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## GDANSK INSTITUTE FOR MARKET ECONOMICS

63, Do Studzienki Street, 80-227 Gdańsk  
tel. (0048) 58 341-15-35, 58 341-39-77  
fax. (0048)58 341-06-20

### The White Paper on Corporate Governance - Conclusions & Recommendations

Piotr Tamowicz, Maciej Dzierzanowski

#### Summary

The last ten years have resulted in many inspiring academic findings, as well as dramatic events like financial crisis spreading worldwide and big name accounting scandals. All of which has put corporate governance at the top of the economic policy interest and agenda. Steps undertaken by governments and international bodies including OECD, EU, World Bank and others aim at improving shareholder protection, law enforcement, and providing minimal ethical and legal standards.

In Central and Eastern Europe, after a long but successful battle with budget deficits, inflation and ineffective management of state-owned assets, governance is gaining more and more attention from authorities. In July 1999, the Russian Corporate Governance Roundtable, under the auspices of the World Bank, was launched. In the same year, Bulgarian authorities created the Corporate Governance Initiative. Governance codes, ratings, institutes, and various forums have emerged creating a flexible portfolio of tools that is slowly but continuously changing the corporate landscape.

At the beginning of 2001, the Center for International Private Enterprise - a foundation affiliated with the US Chamber of Commerce - awarded the Gdansk Institute for Market Economics a grant (under the Marek Hessel Corporate Governance Small Grant Program) for drawing up a "Corporate Governance Code" and "White Paper" on corporate governance in Poland. The first "product" was introduced to the public by Gdansk Institute staff at a conference in Warsaw in April 2002. The Code proposal sets 7 general recommendations and 35 explanatory prescriptions. In general, the so-called Gdansk Code is intellectually based on OECD guidelines; some other European solutions are also included. The Code addresses the most important weaknesses faced by the Polish public capital market for years. It strongly emphasizes the need to protect minorities preferably by making supervisory boards more balanced and independent. It also recommends more corporate transparency and credible audit systems.

The corporate governance rating and Polish Corporate Governance Forum are two - originally unplanned - by-products of this CIPE sponsored project. The rating, mostly based on the Code recommendations, could be - in our opinion - an effective public tool in

exerting pressure on corporate managers. The Polish Forum will be an institution oriented towards education and policy recommendation.

The "White Paper on Corporate Governance" is a review of all the elements - legal or economic, formal or informal - that comprise the system governing Polish corporations, in particular those publicly listed. The paper begins with a brief overview of the corporate sector in Poland. It comprises 160,000 limited liability and stock corporations. In particular, there are about 220 corporations whose shares are listed on the Warsaw Stock Exchange. They account for about 3% of total employment and 8 % of industrial and financial enterprise turnover. Next, the ownership and control structure of the listed corporations is presented. The patterns observed here are similar to that in continental Europe: the median blockholder has about 39% of votes in her/his hand. This observation leads to the conclusion that Polish corporations operate within a so-called insider system (as opposed to an outsider system) emphasizing the internal control mechanisms.

The "White Paper" next discusses types of shareholders being involved in corporate governance in Poland beginning with strategic or controlling investors - most visible - type of shareholder in Poland. Their positions in corporations are very strong as they alone own large blocks of shares, appoint managers and the majority of supervisory board members. Most of these investors appeared in corporations thanks to large privatization schemes performed frequently through IPOs. Insurance societies, venture capital and private equity funds, employees and managers that appear among shareholders are also discussed.

The treatment of minority interests is gaining more and more attention in Poland. The reason behind such interest is the growing pension funds sector as well as a recent wave of reported abuse of minority rights not only by controlling shareholders but also surprisingly by the state. This has led to a loss of credibility in the public capital market in Poland. Therefore the "White Paper" gives special attention to the protection of shareholder rights. One can find here an overview of corporate transparency - information that corporations are obliged to reveal as well as non-mandatory transparency (additional information provided to shareholders through corporate websites). Moreover, the legal devices that may protect or undermine minority interests are presented (supervisory board composition, its functioning and remunerating, management of conflicts of interest, anti-takeover measures). In the final section, the "White Paper" discusses audits and the auditor's role in supplying shareholders with accurate and objective information, the involvement of banks in corporate governance (through ownership and through debt) and the new bankruptcy bill.

Additional text boxes shed some light on issues that could be of interest to the reader: why do corporations go public, CalPERS role in promoting good governance standards, how corporate social responsibility enters Polish corporations, how insider trading can be limited by company internal self-regulations. In three appendixes the reader will find a brief overview of corporate social responsibility by dr. Bolesław Rok, recommendations from Gdansk's Code, and a list of legal acts that provide the foundation for corporate governance in Poland.

The "White Paper" is addressed mostly to policy makers. But its primary goal is not to cause any immediate changes in laws or by-laws although such changes are welcomed. We hope the "White Paper" will first of all educate: by showing that corporate governance is not purely an academic invention but a real engine of economic growth, and by



demonstrating how corporate governance mechanisms are structured, interlinked, how they substitute and complement, how they operate. We also intend the "White Paper" to be a useful guide for entrepreneurs, journalists, students and the general public in exploring governance issues. We intend to produce a "White Paper" every 2-3 years to review any changes in corporate governance in Poland. We also hope to omit in the next edition any mistakes we may have made in this edition.



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## Conclusions & Recommendations

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The “White Paper on Corporate Governance in Poland” has been prepared by the Gdańsk Institute for Market Economics (IBnGR) within the framework of the Polish Forum for Corporate Governance (PFCG). It is the first paper, which reviews the key issues and problems of corporate governance in Poland. The PFCG “Corporate Governance Code”, prepared under the auspices of the IBnGR, is an integral part of the White Paper. Below follows a presentation of both general and more specific conclusions arising from the research and analyses that preceded the drafting of the Code and the White Paper. The authors believe that the remarks can help lay down a potential course for future work on improving and refining the system of corporate governance in Poland.

### **The business community and public authorities must show more interest in corporate governance**

The issues of corporate governance are more and more present in public debates in Poland. However, the debates still seem to be far from full understanding of the concept, as well as from reaching a consensus on the directions of change. Particularly disconcerting is the fact that the discussions tend to over-stress formal aspects of corporate governance, are confined within narrow-scope analysis and proceed without due involvement of the business community. The public authorities, on the other hand, so far have not undertaken any systematic and detailed analysis of the existing corporate governance mechanisms. To date, any research into the issue has been initiated exclusively by academic institutions, and by its nature has been designed to pursue different objectives within a limited scope only.

### **Better corporate governance is a prerequisite of capital market development**

Many international studies have proven that weak protection of shareholders’ rights, including minority shareholders’ rights, thwarts the development of financial markets. Undoubtedly, that is the case of Poland, too. Improved corporate governance should create better conditions for the development of the Polish capital market. Although the Polish capital market will still take a lot of time before it plays a role tantamount to that of the credit market, it is still an important financing mechanism for new companies with large growth potential. Better corporate governance will also release the potential of pension funds, attract foreign portfolio capital and will help the state to execute a number of large privatisation projects via the public capital market.

### **Protection of the minority should be a priority**

A priority objective for the process of corporate governance improvement in Poland should be to implement mechanisms safeguarding sufficient protection of minority shareholders’ rights in companies with controlling shareholders. This is necessary to restore credibility of the capital market fast. At the same time, in the long-term Poland must implement solutions that would secure proper protection of shareholders’ interests against the opportunism of managers in widely-held companies.

### **Need for self-regulation and wise revisions of law**

Any changes introduced into the corporate governance system must be well-balanced. One reason for that is that in transition countries the role of controlling shareholders may for some time still be more important than the role of the domestic capital market (institutional and individual investors). That is why a self-regulatory approach to corporate governance is recommended, i.e. a path of voluntary grassroots regulations developed by the capital market community itself, for example in the form of a voluntary corporate governance code for publicly-listed companies, takeover rules or internal control rules. The grassroots self-regulation path is highly flexible, and always leaves an open option to sanction – if necessary – selected corporate governance standards by the force of law. On the other hand, any top-to-bottom approach involving hasty legislative decisions will always create more problems down the road, when flawed solutions will have to be abandoned (a good example being the regulation on lowering the admissible threshold for voting-rights-preferred shares).

### **The reform should focus on law enforcement**

An analysis of Polish law shows that the reform should focus on improving law enforcement. To achieve better efficiency of courts and better knowledge of economics among prosecutors and judges is a major challenge in this context. Plans to increase some competencies of the Polish Securities and Exchanges Commission are welcome, as is the proposal to establish a court specialising in capital market litigation cases, which should also act as an appellate instance against decisions of the Securities Commission. However, when increasing the restrictiveness of the regulatory regime one should also take into account another factor important in the corporate governance system, i.e. competition, including competition for sources of financing. Hence the barriers of entry into the capital market should be balanced properly, incorporating the presence therein of professional institutional investors (which are seen around ever more frequently). Better market access and competition among issuers for investor funds should serve as an important mechanism providing better safeguards of minority shareholders' interests.

### **Companies should be more active in developing investor relations**

Companies should use self-regulation much more often: develop in-house by-laws counteracting insider trading or in-house corporate governance codes. At present in Poland companies very rarely go beyond the bare minimum standards defined by the Commercial Companies Code (Polish company law), even though the Code does leave a relatively broad leeway to put a host of desirable provisions into company's articles of incorporation. This practice must be changed. Furthermore, the scope of information that companies provide to shareholders on a voluntary basis must be much broader. Exhaustive information about company directors and officers, remuneration thereof, or fundamental documents governing the company (e.g. the articles of incorporation, by-laws of the general shareholders' meeting) should become a good practice. Undoubtedly, the Internet emerges as the basic tool of the company's communication with its shareholders and its environment.

### **Effective corporate governance requires credible supervisory boards**

In Poland the prevailing form of supervisory board functioning is in bad need of change. Many commentators believe that so far supervisory boards of companies in Poland have played a passive role only. A more active role of the supervisory board is even more needed in a situation of concentrated shareholding structures, whereby the takeover market cannot function effectively. It is advisable therefore to develop the practice of appointing the so-

called independent members of supervisory boards, who should be furnished with a proper scope of competencies. The recommendation of the Corporate Governance Code developed by the Gdańsk Institute for Market Economics to appoint two independent directors is a good starting point, for it takes into account both the interests of minority shareholders as well as that of the controlling shareholder. The overall scope of supervisory board's authorities should be broadened significantly, especially as regards control over transactions with related parties, subsidiaries and dominant shareholders. The supervisory board should also be entitled to hire external experts, and be more active in overseeing the system of internal control in the company.

### **Shareholders must be more active and have better conditions to exercise their rights**

It is shareholders themselves who have to play a major role in forcing companies to improve corporate governance standards. Pension funds and other institutional investors are becoming more active shareholders, which is a positive trend. Furthermore, continued support should be lent to the community of individual shareholders and its voluntary organisations. It is advisable to promote a broader scope of shareholders' participation in shareholders' meetings by the way of instituting possibilities to take part in the proceedings via the Internet or other direct communication media, as well as by allowing shareholders to vote by correspondence, and by shortening the time of lock-up on company's shares prior to the general shareholders' meeting.

### **Pension funds must take the lead in the corporate governance reform**

Pension funds can play an immense role in active corporate governance. To this end, proper regulatory policy should generate strong stimuli for pension funds to get actively involved in corporate governance procedures. Of course, greater competition among pension funds is highly advisable. In this context the high level of the pension fund market concentration and the minimum rate of return mechanism (which results in strong convergence of pension fund investment policies, shortens their investment horizons and encourages continuation of non-performing investments) may create, rather than solve, many more problems. Greater influence of pension funds on corporate governance standards will not happen without allowing Polish pension funds to invest more assets abroad. This is how pension funds may mitigate the risk of becoming hostage to their own investment portfolios and fuel the expansion of the so-called speculative bubble at home. On the other hand, it would be highly inadvisable to reduce the powers of pension funds to exercise voting rights at shareholders' meetings. Corporate governance will also be well served by a greater involvement of institutional investors in the development of the capital market infrastructure. Particularly desirable in this context would be to adopt a fast track of engaging pension funds in the privatisation of the Warsaw Stock Exchange, even before selecting a strategic investor for it.

### **More sensitivity is required to stakeholder relations and corporate social responsibility**

Irrespective of promoting company's accountability vis-à-vis its shareholders, corporate governance should also promote the ideas of corporate social responsibility in order to highlight the need and benefits of company sustainable development. Moreover, a practical mechanism should be found to bring in the aspect of stakeholder interests into company management. The growing role of human capital and knowledge in today's economy cannot be ignored. In corporations whose core is built on intellectual capital, an important corporate

governance issue is proper incentivising of key personnel, whose knowledge and skills represent the critical asset of the company.

### **The audit function should be more credible and independent**

In the aftermath of financial scandals in the United States investor confidence in the audit function has been undermined gravely. A similar problem emerged in Poland with the fall of the Szczecin Shipyard and some companies' disclosures of accounting irregularities. In Poland, credibility of audits is based on self-control of the auditor community and provisions of the Accounting Law (which defines audit independence criteria). However, those mechanisms are not sufficient. The problem of hiring the same firm for consulting and audit is still waiting to be resolved. At the in-house level, corporations should regulate such issues as frequency of changing the company auditor, transparent rules of auditor selection, rights of shareholders to query the auditor as well as the rules of the auditor's participation in the shareholders' meeting. The Corporate Governance Code developed by the Gdańsk Institute for Market Economics includes a number of recommendations designed to meet those aims. It seems that at the moment the suggestion to create in Poland (following the U.S. example) an audit market regulator reaches too far. Nevertheless the issue itself warrants careful consideration.

### **The regulatory framework should promote dispersed shareholding structures**

To raise the level of minority shareholders' protection, it seems advisable to consider lowering the ownership threshold above which a shareholder is required to place a mandatory bid for all the other shares. A threshold of 33 percent (*vis-à-vis* the existing threshold of 50 percent) seems a rational solution, because the lower the threshold, the weaker the position of the controlling shareholder, i.e. the lower the risk that the interests of minority shareholders will be violated. It also increases the likelihood of another entity coming forward as willing to take over and bid successfully for the shares held by the small shareholders. Thus a lower threshold triggering off the mandatory bid procedure should promote more dispersed shareholding structures. A situation in which the market is dominated by companies with concentrated private ownership actually runs against the idea of a public capital market.

The problem of dispersed shareholding structures also begs the question of preferred shares, i.e. tools of separating ownership from control. Poland now observes a major concentration of both ownership and control (achieved in part by the way of purchasing large share packages) which undermines market liquidity. The concept of preferred shares is therefore the most transparent alternative: it is certainly good for liquidity, however at the same time does weaken control over company managers. Other – albeit worse (i.e. less transparent) – separation vehicles include the so-called pyramiding or assigning individual ownership competencies to selected shareholders. The regulatory reduction of the voting rights preference attached to shares (from five to two votes) was therefore a mistake in the context of generating market liquidity and clear separation of ownership from control; a mistake which will be hard to reverse.

### **The takeover market must be more effective**

In order to secure proper mechanisms of shareholder protection in dispersed ownership scenarios, the takeover market must be regulated shrewdly. In Poland, the requirement to disclose acquisition of large share packages stands high (even higher than is required by the

relevant European Union directive), which may weaken the takeover market, and in particular discourage hostile takeovers. In Poland, an investor is also obliged to apply to the Securities and Exchanges Commission every time the investor is planning to increase its shareholding in a publicly-listed company above a statutory threshold. This regulation may disrupt the takeover market, for already at present the Securities Commission faces a conflict of interests: a potential wave of takeovers in the public market goes counter to the development of the domestic capital market and the *raison d'être* of the national regulator. It also seems advisable to liberalise the Law on the Public Trading of Securities as regards de-listings as well as institute a squeeze out procedure for publicly-listed companies and a parallel sell-out rights procedure to be available to minority shareholders. All such procedures must provide for proper exit mechanisms, i.e. ensure that minority shareholders can expect to receive a fair price for their shareholdings. It seems advisable to institute an option of an independent valuation to be carried out by a specially appointed chartered auditor.

### **Laws must be reviewed and cleared of evident flaws**

The on-going debate on a revision of the Polish Commercial Companies Code, as well as the planned revision of the Law on the Public Trading of Securities, provide a good opportunity to review the existing system of legal safeguards to shareholder rights. A number of problems call for a rapid response of the legislator and elimination of the evident flaws. The provisions regarding special assignment auditors must be elaborated and refined, in order to remove the possibility of appointing an entity exposed to a conflict of interests (e.g. the incumbent auditor of the company, the auditor of the controlling shareholder, etc.). The difference in thresholds applicable to the right to appoint a special assignment auditor (i.e. at least 5 percent of total votes) and the right to demand a shareholders' meeting (i.e. 10 percent of all votes), respectively, should be eliminated. Furthermore, both the Commercial Companies Code and the Law on the Public Trading of Securities should be amended to clarify situations in which a shareholder may be deprived of their voting rights, in order to eliminate any possibility of unjustified attempts to question a shareholder's voting rights (which in the past has led to a highly undesirable practice of duplicating shareholders' general meetings and company governance bodies). In this context, we welcome a proposal put forward by Weil, Gotshal & Manges lawyers to obligate the company to inform (prior to the shareholders' meeting) about any irregularities found in documents presented in relation to the participation in the shareholders' meeting, including an instruction about the potential negative effects thereof for the shareholder in question. Action-in-concert regulations should be reworded, to prevent them from being invoked to disable minority shareholders from forming an effective alliance (with the present wording, exercise of voting rights may be blocked on the grounds that by forming an alliance the minority shareholders have exceeded the threshold of 25 percent without a prior consent from the Securities and Exchanges Commission, or that they have not placed a mandatory bid upon forming a block of 10 percent of shares in a period shorter than three months). Moreover, the law should institute an obligation to disclose any shareholders' agreements to the effect of voting in concert. The existing law does not require such a disclosure to be made unless one of the parties to such an agreement enters into a transaction as a result of which it acquires a package of shares that triggers off the market disclosure requirement. Finally, the legislator should also remove provisions relieving an investor from the mandatory bid obligation if the investor exceeded the 50 percent threshold following a transaction with the state treasury.

### **Lender control mechanisms should be analysed and improved**

The lender control market should be analysed. In view of the fact that the Polish financial system is dominated by banks, and the capital market is still underdeveloped, the features and effectiveness of debt-related control is of much bearing for the corporate sector, restructuring processes and economic development. Furthermore, lender control mechanisms are also a factor of the financial system stability. The insolvency of the Szczecin Shipyard has raised some evident questions concerning such control mechanisms, not only in this single case, but for the financial system at large as well. We welcome the Government's proposals of revisions to the Bankruptcy Law, which should create more leeway for the effective restructuring of corporations which face a risk of insolvency, as well as motivate banks to be more active in monitoring borrower companies.

### **Corporate governance in state-owned enterprises must be improved urgently**

The privatisation of state-owned enterprises should be continued at an intensive pace. The process should be a clear priority, although it should not distract attention from justified short-term actions to improve corporate governance standards in state-owned enterprises awaiting privatisation. Priority actions include above all measures to improve transparency of supervisory bodies, including independence and fit and proper status of their members. Noteworthy, however, the critical point of such structures is the state ownership itself, which is most frequently used by the political groups in power to achieve benefits, blur good performance criteria and weaken the pressure on in-depth restructuring. The law setting a cap on the pay of state-owned companies' managers must be revised, as well, because in the current wording the law does not offer any effective tools to incentivise managers of such enterprises. Furthermore, continued focus on corporate governance should be ensured in enterprises for which state ownership has been chosen as a longer term option. To this end, control mechanisms vested in workers councils should be modified or such enterprises should continue operation as corporations regulated by the Commercial Companies Code with the state as an owner.