction to the contrary is received, the custodian will vote the shares in a particular manner which it deems consistent with shareholder interest.

4.3 Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

The general meeting is the most frequent venue for shareholders to hold the management of the company, as represented by the executive and supervisory boards, to account for their action. It is therefore essential that the management and controlling investors should not seek to discourage non-controlling or foreign investors from trying to influence the direction of the company and should listen to all concerns raised by, and respond to, all shareholders. Companies should not charge fees for voting. Nor should other impediments including prohibitions on proxy voting and the requirement of personal attendance at general shareholder meetings to vote be allowed.

Furthermore, other procedures which make it practically impossible to exercise ownership rights should not be adopted. Proxy materials should be sent a minimum of 30 days in advance of the meeting, except as permitted by the Commercial Code and should allow sufficient time of the general shareholder meetings to allow investors adequate time for reflection and consultation.

At the general meeting the directors should 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 should be the subject of a separate vote and in the case of the appointment of members to the supervisory and board of directors, each member should be voted upon separately.

4.4 Insider trading and abusive self-dealing should be prohibited.

Section 196(a) of the Commercial Code prohibits abusive self-dealing and regulates conflict of interest by board members. However experience in many countries suggests that shareholders must be vigilant question the board and hold it to account.

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 companies assets or products to management, key executives, board members or shareholders, or persons connected with them (as defined by the Section 4.5, para.7 of the Securities Act) should all be undertaken at arms length. Such contracts should be explained together with the connection be approved by a general meeting of the company prior to their completion. Since insider trading entails manipulation of the capital markets and, as such is prohibited by the Securities Act and other laws and regulations it is a breach of law. The companies should have a list of insiders (Sec. 84, para. 2 of the Securities Act) and the list should be disclosed.

4.5 Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the company and should abstain from participating in any vote on such transactions

This item refers to situations where members of the boards and all managers have a business, family or other special relationship to the company that could affect their judgement with respect to a transaction. They must disclose such material interests and should not vote on any related decision.

4.6 At all times companies should act honourably towards and develop good relationships with shareholders which will include:

- ***Companies should count all proxy votes and announce the proxy count on each resolution after it has been dealt with on a show of hands and to make a notarial record of such resolution.***

- ***Companies should propose a separate resolution at the General Meeting on each substantially separate issue and allow reasonable time for the discussion of each such resolution. Companies should propose a separate resolution at the General Meeting relating to the report and accounts.***

- ***The chairman of the supervisory board should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the General Meeting.***

- ***Companies should arrange for the Notice of the General Meeting and related papers to be sent to shareholders at least 30 working days before the meeting. The company should instruct the Securities Center (Sec. 27a, para. 1, letter a of the Securities Act) that it stops transferring shares within a period of 7 days before the date of the general meeting.***

The above list should be regarded as illustrative and not exclusive. The objective is to ensure that all shareholders are properly informed and have an opportunity to question those who are responsible for the management of the company in which they invest. Thus it is important that the shareholders can question the various committees on their decisions, for example to award substantial pay increases to individual members of the boards or key executives.

4.7 Companies should use the General Meeting to communicate with private investors and encourage their participation.

Companies should be encouraged to appreciate the skills required for developing good investor relations. 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.

The KCP would encourage the establishment of an association of investor relations advisors as a means of improving the standards of investor information generally available to investors of all size. The British Embassy is sponsoring a series of workshops targeted at companies and focusing on investor relations to explain the benefits of developing good communication with investors.

5. The company should ensure that timely and accurate disclosure is made on all material matters regarding the company, including the financial situation, performance, ownership, and governance of the company. In particular the company should observe the standards of best practice issued by the Czech Securities Commission on the contents of the annual report, half-year report and ongoing disclosure requirements.

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 should be encouraged to make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand. The KCP has prepared guidance on what it expects to see both as minimum disclosure in the annual and half year reports and by way of ongoing disclosure and this is the subject of a separate consultation process.
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 behaviour 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 of 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 markets and increase the cost of capital and result in a poor allocation of resources.

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 may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor. It is essential that such non disclosure is strictly limited and thus a test of materiality is often used. 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.

Disclosure should include, but not be limited to, material information on:

5.1 ***The financial and operating results of the company.***

Sections 80(a) and (b) of the Securities Act require disclosure of the audited financial statements showing the financial performance and the financial situation of the company and audited consolidated financial statements where appropriate. These most typically including the balance sheet, the profit and loss statement, the cash flow statement and notes to the financial statements. These financial statements should enable appropriate monitoring of the company and provide the basis to value securities. These should be accompanied by management's discussion and analysis of operations as this provides light on the future performance of the company. Transactions relating to an entire group should be disclosed to ensure disclosure of the complete situation.

5.2 ***Company objectives.***

In addition to quantitative targets, their time horizons and cost this should 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.

5.3 Major share ownership and voting rights.

This should include on going disclosure of information on the ownership structure of the company and the shareholder's rights vis-à-vis the rights of other owners. However, the company should 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. Companies should also disclose information on related party transactions (Sec.66a, para.9 of the Commercial Code). Similarly the companies should disclose acting in concert (Sec.66b, para.1 and 2 of the Commercial Code).

5.4. Members of the boards and key executives, and their remuneration.

Companies should disclose information on individual board members and key executives to enable shareholders to evaluate their experience and qualifications and assess any potential conflicts of interest. The disclosure of this information is critical to the achievement of transparency. Since the direction and management of the company is so important, shareholders need information on the qualifications of the board members in order that they can have confidence in their abilities and may ensure that there is a balance of experience available to the company. Only with this information can shareholders accurately call board members to account for their actions and decisions. This recommendation reinforces the requirements for nomination and remuneration committees and ensures transparency through disclosure of this information.

5.5 Material foreseeable risk factors.

Companies should disclose information on reasonably foreseeable material risks including: risks that are specific to the industry or geographical areas; dependence on commodities; financial market risk including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; risks related to environmental liabilities; and whether or not companies have put systems for monitoring risk in place is also useful.

5.6 Material issues regarding employees and other stakeholders.

Companies should disclose information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. These may include management/employee relations, and relations with other stakeholders such as creditors, suppliers, and local communities.

5.7 Channels for disseminating information should provide for fair, timely and cost efficient access to relevant information by users.

Channels for the dissemination of information can be as important as the content of the information itself. The channels for disseminating information should be stated in the statutes including e-mail and website addresses where the information can be requested. The Czech Securities Commission has recently requested issuers to file their statutory reports electronically and this should greatly enhanced disclosure. Such data will be available on the websites at both the Czech Securities Commission and the Centre for Securities. The Prague Stock Exchange also publishes such information for those companies listed on its main and second markets.

5.8 Governance structures and policies.

Companies should be encouraged to report on how they apply relevant corporate governance principles in practice. This should include the division of authority between shareholders and members of the executive and supervisory boards and should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

The quality of information depends on the standards under which it is compiled and disclosed.
An annual audit should be conducted by an independent auditor, appointed by an audit committee in order to provide an external and objective assurance on the way in which governance and financial statements have been prepared and presented. The KCP, the Prague Stock Exchange and the Chamber of Auditors, currently, are working to develop the format of such report.

5.8.1 The board should be accountable to the shareholders and ensure proper internal controls and auditing procedures.

The annual audit of the company is fundamental to corporate governance. Directors are required to report by law on their stewardship of the company in the annual report to all shareholders and this is particularly important in companies where the management are, or are related to, the controlling shareholders. It is thus essential that the audit is objective and effective as such an audit gives reassurance to all those who have a financial interest in the company. The audit should be carried out to the highest international accounting standards. The following should be addressed.

- The members of the board of directors should explain their responsibility for preparing the accounts, next to a statement by the auditors about their reporting responsibilities.
- The board of directors should consider 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 should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- The members of the supervisory board should review the effectiveness of the company's system of internal control and should report to shareholders. This report should cover all controls, including financial, operational and compliance controls and risk management.
- The members of the board of directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.
- Companies which do not have an internal audit function should from time to time review the need for one.
- The executive and supervisory boards should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.
- The supervisory board should establish an audit committee of at least three independent members of the supervisory board with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent members of the supervisory board, should be named in the report and accounts.
- 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 should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.

6. The board of directors should undertake all key functions in the management of the company and the supervisory board should effectively supervise such functions.

The board should fulfil certain key functions, including:

- 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.
- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- 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.
- Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
- Overseeing the process of disclosure and communications.
- The board should present a balanced and understandable assessment of the company's position and prospects.
- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.
- The board should ensure compliance with applicable law.

6.1 Both the board of directors and the supervisory board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.

The structure which it is understood prevails in many companies, whereby 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 by the OECD standards as can be noted. The general manager is an employee and as such is not accountable to the shareholders. Previously 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 introduces through the Section 66, para.6a special liability of true leading persons.

The objectivity of the directors is critical to the OECD principles and as such must be addressed. The proposal of this paper is to take a first step by way of requiring that the general manager must be a member of the board of directors but companies must acknowledge that a more usual structure should be adopted within say a 3 year period.

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

Together with guiding 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. In order for both the executive and supervisory boards to effectively fulfil their responsibilities they must have some degree of independence from the controlling shareholder and the management.

Another important board responsibility is to implement systems designed to ensure that the company obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. In addition, both the executive and supervisory boards are expected to take due regard of, and deal fairly with, other 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.

6.2 Both the executive and supervisory board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

This is critical to the role of both boards and underlines the problem described above. The Czech Institute of Directors has arranged for the preparation of a set of best practice standards for boards and have kindly agreed that they can be published together with this Code as Annex 1. They will be available on the KCP corporate governance website [address].

6.3 Board members should devote sufficient time to their responsibilities.

Thus service on 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 and full disclosure made in the biographical details when they are put to the general meeting. Whilst there has been a suggestion that the Code should recommend a maximum number of board appointments, this approach is considered too prescriptive and would encroach on what should be the decision of the shareholders. Clearly, if a member participates on too many boards this limits the amount of time he/she can devote to any of them and this in turn weakens any defence he/she may have against charges of failing to discharge his/her functions in accordance with the Commercial Code. Thus Board members should perceive that it is in their own interests not to accept too many board appointments.

7. *Institutional Shareholders should act responsibly in their dealings with the Company.*

It is necessary to consider two types of institutional investor. Those foreign investors who will actively support this Code and generally will be happy to undertake the role ascribed to them. However the Czech institutional investors will require encouragement as they are clearly more interested in investing outside the Czech Republic and will undoubtedly be tempted back once the investment environment improves.

In many advanced capital markets institutional investors own the majority of shares in quoted companies. They hold these on behalf of individuals, as members of pension funds, insurance policies etc. Thus there is a high level of common interest.

In practice, in the UK, the greatest protection for individual minority shareholders is through the participation and surveillance of the institutional investors. Their role is critical to improving standards.

It has been encouraging to see the level of support from the current associations and indeed individual members of institutional investors for the Code and it is anticipated that they will play an active role in the improvement of the corporate governance environment.

7.1 ***Institutional shareholders have a responsibility to make considered use of their votes.***

They should be encouraged not to act as passive investors but to take an active role in supervising their investments. To do this effectively they require easy access to all the information outlined above and access to any additional information they reasonably require. Additionally they should have access to management. They should hold management to account for its mistakes, including, where necessary requiring the resignation of responsible executives.

7.2 Institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives.

This requires the management and the board to adopt an open approach to its institutional investors and to enter into dialogue with them. The British Embassy supported project on investor relations will explain and encourage this approach.

7.3 When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

Once a corporate governance regime is adopted all institutional investors should be encouraged to ensure that the companies in which they invest accept and implement the code. Responsible individual shareholders may often draw to the attention of the institutional investor problems with such implementation and the institutional investor should be encouraged to consider such information and act in accordance with the provisions of the code.

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

It should be accepted that there will be times when the investor simply cannot achieve improvements and in this case it must be allowed, and indeed encouraged to "vote with its feet" by selling its holding in the company. Once companies realise that this is a course of action which investors will take they should pay more heed to the requests and views of the institutional investors.

7.5 Institutional investors should disclose their own policies with respect to the companies in which they invest.

Since the Code focuses on transparency and accountability, compliance with its provisions will greatly enhance the attractiveness of the company to institutional investors and it is for this reason that there is currently so much support for it. However, it is important that institutional investors themselves adopt the code and that they require the companies in which they invest to do so as this will widen the impact and indeed the implementation.

7.6 Institutional shareholders should endeavour to eliminate unnecessary variations in the criteria which each applies to the corporate governance arrangements and performance of the companies in which they invest.

The various Associations which have indicated their support for the code will need to address this with their members.

7.7 Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non discretionary proxies lodged.

Institutional investors must act in a transparent manner towards their clients and adopt good practice themselves.

7.8 Institutional shareholders should take steps to ensure that their voting intentions are being translated into practice.

It is essential that institutional shareholders hold the boards accountable for their action and thus must monitor that decisions made at the general meeting are implemented.

8. Shareholders should have certain rights and exercise certain responsibilities in connection with the company.

8.1 All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Investors' confidence that the capital they provide will be protected from misuse or misappropriation by corporate managers, board members or controlling shareholders is an important factor in the capital markets. Corporate boards, managers and controlling shareholders may have the opportunity to engage in activities that may advance their own interests at the expense of non-controlling shareholders.

One of the ways in which shareholders can enforce their rights is to be able to initiate legal and administrative proceedings against management and board members.

Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority Investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated (Section 182, para.1, letter c of the Commercial Code).

There is some risk that a legal system, which enables any investor to challenge corporate activity in the courts, can become prone to excessive litigation. A balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation (Section 56a, Section 131 and Section 265 of the Commercial Code)..

Some countries have found that alternative adjudication procedures, such as administrative hearings or arbitration procedures organised by the securities regulators or other regulatory bodies, are an efficient method for dispute settlement, at least at the first instance level. This has an added advantage where there are delays in the courts.

8.2 All shareholders should be encouraged to accept that the rights, which they have as shareholders, also bring responsibilities.

Shareholders must be encouraged to accept that they have duties, for example to attend the General Meetings, to vote, to scrutinise annual reports, to question the boards and to hold them to account for any failures. This is an essential correlation of the shareholders' rights.

9. *The role of stakeholders in corporate governance*

The concept of stakeholders may require some explanation. It encompasses a number of parties who are interested in the success and the mode of operation of the company. It includes employees, members of the local community who are keen to ensure their environment is not polluted; local businesses who sell goods to the company employees, cafes, restaurants, schools, doctors, etc and the businesses which the company does business with, both suppliers and distributors.

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

A key aspect of corporate governance is concerned with ensuring the flow of external capital to firms. Corporate governance is also concerned with finding ways to encourage the various stakeholders in the firm 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 part of the decision making process.

Thus a company, which is a major manufacturer in an area, should consider the impact of its decisions on the local businesses, people and economy. If, for example it reduces its manufacturing capacity, the impact will be felt by its suppliers, its employees, some of whom may lose their jobs and local shops and businesses which are likely to see a reduction in custom and spending.

9.2 Companies should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies and the rights of stakeholders that are protected by law should be respected.

It should be accepted that it is in the long-term interest of companies to foster wealth-creating co-operation among stakeholders and it should recognise that the interests of the company are served by recognising the interests of stakeholders and their contribution to the long-term success of the company.

In most countries, including the Czech Republic, stakeholder rights are established by law, i.e. labour law, business law, contract law, and insolvency law. Even in areas where stakeholder interests are not legislated, many firms 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. However, where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights and the legal framework and process should be transparent and not impede the ability of stakeholders to communicate and to obtain redress for the violation of rights.

9.3 Corporate governance frameworks will provide for different roles for stakeholders.

The degree to which stakeholders participate in corporate governance depends on laws and practices, and may vary from company to company as well. 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 stakeholder viewpoints in certain key decisions. They may, in addition, include creditor involvement in governance in the context of insolvency proceedings and arbitration arrangements into the contracts.

9.4 Where stakeholders participate in the corporate governance process, they should have access to relevant information.

Where laws and practice of corporate governance systems provide for participation by stakeholders, it is important that stakeholders have access to information necessary to fulfil their responsibilities.

ANNEX 1

CORPORATE GOVERNANCE BOARD COMMITTEES
Prepared for the Czech Institute of Directors

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.

N.B. Statutory Board Reports

- The Statutory Board report should name the members of these three committees
- The Statutory 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. **<u>Recommend (as appropriate) external auditors and/or the renewal of their existing mandates; co-ordinate with external auditors</u>**

- 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 heath 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. **<u>Evaluate all special financial operations with significant consequences for the company</u>**

- 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 as 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

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

2. <u>Consider performance elements carefully</u>

- 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 ofr other areas

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

A GUIDE TO BEST PRACTICE FOR EXECUTIVE BOARDS IN THE CZECH REPUBLIC
Prepared for the Czech Institute of Directors

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 take-over, 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.

PRO FORMA CODE OF ETHICS FOR BUSINESS
Prepared for the Czech Institute of Directors

Introduction

All businesses are increasingly being judged by investors, employees, customers and society in general on their standards of business conduct and their trustworthiness.

Good business relationships are all about reputation: the standing of your company with all of the businesses' stakeholders mentioned above.

Proposed Code

1. Establish your core business values and adhere to them to foster your reputation.
Where your stakeholders understand that you will stick by your policies of ethical behaviour this will give them the confidence to consider favourably long term relationships.

2. Ensure that the welfare of your staff is a paramount aim of the company. Further ensure that staff are reasonably rewarded and motivated to perform to the best of their ability.
Where your staff feel an important and valued part of the business you will achieve greatly improved and dedicated performances.

3. Remember that the management's behaviour is likely to be taken as a role model by the staff and that this will also impact on customers and shareholders' perception of your company.
Whatever the staff see you do they are likely to emanate. They will assume that it is acceptable behavior and a reasonable standard of work ethics.

4. Where you have joint business with others and/or capital at risk ensure that the other parties share both your vision and values.
It is necessary that you can have confidence in and do not diverge from the standards and values of business partners. If you do not trust your partners this adds unnecessary risks to the business.

5. Work at your relationships with customers: the relationship does not stop at the point of sale.
Continuation business is far more valuable than an one-off sale. Companies are designed for the long term (even though the personnel may change) and business is rarely an overnight success. It takes a considerable period of time to build a sustainable profitable entity.

6. Don't criticise your competitors.

Criticism of the competition actually serves no purpose in business. All that matters is what your company does and how well it does it. The perceived need to criticise is often seen as camouflage to hide a deficiency in those venturing the criticism.

7. Adhere to your agreed terms of payment and conditions of business.

   It is most important that your customers can trust in your reliability as this will effect their business in turn. Quality control and timely delivery are key to establishing the reputation of your company. Customers get upset by what they see as "additional or hidden charges" as they will have chosen your product, among other things, on its quality and price and will feel cheated if these change between ordering and delivery and payment. Remember you make more from repeat business and returning customers than from one off sales.

8. Record all financial transactions in your books and do so in a transparent form.

   Whenever this does not happen someone is being cheated. The loser may be the shareholders, employees or the authorities. The authorities tend to be far more flexible when presented with transparent and accurate audits. In any event the real losers will be the managers since reputations take a long time to earn but can be destroyed in an instant and eventually someone will always catch the perpetrators out. To manage a business efficiently is only possible when the managers are in control of all the facts and have the support and confidence of all the owners.

9. Try and find ways of supporting the communities in which your business operates.

   The local community is also a stakeholder in your business. This may be an environmental, employment supply or local support business for the company or its employees. Good local relations are important for the development prospects and sustainability of the business.

10. When the management and/or staff are unsure on an ethical issue, take advice from independent sources.

    Ethical issues often have emotive or profit effecting consequences. It is thus beneficial to gain advice which is independent and neither emotional nor profit oriented in its nature where such issues are concerned (i.e. there are no conflicts of interest).

Implementation

1. Design and implement a strategy to integrate the Code into the running of the business when it is issued.

2. Ensure the Code is endorsed by the Supervisory Board, Board of Directors and the Company management.

3. Ensure that all members of management and staff become familiar with the Code, so that good ethical practice permeates throughout the business.

4. Provide advice on what to do when faced with an ethical choice.

5. Permit all company management and staff an opportunity to respond to the contents of the Code.

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.