

Meeting Summary

IV Meeting of the Latin American Network on Corporate Governance of State-Owned Enterprises

2-3 June 2015

Economic Commission for Latin America and the Caribbean (ECLAC)

United Nations, Av. Dag Hammarskjold 3477, Vitacura, Santiago, Chile

This year, the OECD, CAF (Latin American development bank), and the World Bank co-organized the fourth meeting of the *Latin American Network on Corporate Governance of State-Owned Enterprises* (the Network), which took place in Santiago, Chile from June 2-3, 2015, with support from the Spanish Government, the Spanish National Commission for Capital Markets (CNMV), the Economic Commission for Latin America and the Caribbean (ECLAC), and the University of Chile Centre for Corporate Governance and Capital Markets. Chile's System of Public Enterprises (SEP) served as this year's host, with sponsorship from Codelco, Metro, Empresa Portuaria San Antonio, Empresa Portuaria Valparaíso and Zofri. Participants totaled over 100 representatives of governments, state-owned enterprises (SOE), universities and think tanks from 13 countries and 5 international organizations (OECD, ECLAC, CAF, World Bank and IDB).

The objective of the Network is to enhance SOE governance in Latin America through an exchange of knowledge and experience on SOE governance policies, practices, and reforms, using the OECD Guidelines on Corporate Governance of State-Owned Enterprises as the main conceptual framework for discussion. Building on the OECD's Guidelines, CAF's Guidelines for Good Corporate Governance of SOEs provide an additional reference adapted to the Latin American context. The Network offers a forum to leverage the experience of governments and institutions, sharing knowledge on policy, institutional frameworks and best practices to support corporate governance (CG) improvements in SOEs across the region.

Attendees, speakers, and organizers described the event as very successful, and stressed the importance of the topics discussed, the participation of specialized professionals in the area of corporate governance of SOEs in Latin America, and the collaborative efforts shown by all parties involved. New reports prepared for the meeting were welcomed, and it was requested that they be issued in both working languages of the Network, in Spanish and English. This will facilitate global as well as Latin American participation in the ongoing discussions of the Network, including through an invitation to Network participants to join a LinkedIn discussion group on Latin American Corporate Governance. Participants welcomed the proposed continuation of this privileged space of exchange for its fifth meeting in 2016, which Mexico has volunteered to host.

The event this year stood out for the quality of its agenda, which was designed based on issues suggested at the end of last year's third conference in Argentina. The topics were: the updating of the OECD's Guidelines on Corporate Governance of SOEs; advances in the reform of SOEs in Latin America; the establishment of Boards; transparency practices; budget and investment frameworks for SOEs; and the role of corporate governance for ensuring SOEs' integrity. Specific cases were presented from countries including Brazil, Chile, Colombia, and at the subnational level, through the case of the City of Medellin. Other cases included Costa Rica, Paraguay, Peru, Sweden and Uruguay. Specific examples

were also presented from companies such as Codelco in Chile, PEMEX and CFE in Mexico, Peru's Social Security SOE, and from an innovative initiative by BM&F BOVESPA for promoting corporate governance improvements in listed public companies.

During the event, the ample space for discussion, including for questions and comments from the audience, was highlighted as key to enhancing the exchange of experiences and knowledge and the sharing of major challenges on issues of CG and SOEs in Latin America.

This summary recaps the interventions of participants, as well as the outstanding issues, recurrent ideas and topics that could be expanded on in the next edition, which include the following:

- 1. Ensuring the State functions as a clearly identifiable, responsible, and proactive owner; achieving the right balance, not too passive and not too active and not engaging in the day-to-day operations of the organization.**
- 2. Increasing frequency of cases of centralized ownership of SOEs, including those at the subnational level.**
- 3. The importance of clearly defining the mandate of SOEs and ensuring adequate financing.**
- 4. Mechanisms for separating the selection process of SOE Boards from the political cycle, and the need for consensus on the criteria for an independent director.**
- 5. Corporate governance regulation at the country level and in SOEs.**
- 6. The importance of having the political commitment to support change.**
- 7. Ensuring that corporate governance is part of companies' DNA.**
- 8. Integrity that goes beyond CG.**

1. Ensuring the State functions as a clearly identifiable, responsible, and proactive owner; achieving the right balance, not too passive and not too active and not engaging in the day-to-day operations of the organization. The conflict of interest that the State may have between its role as owner, and its role as both regulator and regulated, presents a major challenge in many countries. During the meeting, cases were also mentioned in which SOEs had weaknesses in their management that required the State to intervene in the operations of their Boards. In many cases, this arises because the mandates of the SOE and/or interested parties may not be clearly defined, whereby SOEs do not have information on who they should be targeting. To correct this situation, a clear normative policy needs to be developed as part of the SOE's enabling law, corporate governance code or the government's ownership policy. Throughout the discussion, recurring questions were raised on how to correctly exercise state ownership to ensure achievement of economic and social objectives and to minimize effects of the political cycle. Participants tried to respond to these questions, considering that the different State visions, as well as their underlying political ideologies, may condition the existence of very different pathways to address this matter. There was interest in deepening this discussion at the next meeting.

The updated OECD Guidelines on Corporate Governance of SOEs that were under preparation at the time of the meeting make specific reference to the definition of SOEs as well as to the idea of State ownership, and to how added value can be created through this proprietary relationship. It is an issue upon which each country must reflect, to decide how far the State's participation goes, and if it is relevant to become involved in certain types of activities. Each country together with their SOEs must establish its ownership policy.

2. Increasing attention drawn to cases of centralized ownership of SOEs, including at the subnational level. In previous events, the example of FONAFE was cited on several occasions to represent the case of centralized ownership. This year, an entire session was dedicated to introducing additional examples such as the case of the Municipality of Medellin, an interesting reference at the subnational level. On the issue of Public Holdings, various initiatives were mentioned that are growing and expanding in Latin America, already reaching a significant size and volume of operations. Holdings were deemed relevant in this and parallel forums, to identify common responses to new problems. For example, participants proposed intra-holding related party transactions as a topic for discussion, reflecting on how companies within a holding can be more efficient and operate jointly and simultaneously, responding to the logic of the public sector. In this context, it is important to keep in mind good practices guidance for the review and transparency of related party transactions. This is a complex issue that has no easy solution, partly due to the lack of a common legal framework among Latin American countries. In addition, another topic for discussion was on the criteria that are taken into account by each holding to define the allocation of powers between the various companies of which they are comprised, while ensuring compliance with regulation to ensure fair competition.

3. Importance of clearly defining the mandate of SOEs and ensuring adequate financing.

SOEs can have very different roles: social, economic, and as generators of revenue and public policies. What is important is that there is clarity on the role of each company based on the objectives for which they were created. An OECD report based on questionnaire responses from participating countries, “Board Practices and Financing for Latin American State-Owned Enterprises” provided additional background on how different countries ensure that SOEs have adequate financing to support achievement of public policy objectives when these go beyond normal commercial practices.

In the case of Brazil, SOEs exist to implement public policies and collect income, the latter being a secondary role, since private companies could be designated to collect taxes. Unresolved issues remain on the role of SOEs in public policies, and mechanisms that different countries employ to ensure that companies are compensated for the public policy functions they perform.

There are examples of countries in the region, such as Peru, where SOEs are entreated to go beyond their main activity to assume a social role, through an explicitly established relationship. Legislative Decree 1031 in Peru states that if the State asks companies to carry out an activity, such a request must be accompanied by an allocation of funding (through Treasury resources). Similarly, in the case of the distribution of resources by SOEs to low-income citizens at lower prices, such as fuel delivery to low-income citizens, SOEs are providing subsidies for individuals, a service that should be paid for by the State. In Brazil, public policies such as those supporting electricity provision to low-income populations,

or loans for purchasing homes, are compensated through the budget, thus fiscally separating the business from the public policies.

It was proposed that future meetings revisit these issues, including a discussion on how different countries seek to ensure a fair return for the goods produced and services rendered by SOEs.

4. Mechanisms to separate the selection process of SOE Boards from the political cycle, and the need for consensus on the criteria of an independent director. The Network's discussions and OECD report on "Board Practices and Financing for Latin American State-Owned Enterprises" revealed widespread recognition of the Board as a key organizational feature, and of the need to strengthen it. The transparency index in the study presented by CAF, "La transparencia del gobierno corporativo en las Empresas de Propiedad del Estado en América Latina" (Transparency of corporate governance in State-Owned Enterprises in Latin America), also mentioned the importance of this issue. Some weaknesses were identified, as evidenced by the fact that only Chile and Peru have formal training and preparation programs for new Board members, which have exhibited positive results. Moreover, in these two countries, the identification of candidates to serve as directors is made through company headhunters, which has also yielded favorable results. Issues such as strengthening the Board, separating nomination cycles from political cycles, selection considering technical and not political criteria, and evaluation of Board members, budgetary autonomy, and reducing dependence of SOEs on the public budget, are all important issues raised in the CAF transparency study, around which it is evident that more work needs to be done.

Repeatedly, the need and importance of separating the Board's election process from the political cycle was highlighted for the Boards to fulfill their responsibilities independently of the administration in office, at the level of ownership. Similarly, it would be useful to have guidelines on how SOEs can fulfill their functions independently from the political cycle. The importance of professionalizing SOE Boards was stressed, ensuring that Board members are clear about the mandate for which they have been selected.

Much of the debate concerning Boards focused on the need to include independent directors who have the right professional profile to perform the duties assigned as a Board member. However, this point generated debate, as many participants expressed doubts about the definition of "independent director," specifically, about what constitutes the term "independent," as its defining criteria may vary greatly from one country to another. Participants emphasized that, to require directors to be independent, a clear definition of independence must first be established.

The representatives of Brazil explained that in their country's market, 'independent' means being independent from the government, but not necessarily independent from the market or other interests. In this sense, there are experiences of independent directors of SOEs that were privatized, maintaining minimal public participation or which were being operated through concessions to private companies, that were in fact, *not* independent, as their sole objective was to stay in office for another term, or to please the private controller. In Argentina, for example, SOEs are required by law to establish Audit Committees. Nevertheless, representatives of Argentina expressed the need to redefine the criteria for determining the independence of directors that are part of these Committees. In the case of Colombia, a staggered model for directors is in place, so that when the Board changes coincide with political

changes, at least one independent member must stay with the company for a minimum of six months. In addition, Municipal Enterprises of Medellín (Empresas Públicas de Medellín - EPM), through the mayor, established a requirement that Boards must be composed of seven members, of which independents should make up at least 40%. These cases highlighted therefore the importance of having a written procedure for the functioning of the Board, including the issue of independent directors, with references to technology strategies, clear definitions of standards, and other mechanisms to ensure Board independence.

During the final session, a representative of Brazil proposed the following list of requirements to ensure independence in the selection of Board members : (i) That the person has the training, qualifications and appropriate experience for the position; (ii) That the person has achieved clear results and deliverables in the development of his/her professional activity; (iii) That the individual has integrity and character; and (iv) That there are no potential conflicts of interest or involvement in another agenda that may conflict with the existing role. Continued efforts are needed to establish clear and unified criteria in this regard.

5. Corporate governance regulation at the country level and in SOEs. Participants repeatedly emphasized the need to strengthen the management of SOEs through the formalization of working practices through which companies develop their functions. In Chile, the discussions have been intense and complex during attempted changes of CG laws for important companies such as the Copper Corporation (CODELCO), the National Petroleum Company (ENAP), or the National Mining Company (ENAMI). Previously, CODELCO's board of directors was appointed by the President of the Republic, composed of ministers and military personnel. Speakers suggested that this close association between the presiding government and the manager failed to consider the long-term perspective, particularly because the company worked according to the political cycle, and was not adequately managed when public finances were under pressure. After many long and intense discussions, there has been a change in CODELCO, but changes in ENAP and ENAMI are still pending.

Network members emphasized that agreeing on a common approach was not a problem. The problem is convincing those who do not regard these issues as important: "Among us, we understand each other very well, but something has to change." The fundamental idea expressed was that politicians must be convinced of the crucial importance of this issue to move forward effectively. Beyond discussions, two paths can help achieve this goal: a wider dissemination of good corporate governance practices with respect to SOEs; and more targeted efforts to convince people who hold political power of the value of such practices. This basically includes countries' congresses or parliaments, where the different political opinions are represented in democracy. This is a crucial issue that deserves to be addressed in depth and objectively, and given due recognition for its importance by all countries. Countries such as Costa Rica and Chile highlighted their difficulties in passing bills that are initiated from SOE monitoring units into law.

6. The importance of having the political commitment to support changes. If the owner at the state level is not involved, structural changes that need to be made in the SOE will probably fail to meet their objectives of being sustained through future administrations. Therefore, it is essential to involve

those who hold political power through a formalized State agreement so that such reforms are institutionalized and not reversed under new administrations.

Some attendees recalled that, ever since the Network had been established to discuss CG issues, one of the topics they intended to address was "what to do with politicians." At this meeting, these issues continued to resurface during discussions. Therefore, one suggestion that came up was to invite senators, members of Parliament, assembly members (as appropriate to each country) to future events to discuss these issues. Participants highlighted how ideas and information on principles of CG circulate through networks of SOEs, but not necessarily through networks of politicians. It was stressed that this is an ongoing political task, which should not depend on the election calendar or Board selection. The case of Sweden represented a very interesting example, demonstrating that political interference does not necessarily represent one of the greatest obstacles in that country. However, the problem is a recurrent one in the case of Latin America.

7. Ensuring that corporate governance is part of companies' DNA. Corporate governance must become part of the organizational culture of the company to ensure continued commitment to the process. Transparency and openness of information are fundamental. These accountability mechanisms are needed to be effective and to elicit positive impacts on management. An increasingly competitive environment has augmented the importance of having efficient and competitive companies. Additionally, CG can help to avoid conflicts and enable citizens to understand the significant role that SOEs play for the country, rather than for the benefit of a few.

The issue becomes more complex when, beyond the relationship with the Government, the SOE must place added importance on relationships with local communities, as has already begun to occur. Today, civil society in general and customers in particular, have higher expectations for SOEs, and that translates into a more demanding business environment. The need to develop internal control and integrated risk management systems to reduce the possibility of fraud was also raised.

The CAF transparency study made clear that, in general, the information provided by companies in Latin America is not sufficient, while transparency is of great importance for CG. Companies that are publicly traded are better classified because the regulator requires greater transparency. The results for those that have issued securities (shares or debt) on the stock exchange are similar for those that may be listed without issuing securities. Although some companies have already been listed on the stock exchange for many years, this is not always a good indicator of how businesses are functioning, since it is known that in some countries, this may have been used as a non-transparent mechanism to induce privatization. Whether companies are listed on stock exchanges or not, this sometimes responds more to their own financing needs than to the quality of their CG. It must also be recognized that for some companies, it may not be necessary or relevant to be listed. This is the case in Uruguay for example, SOEs may issue debt but they cannot be listed, since they are constituted by public law.

8. Integrity goes beyond CG. The issue of corruption and distrust of business as well as public institutions – both within Latin America and globally - and how this can be addressed through a stronger focus on different mechanisms to promote business integrity was highlighted in an initial presentation

of the OECD's "Trust and Business" initiative. Participants talked about how the issues of integrity and ethics can be addressed in Latin American countries where culture is affected by inequality, resulting in ethical factors that impact various areas of both governance and SOEs. These issues could be addressed with a holistic approach. Integrity is not only a statutory requirement; it should aspire to reach beyond legal compliance. The ethical behavior of management and directors influences the reputation of the organization, and because that reputation is an asset of the company, it must be protected for public companies, serving as a benchmark for the entire nation.

Some countries have established regulations that, to some extent, help limit the discretion of officials, such as ethics laws and formalities for civil servants. For example, in Argentina, public officials are required to file an asset declaration every year that is made public.

Gender issues are also linked to issues of integrity, related to promoting representation of diverse viewpoints. In Chile, the commitment to prioritize gender issues has been backed by the President of the Republic, resulting in a target that at least 40% of Board members should be women (although the current percentage is 27.8).

It was proposed that the issue of integrity be taken up again in future editions of the Network, placing emphasis on monitoring efforts to ensure that integrity does not focus solely on control, but also on how these efforts are being promoted, with proper balance between promotion and control.