

OECD GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES

DRAFT FOR PUBLIC COMMENT – MAY 2014

This document presents a draft text of the OECD Guidelines on Corporate Governance of State-Owned Enterprises, which are being revised in 2014 by the OECD Working Party on State Ownership and Privatisation Practices. The draft is a work in progress that is made available online to solicit input from business and labour representatives, civil society, the OECD's partner countries and other interested stakeholders. Its content is without prejudice to the final text that will be agreed by the Working Party.

The Guidelines were adopted in 2005 as an internationally-agreed standard on how governments should exercise ownership of state-owned enterprises. They are being updated to take into account developments since the Guidelines were first adopted and the experiences of the growing number of countries that have taken steps to implement their recommendations.

Comments can be sent by 8 September to StateOwnedEnterprises@oecd.org. Comments received by that date will be published online unless otherwise requested.

PREAMBLE

1. In many OECD countries, state-owned enterprises (SOEs) represent a substantial part of GDP, employment and market capitalisation. A number of non-OECD countries have significant state-owned sectors, which in some cases are even a dominant feature of the economy. These countries are in many cases reforming the way in which they organise and manage their SOEs and have sought to share their experiences with OECD countries in order to support reforms. Moreover, in all countries SOEs are often prevalent in utilities and infrastructure industries, such as energy, transport and telecommunications, whose performance is of great importance to broad segments of the population and to other parts of the business sector. Consequently, the governance of SOEs is critical to ensure their positive contribution to economic efficiency and competitiveness. OECD experience has also shown that good corporate governance of SOEs is an important prerequisite for economically effective privatisation, since it will make the enterprises more attractive to prospective buyers and enhance their valuation.

2. Over the years, the rationale for state ownership of commercial enterprises has varied among countries and industries and has typically comprised a mix of social, economic and strategic interests. Examples include industrial policy, regional development, the supply of public goods and the existence of so called “natural” monopolies. Over the last few decades however, globalisation of markets, technological changes and deregulation of previously monopolistic markets have called for readjustment and restructuring of the state-owned sector. These developments are surveyed in a number of OECD reports that have served as input to these Guidelines¹.

3. The *Guidelines on Corporate Governance of State-Owned Enterprises* were first developed in 2005. In 2014, the OECD Corporate Governance Committee asked its subsidiary Working Party on State Ownership and Privatisation Practices to review and revise this instrument in the light of almost a decade of experiences with its implementation. A report had previously taken stock of changes in corporate governance and state ownership arrangements in OECD countries since 2005 and concluded that national reform efforts have, with few exceptions, been consistent with the Guidelines². Based on this the Working Party concluded that the Guidelines should continue to set high levels of aspiration for SOE owners and serve as a guidepost for their continued reform efforts.

4. The World Bank and the Republic of Lithuania act as Participants in the Working Party with observer status, and a number of other countries (e.g. Brazil, China, Colombia, Latvia, Russia and South Africa) have taken part as invitees in many of the Working Party’s meetings. The following countries acted as Associates (with the same rights and duties as OECD member countries) in the revision of the Guidelines and have formally associated themselves with the revised instrument: Colombia, Latvia, Russia, [more to be added]. Extensive consultations with stakeholders were organised during the revision of the Guidelines. Draft versions of the text were posted on the OECD website for public comment and resulted in a significant number of useful and constructive comments from business and trade unions, civil society, academia and non-member governments.

¹ “Accountability and Transparency: A Guide for State Ownership”, OECD, 2011; “Competitive Neutrality: Maintaining a Level Playing Field Between Public and Private Business”, OECD, 2012; “Boards of Directors of State-Owned Enterprises”, OECD, 2013; and “Financing State-Owned Enterprises: An Overview of National Practices”, OECD, 2014.

² “Corporate Governance of State-Owned Enterprises: Change and Reform in OECD Countries since 2005”, OECD, 2010.

5. In order to carry out its ownership responsibilities, the state can benefit from using tools that are applicable to the private sector, including the OECD Principles of Corporate Governance. The Guidelines are intended as a complement to the Principles, with which they are fully compatible. This is especially true for listed SOEs. For fully-owned SOEs as well the Guidelines may be read as providing advice on how government can ensure that SOEs are as accountable to the general public as a listed company should be to its shareholders.

6. SOEs also face some distinct governance challenges. One is that SOEs may suffer just as much from undue hands-on and politically motivated ownership interference as from totally passive or distant ownership by the state. There may also be a dilution of accountability. SOEs are often protected from two major threats that are essential for policing management in private sector corporations, i.e., takeover and bankruptcy. More fundamentally, corporate governance difficulties derive from the fact that the accountability for the performance of SOEs involves a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly and easily identifiable, or with remote, principals. To structure this complex web of accountabilities in order to ensure efficient decisions and good corporate governance is a challenge.

7. As the Guidelines are intended to provide general advice that will assist governments in improving the performance of SOEs, the decision to apply the Guidelines to the governance of particular SOEs should be made on a pragmatic basis. For example, the term “ownership entity” refers to the state entity responsible for executing the ownership rights of the state, whether it is a specific department within a ministry, an autonomous agency or other. The term “board” as used in this document is meant to embrace the different national models of board structures. In the typical two tier system, found in some countries, “boards” refers to “supervisory board”, whereas in countries with one-tier boards the term “board member” will normally refer to non-executive directors. Finally, the Guidelines should be considered as an integrated instrument. Several recommendations are intended to be implemented in unison with others and might, if applied in separation, have little or no effect on good governance.

8. The document is divided into two main parts. The Guidelines presented in the first part of the document cover the following areas: I) Rationales for State Ownership; II) The State’s Role as an Owner; III) State-Owned Enterprises in the Marketplace; IV) Equitable Treatment of Shareholders; V) Stakeholder Relations and Sustainable Business; VI) Transparency and Disclosure; VII) The Responsibilities of Boards of Directors. Each of the sections is headed by a single Guideline that appears in bold italics and is followed by a number of supporting sub-Guidelines. In the second part of the document, the Guidelines are supplemented by annotations that contain commentary on the Guidelines and are intended to help readers understand their rationale. The annotations may also contain descriptions of dominant trends and offer alternative implementation methods and examples that may be useful in making the Guidelines operational.

APPLICABILITY AND DEFINITIONS

9. The Guidelines are an “OECD Recommendation” – that is, a set of non-binding guidelines and best practices to which the OECD members and associate countries have expressed their commitment. They provide guidance that is generally relevant to any corporate asset in public sector ownership. However, no one size fits all and not every aspect of the recommendations is applicable in every context. This section reviews some of the questions and trade-offs that the owners of enterprises need to address in order to decide on the applicability of the Guidelines.

10. **Ownership and control.** The Guidelines apply to enterprises that are effectively controlled by the state, either by holding a majority of the voting shares or otherwise exercising an equivalent degree of control. The latter applies, for instance, where legal stipulations or corporate articles of association ensure continued state control over an enterprise or its board of directors in which it holds a minority stake. Some borderline cases need to be addressed on a case-by-case basis. For example whether a “golden share” amounts to control depends on the extent of the powers it confers on the state. Also, minority ownership by the state can be considered as covered by the Guidelines if corporate or market structures confer a non-trivial degree of influence on the state. Conversely, corporate assets held indirectly via asset managers operating independently of the government would normally not be considered as SOEs. Different modes of exercising state control will also give rise to different governance issues.

11. **Defining an SOE.** A very broad definition of an SOE, applied for instance by national account statisticians, includes all autonomous government entities that generate at least half of their income through the sale of goods and services and have autonomous budgets and balance sheets. However, most national authorities apply a narrower concept, which is in many cases anchored in SOE-related legislation. For the purpose of the Guidelines, any state-owned corporate entity recognised by national law as an enterprise should be considered as an SOE. This includes joint stock companies, limited liability companies and partnerships limited by shares. Moreover statutory corporations, with their legal personality established through specific legislation, should be considered as SOEs if their purpose and activities are of a largely commercial nature. Whether or not to consider other units of general government as SOEs would need to depend on a value judgement, including regarding their degree of market orientation. For example, entities whose primary purpose is to exercise state powers would generally not be considered as SOEs.

12. **Economic activities.** The Guidelines are principally applicable to SOEs engaging in economic activities. By economic activity is meant an activity which involves offering goods or services on a given market and which could, at least in principle, be carried out by a private operator in order to make profits. The market structure (e.g. whether or not it is characterised by competition, oligopoly or monopoly) is not decisive for determining whether an activity is economic. Mandatory user fees imposed by the government should normally not be considered as a sale of goods and services in the marketplace.

13. **Competitive activities.** A subset of the economic activities can be characterised as competitive. Competitive activities means selling goods and services in economic markets where competition with other enterprises already occurs or where competition given existent laws and regulations could occur. The Guidelines are applicable to SOEs pursuing competitive activities, either exclusively or together with the pursuit of public policy objectives.

14. **Public policy objectives.** For the purpose of this document, public policy objectives is taken to mean specific performance requirements imposed on SOEs other than the maximisation of profits and shareholder value. These would include, for example, universal service obligations (where not addressed through sector regulation) and well defined sectoral policy goals. In many cases, public policy objectives might otherwise be achieved via government agencies, but have been assigned to an SOE for efficiency or other reasons. More broadly defined “expectations” communicated to SOEs, for example related to

corporate social responsibility, according to national context may or may not be considered as part of the public policy objectives.

15. ***The level of government.*** Enterprises in which the central or federal levels of government exercise the ownership rights should be considered as SOEs. Enterprises held at subnational levels of government would, according to national context and legislation, normally not qualify as SOEs. However, while these may not be under the control of the central authorities their ownership functions should nevertheless be encouraged to implement as many of the recommendations in the Guidelines as applicable. In federal structures a strong case can be made for applying the Guidelines to enterprises at the level of “states” which are constitutionally assigned important sovereign powers. At the local and municipal level it should be kept in mind that parts of the Guidelines aim at the situation where those who exercise the ownership hold significant powers of regulation, taxation, etc. that might contrast with their role as enterprise owners.

16. ***Boards of state-owned enterprises.*** Some SOEs have two-tier boards that separate the supervisory and management function into different bodies. Others only have one-tier boards, which may or may not include executive (managing) directors. In the context of this document “board” refers to the corporate body charged with the functions of governing the enterprise and monitoring management. Many governments include “independent” members in the boards of SOEs, but the scope and definition of independence varies considerably according to national legal context and codes of corporate governance.

17. ***Chief executive officer (CEO).*** A CEO is the company’s highest ranking executive officer, responsible for managing the company’s operations, acting as the primary liaison between the board and the operational units of the company, and implementing corporate strategy developed by the board. In companies with two-tier board systems the CEO chairs the board of executive directors.

18. ***Listed SOEs.*** Some parts of the Guidelines are specifically oriented towards “listed SOEs”. For the purpose of this document, “listed SOEs” refers to SOEs whose voting shares are traded on a stock exchange. In some jurisdictions SOEs that have issued preference shares and/or exchange-traded debt securities may also be considered as listed. Generally applicable corporate governance requirements are in some cases extended to these classes of companies, in which case the Guidelines should normally also be applied.

I. RATIONALES FOR STATE OWNERSHIP

The state exercises the ownership of SOEs on behalf of the general public. It should therefore carefully evaluate and disclose the public policy objectives that motivate state ownership and subject these to a recurrent review.

- A. The government should develop an ownership policy. The policy should *inter alia* define the overall rationales for state ownership, the state's role in the corporate governance of SOEs, and how the government will implement its ownership policy.
- B. The ownership policy should be subject to appropriate procedures of political accountability and disclosed to the general public. The government should review at regular intervals its ownership policy.
- C. The government should define the rationales for owning individual SOEs and subject these to recurrent review. Any public policy objectives that individual SOEs, or groups of SOEs, are required to achieve should be clearly mandated by the relevant authorities and disclosed.

II. THE STATE'S ROLE AS AN OWNER

The state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, in accordance with the ownership policy and with the necessary degree of professionalism and effectiveness.

- A. Governments should simplify and streamline the legal forms under which SOEs operate. Their operational practices should follow commonly accepted corporate norms.
- B. The government should not be involved in the day-to-day management of SOEs and should allow them full operational autonomy to achieve their defined objectives.
- C. The state should let SOE boards exercise their responsibilities and should respect their independence.
- D. The exercise of ownership rights should be clearly identified within the state administration. The exercise of ownership rights should be centralised in a single ownership function, or, if this is not possible, carried out by a co-ordinating body. This “ownership entity” should have the capacity and competencies to effectively carry out its duties.
- E. The ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.
- F. The state as an informed and active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities include:
 - 1. Being represented at the general shareholders meetings and effectively exercising voting rights;
 - 2. Establishing well-structured, merit-based and transparent board nomination processes in fully or majority-owned SOEs, and actively participating in the nomination of all SOEs' boards;
 - 3. Setting and monitoring the implementation of broad mandates and objectives for SOEs, including financial targets, capital structure objectives and risk tolerance levels;
 - 4. Setting up reporting systems that allow the ownership entity to regularly monitor, audit and assess SOE performance, and monitor their compliance with applicable corporate governance standards;
 - 5. Developing a disclosure policy for SOEs that identifies what information should be publicly disclosed, the appropriate channels for disclosure, and procedures for ensuring quality of information.
 - 6. When permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control organs;
 - 7. Ensuring that remuneration schemes for all SOE board members foster the long term interest of the company and can attract and motivate qualified professionals.

III. STATE-OWNED ENTERPRISES IN THE MARKETPLACE

Consistent with the rationale for state ownership, the legal and regulatory framework for SOEs should ensure a level playing field in markets where SOEs and private sector companies compete in order to avoid market distortions.

- A. There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation.
- B. Stakeholders, including competitors, should have access to efficient redress through unbiased legal or arbitration instances when they consider that their rights have been violated.
- C. Where SOEs combine commercial and public policy objectives, high standards of transparency and disclosure regarding their cost structures must be maintained, allowing for an attribution of costs and liabilities to main activity areas. This can be facilitated, when feasible and efficient, by the structural separation of an SOE's commercial and public policy activities. Costs related to public policy objectives should be funded by the state budget and disclosed.
- D. SOEs should not be exempt from the application of general laws, tax codes and regulations. At the same time, SOEs should not face uncompensated financial or operational obligations that could put them at a material disadvantage *vis-à-vis* private companies in like circumstances.
- E. SOEs' competitive activities should face market consistent conditions regarding access to debt and equity finance. In particular:
 - 1. SOEs' relations with all financial institutions, as well as non-financial SOEs, should be based on purely commercial grounds.
 - 2. SOEs' competitive activities should not benefit from indirect financial support such as preferential financing, tax arrears or undue trade credits from other SOEs.
 - 3. SOEs' competitive activities should be required to earn rates of return that are, taking into account their operational conditions, consistent with those obtained by competing private enterprises.
- F. When SOEs engage in public procurement, whether as bidder or procurer, the procedures involved should be competitive, non-discriminatory and safeguarded by appropriate standards of transparency.

IV. EQUITABLE TREATMENT OF SHAREHOLDERS AND OTHER OUTSIDE INVESTORS

Where SOEs are listed on stock exchanges or otherwise include non-state investors among their owners, the state and the enterprises should recognise the rights of all shareholders and ensure shareholders' equitable treatment and equal access to corporate information.

- A.** The state should strive toward an unqualified implementation of the OECD Principles of Corporate Governance when it is not the sole owner of SOEs, and of all relevant sections when it is the sole owner of SOEs. Concerning shareholder protection this includes:
 - 1. The state and SOEs should ensure that all shareholders are treated equitably.
 - 2. SOEs should observe a high degree of transparency towards all shareholders.
 - 3. SOEs should develop an active policy of communication and consultation with all shareholders.
 - 4. The participation of minority shareholders in shareholder meetings should be facilitated so they can take part in fundamental corporate decisions such as board election.
 - 5. Transactions between the state and SOEs should take place on market consistent terms.
- B.** National corporate governance codes should be adhered to by all listed and, where feasible, unlisted SOEs.
- C.** Where SOEs are required to pursue public policy objectives, adequate information about these should be available to non-state shareholders at all times.
- D.** When SOEs engage in co-operative projects such as joint ventures and public-private partnerships, they and their owners should ensure that contractual rights are upheld and that disputes are addressed in a timely and objective manner.

V. STAKEHOLDER RELATIONS AND SUSTAINABLE BUSINESS

The state ownership policy should fully recognise SOEs' responsibilities towards stakeholders and request that they report on their relations with stakeholders. It should make clear any expectations the state has in respect of responsible business conduct by SOEs.

- A. Governments, the state ownership entities and SOEs themselves should recognise and respect stakeholders' rights established by law or through mutual agreements.
- B. Listed or large SOEs, as well as SOEs pursuing important public policy objectives, should report on stakeholder relations.
- C. The boards of SOEs should be required to develop, implement and communicate compliance programmes for internal codes of ethics. These codes of ethics should be based on country norms, in conformity with international commitments and apply to the company and its subsidiaries.
- D. Where governments have expectations regarding responsible business conduct by SOEs, these should be publicly disclosed and mechanisms for their implementation be clearly established.
- E. SOEs should not be used as vehicles for financing political activities. SOEs themselves should normally not make political campaign contributions.

VI. TRANSPARENCY AND DISCLOSURE

SOEs should observe high standards of transparency and disclosure and be subject to the same high quality accounting and auditing standards as listed companies.

- A.** SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent company organ.
- B.** SOEs should also be subject to an annual independent external audit based on internationally recognised standards. Specific state control procedures do not substitute for an independent external audit.
- C.** SOEs should disclose material financial and non-financial information on the company in line with high quality internationally recognised standards of corporate disclosure, and including areas of significant concern for the state as an owner and the general public. This includes in particular SOE activities that are carried out in the public interest. With due regard to company capacity and size, examples of such information include:
 - 1. A clear statement to the public of the company objectives and their fulfilment (for fully-owned SOEs this would include any mandate elaborated by the state ownership entity);
 - 2. Company financial and operating results, including the costs and funding arrangements pertaining to public policy objectives;
 - 3. The governance, ownership and voting structure of the company, including the content of any corporate governance code or policy and implementation processes;
 - 4. Information on board member remuneration policies and levels as well as board member qualifications, selection process, roles on other company boards and whether they are considered as independent by the SOE board;
 - 5. Any material foreseeable risk factors and measures taken to manage such risks;
 - 6. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE, including contractual commitments and contingent liabilities arising from public-private partnerships;
 - 7. Any material transactions with the state and other related entities, including other SOEs;
 - 8. Any relevant issues relating to employees and other stakeholders.
- D.** The ownership entity should develop consistent reporting on SOEs and publish annually an aggregate report on SOEs. Good practice calls for the use of web-based communications to facilitate access by the general public.

VII. THE RESPONSIBILITIES OF THE BOARDS OF STATE-OWNED ENTERPRISES

The boards of SOEs should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

- A.** The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The role of SOE boards should be clearly defined in legislation, preferably according to company law. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably.
- B.** SOE boards should effectively carry out their functions of setting strategy and supervising management, based on a broad mandate set by the government. They should have the power to appoint and remove the CEO.
- C.** SOE board composition should allow the exercise of objective and independent judgement. All board members, including any public officials, should be nominated based on qualifications and have identical legal responsibilities.
- D.** Independent board members, where applicable, should be free of any material interests or relationships with the company, its management or the ownership entity that could jeopardise their exercise of objective judgement.
- E.** Mechanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and to limit political interference in board processes.
- F.** The Chair should assume responsibility for boardroom efficiency and, when necessary in coordination with other board members, act as the liaison for communications with the state ownership entity. The roles of CEO and Chair should be separate.
- G.** If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence.
- H.** When necessary, SOE boards should set up specialised committees, composed of independent and qualified members, to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration. The establishment of specialised committees should improve boardroom efficiency and should not detract from the responsibility of the full board.
- I.** SOE boards should carry out an annual, well-structured evaluation to appraise their performance. The outcomes of the board evaluations should inform the board nomination process.

ANNOTATIONS TO CHAPTER I: RATIONALES FOR STATE OWNERSHIP

The state exercises the ownership of SOEs on behalf of the general public. It should therefore carefully evaluate and disclose the public policy objectives that motivate state ownership and subject these to a recurrent review.

19. As ultimate owners of SOEs must be considered the members of the public whose government exercises the ownership rights. This implies that those who exercise ownership rights over SOEs owe duties toward the public that are not unlike the fiduciary duties of a board toward the shareholders. High standards of transparency and accountability are needed to allow the public to assure itself that the government exercises its powers in accordance with its best interest. This applies to overall ownership policies as well as the government's use of specific SOEs to carry out public policy functions.

20. **A. The government should develop an ownership policy. The policy should *inter alia* define the overall rationales for state ownership, the state's role in the corporate governance of SOEs, and how the government will implement its ownership policy.**

21. Multiple and contradictory objectives of state ownership can lead to either a very passive conduct of ownership functions, or conversely result in the state's excessive intervention in matters or decisions which should be left to the company and its governance organs. In order for the state to clearly position itself as an owner, it should clarify and prioritise its objectives for state ownership by developing a clear and explicit ownership policy. This will provide SOEs, the market and the general public with predictability and a clear understanding of the state's overall objectives as an owner as well as of its long term commitments.

22. The ownership policy should ideally take the form of a concise, high level policy document that outlines the state's overall objectives for owning enterprises. In addition, the ownership policy can include more detailed information on how ownership rights are exercised within the state administration, including the ownership entity's mandate and main functions. It should also reference and synthesise the main elements of any policies, laws and regulations applicable to SOEs, as well as any additional guidelines that inform the exercise of ownership rights by the state.

23. **B. The ownership policy should be subject to appropriate procedures of political accountability and disclosed to the general public. The government should review at regular intervals its ownership policy.**

24. In developing and updating the state's ownership policy, governments should make appropriate use of public consultation. The ownership policy should be accessible to the general public and widely circulated amongst the relevant ministries, agencies, SOE boards, management, and the legislature. The political commitment can be further strengthened by relying on proper accountability mechanisms such as regular parliamentary approval.

25. The state should strive to be consistent in its ownership policy and avoid modifying the overall rationales for state ownership too often. However, rationales and objectives may evolve over time, in which case the ownership policy needs to be updated accordingly. Dependent on national context the best way to do this may include reviews of SOE ownership as part of the state budgetary processes, medium-term fiscal plans or in accordance with the electoral cycle.

26. **C. The government should define the rationales for owning individual SOEs and subject these to recurrent review. Any public policy objectives that individual SOEs, or groups of SOEs, are required to achieve should be clearly mandated by the relevant authorities and disclosed.**

27. The rationales for owning individual enterprises – or as the case may be, classes of enterprises – can vary. For example, sometimes certain groups of enterprises are state-owned because they fulfil important public policy functions, while other groups of a predominantly commercial nature remain state-owned for strategic reasons, or because they operate in sectors with “natural” monopoly characteristics. To clarify the respective policy rationales underpinning their maintenance in state ownership, it can sometimes be useful to classify those SOEs into separate categories and define their rationales accordingly.

28. SOEs are sometimes expected to fulfil special responsibilities and obligations for social and public policy purposes. In some countries this includes a regulation of the prices at which SOEs have to sell their products and services. These special responsibilities and obligations may go beyond the generally accepted norm for commercial activities and should be clearly mandated and motivated by laws and regulations. They could also be incorporated into company bylaws. The market and the general public should be clearly informed about the nature and extent of these obligations, as well as about their overall impact on the SOEs’ resources and economic performance.

29. Countries differ in respect of the authorities that are mandated to communicate specific obligations to SOEs. In some cases only the government has this power. In others parliament can establish such obligations through the legislative process. In the latter case it is important that proper mechanisms for consultation be established between the legislature and the state bodies responsible for SOE ownership, to ensure adequate co-ordination and avoid undermining the autonomy of the ownership entity.

ANNOTATIONS TO CHAPTER II: THE STATE'S ROLE AS AN OWNER

The state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.

30. In order to carry out its ownership functions, the government should refer to private and public sector governance standards, notably the *OECD Principles of Corporate Governance*, which are also applicable to SOEs. In addition, there are specific aspects of SOE governance that either merit special attention or should be documented in more detail in order to guide SOE board members, management and the state ownership entity in effectively performing their respective roles.

31. A. Governments should simplify and streamline the legal forms under which SOEs operate. Their operational practices should follow commonly accepted corporate norms.

32. SOEs may have different legal forms from other companies. This may reflect specific objectives or societal considerations as well as special protection granted to certain stakeholders. This particularly concerns employees whose remuneration may be fixed by regulatory acts/bodies and who benefit from specific pension rights and protection against redundancies equivalent to those provided to civil servants. In a number of cases, SOEs are also to a large extent protected from insolvency or bankruptcy procedures by their specific legal status. This is sometimes due to the necessity to ensure continuity in the provision of public services.

33. Where this occurs, the SOEs often differ from private limited liability companies through: (i) the respective authority and power of the board, management and ministries; (ii) the composition and structure of these boards; (iii) the extent to which they grant consultation or decision making rights to some stakeholders, more particularly, employees; (iv) disclosure requirements; and (v) the extent to which they are subjected to insolvency and bankruptcy procedures, etc. The legal form of SOEs also often includes a strict definition of the activity of the SOEs concerned, preventing them from diversifying or extending their activities in new sectors and/or overseas. These limits have been legitimately set to prevent misuse of public funds, stop overly ambitious growth strategies or prevent SOEs from exporting sensitive technologies.

34. When streamlining the legal form of SOEs, governments should base themselves as much as possible on corporate law and avoid creating a specific legal form when this is not absolutely necessary for achieving the objectives of the enterprise. Streamlining of the legal form of SOEs enhances transparency and facilitates oversight through benchmarking. The streamlining should particularly target SOEs operating in competitive markets. It should focus on making those means and instruments usually available to private owners, also available to the state as an owner. Streamlining should therefore primarily concern the role and authority of the company's governance organs as well as transparency and disclosure obligations.

35. B. The government should not be involved in the day-to-day management of SOEs and should allow them full operational autonomy to achieve their defined objectives.

36. The prime means for an active and informed ownership by the state are a clear and consistent ownership policy, the development of broad mandates and objectives for SOEs, a structured board nomination process and an effective exercise of established ownership rights. Any involvement in the day-to-day management of SOEs should be avoided.

37. This does not imply that the government should not act as an active owner. It means that the ownership entity's ability to give direction to the SOE or its board should be limited to strategic issues and public policy objectives. The state should publicly disclose and specify in which areas and types of decisions the ownership entity is competent to give instructions.

38. **C. The state should let SOE boards exercise their responsibilities and should respect their independence.**

39. In the nomination and election of board members, the ownership entity should focus on the need for SOE boards to exercise their responsibilities in a professional and independent manner. It is important that when carrying out their duties, individual board members do not act as representatives of different constituencies. Independence requires that all board members carry out their duties in an even-handed manner with respect to all shareholders. Except when this is compatible with the company charter or the explicit objectives of the company, this means that board members should not be guided by any political concerns when carrying out their board duties.

40. When the state is a controlling owner, it is in a unique position to nominate and elect the board without the consent of other shareholders. This legitimate right comes with a high degree of responsibility for identifying, nominating and electing board members. In this process, and in order to minimise possible conflicts of interest, the ownership entity should avoid electing an excessive number of board members from the state administration. This is particularly relevant for partly-owned SOEs and for SOEs in competitive industries. Some countries have decided to avoid nominating or electing anyone from the ownership entity or other state officials on SOE boards. This aims at clearly depriving the government of the possibility to directly intervene in the SOE's business or management and at limiting the state's responsibility for decisions taken by SOE boards.

41. Employees of the ownership entity, professionals from other parts of the administration or from the political constituencies should only be elected to SOE boards if they meet the required competence level for all board members and if they do not act as a conduit for undue political influence. They should have the same duties and responsibilities as the other board members and act in the interest of the SOE and all its shareholders. Disqualification conditions and situations of conflict of interest should be carefully evaluated and guidance provided about how to handle and resolve them. The professionals concerned should have neither excessive inherent nor perceived conflicts of interest. In particular this implies that they should neither take part in regulatory decisions concerning the same SOE nor have any specific obligations or restrictions that would prevent them from acting in the company's interest. More generally, all potential conflicts of interests concerning any member of the board should be reported to the board which should then disclose these together with information on how they are being managed.

42. It is particularly necessary to clarify the respective personal and state liability when state officials are on SOE boards. The state officials concerned might have to disclose any personal ownership they have in the SOE and follow the relevant insider trading regulation. Guidelines or codes of ethics for members of the ownership entity and other state officials serving as SOE board members could be developed by the ownership entity. These Guidelines or codes of ethics should also indicate how confidential information passed on to the state from these board members should be handled.

43. Direction in terms of broader policy objectives should be channelled through the ownership entity and enunciated as enterprise objectives rather than imposed directly through board participation. SOE boards should not respond to policy signals until they are authorised by the Parliament or approved by specific procedures.

44. **D. The exercise of ownership rights should be clearly identified within the state administration. The exercise of ownership rights should be centralised in a single ownership function, or, if this is not possible, carried out by a co-ordinating body. This “ownership entity” should have the capacity and competencies to effectively carry out its duties.**

45. It is critical for the ownership function within the state administration to be clearly identified, whether it is located at a central ministry such as the finance or economics ministries, in a separate administrative entity, or within a specific sector ministry.

46. To achieve a clear identification of the ownership function, it can be centralised in a single entity, which is independent or under the authority of one ministry. This approach helps in clarifying the ownership policy and its orientation, and also helps ensure its more consistent implementation. Centralisation of the ownership function also allows for reinforcing and bringing together relevant competencies by organising “pools” of experts on key matters, such as financial reporting or board nomination. In this way, centralisation can be a major force in the development of aggregate reporting on state ownership. Finally, centralisation is also an effective way to clearly separate the exercise of the ownership function from other activities performed by the state, particularly market regulation and industrial policy, as mentioned in Guideline III.A below.

47. If the ownership function is not centralised, a minimum requirement is to establish a strong co-ordinating entity among the different administrative departments involved. This will help to ensure that each SOE has a clear mandate and receives a coherent message in terms of strategic guidance or reporting requirements. The co-ordinating entity would harmonise and co-ordinate the actions and policies undertaken by different ownership departments in various ministries. The co-ordinating entity should also be in charge of establishing an overall ownership policy, developing specific guidelines and unifying practices among the various ministries.

48. When the ownership function cannot be handled by a single entity, some key functions could nevertheless be centralised in order to make use of specific expertise and ensure independence from individual sector ministries. One example when such partial centralisation can be useful is the nomination of board members.

49. Throughout the Guidelines and Annotations, the term “ownership entity” is used without prejudice to the choice of ownership model. “Ownership entity” is understood to encompass both the single state ownership entity model and the co-ordinating entity model.

50. **E. The ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.**

51. The relationship of the ownership entity with other government bodies should be clearly defined. A number of state bodies, ministries or administrations may have different roles *vis-à-vis* the same SOEs. In order to increase public confidence in the way the state manages ownership of SOEs, it is important that these different roles be clarified and explained to the general public. For instance, the ownership entity should maintain co-operation and continuous dialogue with the state supreme audit institutions responsible for auditing the SOEs. It should support the work of the state audit institution and take appropriate measures in response to audit findings, following in this regard the INTOSAI Lima Declaration of Guidelines on Auditing Precepts.

52. The ownership entity should be held clearly accountable for the way it carries out the state ownership function. Its accountability should be, directly or indirectly, to bodies representing the interests

of the general public, such as the Parliament. Its accountability to the legislature should be clearly defined, as should the accountability of SOEs themselves, which should not be diluted by virtue of the intermediary reporting relationship.

53. Accountability should go beyond ensuring that the exercise of ownership does not interfere with the legislature's prerogative as regards budget policy. The ownership entity should report on its own performance in exercising state ownership and in achieving the state's objectives in this regard. It should provide quantitative and reliable information to the public and its representatives on how the SOEs are managed in the interests of their owners. Specific mechanisms such as *ad hoc* or permanent commissions could be set up to maintain the dialogue between the ownership entity and the legislature. In the case of Parliament hearings, confidentiality issues should be dealt with through specific procedures such as confidential or closed meetings. While generally accepted as a useful procedure, the form, frequency and content of this dialogue may differ according to the constitutional law and the different parliamentary traditions and roles.

54. Accountability requirements should not unduly restrict the autonomy of the ownership entity in fulfilling its responsibilities. For example, cases where the ownership entity needs to obtain the legislature's *ex ante* approval should be limited and relate to significant changes to the overall ownership policy, significant changes in the size of the state sector and significant transactions (investments or disinvestment). More generally, the ownership entity should enjoy a certain degree of flexibility *vis-à-vis* its responsible ministry in the way it organises itself and takes decisions with regards to procedures and processes. The ownership entity could also enjoy a certain degree of budgetary autonomy that can allow flexibility in recruiting, remunerating and retaining the necessary expertise, including from the private sector.

55. **F. The state as an informed and active owner should exercise its ownership rights according to the legal structure of each company.**

56. To avoid either undue political interference or passive state ownership, it is important for the ownership entity to focus on the effective exercise of ownership rights. The state as an owner should typically conduct itself as any major shareholder when it is in a position to significantly influence the company and be an informed and active shareholder when holding a minority post. It would be well advised to exercise its rights in order to protect its ownership and optimise its value.

57. Four basic shareholder rights are: (i) to participate and vote in shareholder meetings; (ii) to obtain relevant and sufficient information on the corporation on a timely and regular basis; (iii) to elect and remove members of the board; and (iv) to approve extraordinary transactions. The ownership entity should exercise these rights fully and judiciously, as this would allow the necessary influence on SOEs without infringing on their day-to-day management. The effectiveness and credibility of SOE governance and oversight will, to a large extent, depend on the ability of the ownership entity to make an informed use of its shareholder rights and effectively exercise its ownership functions in SOEs.

58. An ownership entity needs unique competencies and should have professionals with legal, financial, economic and management skills that are experienced in carrying out fiduciary responsibilities. Such professionals must also clearly understand their roles and responsibilities as civil servants with respect to the SOEs. In addition, the ownership entity should include competencies related to the specific obligations that some SOEs under their supervision are required to undertake in terms of public service provisions. The ownership entity should also have the possibility to have recourse to outside advice and to contract out some aspects of the ownership function, in order to exercise the state's ownership rights in a better manner. It could, for example, make use of specialists for carrying out evaluation, active monitoring, or proxy voting on its behalf where deemed necessary and appropriate.

59. **Its prime responsibilities include:**

60. **1. Being represented at the general shareholders meetings and effectively exercising voting rights;**

61. The state as an owner should fulfil its fiduciary duty by exercising its voting rights, or at least explain if it does not do so. The state should not find itself in the position of not having reacted to propositions put before the SOEs' general shareholder meetings. It is important to establish appropriate procedures for state representation in general shareholders meetings. This could be achieved for example by clearly identifying the ownership entity as representing the state's shares.

62. For the state to be able to express its views on issues submitted for approval at shareholders' meetings, it is further necessary that the ownership entity organises itself to be able to present an informed view on these issues and articulate it to SOE boards via the general shareholders meeting.

63. **2. Establishing well-structured, merit-based and transparent board nomination processes in fully- or majority-owned SOEs, and actively participating in the nomination of all SOEs' boards;**

64. The ownership entity should ensure that SOEs have efficient and well-functioning professional boards, with the required mix of competencies to fulfil their responsibilities. This will involve establishing a structured nomination process and playing an active role in this process. This will be facilitated if the ownership entity is given sole responsibility for organising the state's participation in the nomination process.

65. The nomination of SOE boards should be transparent, clearly structured and based on an appraisal of the variety of skills, competencies and experiences required. Competence and experience requirements should derive from an evaluation of the incumbent board and needs related to the company's long term strategy. These evaluations should also take into consideration the role played by employee board representation when this is required by law or mutual agreements. To base nominations on such explicit competence requirements and evaluations will likely lead to more professional, accountable and business-oriented boards.

66. Where the state is not the sole owner, the ownership entity should consult with other shareholders ahead of the general shareholders meetings. SOE boards should also be able to make recommendations to the ownership entity based on the approved board member profiles, skill requirements and board member evaluations. Setting up nomination committees may be useful, helping to focus the search for good candidates and in structuring further the nomination process. In some countries, it is also considered good practice to establish a specialised commission or "public board" to oversee nominations in SOE boards. Even though such commissions or public boards might have only recommendation powers, they could have a strong influence in practice on increasing the independence and professionalism of SOE boards. Proposed nominations should be published in advance of the general shareholders meeting, with adequate information about the professional background and expertise of the respective candidates.

67. It could also be useful if ownership entities maintain a database of qualified candidates, developed through an open competitive process. The use of professional staffing agencies or international advertisements is another means to enhance the quality of the search process. These practices can help to enlarge the pool of qualified candidates for SOE boards, particularly in terms of private sector expertise and international experience. The process may also favour greater board diversity, including gender diversity.

68. **3. Setting and monitoring the implementation of broad mandates and objectives for SOEs, including financial targets, capital structure objectives and risk tolerance levels;**

69. The state as an active owner should define and communicate broad mandates for fully state-owned SOEs. In the case of partially-owned SOEs, the state may not be in a position to formally “mandate” the fulfilment of specific objectives, but should rather communicate its expectations via the standard channels as a significant shareholder.

70. SOE mandates are concise documents that give a brief overview of an SOE’s high-level long-term objectives. A mandate will usually define the predominant activities of an SOE and give some indications regarding its main commercial and, where relevant, public policy objectives. Clearly defined mandates help ensure appropriate levels of accountability at the company level, and can help limit unpredictable changes to an SOE’s operations, such as non-recurring special obligations imposed by the state that might threaten an SOE’s commercial viability. They also provide a framework to help the state define and subsequently monitor the fulfilment of an SOE’s more immediate-term objectives and targets.

71. In addition to defining the broad mandates of SOEs, the ownership entity should also communicate more specific financial and non-financial performance objectives to SOEs, and regularly monitor their implementation. This will help in avoiding the situation where SOEs are given excessive autonomy in setting their own objectives or in defining the nature and extent of their public service obligations. The objectives may include avoiding market distortion and the pursuit of profitability, expressed in the form of specific targets, such as rate-of-return targets, dividend policy and guidelines for assessing capital structure appropriateness. Setting objectives may include trade-offs, for example between shareholder value, public service and even job security. The state should therefore go further than defining its main objectives as an owner; it should also indicate its priorities and clarify how inherent trade-offs shall be handled. In doing so, the state should avoid interfering in operational matters, and thereby respect the independence of the board.

72. **4. Setting up reporting systems that allow the ownership entity to regularly monitor, audit and assess SOE performance, and monitor their compliance with applicable corporate governance standards;**

73. In order for the ownership entity to make informed decisions on key corporate matters, they should ensure that they receive all necessary and relevant information in a timely manner. They should also establish means that makes it possible to monitor SOEs’ activity and performance on a continuous basis. The ownership entity should ensure that adequate external reporting systems are in place for all SOEs. The reporting systems should give the ownership entity a true picture of the SOE’s performance or financial situation, enabling them to react on time and to be selective in their intervention.

74. The ownership entity should develop the appropriate devices and select proper valuation methods to monitor SOEs’ performance in respect of established objectives. It could be helped in this regard by developing systematic benchmarking of SOE performance, with private or public sector entities, both domestically and abroad. This benchmarking should cover productivity and the efficient use of labour, assets and capital. This benchmarking is particularly important for SOEs in non-competitive sectors. It allows the SOEs, the ownership entity and the general public to better assess SOE performance and reflect on their development.

75. Effective monitoring of SOE performance can be facilitated by having adequate accounting and audit competencies within the ownership entity to ensure appropriate communication with relevant counterparts, both with SOEs’ financial services, external auditors and specific state controllers.

76. **5. Developing a disclosure policy for SOEs that identifies what information should be publicly disclosed, the appropriate channels for disclosure, and procedures for ensuring quality of information;**

77. In order to ensure adequate accountability by SOEs to shareholders, reporting bodies and the broader public, the state as an owner should develop and communicate a coherent transparency and disclosure policy for the companies it owns. The disclosure policy should emphasise the need for SOEs to report material information and avoid “box ticking”. The development of the disclosure policy should build on an extensive review of existing legal and regulatory requirements applicable to SOEs, as well as the identification of any gaps in requirements and practices as compared with good practice and national listing requirements. Based on this review process, the state might consider a number of measures to improve the existing transparency and disclosure framework, such as proposing amendments to the legal and regulatory framework, or elaborating specific guidelines, principles or codes to improve practices at the company level. The process should involve structured consultations with SOE boards and management, as well as with regulators, members of Parliament and other relevant stakeholders. The ownership entity should communicate widely and effectively about the transparency and disclosure framework for SOEs.

78. 6. When permitted by the legal system and the state’s level of ownership, maintaining continuous dialogue with external auditors and specific state control organs;

79. Depending on the legislation, the ownership entity may be entitled to nominate and even appoint the external auditors. Regarding wholly-owned SOEs, the ownership entity should maintain a continuous dialogue with external auditors, as well as with the specific state controllers when the latter exist. This continuous dialogue could take the form of regular exchange of information, meetings or *ad hoc* discussions when specific problems occur. External auditors will provide the ownership entity with an external, independent and qualified view on the SOE performance and financial situation. However, continuous dialogue of the ownership entity with external auditors and state controllers should not be at the expense of the board’s responsibility.

80. When SOEs are publicly traded or partially-owned, the ownership entity must respect the rights and fair treatment of minority shareholders. The dialogue with external auditors should not give the ownership entity any privileged information and should respect regulation regarding privileged and confidential information.

81. 7. Ensuring that remuneration schemes for all SOE board members foster the long term interest of the company and can attract and motivate qualified professionals.

82. There is a trend toward bringing the remuneration of board members of SOEs closer to private sector practices. However, in many countries, this remuneration is still far below market levels for the competencies and experience required, as well as for the responsibilities involved. This can pose a challenge for attracting top talent to SOE boards, although other factors such as reputational benefits, prestige and access to networking are sometimes considered to represent non-negligible aspects of board remuneration.

83. For SOEs with predominantly commercial objectives operating in a competitive environment, board remuneration levels should reflect market conditions insofar as this is necessary to attract and retain highly qualified board members. This will help ensure that board members contribute to the overall professionalism and performance of the board.

ANNOTATIONS TO CHAPTER III: STATE-OWNED ENTERPRISES IN THE MARKETPLACE

Consistent with the rationale for state ownership, the legal and regulatory framework for SOEs should ensure a level playing field in markets where SOEs and private sector companies compete in order to avoid market distortions.

84. When SOEs engage in competitive economic activities then it is commonly agreed that those activities must be carried out without any undue advantages or disadvantages relative to private enterprises. There is less consensus about how a level playing field is to be obtained in practice – particularly where SOEs combine their competitive activities with non-trivial public policy objectives. In addition to specific challenges such as ensuring equal financial, regulatory and tax treatment come some more overarching issues, including ensuring a proper cost discovery and, where feasible, separation of competitive and non-competitive activities. The publication OECD (2012) *Competitive Neutrality: Maintaining a Level Playing Field between Public and Private Business*, which provides best practices from OECD member countries, may serve as a point of inspiration for regulators and policy makers.

85. **A. There should be a clear separation between the state’s ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation.**

86. The state often plays a dual role of market regulator and owner of SOEs with commercial operations, particularly in the newly deregulated and often partially privatised network industries. Whenever this is the case, the state is at the same time a major market player and an arbitrator. Full administrative separation of responsibilities for ownership and market regulation is therefore a fundamental prerequisite for creating a level playing field for SOEs and private companies and for avoiding distortion of competition. Such separation is also advocated by the *OECD Principles of Regulatory Reform*.

87. Another important case is when SOEs are used as an instrument for industrial policy. This can easily result in confusion and conflicts of interest between industrial policy and the ownership functions of the state, particularly if the responsibility for industrial policy and the ownership functions are vested with the same branch or sector ministries. A separation of industrial policy and ownership will enhance the identification of the state as an owner and will favour transparency in defining objectives and monitoring performance. However, such separation does not prevent necessary co-ordination between the two functions.

88. In order to prevent conflicts of interest, it is also necessary to clearly separate the ownership function from any entities within the state administration which might be clients or main suppliers to SOEs. General procurement rules should apply to SOEs as well as to any other companies. Legal as well as non-legal barriers to fair procurement should be removed. In implementing effective separation between the different state roles with regard to SOEs, both perceived and real conflicts of interest should be taken into account.

89. **B. Stakeholders, including competitors, should have access to efficient redress through unbiased legal or arbitration instances when they consider that their rights have been violated.**

90. SOEs as well as the state as a shareholder should not be protected from challenge via the courts or the regulatory authorities, in case they infringe the law. Stakeholders should be able to challenge the state as an owner in the courts and be treated fairly and equitably in such cases by the judicial system.

91. **C. Where SOEs combine commercial and public policy objectives, high standards of transparency and disclosure regarding their cost structures must be maintained, allowing for an attribution of costs and liabilities to main activity areas. This can be facilitated, when feasible and efficient, by the structural separation of an SOE's commercial and public policy activities. Costs related to public policy objectives should be funded by the state budget and disclosed.**

92. In order to maintain a level playing field with private competitors, SOEs need to be adequately compensated for the fulfilment of public policy objectives, with measures taken to avoid both over compensation and under compensation. On the one hand, if SOEs are over compensated for their public policy activities, this can amount to an effective subsidy on their competitive activities, thus distorting the level playing field with private competitors. On the other hand, under compensation for public policy activities can jeopardise the commercial viability of an SOE's competitive activities, putting them at an undue commercial disadvantage.

93. It is therefore important that any costs related to the fulfilment of public policy objectives be clearly identified, disclosed and adequately compensated by the state budget on the basis of specific legal provisions and/or through contractual mechanisms, such as management or service contracts. Compensation should be structured in a way that avoids market distortion. This is particularly the case if the enterprises concerned are in competitive sectors of the economy. Ensuring that compensation is calibrated to the actual cost of fulfilling public policy objectives can be facilitated by the structural separation of commercial and public policy activities and accounts.

94. **D. SOEs should not be exempt from the application of general laws, tax codes and regulations. At the same time, SOEs should not face uncompensated financial or operational obligations that could put them at a material disadvantage *vis-à-vis* private companies in like circumstances.**

95. Experience has shown that in some countries SOEs may be exempt from a number of laws and regulations, especially where statutory corporations and other SOEs operating in a non-standard corporate form are concerned. Derogations from competition law sometimes occur, which is generally justified where natural and legal monopolies are concerned but which can become problematic if the same SOEs engage in competitive activities in other market segments. SOEs are also in some cases not covered by bankruptcy law and creditors sometimes have difficulties in enforcing their contracts and in obtaining payments. Such exemptions from the general legal provisions should be avoided to the fullest extent possible in order to avoid market distortions and underpin the accountability of management.

96. At the same time, SOEs should not be subject to additional legal or operational restrictions that could distort the level playing field with private competitors. For example, SOEs should not face uncompensated restrictions related to the government's employment and environmental policies.

97. **E. SOEs' competitive activities should face market consistent conditions regarding access to debt and equity finance.**

98. Whether financing for an SOE's competitive activities comes from the state budget or the commercial marketplace, measures should be implemented to ensure that the terms of both debt and equity financing are market consistent.

99. **In particular:**

100. **1. SOEs' relations with all financial institutions, as well as non-financial SOEs, should be based on purely commercial grounds.**

101. Creditors and the board often assume that there is an implicit state guarantee on SOEs' debts. This situation has in many instances led to excessive indebtedness, wasted resources and market distortion, to the detriment of both creditors and the taxpayers. Moreover, in some countries, state-owned banks and other financial institutions tend to be the most significant if not the main creditors of SOEs. This environment leaves great scope for conflicts of interest. It may lead to bad loans by state-owned banks as the enterprise might feel itself under no obligation to repay the loan. This may shelter SOEs from a crucial source of market monitoring and pressure, thereby distorting their incentive structure.

102. A clear distinction is necessary between the state and SOEs' respective responsibilities in relation to creditors. The state often grants guarantees to SOEs to compensate for its inability to provide them with equity capital, but this facility is often widely abused. As a general principle, the state should not give an automatic guarantee in respect of SOE liabilities. Fair practices with regard to the disclosure and remuneration of state guarantees should also be developed and SOEs should be encouraged to seek financing from capital markets.

103. Mechanisms should be developed to manage conflicts of interests and ensure that SOEs develop relations with state-owned banks, other financial institutions as well as other SOEs based on purely commercial grounds. State-owned banks should grant credit to SOEs on the same terms and conditions as for private companies. These mechanisms could also include limits on, and careful scrutiny of, SOEs' board members sitting on the boards of state-owned banks.

104. **2. SOEs' competitive activities should be required to earn rates of return that are, taking into account their operational conditions, consistent with those obtained by competing private enterprises.**

105. SOEs' competitive activities should face commercial rate-of-return requirements, to ensure a level playing field and discourage cross-subsidisation. Any equity financing provided by the state budget should be subject to a minimum expected rate-of-return (RoR) consistent with private sector practices. A number of countries have enshrined this principle in national practices. However, methodologies to calculate RoR targets and measure performance vary across jurisdictions. So do the periods over which average performance is calculated: RoR targets make sense only as a medium- to long-term measure. Sufficient room must be left for short-term variations.

106. A number of governments further allow lower RoR to compensate for balance sheet anomalies such as temporary needs for high capital spending. If carefully calibrated this does not depart from commonly accepted corporate practices. Conversely, some governments also tend to lower RoR requirements to compensate SOEs for such public policy objectives as they are charged with. This is not a good practice since this kind of objective, as discussed elsewhere in these Guidelines, should be compensated separately.

107. **3. SOEs' competitive activities should not benefit from indirect financial support such as preferential financing, tax arrears or undue trade credits from other SOEs.**

108. Beyond direct state subsidies and preferential loans, SOEs sometimes benefit from other support that has an equivalent effect of reduced financing costs. For example, unincorporated SOEs may face different tax treatment owing to their legal form or specific tax exemptions granted by the public authorities. To the extent possible, SOEs should be subject to an equal or equivalent tax treatment as private competitors in like circumstances.

109. SOEs may also benefit from "off market" funding arrangements from other SOEs, such as trade credits. Such funding arrangements amount to preferential lending when they depart from normal

commercial practices. Measures should be implemented to ensure that inter-SOE transactions take place on purely commercial terms.

110. F. When SOEs engage in public procurement, whether as bidder or procurer, the procedures involved should be competitive, non-discriminatory and safeguarded by appropriate standards of transparency.

111. The participation of SOEs in public procurement processes has been an area of concern for governments committed to a level playing field. Designing bidding regimes that in principle do not favour any category of bidder is uncomplicated, and indeed is embedded in the legislation of a growing number of jurisdictions. Practice may, however, sometimes depart from principles. Whether or not such rules are limited to procurement by the general government or extended to procurement by the SOEs as well differs between countries. The case for making SOEs subject to public procurement rules is generally weak when SOEs are fully corporatised and subject to competition.

112. When SOEs participate in public procurement as bidders, experience from a number of countries shows that they have a disproportionately high chance of being successful. In some cases this has reflected bidding criteria designed to favour the government's own enterprises. However, often this has merely reflected the fact that the contracts are awarded in areas where SOEs have important incumbency advantages over more recent private sector entrants. Such advantages are not easily eliminated and indeed it would not always be efficiency-enhancing to eliminate them. The decision by some governments to bar SOE incumbents from participating in bidding for public contracts can generally not be considered as a good practice.

ANNOTATIONS TO CHAPTER IV: EQUITABLE TREATMENT OF SHAREHOLDERS AND OTHER OUTSIDE INVESTORS

Where SOEs are listed on stock exchanges or otherwise include non-state investors among their owners, the state and the enterprises should recognise the rights of all shareholders and ensure shareholders' equitable treatment and equal access to corporate information.

113. It is in the state's interest to ensure that, in all enterprises where it has a stake, all shareholders are treated equitably, since its reputation in this respect will influence its capacity to attract outside funding and the valuation of the company. It should therefore ensure that other shareholders do not perceive the state as an opaque, unpredictable and unfair owner. The state should on the contrary establish itself as exemplary and follow best practices regarding the treatment of shareholders.

114. **A. The state should strive toward an unqualified implementation of the OECD Principles of Corporate Governance when it is not the sole owner of SOEs, and of all relevant sections when it is the sole owner of SOEs. Concerning shareholder protection this includes:**

115. **1. The state and SOEs should ensure that all shareholders are treated equitably.**

116. Whenever a part of an SOE's capital is held by private shareholders, institutional or individual, the state should recognise their rights. Non-state shareholders should in particular be protected against abusive action by the state as an owner, and should have efficient means of redress. Insider trading and abusive self-dealing should be prohibited. Requiring pre-emptive rights and qualified majorities for certain shareholder decisions can also be a useful *ex-ante* means of ensuring minority shareholder protection. Specific care should be taken to ensure the protection of shareholders in cases of partial privatisation of SOEs.

117. As a dominant shareholder, the state is in many cases able to make decisions in general shareholders meetings without the agreement of any other shareholders. It is usually in a position to decide on the composition of the board of directors. While such decision making power is a legitimate right that follows with ownership, it is important that the state doesn't abuse its role as a dominant shareholder, for example by pursuing objectives that are not in the interest of the company and are thereby to the detriment of other shareholders. Abuse can occur through inappropriate related party transactions, biased business decisions or changes in the capital structure favouring controlling shareholders. The measures which can be taken include better disclosure, a duty of loyalty of board members, as well as qualified majorities for certain shareholder decisions.

118. The ownership entity should develop guidelines regarding equitable treatment of non-state shareholders. It should ensure that individual SOEs, and more particularly their boards, are fully aware of the importance of the relationship with shareholders and are active in enhancing it. When the state as a controlling shareholder is able to exercise a degree of control that does not correspond to its level of risk, then the potential for abuse is marked. Governments should, as far as possible, limit the use of golden shares and disclose shareholders' agreements and capital structures that allow a shareholder to exercise a degree of control over the corporation disproportionate to the shareholders' equity ownership in the company.

119. **2. SOEs should observe a high degree of transparency towards all shareholders.**

120. A crucial condition for protecting shareholders is to ensure a high degree of transparency. Material information should be reported to all shareholders simultaneously to ensure their equitable treatment. Moreover, any shareholder agreements, including information agreements covering board members, should be disclosed.

121. Minority and other shareholders should have access to all the necessary information to be able to make informed investment decisions. Meanwhile, significant shareholders, including the ownership entity, should not make any abusive use of the information they might obtain as controlling shareholders or board members. For non-listed SOEs, other shareholders are usually well identified and often have privileged access to information, through board seats for example. However, whatever the quality and completeness of the legal and regulatory framework concerning disclosure of information, the ownership entity should ensure that all enterprises where the state has shares put mechanisms and procedures in place to guarantee easy and equitable access to information by all shareholders.

122. **3. SOEs should develop an active policy of communication and consultation with all shareholders.**

123. SOEs, including any enterprise in which the state is a minority shareholder, should identify their shareholders and keep them duly informed in a timely and systematic fashion about material events and forthcoming shareholder meetings. They should also provide them with sufficient background information on issues that will be subject to decision. It is the responsibility of SOE boards to make sure that the company fulfils its obligations in terms of information to the shareholders. In doing so, SOEs should not only apply the existing legal and regulatory framework, but are encouraged to go beyond it when relevant in order to build credibility and confidence. Where possible, active consultation with minority shareholders will help in improving the decision making process and the acceptance of key decisions.

124. **4. The participation of minority shareholders in shareholder meetings should be facilitated so they can take part in fundamental corporate decisions such as board election.**

125. Minority shareholders may be concerned about actual decisions being made outside the company's shareholder meetings or board meetings. This is a legitimate concern for listed companies with a significant or controlling shareholder, but it can also be an issue in companies where the state is the dominant shareholder. It might be appropriate for the state as an owner to reassure minority shareholders that their interests are taken into consideration.

126. The right to participate in general shareholder meetings is a fundamental shareholder right. To encourage minority shareholders to actively participate in SOEs' general shareholder meetings and to facilitate the exercise of their rights, specific mechanisms could be adopted by SOEs. These could include qualified majorities for certain shareholder decisions and, when deemed useful by the circumstances, the possibility to use special election rules, such as cumulative voting. Additional measures should include facilitating voting *in absentia* or developing the use of electronic means as a way to reduce participation costs. Moreover, employee-shareholder participation in general shareholders meetings could be facilitated by, for example, the collection of proxy votes from employee-shareholders.

127. It is important that any special mechanism for minority protection is carefully balanced. It should favour all minority shareholders and in no respect contradict the concept of equitable treatment. It should neither prevent the state as a majority shareholder from exercising its legitimate influence on the decisions nor should it allow minority shareholders to unduly hold up the decision-making process.

128. **5. Transactions between the state and SOEs should take place on market consistent terms.**

129. To ensure equitable treatment of all shareholders, transactions between the state and SOEs should take place on the same terms as those between any other market participants. This is conceptually related to the issue of abusive related party transactions, but it differs insofar as “related parties” are more weakly defined in the case of state ownership. The government is advised to ensure the market consistency of all transactions by SOEs with the state and state-controlled entities and, as appropriate, test them for probity. The issue is further linked to the board obligations treated elsewhere in these Guidelines, because the protection of all shareholders is a clearly articulated duty of loyalty by board members to the company and its shareholders.

130. B. National corporate governance codes should be adhered to by all listed and, where feasible, unlisted SOEs.

131. Most countries have corporate governance codes for stock-market listed enterprises. However, their implementation mechanisms differ significantly, with some being merely advisory, others being implemented (by stock markets or securities regulators) on a comply-or-explain basis, and yet others being mandatory. It is a basic premise of these Guidelines that SOEs should be subject to best practice governance standards of listed enterprises. This implies that a listed SOE should always comply with the national corporate governance code, irrespectively of how “binding” they are. Similarly, non-listed SOEs should be encouraged – to the greatest extent feasible – to do the same.

132. C. Where SOEs are required to pursue public policy objectives, adequate information about these should be available to non-state shareholders at all times.

133. As part of its commitment to ensure a high degree of transparency with all shareholders, the state should ensure that material information on any public policy objectives an SOE is expected to fulfil are disclosed to non-state shareholders. The relevant information should be disclosed to all shareholders at the time of investment and be made continually available throughout the duration of the investment.

134. D. When SOEs engage in co-operative projects such as joint ventures and public-private partnerships, they and their owners should ensure that contractual rights are upheld and that disputes are addressed in a timely and objective manner.

135. When SOEs engage in co-operative projects with private partners, care should be taken to uphold the contractual rights of all parties and to establish effective dispute resolution mechanisms. Relevant other OECD recommendations should be observed, in particular the *OECD Principles for Public Governance of Public-Private Partnerships* as well as, in the relevant sectors, the *OECD Principles for Private Sector Participation in Infrastructure*. One of the key recommendations from these instruments implies that care should be taken to monitor and manage any implicit or explicit fiscal risks for the government resulting from public-private partnerships or other arrangements that the SOE enters into.

136. Moreover, formal agreements between the state and private partners should clearly specify the respective responsibilities of project partners in the case of unforeseen events, while at the same time there should be sufficient flexibility for contract renegotiation in case of need. Dispute resolution mechanisms need to ensure that any disputes occurring throughout the duration of the project are addressed in a fair and timely manner.

ANNOTATIONS TO CHAPTER V: STAKEHOLDER RELATIONS AND SUSTAINABLE BUSINESS

The state ownership policy should fully recognise SOEs' responsibilities towards stakeholders and request that they report on their relations with stakeholders. It should make clear any expectations the state has in respect of responsible business conduct by SOEs.

137. In some OECD countries, legal status, regulations or mutual agreements/contracts grant certain stakeholders specific rights in SOEs. Some SOEs might even be characterised by distinct governance structures regarding the rights granted to stakeholders, principally employee board level representation, or other consultation/decision making rights to employees' representatives and consumer organisations, for example through advisory councils.

138. SOEs should acknowledge the importance of stakeholder relations for building sustainable and financially sound enterprises. Stakeholder relations are particularly important for SOEs as they may be critical for the fulfilment of general service obligations whenever these exist and as SOEs may have, in some infrastructure sectors, a vital impact on the economic development potential and on the communities in which they are active. Moreover, some investors increasingly consider stakeholder related issues in their investment decisions and appreciate potential litigation risks linked to stakeholder issues. It is therefore important that the ownership entity and SOEs recognise the impact that an active stakeholder policy may have on the company's long term strategic goals and reputation. They should thus develop and adequately disclose clear stakeholder policies.

139. However, the government should not use SOEs to further goals which differ from those which apply to the private sector, unless compensated in some form. Any specific rights granted to stakeholders or influence on the decision making process should be explicit. Whatever rights granted to stakeholders by the law or special obligations that have to be fulfilled by the SOE in this regard, the company organs, principally the general shareholders meeting and the board, should retain their decision making powers.

140. A. Governments, the state ownership entities and SOEs themselves should recognise and respect stakeholders' rights established by law or through mutual agreements.

141. As a dominant shareholder, the state may control corporate decision making and be in a position to take decisions to the detriment of stakeholders. It is therefore important to establish mechanisms and procedures to protect stakeholder rights. The ownership entity should have a clear policy in this regard. SOEs should fully respect the rights of stakeholders, as established by law, regulations and mutual agreements. They should act in the same way as private sector listed companies.

142. To encourage active and wealth-creating co-operation with stakeholders, SOEs should ensure that stakeholders have access to relevant, sufficient and reliable information on a timely and regular basis to be able to exercise their rights. Stakeholders should have access to legal redress in the event their rights are violated. Employees should also be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing that.

143. Performance enhancing mechanisms for employee participation should be permitted to develop when considered relevant with regard to the importance of stakeholder relations for some SOEs. However, when deciding on the relevance and desired development of such mechanisms, the state should give careful consideration to the inherent difficulties in transforming entitlement legacies into effective performance enhancing mechanisms.

144. **B. Listed or large SOEs, as well as SOEs pursuing important public policy objectives, should report on stakeholder relations.**

145. Good practice increasingly requires listed companies to report on stakeholder issues. By doing so, SOEs will demonstrate their willingness to operate more transparently and their commitment to co-operation with stakeholders. This will in turn foster trust and improve their reputation. Consequently, listed or large SOEs should communicate with investors, stakeholders and the public at large on their stakeholder policies and provide information on their effective implementation. This should also be the case for any SOE pursuing important public policy objectives or having general services obligations, with due care to the costs involved related to their size. Reports on stakeholder relations should include information on social and environmental policies, whenever SOEs have specific objectives in this regard. To this end, they could refer to best practice and follow existing guidelines on social and environmental responsibility disclosure. It might also be advisable that SOEs have their stakeholder reports independently scrutinised in order to strengthen their credibility.

146. **C. The boards of SOEs should be required to develop, implement and communicate compliance programmes for internal codes of ethics. These codes of ethics should be based on country norms, in conformity with international commitments and apply to the company and its subsidiaries.**

147. SOE boards, like private company boards, should apply high ethical standards. This is in the long term interest of any company as a means to make it credible and trustworthy in day-to-day operations and with respect to its longer term commitments. In the case of SOEs, there may be more pressure to deviate from high ethical standards given the interaction of business considerations with political and public policy ones. Moreover, as SOEs might play an important role in setting the business tone of the country, it is also important for them to maintain high ethical standards.

148. SOEs and their officers should conduct themselves according to high ethical standards. SOEs should develop internal codes of ethics, committing themselves to comply with country norms and in conformity with broader codes of behaviour. This should include a commitment to comply with *the OECD Guidelines for Multinational Enterprises*, which have been adopted by all OECD member countries and reflect all four principles contained in the *ILO Declaration on Fundamental Principles and Rights at Work*, *the OECD Anti-Bribery Convention* and *the UN Guiding Principles on Business and Human Rights*. Codes of ethics should apply to the SOEs as a whole and to their subsidiaries.

149. Codes of ethics should give clear and detailed guidance as to the expected conduct of all employees and compliance programs should be established. It is considered good practice for these codes to be developed in a participatory way in order to involve all the employees and stakeholders concerned. These codes should also be fully supported and implemented by the boards and senior management. Company compliance with codes of ethics should be periodically monitored.

150. Codes of ethics should include guidance on procurement processes, as well as specific mechanisms protecting and encouraging stakeholders, and particularly employees, to report on illegal or unethical conduct by corporate officers. In this regard, the ownership entities should ensure that SOEs under their responsibility effectively put in place safe-harbours for complaints for employees, either personally or through their representative bodies, or for others outside the company. SOE boards could grant employees or their representatives a confidential direct access to someone independent on the board, or to an ombudsman within the company. The codes of ethics should also comprise disciplinary measures, should the allegations be found to be without merit and not made in good faith, frivolous or vexatious in nature.

151. **D. Where governments have expectations regarding responsible business conduct by SOEs, these should be publicly disclosed and mechanisms for their implementation be clearly established.**

152. Like private companies, SOEs often have a commercial interest in minimising reputational risks and being perceived as “good corporate citizens”. The ownership entity may therefore elaborate certain expectations regarding SOEs’ respect of environmental, health and labour standards, and require SOEs to report on related performance. Where such expectations exist, SOE boards and managements should ensure that they are integrated into the corporate governance of SOEs, supported by incentives and subject to appropriate reporting and performance monitoring.

153. Conversely, SOEs should normally not be required to engage in charitable acts, to provide public services to employees and the broader population, or offer other services that would more appropriately be carried out by the relevant public authorities. Regardless of the level of expectation the state may have for the responsible business conduct of SOEs, any expectations should be disclosed in a clear and transparent manner.

154. **E. SOEs should not be used as vehicles for financing political activities. SOEs themselves should normally not make political campaign contributions.**

155. SOEs should not under any circumstances be used directly as sources of capital to finance political campaigns or activities. Where SOEs have been used in the past for party financing this has not necessarily taken the form of direct disbursements. In some cases, the use of transactions between SOEs and corporations controlled by political interests, through which the SOEs were effectively put at a loss, have been alleged in some countries.

156. Moreover, although it is in some countries a common practice for private companies to make political campaign contributions for commercial reasons, SOEs should normally not do so. The ultimate control, including through regulation, over SOEs is the responsibility of politicians who belong to political parties that benefit from the largesse of corporate sponsors. Thus, the risk of conflicts of interest – already present in private sector companies – multiplies in the case of SOEs.

ANNOTATIONS TO CHAPTER VI: TRANSPARENCY AND DISCLOSURE

State-owned enterprises should observe high standards of transparency and disclosure and be subject to the same high quality accounting and auditing standards as listed companies.

157. **A. SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent company organ.**

158. As in large public companies, it is necessary for large SOEs to put in place an internal audit system. “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”³. Internal auditors are important to ensure an efficient and robust disclosure process and proper internal controls in the broad sense. They should define procedures to collect, compile and present sufficiently detailed information. They should also ensure that company procedures are adequately implemented and be able to guarantee the quality of the information disclosed by the company.

159. To increase their independence and authority, the internal auditors should work on behalf of, and report directly to, the board and its audit committee in one-tier systems, to the supervisory board in two-tier systems or the audit boards when these exist. Internal auditors should have unrestricted access to the Chair and members of the entire board and its audit committee. Their reporting is important for the board’s ability to evaluate actual company operations and performance. Consultation between external and internal auditors should be encouraged. Finally, it is also recommended as good practice that an internal control report is included in the financial statements, describing the internal control structure and procedures for financial reporting.

160. **B. SOEs should also be subject to an annual independent external audit based on internationally recognised standards. Specific state control procedures do not substitute for an independent external audit.**

161. In the interest of the general public, SOEs should be as transparent as publicly traded corporations. Regardless of their legal status and even if they are not listed, all SOEs should report according to best practice accounting and auditing standards.

162. SOEs are not necessarily required to be audited by external, independent auditors. This is often due to specific state audit and control systems that are sometimes considered sufficient to guarantee the quality and comprehensiveness of accounting information. These financial controls are typically performed by specialised state or “supreme” audit entities, which may inspect both SOEs and the ownership entity. In many cases they also attend board meetings and are often reporting directly to the Parliament on the performance of SOEs. However, these specific controls are designed to monitor the use of public funds and budget resources, rather than the operations of the SOE as a whole.

163. To reinforce trust in the information provided, the state should require that, in addition to special state audits, at least all large SOEs be subject to external audits that are carried out in accordance with

³. Definition of the Institute of Internal Auditors (<http://www.theiia.org>)

international standards. Adequate procedures should be developed for the selection of external auditors and it is crucial that they are independent from the management as well as large shareholders, i.e. the state in the case of SOEs. Moreover, external auditors should be subject to the same criteria of independence as for private sector companies. This generally includes limits on providing consulting or other non-audit services to the audited SOE, as well as periodic rotation of audit partners or audit firms.

164. C. SOEs should disclose material financial and non-financial information on the company in line with high quality internationally recognised standards of corporate disclosure, and including areas of significant concern for the state as an owner and the general public. This includes in particular SOE activities that are carried out in the public interest.

165. All SOEs should disclose financial and non-financial information, and large and listed ones should do so according to high quality internationally recognised standards. This implies that SOE board members sign financial reports and that CEOs and CFOs certify that these reports in all material respects appropriately and fairly present the operations and financial condition of the SOE.

166. To the extent possible, a cost-benefit analysis should be carried out to determine which SOEs should be submitted to high quality internationally recognised standard. This analysis should consider that demanding disclosure requirements are also both an incentive and a means for the board and management to perform their duties professionally. SOEs under a certain size could be excluded, provided that they do not pursue important public policy objectives. Such exceptions could only be decided on a pragmatic basis and will vary among countries, industrial sectors and the size of the state sector.

167. A high level of disclosure is also valuable for SOEs pursuing important public policy objectives. It is particularly important when they have a significant impact on the state budget, on the risks carried by the state, or when they have a more global societal impact. In the EU, for example, companies that are entitled to state subsidies for carrying out services of general interest are required to keep separate accounts for these activities.

168. SOE should face at least the same disclosure requirements as listed companies, while not being expected to compromise essential corporate confidentiality. They should report on their financial and operating results, remuneration policies, related party transactions, governance structures and governance policies. SOEs should disclose whether they follow any code of corporate governance and, if so, indicate which one. Regarding disclosure of remuneration of board members and key executives, it is viewed as good practice to carry this out on an individual basis. The information should include termination and retirement provisions, as well as any specific facility or in kind remuneration provided to board members. SOEs should be particularly vigilant and improve transparency in the following areas.

169. With due regard to company capacity and size, examples of such information include:

170. 1. A clear statement to the public of the company objectives and their fulfilment (for fully-owned SOEs this would include any mandate elaborated by the state ownership entity);

171. It is important that each SOE is clear about its overall objectives. Regardless of the existing performance monitoring system, a limited set of basic overall objectives should be identified together with information about how the enterprise is dealing with trade-offs between objectives that could be conflicting.

172. When the state is a majority shareholder or effectively controls the SOE, company objectives should be made clear to all other investors, the market and the general public. Such disclosure obligations will encourage company officials to clarify the objectives to themselves, and could also increase management's commitment to fulfilling these objectives. It will provide a reference point for all

shareholders, the market and the general public for considering the strategy adopted and decisions taken by the management.

173. SOEs should report on how they fulfilled their objectives by disclosing key performance indicators. When the SOE is also used for public policy objectives, such as general services obligations, it should also report on how these are being achieved.

174. 2. Company financial and operating results, including the costs and funding arrangements pertaining to public policy objectives;

175. Like private companies, SOEs should disclose information on their financial and operating performance. In addition, when SOEs are expected to fulfil specific public policy objectives, information on the costs of related activities, and how they are funded, should be clearly disclosed.

176. 3. The governance, ownership and voting structure of the company, including the content of any corporate governance code or policy and implementation processes;

177. It is important that the ownership and voting structures of SOEs are transparent so that all shareholders have a clear understanding of their share of cash-flow and voting rights. It should also be clear who retains legal ownership of the state's shares and where the responsibility for exercising the state's ownership rights are located. Any special rights or agreements that may distort the ownership or control structure of the SOE, such as golden shares and power of veto, should be disclosed.

178. 4. Information on board member remuneration policies and levels as well as board member qualifications, selection process, roles on other company boards and whether they are considered as independent by the SOE board;

179. Full transparency surrounding board member qualifications and remuneration is especially important for SOEs. SOE board member nomination is often the direct responsibility of the government and as such, board members can be perceived as acting on behalf of the state or specific political constituencies, rather than in the long term interest of the company. Requiring high levels of transparency surrounding board member qualifications, nomination processes, and remuneration policies can play a part in increasing the professionalism of SOE boards. It also allows investors to evaluate board member qualifications and identify any potential conflicts of interest.

180. 5. Any material foreseeable risk factors and measures taken to manage such risks;

181. Severe difficulties arise when SOEs undertake ambitious strategies without clearly identifying, assessing or duly reporting on the related risks. Disclosure of material risk factors is particularly important when SOEs operate in newly de-regulated and increasingly internationalised industries where they are facing a series of new risks, such as political, operational, or exchange rate risks. Without adequate reporting of material risk factors, SOEs may give a false representation of their financial situation and overall performance. This in turn may lead to inappropriate strategic decisions and unexpected financial losses.

182. Appropriate disclosure by SOEs of the nature and extent of risk incurred in their operations requires the establishment of sound internal risk management systems to identify, manage, control and report on risks. SOEs should report according to new and evolving standards and disclose all off-balance-sheet assets and liabilities. When appropriate, such reporting could cover risk management strategies as well as systems put in place to implement them. Companies in extracting industries should disclose their reserves according to best practices in this regard, as this may be a key element of their value and risk profile.

183. **6. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE, including contractual commitments and contingent liabilities arising from public-private partnerships;**

184. To give a fair and complete picture of an SOE's financial situation, it is necessary that mutual obligations, financial assistance or risk sharing mechanisms between the state and SOEs are appropriately disclosed. Disclosure should include details on any state grant or subsidy received by the SOE, any guarantee granted by the state to the SOE for its operations, as well as any commitment that the state undertakes on behalf of an SOE. Disclosure of guarantees could be done by SOEs themselves or by the state. It is considered good practice that Parliaments monitor state guarantees in order to respect budgetary procedures.

185. Public-private partnerships should also be adequately disclosed. Such ventures are often characterised by transfers of risks, resources and rewards between public and private partners for the provision of public services or public infrastructure and may consequently induce new and specific material risks.

186. **7. Any material transactions with the state and other related entities, including other SOEs;**

187. Transactions between SOEs and related entities, such as an equity investment of one SOE in another, might be a source of potential abuse and should be disclosed. Reporting on transactions with related entities should provide all information that is necessary for assessing the fairness and appropriateness of these transactions.

188. **8. Any relevant issues relating to employees and other stakeholders.**

189. SOEs are encouraged, and in some countries even obliged, to provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. Disclosure may include management/employee relations, and relations with other stakeholders such as creditors, suppliers and local communities.

190. Some countries require extensive disclosure of information on human resources. Human resource policies, such as programmes for human resource development and training, retention rates of employees and employee share ownership plans, can communicate important information on the competitive strengths of companies to market participants and other stakeholders.

191. **D. The ownership entity should develop consistent reporting on SOEs and publish annually an aggregate report on SOEs. Good practice calls for the use of web-based communications to facilitate access by the general public.**

192. The ownership entity should develop aggregate reporting that covers all SOEs and make it a key disclosure tool directed to the general public, the Parliament and the media. This reporting should be developed in a way that allows all readers to obtain a clear view of the overall performance and evolution of the SOEs. In addition, aggregate reporting is also instrumental for the ownership entity in deepening their understanding of SOE performance and in clarifying their own policy.

193. The aggregate reporting should result in an annual aggregate report issued by the state. This aggregate report should primarily focus on financial performance and the value of the SOEs. It should at least provide an indication of the total value of the state's portfolio. It should also include a general statement on the state's ownership policy and information on how the state has implemented this policy. Information on the organisation of the ownership function should also be provided, as well as an overview of the evolution of SOEs, aggregate financial information and reporting on changes in SOEs' boards. The

aggregate report should provide main financial indicators including turnover, profit, cash flow from operating activities, gross investment, return on equity, equity/asset ratio and dividends. Information should also be provided on the methods used to aggregate data. The aggregate report could also include individual reporting on the most significant SOEs. It is important to underline that aggregate reporting should not duplicate but should complement existing reporting requirements, for example, annual reports to Parliaments. Some ownership entities could aim at publishing only “partial” aggregate reports, i.e. covering SOEs active in comparable sectors. Finally, publishing bi-annual aggregate reports would further improve transparency of state ownership.

194. In some countries it has proven useful for the ownership entity to develop a website, which allows the general public easy access to information. Such websites could provide information both on the organisation of the ownership function and the general ownership policy, as well as information about the size, evolution, performance and value of the state sector.

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ANNOTATIONS TO CHAPTER VII: THE RESPONSIBILITIES OF THE BOARDS OF STATE-OWNED ENTERPRISES

The boards of SOEs should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

195. In a number of countries, SOE boards tend to be too large and lack business perspective and independent judgment. They may also include an excessive number of members from the state administration. Moreover, they may not be entrusted with the full range of board responsibilities and can therefore be overruled by senior management and by the ownership entities themselves. Moreover, their function may also be duplicated by specific state regulatory bodies in some areas.

196. Empowering and improving the quality and effectiveness of SOE boards is a fundamental step in improving the corporate governance of SOEs. It is important that SOEs have strong boards that can act in the interest of the company and effectively monitor management without undue political interference. To this end, it is necessary to ensure the competency of SOE boards, enhance their independence and improve the way they function. It is also necessary to allow them clear and full responsibility for their functions and ensure that they act with integrity.

197. **A. The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The role of SOE boards should be clearly defined in legislation, preferably according to company law. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably.**

198. SOE boards should, in principle, have the same responsibilities and liabilities as stipulated in company law. However, in practice, board members may have a reduced liability, particularly the ones nominated by the state.

199. The responsibilities of SOE boards should be articulated in relevant legislation, regulations, the government ownership policy and the company charters. It is essential and should be emphasised that all board members have the legal obligation to act in the best interest of the company and to treat all shareholders equitably. The collective and individual liability of board members should be clearly stated. There should not be any difference between the liabilities of different board members, whether they are nominated by the state or any other shareholders or stakeholders. Training should be required in order to inform SOE board members of their responsibilities and liabilities.

200. To encourage board responsibility and in order for boards to function effectively, they should follow best practices adhered to in the private sector and be limited in size. Experience indicates that smaller boards allow for real strategic discussion and are less prone to become rubberstamping entities. To underline the board's responsibilities, a Directors' Report should be provided along with the annual statements and submitted to the external auditors. The Directors' Report should give information and comment on the organisation, financial performance, material risk factors, significant events, relations with stakeholders, and the effects of directions from the ownership entity.

201. **B. SOE boards should effectively carry out their functions of setting strategy and supervising management, based on a broad mandate set by the government. They should have the power to appoint and remove the CEO.**

202. In many instances, SOE boards are not granted full responsibility and the authority required for strategic guidance, monitoring of management and control over disclosure. SOE boards may see their roles

and responsibilities encroached from two ends; by the ownership entities and by management. The ownership entity, if not the government itself, may be tempted to become too involved in strategic issues, although it is their responsibility to define the overall objectives of the company, particularly since the difference between defining objectives and setting strategies can be rather unclear. SOE boards may also encounter difficulties in monitoring management as they do not always have the legitimacy, or even the authority, to do so. Furthermore, in certain countries, there is a strong link between the management and the ownership function or directly with the government. SOE senior management often reports to the ownership entity or the government directly, thereby circumventing the board.

203. In order to carry out their role, SOE boards should actively (i) formulate or approve, monitor and review corporate strategy, within the framework of the overall corporate objectives; (ii) establish appropriate performance indicators and identify key risks; (iii) monitor disclosure and communication processes, ensuring that the financial statements fairly present the affairs of the SOE and reflect the risks incurred; (iv) assess and monitor management performance; and (v) develop effective succession plans for key executives.

204. One key function of SOE boards should be the appointment and dismissal of CEOs. Without this authority it is difficult for SOE boards to fully exercise their monitoring function and assume responsibility for SOEs' performance. In some cases, this might be done in concurrence or consultation with the ownership entity. In some countries, a full owner can directly appoint a CEO and this possibility extends to SOEs. This may also occur when the state is a dominant owner in SOEs that are assigned important public service purposes. To ensure that the integrity of the board is maintained, good practice would require consultation with the board. Regardless of the procedure, appointments should be based on professional criteria. Rules and procedures for nominating and appointing the CEO should be transparent and respect the line of accountability between the CEO, the board and the ownership entity. Any shareholder agreements with respect to CEO nomination should be disclosed.

205. It follows from their obligation to assess and monitor management performance that SOE boards should also have a decisive influence over the compensation of the CEO. They should ensure that the CEO's remuneration is tied to performance and duly disclosed.

206. **C. SOE board composition should allow the exercise of objective and independent judgement. All board members, including any public officials, should be nominated based on qualifications and have identical legal responsibilities.**

207. A central prerequisite in empowering SOE boards is to structure them so that they can effectively exercise objective and independent judgement, be in position to monitor senior management and take strategic decisions. All board members should be nominated through a transparent process and it should be clear that it is their duty to act in the best interests of the company as a whole. They should not act as individual representatives of the constituencies that appointed them. SOE boards should also be protected from undue and direct political interference that could prevent them from focusing on achieving the objectives agreed on with the government and the ownership entity. Good practice calls for persons linked directly with the executive powers not to sit on boards.

208. Mechanisms to evaluate and maintain the effectiveness of board performance and independence should be developed. These include, for example, limits on the possible number of reappointments and resources granted to the board to have access to independent information or to resources to carry out independent expertise.

209. In some countries, diversity in board composition is also an issue and it includes gender consideration.

210. **D. Independent board members, where applicable, should be free of any material interests or relationships with the company, its management or the ownership entity that could jeopardise their exercise of objective judgement.**

211. To enhance the objectivity of SOE boards, an increasing number of countries require that a minimum number of independent board members sit on SOE boards. Some require that SOEs apply the same requirements for independent board members that apply to listed companies. What is understood by “independence” varies significantly across countries. Good practice calls for independent board members to be free of any material interests or relationships with the company, its management or its ownership that could jeopardise the exercise of objective judgement. Some countries apply more strict requirements for independence, for example excluding persons based on marital or other family relationships with the company’s executives or controlling shareholders.

212. Independent board members should have the relevant competence and experience to enhance the effectiveness of SOE boards. It is advisable that they be recruited from the private sector, which can help make boards more business-oriented, particularly for SOEs that operate in competitive markets. Their expertise could also include qualifications related to the SOE’s specific obligations and policy objectives.

213. **E. Mechanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and to limit political interference in board processes.**

214. All SOE board members can potentially be subject to conflicts of interest. In addition to minimising potential conflicts of interest through the nomination of independent board members, measures should also be implemented to address conflicts of interest if they do arise. All board members should disclose any conflicts of interest to the board which must decide how they should be managed.

215. Particular measures should be implemented to prevent political interference on the boards of SOEs. There is a growing consensus that certain public sector representatives should not, under any circumstances, sit on SOE boards. This applies to ministers, state secretaries and any other direct representatives of the executive powers. In some cases, this exclusion is extended to other civil servants who have a direct working relationship with the executive powers, such as serving politicians, members of Parliament and civil servants who in the course of their duties can exercise regulatory influence over SOEs.

216. **F. The Chair should assume responsibility for boardroom efficiency and, when necessary in co-ordination with other board members, act as the liaison for communications with the state ownership entity. The roles of CEO and Chair should be separate.**

217. A crucial element in promoting board efficiency and effectiveness is the Chair. It is the Chair’s task to build an effective team out of a group of individuals. This requires specific skills, including leadership, the capacity to motivate teams, the ability to understand different perspectives and approaches, the capacity to diffuse conflicts as well as personal effectiveness and competence. The Chair of the board should act as the primary point of contact between the company and the ownership entity. Finally, the Chair can play an essential role in board nomination procedures by assisting the ownership entity, with input from the board’s annual self-assessments, to identify skills gaps in the composition of the current board.

218. For enhancing board independence, it is commonly regarded as good practice that the Chair person is separated from the CEO in single board structures. Separation of the Chair from the CEO helps to ensure a suitable balance of power, improves accountability and reinforces the board’s ability to make objective decisions without undue influence from management. An adequate and clear definition of the

functions of the board and of its Chair helps prevent situations where the separation might give rise to inefficient opposition between the two company officers. In the case of two-tier board systems, it is similarly considered good practice that the head of the lower board (management board) does not become the Chair of the supervisory board upon retirement.

219. Separation of the Chair from the CEO is particularly important in SOEs, where it is usually considered necessary to empower the board's independence from management. The Chair has a key role in guiding the board, ensuring its efficient running and encouraging the active involvement of individual board members in the strategic guidance of the SOE. When the Chair and the CEO are separate, the Chair should also have a role in agreeing with the ownership entity on the skills and experience that the board should contain for its effective operation. The separation of the Chair from the CEO should therefore be considered as a fundamental step in establishing efficient SOE boards.

220. G. If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence.

221. The purpose of employee representation on SOE boards is to strengthen accountability towards employees as stakeholders and to facilitate information sharing between employees and the board. Employee representation can help enrich board discussions and facilitate the implementation of board decisions within the company. When employee representation on SOE boards is mandated by the law or collective agreements, it should be applied so that it contributes to the SOE boards' independence, competence and information. Employee representatives should have the same duties and responsibilities as all other board members, should act in the best interests of the company and should treat all shareholders equitably. Employee representation on SOE boards should not in itself be considered as a threat to board independence.

222. Procedures should be established to facilitate the professionalism and the true independence of employee board members, and to make sure that they respect their duty of confidentiality. These procedures should include adequate, transparent and democratic election procedures, training and clear procedures for managing conflicts of interest. A positive contribution to the board's work will also require acceptance and collaboration by other members of the board as well as by SOE management.

223. H. When necessary, SOE boards should set up specialised committees, composed of independent and qualified members, to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration. The establishment of specialised committees should improve boardroom efficiency and should not detract from the responsibility of the full board.

224. The use of specialised board committees in SOEs has increased, in line with practices in the private sector. The type of special committees that boards make use of can vary between companies and industries and includes: audit committees, remuneration committees, strategy committees, ethics committees, and in some cases risk and procurement committees. In some countries, an equivalent body to the audit committee performs a similar function.

225. The establishment of specialised board committees can be instrumental in reinforcing the competency of SOE boards and in underpinning their critical responsibility in matters such as risk-management and audit. They may also be effective in changing the board culture and reinforcing its independence and legitimacy in areas where there is a potential for conflicts of interests, such as with regards to procurement, related party transactions and remuneration issues.

226. When board committees are not mandated by law, the ownership entity should develop a policy to define in which cases specialised board committees should be considered. This policy should be based on a combination of criteria, including the size of the SOE and specific risks faced or competencies which should be reinforced within SOE boards. Large SOEs should at least be required to have an audit committee or equivalent body with powers to meet with any officer of the company.

227. It is essential that specialised board committees be chaired by a non-executive and include a sufficient number of independent members. The proportion of independent members as well as the type of independence required (e.g. from management or from the main owner) will depend on the type of committee, the sensitivity of the issue to conflicts of interests, and the SOE sector. The audit committee, for example, should be composed of only independent and financially literate board members. To ensure efficiency, the composition of board committees should include qualified and competent members with adequate technical expertise.

228. The existence of specialised board committees should not excuse the board from its collective responsibility for all matters. Specialised board committees should have written terms of reference that define their duties, authority and composition. Specialised board committees should report to the full board and the minutes of their meetings should be circulated to all board members.

229. SOE boards could also establish a nomination committee to co-operate with the ownership entity with regard to the board nomination process. In some countries it is the practice that nomination committees can also be set up outside the board structure, particularly including several main owners. Regardless of who establishes the nomination committee, it is important to involve the board in thinking about its own composition and succession planning, through its involvement in the search process and its ability to make recommendations. This can contribute to focusing the nomination process on competence.

230. I. SOE boards should carry out an annual, well-structured evaluation to appraise their performance. The outcomes of the board evaluations should inform the board nomination process.

231. A systematic evaluation process is a necessary tool in enhancing SOE board professionalism, since it highlights the responsibilities of the board and the duties of its members. It is also instrumental in identifying necessary competencies and board member profiles. Finally, it is a useful incentive for individual board members to devote sufficient time and effort to their duties as board members.

232. The evaluation should focus on the performance of the board as an entity. It could also include the effectiveness and contribution of individual board members. However, the evaluation of individual board members should not impede the desired and necessary collegiality of board work.

233. Board evaluation should be carried out under the responsibility of the Chair and according to evolving best practices. The board evaluation should provide input to the review of issues such as board size, composition and remuneration of board members. The evaluations could also be instrumental in developing effective and appropriate induction and training programmes for new and existing SOE board members. In carrying out the evaluation, SOE boards could seek advice from external and independent experts as well as the ownership entity.

234. Well-structured board evaluations can also act as a helpful tool to inform the board nomination process.