



Note by the OECD Secretariat on
**Latvia's implementation of corporate governance
accession review recommendations**

This Secretariat Note considers Latvia's progress in implementing the recommendations of the Committee's Corporate Governance Accession Review [published as OECD (2017), Corporate Governance in Latvia <http://dx.doi.org/10.1787/9789264268180-en>]. It was discussed by the Corporate Governance Committee and the Working Party on State Ownership and Privatisation Practices at their meeting in March 2017. For further information, contact Daniel.Blume@oecd.org

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Introduction

1. The Corporate Governance Committee's 15 April, 2016 Formal Opinion on Latvia's accession to the OECD reached a positive assessment of Latvia's willingness and ability to implement the OECD legal instruments in the field of corporate governance, and concluded that its policies and practices were "increasingly consistent with OECD best policies and practices in this area." Nevertheless, the Committee with the Working Party on State Ownership and Privatisation Practices also underlined the importance of Latvia following through on its commitment to implement four "priority recommendations" identified in the Formal Opinion, and recommended to Council that Latvia report on its implementation of these recommendations by 15 February 2017 to enable the Working Party and Committee to carry out a follow-up assessment at their first meetings in 2017. Latvia also agreed to provide updates in the context of regular reporting to the Committee and Working Party on its progress in addressing "additional recommendations" to support implementation of the *Recommendation of the Council on Principles of Corporate Governance* and the *Recommendation of the Council on Guidelines on Corporate Governance of State-Owned Enterprises*.

2. Latvia's Ministry of Justice and State Co-ordination Council subsequently submitted progress reports in advance of the 15 February 2017 deadline,¹ providing responses both to the "priority recommendations" and "additional recommendations" for the Working Party's and Committee's review. This report by the Secretariat therefore provides information on Latvia's progress against all of the Committee's and Working Party's recommendations, drawing not only from Latvia's submissions but also from other relevant documents and information gathered from a December 2016 fact-finding mission that included interviews with relevant government authorities and stakeholders.

3. The description and assessment of implementation of recommendations related to the *Guidelines* as set out in paragraphs 5 to 36; the *Principles*-related recommendations are set out in paragraphs 37 to 57. A final section sets out conclusions on the priority recommendations agreed by both bodies.

The priority corporate governance recommendations

4. The Formal Opinion identified the following **priority recommendations** for the Committee and Working Party to monitor and assess through follow-up reporting to ensure the implementation of the OECD's corporate governance instruments:

- To ensure effective separation of the regulatory and ownership functions for state-owned enterprises and to further implement the *Recommendation of the Council on Guidelines on Corporate Governance of State-Owned Enterprises*, Latvia should:
 - Follow through on its pledge to establish professional boards of directors in all large commercial SOEs, based on the application of clear selection and nomination procedures for SOE board members. The Committee noted that Latvia had agreed to make a legally binding commitment to implement this recommendation by the end of 2016, by including it in its Final Statement accepting the obligations of OECD membership, which subsequently became part of the Final Statement of the Accession Agreement with the OECD, which is an international agreement ratified by Latvia's parliament.

¹ The two separate reports were formally submitted on 7 February, 2017, with additional amendments provided by the Cross-Sectoral Co-ordination Centre on February 24th. Latvia also provided interim reports to the Secretariat during the year, including prior to the Secretariat's 13-14 December 2016 fact-finding mission.

- Build on progress made in 2015 to strengthen the performance of its ownership function by, before the end of 2016, taking clear steps to ensure the effective implementation of the Public Persons Capital Shares and Companies Law (PPCSCL) and its implementing regulations and guidelines. This should encompass the development, review and monitoring by line ministries, in cooperation with the Coordination Institution of SOEs' medium-term operations strategies, including the clarification therein of SOEs' commercial and non-commercial objectives; and the development of future annual aggregate reports.
- Ensure that the 13 of Latvia's largest SOEs which have committed to apply International Financial Reporting Standards (IFRS) to their individual and consolidated (where applicable) annual accounts beginning with the 2016 annual reporting period, follow through on this commitment. As required for listed companies on Latvia's main listing segment, all large commercial SOEs should choose to apply IFRS to their financial accounts on the basis of the new 2015 Annual Accounts and Consolidated Annual Accounts Law.
- With respect to the *Principles*, to ensure the enforcement of shareholder rights and their equitable treatment, Latvia should address weaknesses identified in the framework for treatment and disclosure of related party transactions by enacting necessary legislation to strengthen this framework by the end of 2016.

Latvia's implementation of priority recommendations related to the SOE Guidelines

Establishing professional boards of directors in all large SOEs based on clear selection and nomination procedures

5. The Latvian government committed during the accession review process to establish boards of directors in all of its large, economically-oriented SOEs before the end of 2016, and this has been accomplished. In addition to five large SOEs that had already established SOE boards as a result of other legal requirements, boards of directors, known in Latvia as supervisory councils, have been established in 12 additional large SOEs (see Table 1 below for details regarding the dates that each board was established, along with information on their composition).

6. Three state-owned hospitals that have the legal status of large SOEs have been excluded from Latvia's commitment to establish boards and were not covered by the Working Party's priority recommendation, because they are not considered to operate on a commercial basis.

7. Selection of board members was undertaken according to Cabinet Regulation No. 686: "Procedure for Nomination of candidates for Posts of Board Members in Capital Companies, where the State as a Participant (Shareholder) has the Right to Nominate Board and Council Members and Board Members in SOEs with a Council" of December 1, 2015. This regulation requires shareholding ministries to establish nomination committees and nomination criteria with the participation of a representative of the Cross-Sectoral Co-ordination Centre (CSCC), independent experts who are not under the command of the shareholder or the supervisory board of the respective SOE, and if necessary, observers with advisory rights. Guidelines were also issued by the CSCC for the selection and assessment of candidates. In one case, for the nomination process for Latvia's largest SOE, Latvenergo, an executive search firm was appointed to help identify candidates. Following identification of leading candidates for interviews, the nominating committees then made recommendations to the shareholding minister for appointments.

8. Appointments were also required to comply with regulatory requirements including language proficiency, education and work experience, for example, in managing limited liability companies, recruitment or related to the sector in which the company operates. In addition, at least half of board

members (or one less in case of an odd number) must meet criteria for independence established by the regulation. To be considered independent, the board member:

- must not be subject to the command of a shareholder (i.e. the line ministry with ownership) while holding another office;
- has not been a board member or a public controller in the same SOE or its subsidiary;
- in an SOE where he/she holds the position of a member of the board or earns revenues only from the discharge of duties of a member of the board of directors;
- over the last three years has not been an external auditor, participant, board member or an employee in an enterprise which performs the functions of the external auditor for an SOE where he or she is a member of the board of directors.

9. Among the 12 SOEs that have established boards, 6 have boards in which all of the members meet the independence criteria; in five of the SOEs, two out of three board members meet independence criteria; and in one SOE there is one independent and one dependent director with a third position remaining to be filled. In all, only 6 of the 39 board members appointed by the government as shareholder in these 12 SOEs do not meet the criteria for independence.

10. Taking a closer look at the backgrounds of the actual appointees, there are some cases where "independent" board members also serve as civil servants in other parts of the government, serve as external advisors to the government, hold or have held positions in other SOEs owned by the same shareholding ministry, or have very recently left the shareholding ministry. Under tighter criteria for independence that take into account such ties to the government or shareholding ministry, some boards such as the Latvian Air Traffic SOE "*Latvijas gaisa satiksme*" the High Voltage Network SOE "*Augstsprieguma tīkls*", the Road Safety Directorate SOE "*Celu satiksmes drošības direkcija*" and the Road Maintenance SOE "*Latvijas Autocelu uzturētājs*" might not be considered majority independent.

11. While the Latvian authorities have indicated that they may consider amendments to tighten independence criteria in the future, they have nevertheless gone beyond the current requirements of the government's regulation in establishing boards with at least half and in six cases all members in line with the independence criteria. Perhaps just as importantly, a Secretariat review of information provided by the government on the backgrounds of the various appointees suggests that for the most part, the SOE board members selected provide a good mix of experience, with a majority either having served as board members or managers in other companies and state-owned enterprises, or possessing other relevant sectoral expertise. Usually there is no more than one and maximum two public officials serving on these boards.

12. Thus, Latvia's introduction of boards, their composition, and the processes followed to appoint them appear to be largely in line with good OECD practices, with some scope for strengthening independence in a few cases.

13. On the other hand, there have been indications that in the brief period in which the new boards have been in place, shareholding ministries at least in some cases are continuing to play a role in the management of the company that under the Guidelines would normally be recommended as a board responsibility. According to media reports, a member of the Riga International Airport Supervisory Board claimed that the Ministry of Transport had pressured the supervisory board to remove the management board's chair and one other member of the management board at the supervisory board's first meeting. Moreover, the Ministry reportedly has regulations requiring that supervisory boards obtain the approval of

the Ministry before removing or selecting members of the management board. Some Ministry of Transport officials have also taken part in some SOE board meetings where they are not members of the board. Furthermore, a requirement that public procurement contracts above 142,000€ must be approved by the shareholding ministry that was in place before the boards were established remains in effect, and would now seem to make less sense, undermining their independent authority to oversee the management of the company.

14. In response to Secretariat written questions about these practices, the CSCC responded that the Ministry of Transport argues that the board of directors is still free to make its own decision on hiring and dismissal of management board, so that the ministry does not approve anyone but only provides an opinion. However, in the case of Riga International Airport, the ministry's internal audit officials had carried out a review that found certain irregularities and problems with respect to the management board, leading to the decision by the supervisory board to dismiss certain members. The Ministry of Transport's position as reported by the CSCC is that the ministry and minister as a shareholder still has overall responsibility over SOEs and that the ministry should retain some control because of negative previous experiences with poorly performing management boards of some SOEs, similar to the level of control it retains over strategy development, dividend policy and assessment of performance results.

15. The Latvian response also stated that Ministry participation in board meetings is not a general practice, but has occurred in particular in relation to decisions on procurements that exceed the 142,000€ threshold. The CSCC has proposed to the Prime Minister's office a resolution that would transfer responsibility for such procurement decisions from the shareholding ministry to the board, which could be signed in the coming weeks. While it remains unclear to what extent thresholds would be increased under the CSCC proposal, CSCC has indicated that the general idea would be for SOEs to establish specific thresholds individually in the articles of association for each SOE.

Table 1. Latvian large SOEs that have established supervisory boards

Line Ministry		SOE	Law Regulating establishment of supervisory boards	Supervisory board establishment	Board composition and related issues
1.	Agriculture, Economy, & Finance	Development finance institution Altum	Law on Financial Development Institution	Previously established	The three shareholding ministries each have a Ministry representative serving on the three-person board. PPSCL requirements for independence are not applicable in this case.
2.	Agriculture	Latvian State Forests www.lvm.lv	PPCSCL	Established 11 June 2016.	All 5 members meet independence criteria.
3.	Economy	Latvenergo www.latvenergo.lv	PPCSCL	Established 16 December, 2016.	All 5 board members meet independence criteria. An executive search firm identified 536 potential candidates in accordance with qualifications criteria, and 80 candidates applied from 10 countries. The nomination committee also included an independent member from the Baltic Institute of Corporate Governance.
4.	Finance	High Voltage Network www.ast.lv	PPCSCL	Established 18 October, 2016	2 of the 3 board members meet independence requirements.
5.	Finance	Latvijas Loto www.latloto.lv	PPCSCL	Established 23 December, 2016	2 of the 3 board members meet independence requirements.
6.	Finance	Country Real Estate www.vni.lv	PPCSCL	Established 19 October, 2016	The board was established with only two of the three positions filled due to a shortage of suitable applicants. One of the two meets independence requirements. A second nomination process will be launched soon to identify a third director.
7.	Privatisation Agency	Latvian Mobile Telephone (LMT) www.lmt.lv	Company Law (CL)	Previously established	N.A.
8.	Privatisation Agency	Latt telecom www.latttelecom.lv	CL	Previously established	N.A.
9.	Privatisation Agency	Reverta www.reverta.lv	CL	Previously established	N.A.
10.	Transportation	Air Baltic www.airbaltic.com	CL	Previously established	N.A.

Line Ministry		SOE	Law Regulating establishment of supervisory boards	Supervisory board establishment	Board composition and related issues
11.	Transportation	Road Safety Directorate www.csdd.lv	PPCSCL	Established on 4 November, 2016	<p>The 7 new boards of directors established under Ministry of Transportation ownership all have three-member boards of directors.</p> <p>All of the members of the boards of Riga International Airport, Latvia Post, Latvia Railways and Passenger Train SOEs meet criteria for independence.</p> <p>For the other three SOEs -- Latvian Road Maintenance, Road Safety Directorate and Latvian Air Traffic, two of the three board members meet criteria for independence.</p>
12.	Transportation	Latvian Road Maintenance www.lau.lv	PPCSCL	Established on 20 May, 2016	
13.	Transportation	Latvian Railways www.ldz.lv	PPCSCL	Established on 22 July, 2016	
14.	Transportation	Latvian Air Traffic www.lgs.lv	PPCSCL	Established on 22 November, 2016	
15.	Transportation	Latvian Post www.pasts.lv	PPCSCL	Established on 18 May, 2016	
16.	Transportation	Passenger Train www.pv.lv	PPCSCL	Established on 30 December, 2016	
17.	Transportation	Riga International Airport www.riga-airport.com	PPCSCL	Established 17 May 2016	

Source: Information provided by Latvian authorities.

16. In interviews with shareholding ministries, it was suggested that the intervention of shareholding ministries in board decisions may be a transitional problem that will be sorted out as the new boards gain more experience, shareholding ministries gain more confidence in their boards, and the shareholding ministries have the time to get used to no longer playing the direct role that they have had since 2009, when SOE boards were abolished.

Strengthening the ownership function including through reviews of strategy, commercial and non-commercial objectives, and further aggregate reporting

17. The second "priority recommendation" called upon Latvia to strengthen the performance of its ownership function in implementing the PPSCL, focusing particularly on its reviews of strategy in order to strengthen the development of commercial and non-commercial objectives, as well as its aggregate reporting.

18. Following publication of its first aggregate annual report in February 2016, covering the 2014 financial year, Latvia issued its second aggregate report on 9 November 2016, covering the 2015 financial year.² The latest aggregate report provides comparative indicators showing substantial improvements in aggregate profit (164.4 million euro, up from 17.4 million); and the ratio of profit to turnover (4.8% in 2015, up from 0.5% in 2014). Total return on equity also rose from 0.5% to 4.3%. Dividends paid by the government totalled 127 million euros, an increase of 14.5% over 2014.

19. In addition to providing aggregate financial indicators of performance (e.g. turnover, profit, EBITDA, EBIT, return on assets and return on equity), the report provides an overview of SOEs by sector, and financial indicators on the performance of each SOE. It also includes a final section describing development of governance of SOEs in 2016, but without assessing the effectiveness of implementation. There remains scope for improvement in the reports, for example, by discussing more clearly SOEs' non-commercial objectives and assessments of their achievement of such objectives.

20. The concluding section of the report notes that "2016 was the first year when the operational results of capital companies were evaluated according to a uniform methodology and legal framework. Shareholders have submitted the assessment of operational results for the majority of SOEs as well as the CSCC has submitted 55 assessments about capital companies' operational results until 20 October 2016." Latvia's progress report updates this information to report that the CSCC reviewed 63 activity reports covering the 2015 financial year, and that it classified attainment of financial objectives of 46 SOEs as "very good" or "good", implying that there were no deviations from the expected results or that they came within 15% of projected amounts.

21. A main preoccupation of the CSCC in 2016 was to assess medium-term operational strategies in relation to its 64 fully-owned SOEs (down from 67 in 2015). The CSCC and line ministry strategy reviews include assessments of the coherence of financial and non-financial objectives, including the cost of achieving non-financial objectives and their impact on financial objectives; and the stability and sustainability of SOEs' projected activities. Latvia's progress report states that 29 of the 64 SOEs already had operational strategies in place before 2016. Therefore, while some SOEs with approved strategies have revised them, the CSCC's main focus has been to review strategies for those SOEs that do not yet have an approved medium-term strategy. As of 22 February, 2017, the CSCC had received strategies of 25 SOEs, including 8 from SOEs that already had strategies in place but which were seeking to revise them. This

² The Latvian version of the report is available at <http://www.pkc.gov.lv/489-publisko-2015-gada-parskatu-par-valsts-kapitalsabiedribu-darbibas-rezultatiem>. The English version was still under preparation and not yet publicly available as of 24 February, 2017, but a preliminary English version was provided to the Secretariat for review.

leaves 18 of 64 SOEs where new strategies either have not yet been developed or submitted for review (See Table 2 below for an overview by shareholding ministry).

Table 2. Shareholding Ministries' development of medium-term operational strategies

Ministry	Number of SOEs	Number of strategies approved before 2016	Number of strategies submitted to the Coordinating Institution until 22 February 2017	Number of SOEs without operational strategies
Ministry of Finance	5	1	5	0
Ministry of Economics	4	1	3	1
Ministry of Transport	12	11	5	1
Ministry of Culture	14	0	6	8
Ministry of Justice	2	0	0	2
Ministry of Environmental Protection and Regional Development	3	1	1	1
Ministry of Health	13	13	0	0
Ministry of the Interior	1	0	1	0
Ministry of Welfare	1	0	1	0
Ministry of Education and Science	3	0	0	3
Ministry of Agriculture	3	1	1	2
National Electronic Mass Media Council	2	0	2	0
SJSC "Privatisation Agency"	1	1	0	0
Total	64	29	25 (8 re-submissions)	18

22. The majority of undeveloped strategies involve SOEs owned by the Ministry of Culture (8) and Ministry of Education and Science (3), which may be considered to oversee less commercially-oriented SOEs than some of the others. Explanations for delays by some of the others related to pending government consideration of changes in ownership.

23. Overall, as the medium-term strategy development process remains a work in progress, it is difficult to assess at this stage how successful these reviews have been in establishing clear non-financial objectives and assessing their costs, which was seen as an important weakness that the strategy development process is meant to address. Line ministries remain responsible for final adoption of the strategies and are not required to follow CSCC recommendations in this regard, but must explain in writing if these recommendations are not followed.

24. Nevertheless, the Coordination Institution has demonstrated a capacity to maintain an active co-ordination role in its first full year of operation in 2016, issuing a second aggregate report on SOEs, reviewing the financial and non-financial objectives of SOEs, reviewing and providing feedback on strategies submitted to them by the line ministries, developing guidance for nomination and remuneration of board members, and participating in more than 30 nomination processes for supervisory and management boards.

Implementation of IFRS in Latvia's largest SOEs

25. At the time of the accession review, the Latvian authorities underlined the commitment of 10 large SOEs to implement IFRS beginning with their 2016 annual financial reports (to be issued by May 2017), joining three others -- Latvenergo, Riga International Airport and Latvian Air Traffic -- that already were following IFRS at the time of the Working Party's last review in March 2016. An additional SOE, the Ministry of Finance's real estate management SOE, indicated it will require an additional year due to the fact that a significant number of real estate properties need to be re-evaluated in order to meet IFRS requirements. Latvia's progress report indicated that its largest SOEs remain on track to implement IFRS as indicated above, except in the Ministry of Health's three SOE hospitals, where the transition will require some time before comparable data is available in IFRS. The three hospitals will still issue their first reports according to IFRS in May 2017, but will lack fully comparable financial information for the previous two years, meaning that full compliance will only occur with annual reports for 2018.

26. As reported during the accession review process, one SOE, Latvia Loto, classified as a large SOE under the PPSCL, will not issue its reports according to IFRS because it does not meet the criteria of a large SOE in accordance with the Law on Annual Accounts and Consolidated Annual Accounts. In order to comply with the law, it would have to also issue its accounts according to Latvian local accounting standards, which would create an unnecessary administrative burden.

27. While it is not possible to confirm Latvia's implementation of this recommendation before the 2016 annual reports are issued later this year, Latvia appears to be reasonably on track to implement this recommendation in line with its commitments. The only slippage reported is in relation to the three SOE hospitals, and, in those cases, the Working Party has already indicated a willingness to allow greater leeway in implementing the Guidelines due to their greater focus on public policy goals rather than commercial objectives.

Latvia's additional recommendations related to implementation of the SOE Guidelines

28. The Formal Opinion provided three "additional recommendations" related to implementation of the SOE Guidelines, which Latvia was invited to report on in the context of the Working Party's regular meetings. While not required to report on these measures for the post-accession progress review, Latvia has nevertheless provided an update with respect to these three additional recommendations in the Formal Opinion, which read as follows:

- *Effectively coordinate and exercise the state ownership function.* The establishment of the Coordination Institution has the potential to facilitate the more effective exercise of the state enterprise ownership function in Latvia. The Government should ensure that the Coordination Institution is equipped with the human and financial resources sufficient for it to fulfil all of its responsibilities under the PPCSCL. At the same time, line ministries should also demonstrate they are committed to cooperating with the Coordination Institution.
- *Clarify the state ownership policy and ownership objectives.* Amendments to the State Administration Structure Law, adopted on 22 October 2015, streamline conditions for state enterprise ownership. In implementing the new ownership policy, the Government should clarify and communicate the criteria to be applied in order to identify which services, goods, and properties are "of strategic importance" and how state enterprise ownership may be justified "in protection of the public interest".
- *Consider establishing boards in remaining commercial SOEs.* Professional supervisory boards serve as a cornerstone of good corporate governance for commercially oriented SOEs. Latvia

should therefore review experience gained in establishing boards in its large SOEs in order to consider their expansion to all remaining commercial SOEs, regardless of size.

29. Effective co-ordination and exercise of the ownership function. The CSCC asserts in its progress submission that it has "sufficient human and financial resources" that have enabled it to successfully ensure the preparation of annual aggregate reports, to evaluate SOE performance results, and to assess and provide opinions on draft medium-term operational strategies. Supervised by the CSCC's deputy head, the CSCC has a head of unit and four consultants currently working on SOE co-ordination, while an additional vacant position was in the process of being filled. An additional consultant in another part of the CSCC is responsible for maintaining the CSCC web site and SOE database.

30. The Co-ordination Institution includes the CSCC as well as the Coordination Institution Council. The Council, and is composed of representatives of eight shareholding ministries, the Latvian Association of Local and Regional Governments, Latvia's Free Trade Union Confederation, and the Employers' Confederation of Latvia. It serves as the decision-making body for issuance of guidelines to shareholding ministries. The Coordination Institution has been active across a range of issues, as noted in previous sections of the report. Additional activities not yet mentioned include the preparation of draft guidelines for determining remuneration for members of the management board and SOE boards; providing advice to both ministries and local governments on unclear points of corporate governance; and participating in more than thirty nomination processes for members to boards of directors and management boards. The Coordination Institution also organised a training seminar to share experiences for members of newly established boards of directors.

31. Clarification of the state ownership policy and ownership objectives. The accession review of Latvia raised concerns that Latvia's criteria for reviewing state ownership were insufficiently clear for determining which services, goods and properties were of "strategic importance" and how state ownership may be justified "in protection of the public interest." Latvia's progress submission provides considerable explanation of how these criteria have been applied in practice to explain or justify government positions on state ownership. Line ministries generally prepare submissions with regard to preservation of government shareholding in SOEs, which are then reviewed by the Cabinet of Ministers in accordance with the State Administration Structures Law.

32. The submission states that one of the criteria of a **strategically important good or service** is that it has a substantial impact on the quality of life of society, national development and security. This criterion applies to cases where the strategic objective of an SOE is linked to the performance of public functions, for example, the maintenance of infrastructure for public use, provision of public services and other specific services, which have a substantial impact on the quality of life of society and national security. The submission goes on to provide specific examples in transport, health care, energy, national security and the media where SOEs fulfil public purposes. National and local governments have the authority to determine what is strategically important, but this can vary according to goals established in long term development planning documents, as well as relevant laws and regulations applying to individual SOEs.

33. Latvia's submission states that a criterion for establishing **assets of strategic importance** is the extent to which the asset is important for the development of state or local government's administrative territory or for national security. For example, real estate can be regarded as significant for society and as a limited public resource. State roads should be considered as a valuable asset, as well as the national railway network, electricity transmission and distribution networks, electricity generation utilities; television and radio broadcasting infrastructure; state-owned forests; real estate to ensure operation of the public administration; and drainage systems and their constructions of national importance.

34. Finally, the Latvian submission describes criteria related to **market failures** as a justification for state participation, including failure of the market to ensure that the public interest is achieved, or to ensure quality services, and conditions of natural monopoly. This justification is used, for example, for the Ministry of Culture's SOEs to ensure high quality theatre, opera, ballet, concert and circus performances based on a finding that state co-financing is necessary due to high costs and limited purchasing power of the public. As they are not commercially viable, this limits private sector engagement in this market. Similar justifications are used for SOEs operating under the Ministry of Health.

35. Considering the establishment of boards in Latvia's remaining commercial SOEs. The PPSCSL currently only allows the establishment of SOEs in Latvia's largest SOEs and those otherwise required under other laws. This means that only 13 of Latvia's 64 fully-owned SOEs now have boards of directors in place, while boards of directors have also been established in four other partially state-owned enterprises, for which the state has nominated and elected members of the board.

36. Latvia's submission states that the Latvian government has agreed that the CSCC should submit a report to the Government by the autumn of 2017 describing and analysing the process of introduction of boards of directors in large SOEs, as well as providing an assessment of their performance. Development of this report will include analysis of potential expansion of the scope of SOEs which would be eligible to establish boards of directors, taking into account characteristics of SOE operation such as sector, size, financing model and extent of commercial orientation. Results of this analysis included in the above-mentioned report could serve as basis for consideration and discussion at political level of possible amendments of the PPSCSL, which determines SOE criteria for establishing boards of directors.

Latvia's implementation of priority recommendations related to the Principles

Addressing weaknesses in the framework for review and disclosure of related party transactions

37. The Committee's corporate governance accession review pointed to weaknesses in Latvia's framework for the review and disclosure of related party transactions (RPTs), including discrepancies in the definitions used for related parties in different laws, as well as insufficiently clear requirements related to board responsibilities for their review. However, it noted that a working group had been established that had developed proposals to address these gaps. Draft amendments to the Company Law and to the Financial Instruments Market Law passed a first reading of the Saeima in December, 2016. The Latvian authorities have indicated that there have been no concerns expressed by the Saeima regarding the RPT provisions, so that these can be expected to be enacted into law following two more readings. The main provisions of the reforms were highlighted in Box 3.1 of the accession review report [OECD (2017), *Corporate Governance in Latvia*] and included the following:

1. **A new definition of a "related party" in the Financial Instruments Market Law (FIML).** The term "related party" will have the same meaning as in the international accounting standard adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (International Accounting Standard 24) and already included in the Annual Accounts and Consolidated Annual Accounts Law (see section IV.4.2.1 below);
2. **A clarification of types of related party transactions (RPTs) and a definition of materiality in the FIML.** Amendments would distinguish between two kinds of related party transactions: "non-routine RPTs" and "RPTs of a significant amount or material routine RPTs". The former include transactions not concluded within the scope of ordinary business operations of the company, or which are not concluded on normal market terms; the latter include material RPTs. In these cases, "material" is defined as a transaction, which amounts to at least 10% of the company's equity according to the latest audited annual accounts or consolidated annual accounts

(if prepared). If several transactions with the same related-party are concluded within any 12-month period, they should be aggregated for the purpose of determining materiality.

3. A requirement that RPTs:
 - **Be immediately disclosed.** Under the amendments to the FIML, information on all non-routine RPTs and material routine RPTs (including information on the nature of the related party relationship, the name of the related party, the value of the transaction, and the impact of the transaction on business and financial results of the company) and the audit committee's or expert's opinion (if any were required) must be disclosed.
 - **Be approved by the supervisory board or shareholder meeting.** Under amendments to the Commercial Law, non-routine RPTs must be approved by the supervisory board or the meeting of shareholders. The abstention of related supervisory board members is mandatory; if all members of the supervisory board are regarded as related ones, a transaction must be approved by the shareholder meeting;
4. **An option for the supervisory board of a company to ask the audit committee or other expert to give its opinion on the RPT.** The opinion of the audit committee or the expert must be disclosed in accordance with the FIML.

38. In addition, the legal reforms would require the board to inform the audit committee regarding all non-routine and material routine RPTs, including the grounds for the transaction and their provisions, an assessment of the impact on the business, its financial situation and on the shareholders who are not related parties in respect to the particular RPT. Companies must also establish an internal procedure under which it determines whether an RPT is to be considered non-routine, and assess annually whether the RPTs are identified properly and the rules on conclusions and disclosure of RPTs are duly followed. Finally, if the approval procedure of RPTs is disregarded, the court may declare the RPT void.

39. Enactment of the amendments would bring Latvia's framework for review and disclosure of RPTs in line with OECD best policies and practices in this area.

Additional recommendations related to Latvia's implementation of the Principles:

40. The Formal Opinion provided two "additional recommendations" related to implementation of the Principles, which Latvia was invited to report on in the context of the Committee's regular meetings. While not required to report on these measures for the post-accession progress review, Latvia has nevertheless provided an update with respect to these two additional recommendations in the Formal Opinion, which read as follows:

- *Strengthen its corporate governance framework for listed companies.* Latvia should continue the progress it has made in strengthening the efficiency of judicial review of commercial cases. The Government should also continue its assessment of its insolvency framework. In addition, Latvia should enact legislative proposals to amend the Financial Instruments Markets Law (FIML) to strengthen the enforcement capacity of the Financial and Capital Market Commission (FCMC) and to clarify the role, composition and functioning of the audit committee.
- *Improve enforcement and establish whistleblower protections.* Latvia should continue efforts to strengthen the effectiveness and coordination of the enforcement of cases of market misconduct, including insider trading, which is integral to deepening confidence in Latvia's capital markets. These efforts should also include establishing appropriate channels for whistleblowing and

protections for whistleblowers, given the important role whistleblowers can play in identifying misconduct.

Strengthening the corporate governance framework for listed companies

Effectiveness of the judiciary

41. Latvia reports that it has continued to work towards improvements in the **effectiveness of its judicial system**, which includes goals to strengthen specialisation, to ensure random distribution of cases, to prevent uneven judicial capacity, and reduce the length of court proceedings. Supported by the European Social Fund, Latvia has been working to implement a capacity building and competence development plan for 2015-2020. Tasks within the scope of the Plan will continue to be fulfilled until 2022. The Plan calls for an independent evaluation of the Latvian judicial system involving foreign experts, leading to recommendations for possible improvement and modernisation that are expected to be issued in 2018. Training programs and conferences are also planned within the scope of the European Social Fund project.

42. In addition, the Ministry of Justice has developed proposals to increase salaries for judges and prosecutors. The Cabinet of Ministers on 16 August, 2016 agreed to support the proposal with additional funding from 2018-2019.

43. Work has also continued to strengthen alternative dispute resolution systems. Amendments to strengthen the arbitration system entered into force on 3 November, 2016 aimed at regulating the arbitration profession and clarifying certain matters related to the registration for arbitrators and arbitration courts. Two pilot projects to strengthen the use of mediation programmes have also been developed and launched.

44. Finally, the average length of court proceedings has been decreasing in most cases (see Table 3 below). The percentage rate of clearance of incoming cases has remained above 100% during this same period (not including insolvency cases for legal or natural persons, which are tracked separately).

Table 3. Average length (in months) of court proceedings in Latvia

Type of proceedings	Court	2013	2014	2015	2016	Tendency
Civil cases	District (municipal) courts	9.2	8.2	8.6	7.8	variable/ decrease
	Regional courts (appeal)	5.1	4.0	3.7	3.9	variable
Criminal cases	District (municipal) courts	6.4	6.2	5.5	5.3	decrease
	Regional courts (appeal)	3.5	3.3	3.5	3.8	variable
Administrative cases	Administrative district court	13.5	10.0	7.3	7.2	significant reduction
	Regional court (appeal)	11.3	13.0	12.7	12.4	variable/ decrease

Effectiveness of the insolvency framework

45. Latvia's submission also reports that it has also been working towards implementation of new **"Insolvency Policy Development Guidelines 2016-2020"** agreed by the Cabinet of Ministers on 21 September 2016. The plan has four main action lines:

1. to ensure that legal protection proceedings are popularized and with that – applied more;
2. to facilitate as complete as possible return of economically valuable assets in the economic circulation thereby increasing the amount of the recovered means;
3. to ensure that insolvency proceeding of natural person provide a second chance to faithful natural person;
4. to ensure that administrators are qualified and professional specialists that fulfill their duties effectively and look after the reputation of the profession.

46. To support implementation of the guidelines, "Amendments to the Insolvency Law" came into force on 6 January 2017, containing reforms to the requirements applicable to insolvency administrators. The amendments establish enforcement mechanisms independent of the profession, by returning examination of insolvency administrators to the state via the Insolvency Administration, and would allow for disciplinary penalties. Under recent legal reforms, insolvency administrators are also designated as public officials and therefore are bound by requirements of the law "On Prevention of Conflict of Interest in Activities of Public Officials". A number of administrators protested against this designation due to additional disclosure requirements and other restrictions, which they argued would constrain their ability to serve simultaneously as both insolvency administrators and attorneys, and could lead to a reduction in the supply of insolvency administrators necessary to handle cases. They sought Parliamentary support to cancel this status, which was supported in the Saeima's Legal Affairs Committee. However, on 8 December, 2016, the Saeima decided against cancelling this designation. Latvia's submission reports that since the decision, 22 administrators terminated their administrators' certificates out of 172 who were simultaneously serving as attorneys and administrators. As of 1 February, 2017, the insolvency register recorded 312 administrators.

47. An electronic insolvency supervisory system has been developed during 2016, which enables insolvency administrators to submit their operational reports on a quarterly basis. An electronic auction system has also been launched for insolvency matters at the beginning of 2016, aimed at strengthening the efficiency and trustworthiness of auctions for immovable property. The electronic insolvency supervisory system is intended not only to serve a supervisory function, but also will be used as a tool to collect data from submitted reports in order to track indicators of the effectiveness of the insolvency framework, including data on length of insolvency proceedings, secured creditors' claims recovery rates, and costs of proceedings. Latvia reported that the new system has some technical deficiencies that need to be corrected and some improvements that need to be made for the system to reach its full potential.

48. To further strengthen the system, Latvia suggests that more attention will need to be given to examination and prevention of criminal offences relating to insolvency and pre-insolvency, including through strengthening of State police employees' capability to examine such cases, and better co-operation between the State police and the Insolvency Administration.

Enforcement capacity of the Financial and Capital Market Commission (FCMC)

49. The FCMC's framework for issuing sanctions has been significantly strengthened through amendments to the Law on the Financial Instruments Market (FIML) to implement the European Union

Directive 2013/50/EU, known as the Transparency Directive. The amended law, which came into effect on 29 June, 2016, allows for sanctions related to infringement of transparency requirements, as well as for violations of requirements for making mandatory share buyout offers. Under the amendments, the FCMC may impose penalties of up to EUR 10 million or up to 5% of annual turnover. The Committee's accession review identified low levels of fines and the inability to impose significant sanctions with respect to violations of provisions related to mandatory bidding requirements as a weakness in Latvia's enforcement framework. Latvia has also subsequently amended its law to lower the threshold at which mandatory bids must be initiated from 50% to 30%. However, the previous requirement of 50% remains in effect for existing, listed companies and the new threshold will only be applied to new listings.

50. Other amendments that took effect on 3 July, 2016 to implement Directive 2014/57/EU on criminal sanctions for market abuse allow for greater flexibility in the sanctioning of insider dealing and market manipulation by allowing for prosecution either as an administrative violation or for more serious cases to be prosecuted as criminal violations. Amendments to the Criminal Law came into force on 1 March, 2016, related to liability for illegal use of insider information and manipulation in financial markets. The issue of prosecution of market abuse cases is addressed in greater detail under the "Additional Recommendation" on enforcement and whistleblowing below.

51. Sanctioning activity by the FCMC during 2016 continued at levels similar to previous years. This included one fine of €5,000 against a company for failing to issue financial reports on time (following repeated delays); and one administrative fine of €1,000 for delayed notification of the holder regarding inside information. In other cases of violations, either warnings were issued or corrective measures were applied without sanction, related to delays in financial reporting, reporting of inside information, and in one case, delayed election of an audit committee. The FCMC reports that violations of transparency provisions all took place before the 29 June, 2016 amendments took effect. Provisions related to enforcement against insider trading are discussed in greater detail below.

Clarifying the role, composition and functioning of the audit committee

52. FIML amendments to implement the EU Directive on Audit, Directive 2014/56/EU, came into effect on 1 January, 2017. The amendments require that the audit committee shall be composed of at least three members, of whom at least one shall be a member of the supervisory board of the company, while the others shall be elected by the shareholders' meeting. This reform addresses a weakness identified in the Committee's accession review, which pointed to the absence of a requirement for any of the members of the supervisory board to serve on the audit committee. The report suggested that the absence of a link between audit committee and supervisory board members may contribute to a risk that the supervisory board delegates all financial supervision to the audit committee and is therefore not sufficiently informed to effectively review the company's accounts and internal controls. The law also provides for the possibility for the FCMC to issue more stringent sanctions or supervisory measures in the event of non-compliance.

53. The legal reforms also clearly stipulate the audit committee's various responsibilities for reviewing annual accounts, efficiency of internal control, risk management and operation of internal audit, as well as for making proposals to rectify any deficiencies found in these areas. As noted above under the section on related party transactions, the supervisory board is also now required to inform the audit committee regarding all material and non-routine related party transactions, and may ask the audit committee (or outside expert) to review a transaction and to provide an opinion.

Improving enforcement and establishing whistleblower protections

54. The corporate governance accession review pointed to the FCMC's review of market misconduct cases as a particular concern for the credibility of the market, which required legal reforms that have now been enacted, and strengthened co-operation between the FCMC and state police for criminal prosecutions. At a Latvian Conference on Corporate Governance held in Riga on 13 December, 2016, a representative of the NASDAQ Riga Exchange cited continuing concerns about the credibility of enforcement related to a couple of cases where their tracking of share trading showed sharp increases in trading activity and fluctuations in prices just before major announcements affecting the share price, pointing to the potential existence of insider trading.

55. The FCMC reports that it investigated three cases involving market manipulation or insider dealing during 2016, including the cases cited by the Exchange. Two of the cases occurred after the new law took effect on June 29, 2016, but the investigations are still pending and there have been no administrative enforcement cases or cases referred to the police for felony prosecution. One case was under investigation before the new law took effect, but after all the necessary information was obtained, FCMC reached the conclusion that there was not a serious breach of the law that would require criminal sanctions. One administrative sanction of €1,000 was issued for delayed notification by the holder of inside information.

Whistleblower protection

56. The Latvian submission reports that the government is continuing to work towards enactment of a draft law on protection of whistleblowers aimed at addressing both public and private sectors under the same law. Taking into account the Committee's recommendation, the draft law includes an article requiring the creation of internal whistleblowing channels to receive and review reports in public institutions and private law legal persons (businesses, associations) with more than 50 employees. The article would also require the State Chancellery to develop best practice guidelines on internal reporting channels. The law will define "whistleblower" and "whistleblowing", and prohibit whistleblower reprisal, as well as provide protection of whistleblowers' confidentiality..

57. A working group led by the State Chancellery worked during 2016 to consult with relevant public institutions and NGOs, resulting in successive drafts issued for review by the State Secretaries meeting in December 2015 and again in October and December 2016. It was discussed by the Cabinet of Ministers Committee on 6 February, 2017, where it received "overall support," subject to further improvements. Improvements subsequently agreed would remove administrative liability for whistleblower reprisal due to difficulties in applying it. Also, the provision on internal reporting channels was revised to take account of objections seeking to make them less burdensome.. The draft law on 23 February 2017 was submitted to the Cabinet of Ministers. The Cabinet of Ministers was scheduled to review it on 7 March 2017, after which the plan is for it to be submitted to the Saeima.

Conclusions

58. Latvia has taken clear steps to implement the "priority recommendations" identified in the Formal Opinion of the Corporate Governance Committee on the Accession of Latvia as necessary to implement the *Recommendation of the Council on Guidelines on Corporate Governance of State-Owned Enterprises*, and the *Recommendation of the Council on Principles of Corporate Governance*.

59. With respect to SOEs, Latvia has established boards of directors in all of its large, commercially-oriented SOEs consistent with its commitments. With 33 of the 39 supervisory board members that have been appointed meeting the government's criteria for independence, and a majority coming from outside of

the government with relevant sectoral expertise or business-related experience, it appears that the composition of the new boards is largely in line with recognised OECD good policies and practices.

60. Some further actions to strengthen board independence and authority to exercise its responsibilities would be welcome. For example, eliminating the €142,000 threshold for procurement contracts above which shareholding ministry approval is required would give the board appropriate responsibilities for review of such contracts. Proposals to further tighten the criteria for independence should be considered, including possible exclusion from independence of individuals who work as a consultant to the government; who have worked for the shareholding ministry within a designated recent period; or those with a role in management or on the board of other SOEs related to the shareholding ministry. Finally, the Guidelines recommend that boards should have the independent authority to appoint and remove the CEO.

61. The Coordination Institution has managed to issue all regulations and guidelines of highest priority for implementation of Latvia's SOE governance reforms, particularly with respect to establishment of boards, nomination processes, nomination criteria, and review of SOE activities and operational strategies. While less than three-quarters of Latvia's 64 fully-owned SOEs have developed medium-term operational strategies as of 22 February, 2017, Latvia's largest, commercially-oriented and most strategically important SOEs generally now have strategies in place. Aggregate SOE reports have also been issued for both the 2014 and 2015 financial years.

62. There remains some scope for improvement, particularly with respect to definition of non-financial objectives, their costs, and more explicit reporting on their achievement; and implementation of medium-term operational strategies in 18 SOEs for which line ministries have yet to submit them to the CSCC for review. However, overall, the Coordination Institution appears to be off to a good start in working with line ministries towards a more transparent ownership framework.

63. Finally, implementation of IFRS within Latvia's largest SOEs also appears largely on track for 2016 financial reports to be issued in 2017, though a few SOEs have provided explanations as to why they will require additional time to be fully compliant with IFRS requirements.

64. To strengthen its implementation of the *Principles*, Latvia has prepared legal reforms that have passed the 1st reading of the Saeima to enhance the framework for review and disclosure of related party transactions (RPTs). Enacting these reforms should continue to be a priority in order to clarify the definition of related parties and what types of transactions are subject to supervisory board approval, ensuring that board members who are related to the transaction do not take part in the decision, and requiring immediate disclosure of non-routine and material RPTs.