GUIDELINES ON THE GOVERNANCE OF STATE-OWNED ENTERPRISES FOR SOUTHERN AFRICA

NOVEMBER 2014

ABOUT THE OECD-SOUTHERN AFRICA NETWORK ON THE GOVERNANCE OF STATE-OWNED ENTERPRISES

The OECD-Southern Africa Network on the Governance of State-Owned Enterprises (SOEs) (hereafter "SOE Network for Southern Africa") is a forum aimed at improving the corporate governance of SOEs, and which provides a forum for regional dialogue and co-operation. It is the first initiative of its kind to focus on SOE governance and mainly covers the member economies of the Southern Africa Development Community (SADC). The forum was launched in 2007 to support regional and national reformers in their efforts to improve the performance of SOEs. Participating institutions represent entities which manage portfolios of SOEs or which oversee government policy vis-à-vis SOEs. Representatives from stakeholder institutions, regional and international organisations, development banks, and corporate governance practitioners participate to the Network.

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ABOUT THIS PUBLICATION

This document represents a shared regional consensus on SOE reform priorities by members of the SOE Network for Southern Africa. The Guidelines are the shared property of Network participants and are offered as a tool to the SADC community. The Guidelines can be endorsed by members who wish to formally associate themselves with them. This document was developed by a regional Taskforce, with input from the Network and broader public through a year-long consultation process. The Guidance was formally launched at the 5th meeting of the Network which took place in Lusaka, Zambia on 26-27 November 2014.

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TABLE OF CONTENTS

PREAMBLE 4
I. AN EFFECTIVE LEGAL AND REGULATORY FRAMEWORK FOR STATE-OWNED ENTERPRISES 6
II. THE STATE ACTING AS AN OWNER 10
III. EQUITABLE TREATMENT OF SHAREHOLDERS AND OTHER OUTSIDE INVESTORS 15
IV. CORPORATE ETHICS AND STAKEHOLDER RELATIONS 20
V. TRANSPARENCY AND DISCLOSURE 24
VI. THE BOARD OF DIRECTORS 28

PREAMBLE

The Guidelines on the Governance of State-Owned Enterprises for Southern Africa ("the Guidelines") represent a shared regional consensus on state-owned enterprise (SOE) reform priorities. Regional SOE Guidelines can help governments assess and improve the way they exercise the ownership function, and are can be used as a tool from which to draw and adapt national ownership and governance practices. Good practices ultimately serve to improve the governance and performance of SOEs, and promote competitive, transparent and more efficiently-run enterprises. These guidelines are intended to capture the regional aspirations and priorities of SOE governance reformers across the Southern Africa region. The benefit of a regional approach is that it is reinforced by a shared history and commonality in terms of the countries' development paths. Adopting a regional approach to corporate governance can also help achieve regional integration goals.

Introduction

SOEs form one of the largest sectors of the economy in many African countries, and are important contributors to national development. SOEs provide citizens with access to vital services such as water, electricity, health, sanitation, telecommunications, and transportation. The competitive position of the private sector-led economy, including small and medium-sized enterprises, is also heavily dependent on the services and infrastructure provided by these firms. On a regional level, SOEs are key players in large cross-border infrastructure projects, which are crucial to realising regional integration goals and to achieving what is considered to be an important development objective.

Many Southern African economies have placed SOEs at the centre of their national development strategies with a growing trend to rely on SOEs to remedy market failures and remove direct obstacles to development. Some go beyond this and aspire to a "developmental" state model in which SOEs drive competitiveness, job creation and industrial development. This is partially a response to disappointment with the outcomes of privatisations and structural reform programmes in the 1990s, but there is also a growing consensus that if governed properly, SOEs can support national development.

Some concerns have been expressed regarding the effectiveness of these approaches, including the managerial and technical capabilities of the participating SOEs. Irregular practices including conflicts of interest and outright corruption have also been alleged. Thus, there is a need for strong efforts to ramp up the efficiency, competitiveness and commercial viability of existing SOEs. Until now, no Southern African regional benchmark for SOE governance has been developed. However a small number of national SOE corporate governance guidelines do exist.

Scope and breadth of the Guidelines

Commercial enterprises. These Guidelines are primarily oriented towards SOEs under central government or sub-national ownership using a distinct legal form (for example, joint stock companies or limited liability companies – and at any rate separate from the general public administration), having a commercial activity and where the State has effective control through full, majority, or significant

minority ownership. Some of its recommendations can be useful to non-commercial incorporated entities, such as parastatals, as well. However, the distinction between commercial and non-commercial purposes must figure centrally when implementing the Guidelines, because some of the recommendations in this document will be irrelevant, and potentially even counterproductive, if applied to SOEs charged largely with carrying out public policy functions.

Outcomes based. This is a set of voluntary guidance which provides a roadmap to help Southern African countries achieve international best practices, adapted to the regional context. It is inspired from national practices and recommendations in addition to international best practices such as the OECD Guidelines on the Corporate Governance of State-Owned Enterprises. The regional Guidelines are intended to be applicable despite differences in legal traditions or economic development among the intended countries and their respective SOEs. For this reason the recommendations are outcomes based. It is up to national governments to determine how they obtain the outcomes that the Guidelines recommend. Options include legislation, regulation, the development of codes and recommendations, as well as largely market based solutions.

Structure of the document. The Guidelines consist of six chapters that focus on policies to ensure good corporate governance, taking the perspective of the State as an owner. Each chapter consists of two parts: (i) recommendations and (ii) annotations which contain commentary on the recommendations and are intended to help readers understand their rationale. The annotations may also contain descriptions of national practices and offer alternative implementation examples that may be useful in achieving the intended outcomes of the Guidelines.

Target audience. The Guidelines can be used by all interested parties concerned by State ownership. First and foremost they are targeted to the State acting as an owner, but they may also provide guidance to board members and executive management of SOEs, state audit bodies, the legislative powers, social partners and other corporate governance stakeholders.

Co-operation between the OECD and Southern African economies

The Guidelines were developed by the OECD-Southern Africa Network on the Governance of State-Owned Enterprises – a regional cooperation forum aimed at improving the corporate governance of SOEs, and mainly covering the member economies of the Southern African Development Community (SADC) region. The participating countries include: Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

The process of developing the Guidelines was spearheaded by a regional taskforce chaired by Botswana (Public Enterprises Evaluation and Privatisation Agency) and including representatives of Mozambique (IGEPE), Namibia (SOE Governance Council), Zambia (Institute of Directors) and Zimbabwe (former Ministry of State Enterprises and Parastatals and the State Enterprise Restructuring Agency). The Development Bank of Southern Africa participated as an observer.

I. AN EFFECTIVE LEGAL AND REGULATORY FRAMEWORK FOR STATE-OWNED ENTERPRISES

Recommendations

1. *An effective legal and regulatory framework must be enforceable and implementable. Any additional good practices should be consistent with existing legal and regulatory frameworks.*

2. *There should be a clear separation between the state's ownership function and other state functions that may influence the operating conditions for SOEs, particularly with regards to legal enforcement and market regulation.*

3. *Governments should strive to simplify, streamline and harmonise the legal form under which SOEs operate. Unless there are strong reasons to the contrary, SOEs should be incorporated subject to ordinary company law.*

4. *Any obligations and responsibilities that a SOE is required to undertake beyond its normal commercial functions should be clearly mandated, disclosed to the public and their costs covered in a transparent manner.*

5. *Where SOEs and private enterprises compete (or might compete) in the market place, a level playing field should be ensured and reconciled with economic development objectives. No entity should have a competitive advantage, or disadvantage, purely in consequence of its ownership.*

Annotations to Chapter I

Recommendation 1*:* The legal and regulatory framework should be designed with a view to ensuring an efficient and transparent SOE sector. It should be based on clear and consistently enforced rules without undue interference in the day-to-day business of the companies. This implies that a well-functioning and efficient SOE sector depends in large measure on ensuring the rule of law in the home jurisdiction. The legal and regulatory framework should enshrine a clear division of responsibilities among authorities. It also implies ensuring that SOEs, private companies and any other economic agents are treated equally by the authorities in like circumstances.

Governments may see a need to issue specific guidance in the form of "owners' expectations", corporate governance codes or good practices for specific SOE activities. These should build on and supplement existent corporate and SOE specific legislation. Exemptions of SOEs from generally applicable laws should be kept to a minimum and, where occurring, be based on specific legislation rather than ad-hoc government policy action. A balance should be struck between compliance with existing rules and legislation and good practices.

Recommendation 2*:* The State plays a dual role as market regulator and owner of commercial SOEs, for instance where partially-privatised state controlled incumbents compete with new market entrants. The potential conflicts can be exacerbated where SOEs retain monopoly elements within their value chains. A classic example of the dichotomy between ownership and regulation would, for example, arise where the State takes action to shield its enterprises from competitive pressures in order to protect the SOEs' value and fiscal revenue streams. Sometimes these two goals can be confused where the government has competing objectives to, on the one hand, place SOEs at the heart of development strategies, while, on the other, encouraging competition in goods and services markets.

A sustained effort should be made to ensure that there is an effective separation between those parts of the State that carry out the ownership functions and those charged with regulatory responsibilities. In the case of market-specific regulations (e.g. competition, access and tariffs), independent regulators can be an important part of the equation, and should definitely be seen as the first choice where SOEs are engaged in competition in the marketplace. Conversely, where SOEs retain inherent monopoly positions (e.g. the case of natural monopolies), the establishment of separate regulators – who, in the absence of competition, would effectively be put in place to deal with one sole enterprise – may not always be a cost-effective way of addressing the challenge. In that case government may choose to rely on line ministries for the regulatory function. In any case, clear laws and regulations should be developed to protect the independence of regulatory bodies (see further OECD 2012 Recommendation on Regulatory Policy and Governance).[1] Most economies in the region have established or are working to set up independent regulatory bodies, including competition authorities. It is important to ensure that commercially operating SOEs fall within their enforcement powers.

Recommendation 3*:* SOEs can be established using different types of legal forms. Three commonly occurring examples are (i) incorporation subject to general company law; (ii) incorporation subject to general legislation guiding SOEs; and (iii) the creation of a company-specific piece of legislation (such SOEs are generally known as "statutory corporations"; for an application to the Southern African context see Box 2). Different legal forms can be a source of confusion and lead to a loss of transparency. Efforts should be made to simplify, streamline and harmonise legal frameworks. SOEs should, where possible,

[1] Independence is characterised based on a number of factors, including but not limited to independent budget and governance structures.

operate according to general company law – and specific legal carve outs and custom-made corporate forms should be avoided unless absolutely necessary.

This is a specific priority of the authorities of many Southern African countries where SOEs – for historic reasons or reflecting the public-policy obligations that many are charged with – take a multitude of corporate forms. As a general rule harmonisation of corporate forms should start with SOEs having a largely commercial character. Where this is not feasible governments should aim to approximate the legal and regulatory frameworks of SOEs to those applying to private companies. This includes similar transparency and disclosure requirements and the establishment of governance organs to ensure that management and oversight bodies act in the best interests of the company and its owners. One solution may be to specify in dedicated legislation governing SOEs that, unless countermanded by other legislation, rules applying to limited liability companies shall apply to SOEs as well. Bodies or entities (i.e. sectoral boards or parastatals) that carry out purely regulatory and related public policy functions should not be considered part of the government's SOE portfolio.

Recommendation 4*:* Most SOEs pursue public policy objectives alongside their commercial objectives, which serve as their main rationale for continued State ownership. The Guidelines do not preclude such public policy objectives, but by giving a public entity a corporate form (as opposed to relying on a government agency), authorities are committed to operating this entity in a corporate fashion. Regardless of the corporate form, SOEs should be transparent about any non-commercial objectives and, where applicable, ensure transparent compensation that is calibrated to their associated costs. Corporate objectives should be anchored in laws, regulations or cabinet decisions disclosed to parliament and the public. Mechanisms should be established to monitor their implementation, directly by the ownership function or for example through performance contracts. Non-commercial objectives should be consistent with the government's overall ownership policy. It is considered good practice to apply a "SMART" approach to objective setting: *Specific* – target a specific area for improvement; *Measurable* – quantify or at least suggest an indicator of progress; *Attainable* – specify who will do it; *Realistic* – state what results can realistically be achieved, given available budgetary resources; and *Time-related* — specify when the result(s) can be achieved.

Most governments provide a form of compensation to SOEs that deliver public service obligations, but direct budgetary support seems to be the exception. These forms include concessionary funding arrangements, regulatory derogations, tax breaks, etc. This is potentially problematic. In order to ensure compensation is provided in a fair and transparent matter it is important to i) separate the accounts of commercial and non-commercial activities; ii) determine the adequate amount that should be compensated for fulfilling non-commercial obligations; iii) ensuring that compensation does not amount to undue subsidies; and iv) determining a compensation method which is neutral. This is an important reform priority for a number of Southern African governments – and one which may merit a reconsideration of SOE-related legislation but also fiscal budgeting procedures.

Recommendation 5*:* Commercial SOEs should operate in competitive markets in a competitively neutral fashion (i.e. no entity should have a competitive advantage or disadvantage, as a consequence of its ownership). Failing to achieve that, a government will find its economy imperilled as less efficient enterprises crowd out more efficient ones. A level playing field entails everything from the legal and regulatory environment in which SOEs operate, to the conditions under which they access finance or compete for public tenders. Commercial SOEs should in particular not face protection from insolvency or bankruptcy procedures. Nor should they benefit from advantageous financing terms or a privileged market position when dealing with the state and other state-owned bodies (including other SOEs). A

framework is suggested under Box 1 comprising 7 individual elements that policy makers may wish to consider for achieving competitive neutrality.

While competitive neutrality is an important public policy goal, its near-term implementation may be fraught with difficulty dependent on the level of economic development of SOEs' home jurisdiction. It is only fully applicable where well-regulated markets exist (including where competition policies and laws are enforced) and private competition is present. Governments in countries at relatively low levels of economic development might even be willing to accept an uneven playing field as a reasonable price to pay for the pursuit of sectoral priorities. However, throughout the process of economic development the State needs to give adequate consideration to the balance between public and private activities. The State must also reconcile the "developmental" state model with other objectives such as encouraging private participation in the economy. It needs to ensure that unequal treatment occurs only in contexts expressly mandated by laws and public policy. Where the government has decided to use SOEs as a key means for driving its agenda, it is even more critical to be transparent about such goals, to quantify the cost of the assigned public policy objectives and to identify an appropriate means for financing them.

Box 1. Framework to achieve competitive neutrality

Governments wishing to obtain and enforce competitive neutrality need to focus attention on the following seven priority areas:

- *Streamline government businesses either in terms of corporate form or the organisation of value chains.* An important question when addressing competitive neutrality is the degree of corporatisation of government business activities and the extent to which commercial and non-commercial activities are structurally separated. Separation makes it easier for commercial activities to operate in a market-consistent way. Incorporating public entities having a commercial activity and operating in competitive, open markets, as separate legal entities enhances transparency.
- *Ensure transparency and disclosure around cost allocation.* Identifying the costs of any given function of commercial government activity is essential if competitive neutrality is to be credibly enforced. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling public service obligations (if applicable). For unincorporated entities, problems arise where they provide services in the public interest as well as commercial activities from a joint institutional platform.
- *Devise methods to calculate a market-consistent rate of return on business activities*. Achieving a commercial rate of return is an important aspect in ensuring that government business activities are operating like comparable businesses. If SOEs operating in a commercial and competitive environment do not have to earn returns at market consistent rates, then an inefficient producer may appear cheaper to customers than an efficient one.
- *Ensure transparent and adequate compensation for public policy obligations*. Competitive neutrality concerns often arise when public policy priorities are imposed on public entities which also operate in the market place. It is important to ensure that concerned entities be adequately compensated for any non-commercial requirements on the basis of the additional cost that these requirements impose.
- *Ensure that government businesses operate in the same or similar tax and regulatory environments.* To ensure competitive neutrality government businesses should operate, to the largest extent feasible, in the same or similar tax and regulatory environment as private enterprises. Where government businesses are incorporated according to ordinary company law, tax and regulatory treatment is usually similar or equal to private businesses.
- *Debt neutrality remains an important area to tackle if the playing field is to be levelled.* The need to avoid concessionary financing of SOEs is commonly accepted since most policy makers recognise the importance of subjecting state-owned businesses to financial market disciplines. However, many government businesses continue to benefit from preferential access to finance in the market due to their explicit or perceived government-backing.
- *Promote competitive and non-discriminatory public procurement.* The basic criteria for public procurement practices to support competitive neutrality are: (1) they should be competitive and non-discriminatory; and (2) all public entities allowed to participate in the bidding contest should operate subject to the above standards of competitive neutrality.

Source: OECD (2012), Competitive Neutrality: Maintaining a level playing field between public and private business, Paris.

II. THE STATE ACTING AS AN OWNER

Recommendations

1. *Government officials and politicians should be mindful of the fact that they exercise ownership rights in SOEs on behalf of, and in the ultimate interest of, the general public. This would justify higher standards of accountability and transparency than those that may apply to similar private enterprises.*

2. *The government should develop and issue an ownership policy that defines the overall objectives and rationale for state ownership and the state's role in the governance of SOEs. The policy should be backed by credible implementation mechanisms.*

3. *The exercise of ownership rights should be clearly identified within the administration and co-ordinated across the government. The preferred model should be rooted in a legal framework designed to ensure a high degree of professionalism and effectiveness. This can be facilitated by establishing a central ownership or a specialised coordinating entity at the cabinet level.*

4. *The government should develop and issue a typology separating SOEs according to their main objectives. The main classes might include: (i) commercial entities with mainly commercial objectives; (ii) Semi-commercial or partially subsidised entities carrying out mixed social/public and commercial objectives; (iii) Fully sponsored entities carrying out social/public objectives. Further to this:*

    a. *SOEs in the first category should operate according to objectives that are, to the largest extent feasible, consistent with private sector best practices.*

    b. *For SOEs in the second category a specification of their non-commercial objectives needs to be developed, publicly disclosed, and accounted for.*

    c. *For SOEs in the third category, these guidelines can be considerd good practice, but not fully applicable to the extent that such entities carry out no commercial activity.*

5. *The government should not be involved in the day-to-day management of SOEs. It should allow companies full autonomy to achieve their defined objectives. Nevertheless the State should exercise its ownership rights according to the legal structure, including:*

    a. *Being involved in board nomination processes, while ensuring that board objectivity and independence are maintained.*

    b. *Where the state owner has specific objectives for SOEs, these should be transparently communicated to the entire board via appropriate channels.*

    c. *Establishing adequate procedures for monitoring and assessing SOE performance.*

Annotations to Chapter II

***Recommendation 1**:* Government officials and politicians are not the owners of SOEs. They are the custodians of corporate assets whose ultimate owners are the tax payers and other members of the public. They should conduct this custodianship subject to obligations of loyalty and care – not unlike the fiduciary duties placed upon the members of a board of directors. An argument occasionally heard from public officials is that in 100% owned SOEs the State should be as free in its exercise of power (e.g. board nominations, appointment of managers, disclosure) as the owners of a 100% privately-owned firm. However, for the above reasons this argument fails to take into account the more complex environment in which SOEs operate. Effectively, the responsible ministers or SOEs' senior management may be held accountable to multiple stakeholders.

The key to ensuring responsibility at the highest levels of state is accountability and transparency. Good practice suggests that SOEs should undertake financial reporting and disclose financial and non-financial information to the public at a level not lower than what is applied to private enterprises listed on stock exchanges. Accountability toward the legislative powers also needs to be ensured. The government bodies responsible for the ownership of enterprises should report regularly to parliament, make themselves available to hearings before parliamentary bodies, and respond to written questions from parliament concerning corporate performance and ownership practices. The general public may inform themselves of these processes in accordance with national laws on freedom of information. Streamlined reporting should be considered to ensure that reporting bodies are able to meet their sometimes multi-dimensional reporting obligations.

Where responsible Minsters are held accountable for SOE performance, this should be conducted in accordance with the legal and constitutional requirements underpinning this arrangement. It should not be confused with, or lead to, undue interference in the day-to-day management of the company. The roles of all responsible parties should be clearly defined in the government ownership policy.

***Recommendation 2**:* A challenge within the region is for the government to define, at an aggregate level, its overall objectives and ownership practices for SOEs. An effective way of doing this is to develop an ownership policy, which as its starting point needs to provide a basic rationale for state ownership of (commercial) enterprises. An ownership policy helps the government avoid the usual pitfalls of either passive ownership or excessive interference that occur when SOEs are tasked with multiple or contradictory objectives. It can also serve as an effective tool for public communication, and it provides companies, market participants and the general public with an understanding of the state's objectives as an owner and its longer-term commitments.

The ownership policy is usually a short, high-level policy document, which may also summarise the most important elements of all other documents related to the state's overall strategy for its SOEs. It normally touches upon aspects of the government's ownership function (e.g. mandate and main functions), as well as the main principles underpinning the government's exercise of its ownership rights. Issues covered could include guidance on the nominations of directors, the role of general meetings, the role and functions of boards of directors, the appointment of external auditors, remuneration policies, etc. The ownership policy should clearly specify which government bodies are in charge of its implementation and what evaluations of implementation must be applied. The process of developing an ownership policy should be inclusive. To gain public acceptance of the state's role as an owner, consultations with all concerned parties are recommended, including the social partners, public servants and representatives of all parts of the political landscape.

In jurisdictions that place SOEs at the heart of their national development strategies, the ownership policy should ensure a coherent and consistent approach with attaining these and other economic objectives. In decentralised or coordinated ownership models, a challenge will be to align objectives set by line ministries for individual SOEs, with the government's broader development objectives. Defining a whole-of-government approach to ownership policy – i.e. ensuring co-ordination among the various state bodies – can help to avoid a situation where SOEs are faced with multiple and competing objectives.

***Recommendation 3**:* It is critical for the ownership function within the public administration to be clearly identified. The "ownership function" can be vested in a specialised ownership agency, a central economic ministry or divided among several economic and/or line ministries. Two considerations offer themselves: (1) the ownership of SOEs must be conducted on a whole-of-government basis so that, even if it may be divided among ministries, it reflects the collective will of the executive power; (2) the ownership function (however organised) must be conducive to the above-mentioned separation of the regulatory and ownership roles of government. Best practices in some countries indicate that the latter outcome is easier to obtain when the ownership function is vested in a central ownership agency. However, this model is not universally applied, and in Southern Africa it is, at best, in its infancy. The prevailing ownership models are the following:

- *A centralised ownership function.* This is an efficient way of ensuring the separation of ownership and control, provided that the ownership can be sufficiently well resourced and its operations shielded from ad-hoc intervention and irregular practices. The success of this model is also to some extent dependent of the quality of overall public governance, the legal environment and the political importance assigned to the ownership function. In weak governance zones pooling large amounts of corporate powers in a central agency carries obvious risks.
- *Dual ownership between an economic and a line ministry*. This serves to separate operational and financial responsibility and may be effective in enhancing accountability. It typically involves an economic ministry which is responsible for the SOEs' financial performance and a line ministry which oversees operations. The appointment of board members may take place by consensus or be divided between the involved ministers. Where line ministries retain regulatory functions, these need to be vested in autonomous units.
- *Decentralised ownership by individual ministries*. This is a preferred model only where the administrative knowledge to oversee SOEs is in scarce supply outside the relevant line ministries. An obvious example would be an economy where most of the important SOEs operate in utilities sectors with monopoly elements and extensive sector regulation. This model necessitates considerable coordination at the central levels of government.
- *A hybrid solution* has in some cases included dual or decentralised ownership combined with a coordinating agency – with distinct national differences regarding the agency's powers to "coordinate". The current state of affairs in a large number of countries in the Southern African region is to have a coordinating or advisory body providing technical and operational support.

***Recommendation 4**:* It is generally advisable to have a clear categorisation of SOE activities. Most governments – in the Southern African region and elsewhere – have an explicit or implicit categorisation demarcating SOEs with purely social/developmental objectives from those pursuing commercial activities. However, since many of the problems with public/private competition tend to be most pertinent in SOEs with mixed objectives it is clearly beneficial to add this as a third category. One example

of this is provided in the Malawi Code's Sector Guidelines for Parastatal Organisations and State Owned Enterprises (2011) (Box 2). The issue is further related to the point about legal forms of SOEs identified in the previous chapter, because SOEs with primarily non-commercial objectives tend to be more "weakly" corporatised than commercially operating ones. In some jurisdictions, the government portfolio of SOEs may include regulatory entities, public enterprises, parastatals or sectoral "boards", charged with purely non-commercial functions. Despite their corporate form, these entities fall largely outside the scope of these Guidelines. A clear categorisation of entities as described in Box 2 can help to differentiate between entities which carrying out government functions, as opposed to those with mixed or purely commercial functions.

Box 2. Defining and categorising SOEs, parastatal organisations and other entities

- A **Parastatal Organisation** is a public (wholly government-owned) corporate body that has been set up for a specific purpose. Parastatal organisations are clearly separated from the regular government administration and are given sufficient autonomy to pursue their objectives in a flexible manner. They are autonomous public bodies, without shareholders but controlled by the government exercising its rights and responsibilities as owner. Its objectives can either be fully social and public, or mixed social/public and commercial.
- A **Statutory Corporation** is an autonomous public corporate body set up under a special Act of Parliament (or of other legislative authority) or otherwise created by statute (trust deed or a fund order).
- A **State-Owned Enterprise** is a company established according to Company or statutory laws. It can be wholly or partially owned, with the government having a significant level of controlling ownership. SOEs have a mainly commercial objective, with an expectation to earn profits and bring in a revenue stream to the government budget.

These entities can be further broken down into three types of categories depending on their degree of funding/subsidisation by the State Budget and commercial versus non-commercial objectives:

- **Fully subsidised entities carrying out social/public objectives**: These entities are fully funded/subsidised by the government/state budget and have insignificant sources of revenue. They have a fully social and public objective character.
- **Commercial entities carrying out mixed social/public and commercial objectives**: These entities are partially funded/subsidised by the government/state budget and partially use their own sources of revenue. They have both social/public and commercial objectives. Some of their objectives have a commercial character with a potential for competition with/from the private "for profit" sector.
- **Commercial entities with fully or largely commercial objectives**: These entities are generally not funded/subsidised by the government/state budget and fully use their own sources of revenue. These entities mainly have commercial objectives as part of their core objectives and there is (a potential for) competition with/from the private "for profit" sector. Such entities are expected to earn profits and contribute revenues to the State budget.

Source: Adapted from Malawi Code: Sector Guidelines for Parastatal Organisations and State Owned Enterprises (2011).

In addition to a categorisation it is often advisable to develop company-specific objectives for individual SOEs. This is particularly the case for companies with mixed objectives, where it is almost impossible to enforce financial and managerial accountability in the SOEs unless their competing objectives have been spelt out in some detail. There are various options for communicating such "mandates" to individual firms ranging from the corporate bylaws, parliamentary decisions on the proposal of governments, performance contracts and corporate statements of intent subject to government approval. A case can be made for relying on regulation in preference over company-specific mandates, because it tends to be more transparent and make it easier to introduce competition at a later point.

Recommendation 5*:* A main reason for corporatising public sector activities is to place them at arms-length from general government. This does not imply that SOEs should operate without taking into consideration the state's objectives as an owner. The state ownership function should give direction to SOEs and their boards in the form of policies, corporate objectives and strategic issues. There should be public disclosure of the areas and types of decisions in which the ownership function is competent to give instructions. Closely equivalent to this, measures need to be taken (further described in a later chapter) to ensure that the board of directors is able to exercise its responsibilities in a professional and independent manner. If board members were to carry out their functions under a constant threat of removal from the board in the case of disagreements with the ownership function then this would be equivalent to ad-hoc interference in the operations of the SOEs. Rather, board members should not be guided by any political concerns when carrying out board duties.

However, this does not mean that the state should not act as an informed and active owner of SOEs – and in some countries the government is indeed constitutionally required to do so. On the contrary, it has a duty to fully exercise its ownership rights in the public interest. Like in private companies this includes being represented at the general shareholders meetings and voting its shares. Regarding the appointment of directors, the ownership function needs to be involved in designing a transparency nomination process, which is clearly structured and based on verifiable skills and experiences of the candidates. The ownership function has the power to communicate the government's expectations to individual SOEs, but it should do so in accordance with the aforementioned considerations and as part of an engagement with the entire board rather than bilaterally *vis-à-vis* individual directors or company managers. Finally, the ownership function should establish reporting systems to allow regular monitoring, reporting and assessment of SOE performance. Accountability is basically not feasible in the absence of regular monitoring, so this needs to be enshrined in legislation as a key priority. Monitoring and assessment are related to the previous point about clarity of objectives: both are virtually impossible to conduct unless the state's expectations of the individual enterprises have been clearly specified.

III. EQUITABLE TREATMENT OF SHAREHOLDERS AND OTHER OUTSIDE INVESTORS

Recommendations

1. *Relevant government agencies and the SOEs themselves should ensure that all shareholders are treated equitably.*

2. *SOEs should observe a high degree of transparency towards all shareholders. In particular, they should ensure that material information is disclosed to minority shareholders at the same time as it is communicated to the government owner.*

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 in order to allow them to take part in fundamental corporate decisions.*

5. *When SOEs engage in undertakings such as joint ventures, strategic partnerships or public-private partnerships care must be taken to ensure high levels of fairness and transparency. This includes:*

    a. *Upholding basic contractual rights. Where renegotiations become necessary, these should be conducted in good faith in a transparent and non-discriminatory manner.*

    b. *Establishing dispute resolution mechanisms through which disputes can be handled in a timely and impartial manner.*

    c. *Ensuring appropriate due diligence and risk management strategies at the governmental and company levels.*

Annotations to Chapter III

Recommendation 1*:* Whenever a part of a SOE's capital is held by private or other outside shareholders the state should recognise their rights and this should be embedded in the company law. As a dominant shareholder the state is in many cases able to make decisions in general shareholder meetings without the agreement of other investors. This is a legitimate right that follows with ownership, but it is important to establish safeguards against abuse. These could include mechanisms to ensure representation of minority shareholders in the SOEs' boards of directors and developing shareholder agreements. Another area of special interest is the pursuit of public policy objectives through the actions of SOEs. It is important to ensure that such measures are not decided purely by majority vote and to the detriment of the minority shareholders. As discussed earlier, this should be done by clarifying any such objectives prior to the investment by outside shareholders and/or by compensating the SOEs adequately for any costs incurred.

Recommendation 2*:* The protection of minority shareholders is hardly feasible unless a high degree of transparency is ensured. Minority and other shareholders should have access to all necessary information to be able to make informed investment decisions. This applies to the disclosure of financial information and non-fiancnial information such as board member nominations, including possible conflicts of interest, and of arrangements potentially influencing the voting pattern at annual general meetings, such as shareholder agreements.

A distinction may be drawn between SOEs whose shares (or bonds) are publicly traded and the rest. Although only a few countries in the region have prior experience with this type of ownership arrangement, the issue deserves increasing attention as policy makers explore the options available to broaden the ownership of their SOEs through the stock market. In the first case it is crucial to ensure simultaneous reporting of information to all shareholders so as to prevent the government from having access to privileged information. Rules may be needed to ensure that public sector representatives on SOE boards of directors are subject to confidentiality rules, prohibiting them from disclosing boardroom information to their employers. In the case of non-listed SOEs other shareholders are usually well identified and often have privileged access to information. However, whatever the legal and regulatory framework concerning disclosure of information, the company shall be held accountable for ensuring an equal access to information for all shareholders.

Recommendation 3*:* State-owned enterprises should identify their shareholders and keep them duly informed in a timely fashion regarding corporate performance, material events and forthcoming shareholder meetings. It is the responsibility of SOEs' boards of directors to make sure that the company fulfils its obligations in terms of providing information to the shareholders. Where possible, active consultations with minority shareholders will help improve decision making processes and secure a wider acceptance of key corporate decisions.

Recommendation 4*:* It is good practice for all major decisions affecting an SOE – even where the state is the overriding shareholder – to be made at annual, or if needed extraordinary, shareholder meetings. Participation in general shareholder meetings is a fundamental shareholder right. To encourage minority shareholders to participate actively in shareholder meetings and exercise their rights special mechanisms could be developed. This could be usefully linked with the board annual calendar. Even where non-listed SOEs are concerned these could be modelled on the rules that in many jurisdictions apply to listed companies. Options include qualified majorities for certain shareholder decisions and the possibility to use special election rules, such as cumulative voting. Additional measures should include

facilitating voting in absentia (for instance through electronic means) and other initiatives to reduce the cost of participating in the decision process.

At the same time, rules to protect minority shareholders need to be carefully balanced against the state's legitimate rights as a majority owner. The protections should not allow minority shareholders – except where the latters' basic rights appear at risk – to hold up the decision-making process.

Recommendation 5*:* Cooperation between SOEs and private enterprises, including in the form of joint ventures and public-private partnerships (PPPs) is on the rise in a number of jurisdictions in Southern Africa, especially for large infrastructure projects. Such cooperation may enhance the availability of technology, know-how and "patient capital" for public policy purposes and should be encouraged, subject to the usual legal safeguards for such arrangements including public procurement rules. At the same time, it may raise the bar for the corporate performance of the SOEs. It also accentuates the need for strong measures to ensure transparency and a level playing field, especially when the partner companies are based in jurisdictions where such standards are at a comparably high level. The basic premise of PPPs is that the public and private sector are partners. This implies that both sides of the deal can be ensured that any problems that may occur are addressed in solidarity and do not lead to a competitive unloading of burdens onto the "partner". Among the priority areas are the following[2]:

- *Contractual rights*. The formal agreement between the public and the private sector participants should be specified in terms of verifiable services to be provided to the on the basis of output or performance based specifications. It should contain provisions regarding responsibilities and risk allocation in the case of unforeseen events. At the same time, it must be recognised that occasional renegotiations are inevitable in long-term partnerships, but they should be conducted in good faith, in a transparent and non-discriminatory manner. No contract is flexible enough to cover every eventuality, but it is important that any modifications be done in a way that respects the "balance of the contract" – i.e. which has a balanced effect on each contractual partner. The best way of balancing the sanctity of contracts with the necessary flexibility may be to include contractual stipulations specifying under what circumstances adjustments to the original agreement may be considered. This can also go a long way in giving assurances and building confidence that investments are secure (especially where there has been a history of abrupt nationalisations or other breeches of contract).

- *Dispute resolution.* Dispute resolution mechanisms should be in place through which disputes arising at any point in the lifetime of a project (especially in infrastructure) can be handled in a timely and transparent manner. Long-term commitments with the public sector are seen as notoriously risky by private enterprises unless they are backed by impartial and independent forums for dispute resolution. Where the rule of law is firmly entrenched and underpinned by an impartial and efficient judiciary, private sector participants may be inclined to resolve disputes in domestic courts or arbitration tribunals. Where this is not the case, the public authorities can contribute to a "fair" outcome of disputes by making it their option of choice and, where appropriate, establish mechanisms through which disagreements will be handled.

[2] This section draws inspiration from OECD (2007), *OECD Principles for Private Sector Participation in Infrastructure*, Paris. Readers may wish to refer also to the SADC PPP Regional Framework and other existing national and regional agreements.

- *Risk management.* It is commonly agreed that in the case of PPPs (and most other partnerships), risks should be allocated to those of the partners which are the best placed to assess and manage them. However, this does not absolve all involved from ensuring proper risk management and undertaking due diligence. This applies to the state as an owner, who needs to form an informed opinion of contingent liabilities and other risk factors; to the SOEs that need to enshrine proper risk governance at the board level; and private enterprises which should not enter into engagements acting purely upon information provided by their public sector partners.

IV. CORPORATE ETHICS AND STAKEHOLDER RELATIONS

Recommendations

1. *Governments and SOEs themselves should respect the legal and contractual rights of creditors, employees and affected communities. These groups should have access to legal redress if they consider that their rights have been violated.*

2. *The boards of SOEs should be required to develop, implement and communicate internal codes of ethics. These should apply to all employees, senior management and the board members themselves. The codes should include:*

   a. *Effective measures to combat bribery, kickbacks and other corrupt practices.*

   b. *Rules limiting conflicts of interest and ensuring adequate disclosure, including with regards to public procurement practices.*

   c. *Rules discouraging discrimination and nepotism.*

3. *The board should ensure that the company's ethics are managed effectively and that the company's ethics performance is assessed, monitored, reported and disclosed.*

4. *The government should communicate its expectations to SOEs regarding corporate responsibility. These should normally include societal and environmental performance plus, where relevant, legal compliance. The government should be mindful of the following:*

   a. *Corporate responsibility is anchored in the SOEs' identity as good corporate citizens. It is unrelated to charitable spending and should not be used to finance societal and environmental responsibilities that more properly reside with the government.*

   b. *The boards of directors are responsible for implementing corporate responsibility. This may involve dialogue with the government, but it should not become a conduit for ad-hoc intervention.*

Annotations to Chapter IV

Recommendation 1*:* A healthy relationship with "stakeholders" (i.e. creditors, company employees and others affected by any given SOE's activities) is in the best interest of state-owned enterprises. This is particularly the case for SOEs that have been tasked with public policy priorities, who often need to communicate with the general public in their pursuit of these priorities. At the same time, as a dominant shareholder the government is in a position to take decisions that are potentially to the detriment of stakeholders. Here, the issue of protecting the creditors and employees may be part of the board members' fiduciary obligations – especially where the latter are specified not only vis-à-vis the shareholders but the company as well. Where stakeholders have not been adequately consulted, this has occasionally led to disruptions in the SOE operations.

It is therefore important to establish mechanisms and procedures to protect stakeholder rights. Doing so is principally the responsibility of the state ownership function, which must ensure that all rights established by law, regulations and mutual agreements are respected. Obtaining this in practice depends to a large extent on implementation rather than rule-making. Where the rule of law is weak, or the powers of state are great, there may be ample potential for SOEs favoured by policy-makers to flout rules and regulations. Examples in the past have allegedly included land acquisitions without adequate compensation, violations of labour rights and derogations from environmental legislation. Such examloes demonstrate why a clear separation of ownership and regulatory functions (discussed above) is recommended. A separate issue relates to the enforceability of rules, regulations and contracts. The protection of stakeholder rights may be an essentially moot point unless SOEs operate in a legal environment where (1) the courts are empowered, and prepared, to issue rulings that go against the perceived interests of senior public officials; and (2) law enforcement officials are empowered, and prepared, to enforce such rulings.

Identifying all relevant stakeholders in advance will help to avoid capture by specific constituencies, as it ensures that all relevant stakeholders have been identified, and that the extent or limits to their rights, powers and interest in the company have also been determined. Such "mapping" can be elaborated, above and beyond the rights established by laws, in guidance notes, sector guidelines or corporate governance frameworks as is done in a number of jurisdictions in the region.

Recommendation 2*:* It is generally in the long term interest of a company to apply high ethical standards in order to make itself responsible in the conduct of its business. The case is even stronger for SOEs, given the interaction of business considerations with public policy ones. Moreover, high ethical standards are also important because SOEs in many economies play an important role in setting the "business tone" of their home countries. SOEs should, therefore, under the leadership of their boards of directors and senior managements, develop internal codes of ethics committing themselves to comply with country norms and in conformity with broader codes of behaviour. These codes of ethics should give clear and detailed guidance as to the expected conduct of management, employees, and other stakeholders and be backed by compliance programmes. This can be further reinforced through employee awareness-raising programmes aimed to help identify corruption and to take appropriate action. Several areas could be covered:

- The fight against corruption is of paramount importance. State-owned enterprises, if not properly checked, can act as veritable poles of corruption, acting both as bribe solicitors and themselves engaging in bribery. Commercial SOEs may be under pressure to bribe to stay in business, especially where such practices are common place among private competitors in certain industries. SOE officials can be bribed by private companies to obtain lucrative contracts and other abusive business contracts. SOEs may also be prone to corruption

through privatisation processes or in their public procurement practices. Likewise, SOEs can be victims of abuse and fraud by their own employees. Regardless of whether it is passive or active, bribery is deeply harmful to the corporate performance of the SOE. The benefits of a transparent enterprise culture are voided if corruption is tolerated, because corrupt practices are by nature non-transparent. Moreover, proper incentive structures, linked to operating performance, are key to motivating employees and executives. In a corrupt environment the state may find itself rewarding dishonesty rather than merit. The application of international and regional conventions on anti-corruption should also apply to the commercial activities of SOEs, regardless as to whether the SOE is an active or passive party.

- Conflicts of interest need to be avoided, or managed, at the levels of individual corporate officers, SOEs and the state ownership function. SOE employees should generally not participate in corporate transactions that have an impact on the earnings (other than their remuneration) of themselves or persons close to them. At the overall corporate level managers and board members should declare any conflict of interest to the entire board, which will be responsible for monitoring the situation and, if necessary, recuse the person concerned from certain decision processes. Mechanisms must also be established to prevent commercial transactions of SOEs, including in public procurement, (including with companies whose beneficiary owners are not clearly established) that lead to irregular practices such as illicit party financing, graft by public officials, etc.

- Employment opportunities in SOEs need to be contestable and open to all qualified individuals. Discrimination on the basis of race, gender, creed, etc. should be clearly ruled out, except where justified by transparent national affirmative action or other policies to promote under-represented groups. Moreover, nepotism (i.e. employment on the basis of personal connections) and the use of SOEs as a source of political patronage should be clearly ruled out by the corporate rules of ethics.

The codes of ethics should include mechanisms to protect and encourage stakeholders (particularly employees) to report on illegal or unethical conduct by corporate officers. In this regard, the ownership functions should ensure that SOEs under their responsibility put in place safe-harbours for complaints for employees or for others outside the company. This could include the creation of a whistle-blower facility, for example in the form of a direct access to an independent board member, a board committee, or an ombudsman placed within each SOE; the facility should ensure that the whistle-blower is adequately protected. At the same time, any allegations that are not made in good faith should be subject to consequences.

Recommendation 3*:* Monitoring corporate ethics is principally the responsibility of the board of directors. Not only are they ultimately responsible for SOEs' corporate performance, but according to most national legislation each board member should be subject to duties of loyalty and care toward the company and its shareholders. For reasons outlined above, unethical practices is a risk that needs to be constantly monitored. The responsibility is, however, not limited to the board. An ownership function also needs to monitor the ethics performance of the SOEs it oversees. According to national legislation and administrative traditions it may rely to some extent on the independent state audit body in these efforts, or involve outside evaluator including from the private sector.

Internal assessment of the company's ethics performance as well as internal reporting on its ethics performance are necessary to provide the board and management with relevant and reliable information

about the achievement on ethics objectives, the outcome of ethics initiatives and the quality of the company's ethics performance. External assessment and disclosure of the company's ethics performance is also necessary to provide internal and external stakeholders with relevant and reliable information about the quality of the company's ethics performance. The ultimate objective of assessment, reporting and disclosure is to improve the company's ethical culture by enhancing its ethical performance. Assessing, reporting and disclosure of ethics performance should enable users of reports to form opinions and make decisions based on disclosed and verified information.

Recommendation 4*:* Corporate responsibility (also known as responsible business conduct) should be anchored in corporate governance, but care should be taken not to confuse the two. Like most private enterprises SOEs and their owners have an interest in being perceived as "good corporate citizens". In fact, if a reputational risk arises from being ill-perceived by the public then dealing with this issue would be considered part of the board's fiduciary responsibilities. At the same time, companies' attention to responsible business conduct should reflect the choices of their owners. Unless the State ownership function makes its expectations in this respect clear to the SOEs, the pursuit of corporate responsibility (like other objectives not directly related to profit maximisation) can become a cushion against managerial accountability.

Governments would normally communicate to their enterprises expectations regarding environmental standards, any social concerns and occupational health or safety standards to be taken into account in their operations. This can be expressed in integrated reporting by which companies report not only on their financial performance but also on their environmental and community impact (e.g. through so-called "triple bottom-line reporting"). Where a strong rule of law prevails these expectations come on top of legal requirements. In weak governance zones they may have to be supplemented by requirements on legal and regulatory compliance, which would be further reflected in the SOEs' codes of ethics. Conversely, corporate responsibility should normally not extend to an obligation to engage in charitable acts. Some SOEs are charged with obligations to provide social services to employees or affected communities which would more properly reside with the public authorities. Others have occasionally been instructed to bankroll investment and other projects unrelated to their corporate charters. Such practices are inconsistent with high standards of state ownership and corporate governance and, where commonly found, amount to ad-hoc interventions in, and fiscal haemorrhaging of, state-owned enterprises under the guise of corporate responsibility.

V. TRANSPARENCY AND DISCLOSURE

Recommendations

1. *The government should ensure consistent aggregate reporting on the operations of SOEs, and publish annually a report providing aggregate and company-specific information.*

2. *SOEs should establish an internal audit function that is monitored by, and reports to, the board of directors. The work of this function should be anchored in efficient and implementable internal audit procedures.*

3. *Those institutions exercising ownership rights should be held accountable to representative bodies such as Parliament and state audit institutions.*

4. *SOEs should be subject to an annual independent external audit based on (especially where large SOEs are concerned) international financial reporting standards.*

5. *SOEs should be subject to the same high quality accounting standards as listed companies. Large SOEs should disclose financial and non-financial information according to high quality internationally recognised standards.*

6. *SOEs should disclose material non-financial information, focussing on areas of significant concern for the state as an owner and the general public. Examples of such information include:*

   a. *Any material risk factors and measures taken to manage such risk.*

   b. *Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE.*

   c. *Any material transactions with related entities.*

   d. *Governance structures, including with a view to identifying potential sources of conflict of interest.*

Annotations to Chapter V

Recommendation 1*:* Aggregate reporting is not commonly practiced among the Southern African economies. Nevertheless it is good practice for the ownership function to develop aggregate reporting that covers all SOEs (ideally this would aggregate information on all SOEs, even in a dual/decentralised model). The reporting should be developed in a way that allows readers to obtain a clear view of the overall performance and evolution of the SOE sector. The aggregate reporting should result in an annual report issued by the state. This aggregate report should primarily focus on financial performance and the value of SOEs, but also provide non-financial information such as for example changes in the composition of the boards of directors. It should also include a general statement of the state's ownership policy and how the state has implemented this policy. Any categorization of SOEs according to their commercial/non-commercial orientations should be disclosed, as should all financial and non-financial objectives communicated to individual state-owned enterprises. Aggregate reporting should not duplicate but complement extant reporting requirements in respect of political accountability, such as for example a duty to provide annual reports to national parliaments.[3]

An advantage of aggregate reporting is that it provide a measure of predictability around the state's overall performance as an owner. It serves as a communication tool vis-à-vis the general public, explaining government priorities and establishing basic accountability. There can also be important intra-governmental benefits. Where the ownership function is divided among a number of ministries or government departments, an obligation to perform annual reporting on a comparable basis can help public decision makers (1) obtain an overview of the public sector's corporate engagements; and (2) foster cohesion and a shared adherence to certain minimum standards across the general government.

Recommendation 2*:* Internal auditors have a unique position in their ability to scrutinise governance practices, and monitor the implementation of risk-management policies, internal controls processes, etc. Internal auditors constitute the first level of review of the quality of information concerning the extent to which the organisation has achieved its objectives. The state ownership function should require all SOEs under its control to have appropriate procedures for internal auditing in accordance with internationally agreed standards. It should also encourage internal auditors to focus not only on compliance but also on performance and risk.

Internal audit functions provide important reassurance to boards of directors (including through board audit committees where such exist) that they are provided complete and reliable information by top management. Internal auditors should work on behalf of and report directly to the board. They should have unrestricted access to the Chair and members of the entire board. Governments in some countries have attempted to substitute for some of the functions of an internal audit function by letting some form of public sector comptroller carry out control functions within individual SOEs. However, in many cases this has resulted in a "trust gap" between boards of directors left without independent verification mechanisms of the executive management. Good practice suggests that establishing independent board audit committees can play an important role in this regard as well as more generally.

Recommendation 3*:* Reporting to Parliament is important for the overall process of transparency and accountability, including in relation to public budget processes. It requires a process of compilation and checking that includes a large number of parties, such as the SOEs themselves, ministries, parliamentarians (and their support staff), the public and the media. Accountability is achieved through

[3] Extensive additional guidance is provided by OECD (2010), *Accountability and Transparency: A Guide for State Ownership*, Paris.

the interaction of various parties in what has been described as “disclosure dynamics”. In most countries reporting comes in three main forms: (1) periodic reporting, typically a legal requirement on an annual basis and associated with the approval of state budgets (as is typically the case in many Southern African economies, through “Public Financial Management Acts” or similar legal requirements); (2) *ad hoc* reporting deriving from the capacity of parliament to demand and receive information on issues such as changes in ownership, employment conditions, etc.; (3) reporting for approval where legislation requires the prior agreement of parliament before certain decisions are made.

Recommendation 4*:* As is often required by company laws, an annual external audit is needed to provide the board and shareholders with an independent, critical and objective report on how financial statements have been prepared and presented. They are carried out to ensure that accounts fairly represent the financial position and performance of the company in all material aspects. As a general rule, auditing standards corresponding to best-practice private sector enterprises should be applied to SOEs. The use of these standards will significantly improve the credibility of audits and also help ensure comparability between the published accounts of SOEs and private companies.

The external auditors should be accountable to the shareholders via the boards, and not to the SOE managers they work with while performing their assignment. Consequently, it is considered good practice that external auditors are appointed by the annual shareholders meeting upon the recommendation, where applicable, of the board audit committee. In addition to being competent and qualified, it is essential to ensure that the external auditors are effectively independent. The State ownership function should put in place safeguards, and perhaps establish specific principles or standards aimed at reinforcing auditors’ independence. External audit should not replace accountability mechanisms, including being accountable to Parliament or state audit institutions.

Recommendation 5*:* In the interest of the general public, SOEs should be as transparent as publicly traded corporations. Regardless of their status, all SOEs should report according to best practice accounting standards which include disclosing financial and non-financial information (large SOEs should do so according to high quality internationally recognised standards). This implies that SOE board members sign financial reports and that the firm’s top management certify that these reports appropriately and fairly represents in all material respects the operations and financial condition of the SOEs.

In the interest of public sector efficiency, it may be necessary to exempt SOEs under a certain size from some of the suggested financial and non-financial reporting requirements. Such exceptions can only be decided on a pragmatic basis, and will very among countries and industrial sectors. Specifically, a high level of disclosure is valuable where SOEs pursue important policy objectives. This is further amplified where these SOEs have a significant impact on public budgets or where their operations entail non-trivial risks carried by the state. In some countries companies that are entitled to government subsidies for carrying out services of general interest are required to keep separate accounts for these activities. This can be ensured through the use of arms-length “management contracts” between the government and SOEs.

Recommendation 6*:* In addition to financial reporting, SOEs should be requested to disclose non-financial information including in areas such as company objectives, remuneration policies, governance structures, foreseeable risk factors and related party transactions. SOEs should disclose whether they follow any code of corporate governance and, if so, provide details of implementation of the provisions of such codes. SOEs should be particular vigilant and strive to improve transparency in the following areas:

- *Material risk factors.* Severe difficulties arise when SOEs undertake ambitious strategies without clearly identifying, assessing or duly reporting on their related risks. Disclosure of material risk factors is particularly important when SOEs operate in newly deregulated and competitive sectors. Appropriate disclosure by SOEs of the nature and extent of risk requires the establishment of sound internal risk management systems. SOEs should be expected to report on "off-budget" (off balance sheet) assets and liabilities, including such as occurring in consequence of their participation in public-private partnerships.

- *Financial assistance from the state.* To provide a fair and complete picture of an SOE's financial situation it is necessary that mutual obligations, financial assistance between the state and the enterprise are appropriately disclosed. Disclosure should include details on any state grant or subsidy received by the SOE, as well as any guarantee granted by the state toward the operations of the SOE.

- *Material transactions with related entities*. Transactions between SOEs and related entities, such as an equity investment of one SOE in another, can be a source of abuse and should be disclosed. However, in economies with a large number of SOEs the number of "related party transactions" will be very large which means that governments should pay close attention to, and disclose their approach to, the materiality criterion. An area of particular concern occurs where SOEs are permitted to amass large payment arrears vis-à-vis state-owned business partners. This may effectively be a way of providing public funding, circumventing the rules normally pertaining to such transactions.

- *Governance structure.* Where SOEs are majority-owned by governments it is important that their ownership and voting structures are transparent, so that all shareholders have a clear understanding of their share of cash-flow and voting rights. Any special rights or agreements that may distort the control structure of SOEs, such as shareholder pacts, golden shares or powers of veto, should be disclosed.

VI. THE BOARD OF DIRECTORS

Recommendations

1. *The board of directors has the ultimate responsibility for an SOE's performance. The board should be fully accountable to the owners and act in the best interest of the shareholders and the company.*

2. *To fulfil its mandate a board needs to fulfil key roles. It must (1) develop or approve corporate strategies to achieve the objectives that the state has communicated to the SOEs; and (2) monitor senior management's implementation of the strategies.*

3. *The board of directors should have the power to appoint and remove senior management. This may involve a process of dialogue with government, but the ultimate responsibility must reside with the board.*

4. *The boards of SOEs should be composed so that they can exercise objective and independent judgement. This implies that they should be unconnected with the highest levels of government and appointed on the basis of professional merits.*

5. *Board nomination and appointments should emulate best practices as closely as feasible, including those applicable to private enterprises. This implies:*

   a. *To the extent feasible, the appointment (and removal) of board members, even in wholly owned SOEs, is the responsibility of the annual shareholders meeting.*

   b. *Nominations should be based on a transparent, contestable and merit-based appointment process where candidates can put their names forward and have their qualifications evaluated.*

   c. *Board remuneration must be sufficient to attract candidates with the necessary qualifications (including, where relevant, from the private sector), but not rise to a level perceived as excessive by the general public.*

   d. *The role of the Chair is crucial. Chairs should not dominate boards but it is their responsibility to secure that the boards work efficiently and in a collegial manner.*

6. *SOE boards should carry out an annual evaluation to appraise their performance, that of the board committees and the CEO. The outcome of the evaluation should be used to inform future board and management appointments.*

Annotations to Chatper IV

Recommendation 1*:* The board of directors is the highest decision-making body of a state-owned (and any other) enterprise. This implies that directors are there to add value and enhance corporate performance – rather than to exercise a controller's function on behalf of the state. In order to fulfil this, boards should act as collegial bodies, and most specifically not act as representatives of specific interests. In a number of countries, however, SOE boards tend to be large and lack business experience or business perspective. Empowering and improving the quality of SOE boards is a fundamental step in proving the governance of SOEs. It is important that boards can act in the interest of the company and effectively assess corporate strategies, direct and monitor their implementation by senior management.

In principle, SOE boards should have responsibilities and liabilities that do not differ from those stipulated in national company laws. Governments that are serious about reforming SOE board practices often use companies listed on the stock market as a yardstick. However, in practice – and especially where designated "directors for the State" are involved – SOE board members benefit from reduced liability. It is essential and should be emphasised in relevant rules and regulations that *all* board members have same fiduciary duties, in other words a legal obligation to act in the best interest of the company and its shareholders. If the state needs to give instructions to a SOE then it needs to do so through the proper channels, involving communication with the *entire* board and not act through individual directors or the executive management.

Recommendation 2*:* In many instances SOE boards are not granted full responsibility and the authority required for strategic guidance, monitoring of management and control over public disclosure. SOE boards may see their roles and responsibilities encroached both from above (by the state ownership function) and from below (by senior management). The traditions of public governance in some countries may tempt government officials to perceive SOEs as executive arms of the state, which creates a tendency to intervene directly in corporate processes. Furthermore, in some countries there is a strong link between management and the executive powers, which may allow the former to effectively circumvent the boards of directors. This challenge can be further exacerbated should boards of directors be removed due to changes in government. Some jurisdictions may consider that the tenure of board members should be secured for a prescribed period of time in order to shelter boards from political processes or undue interference. Board dismissals prior the end of tenure should take place only for a cause. Generally, directors should be removed before the end of their term only for a cause – i.e. a breach of duties, unlawful behaviour or any conflicts of interest that may have arisen following their appointment. The board evaluation procedures may help identify board members who are not performing according to their professional responsibilities.

In order to carry out their role SOE boards should actively (i) formulate (or approve), monitor and review corporate strategies within the framework of the overall corporate objectives communicated by the ownership function; (ii) establish appropriate performance indicators for the company and its key executives; (iii) identify key risks and take appropriate steps to assess and manage them; (iv) direct, assess and monitor the performance of the executive management's performance; and (v) develop effective succession plans for key executives. In order to make informed decisions boards should, when appropriate, be supported by board committees who can inform the board with proposals on specific topics such as auditing, risk and remuneration. It can also be useful to enshrine established board policies and practices in written documents such as board charters.

Recommendation 3*:* The appointment and removal of the corporate executive officer (CEO) should be a key role for an SOE board. If CEOs feel that they "owe their jobs" to the executive powers in government or the ownership function then it is virtually impossible for SOE boards to exercise their monitoring function and assume full responsibility for corporate performance. That said, it is unrealistic to expect that a government will not want to exercise a degree of control over who manages (at least) the country's largest SOEs. This implies that some form of joint-decision making process may have to be established, which could for instance involve consultative mechanisms between the board (or solely the Chair) and the ownership function. In other countries boards of directors involved the state in the appointment of CEOs in the following ways: a) the decision can be subject to a veto from the state owner, b) candidates are subject to a vetting procedure hosted by the ownership function; or c) a candidate is selected from a shortlist proposed by the ownership function.

A corollary issue relates to CEO and executive management remuneration – SOE boards should decide, subject to applicable rules established by the state, the compensation of the CEO and executive management. Remuneration should be tied to performance and duly disclosed. Claw back provisions may be considered to grant the company the right to recover compensation paid to executives in cases of managerial fraud and similar circumstances, such as non-compliance with financial reporting requirements. A number of governments have put in place limits of SOE executive remuneration graduated according to entity size and sector of operation.

Recommendation 4*:* If SOE boards are to feel empowered to fulfil their duties to monitor management and determine corporate strategies then they must be structured in such a way that they are capable of objective and independent judgment. This means that, they should not act as individual representatives of the constituencies that nominated them. It also implies that mechanisms must be established to protect them from undue political interference, which could detract them from carrying out their duties in the interest of the company and its shareholders.

While separation of the role of Chair and CEO (in companies with a one-tier board structure) is generally good practice, it is particularly important in state-owned enterprises. The respective roles and responsibilities of the CEO and Chair should be clearly defined. The separation of these roles is viewed as necessary to underscore the separation of oversight and executive functions. The Chair has a key role in guiding the board, ensuring its efficient running and encouraging the active involvement of individual board members in strategic decisions. This is hardly feasible when the CEO doubles as Chair and hence in theory would have the responsibility of guiding – and influencing the composition of – the body charged with monitoring his/her own performance.

The risk of political interference in the appointment of CEOs further exacerbates this problem. The appointment (and removal) of the CEO should be vested with the board, and based on a competitive recruitment process, sheltered from political interference. The risk is that a state appointed CEO will take instructions directly from political circles, circumventing the role of board of directors.

A central requirement to enhance the objectivity of SOE boards is to nominate a sufficient number of competent non-executive board members who are capable of independent judgement – independent from management, government and business relationships. These independent board members should have relevant commercial competences and experiences and it is strongly advised that they be recruited from the private sector. It will help make boards more business focused – a key consideration particularly in SOEs that operate in commercial markets. However, the expertise sought in SOE directors may – especially in companies with significant public policy obligations – include an understanding of the political environment in which the SOE has to operate. In all cases, board members should disclose any conflicts of interest to the board, which must decide how these should be managed. Other requirements

for board composition may also exist, including ensuring gender parity and minority representation, which can help to ensure more diverse, representative boards. To effectively fulfil their role, SOE board members should maintain regular attendance at all board meetings.

In most jurisdictions, members of government (often civil servants and even sometimes ministers or other persons related to the executive power) are represented on boards of directors, thus the question of board independence is of real concern. The risk is that boards will no longer be protected from undue and direct political interference that could detract from focusing on achieving objectives agreed with the government and the ownership function. Persons directly linked with the executive powers should not sit on SOE boards. Other state representatives should be nominated based on qualifications, subject to specific vetting mechanisms, and should be balanced with an adequate number of independent board members. Some jurisdictions also place limits on board size to ensure board effectiveness.

To encourage well-performing boards, a number of tools can be developed by the ownership function. These include board charters, shareholder compacts, board remuneration schemes, and evaluation tools. Governance tools should be developed in an interactive manner, including input from boards. Board charters can serve to : define the vision and mission of the SOE; recite the legal and fiduciary duties of individual board members; define policy relating to board composition and selection; define independence; recite legal requirements relating to conflicts of interest by board members (including those arising when government officials serve on boards); and determine the board committee structures.

Recommendation 5*:* The nomination of the board of directors in fully state-owned companies is almost invariably a government responsibility. According to ownership structures (centralised, dispersed or dual structures) this may rely on individual ministers or the entire cabinet and/or executive powers which exercise the formal nomination power. In exercising these powers, ministers should be mindful that they are custodians of the public interest. The process should be rules-based and overseen by a governmental ownership function (which could be central, co-ordinating or placed within a ministry). Insofar as the ownership function has discretionary powers, it is well advised to exercise them along private sector practices. Specific considerations include:

- Where governments are the sole shareholder in a company they obviously have the right to appoint the whole board of directors. However, good practice calls for this to be done via the annual general shareholder meeting. Especially where SOEs operate according to company law, which among other things implies the filing of minutes with company registries; this is an important source of transparency and accountability.

- While the nomination powers may be vested in one or several ministries (even in countries with a centralised ownership agency it is rare for it to hold absolute powers over board nominations), rules and procedures need to be established to guide them. Some countries have established purely advisory bodies which, though formally do not exercise the nomination power, have nevertheless been able to improve the independence and professionalism through their advocacy and a heightened transparency around the nomination process. Some countries have gone further in establishing formal checks and balances on ministerial powers, including:

    - *Pre-declaration of formal qualification requirements.* Some countries stipulate in law minimum formal qualification that individuals must possess to be eligible for board nomination. Where such exist they are usually backed by some form of accreditation mechanism attached to the ownership function.

- *Processes to vet ministerial appointees.* Vetting of ministerial nominees may take place on an informal basis, or backed by specific procedures. Two models are found in different jurisdictions according to which the ownership function may either (1) proactively put a slate of suitable candidates before the nominating minister(s); or (2) reactively advice the minister(s) on the suitability of their proposed nominees.

- *Nomination committees.* Large SOEs – following a practice also used by a number of listed companies – may have external nomination committees attached to their annual general meetings. These committees may contain both civil servants and private sector representatives. For companies in mixed ownership it makes sense for such committees to be elected by the AGMs.

- Board remuneration can be a politically contentious issue, but it must be tackled to balance public opinion (usually hostile toward high salaries in the public sector) with the need to attract qualified directors. This issue is linked with the independence of directors and the accountability of the nomination procedures, because the public resistance to market-consistent board remuneration is almost invariably stronger when there is a perception that directors have not been appointed on the basis of merits. As a general rule, board members (contrary to the executive management) should not be incentivised through performance-linked pay. Such incentives are more appropriately created through specific guidance, for instance articulated in the form of board compacts. Some countries have devised a system of classification of SOEs (i.e. into those which are mainly commercial from non-commercial) which also takes into account assets, revenues and employment, to determine remuneration levels of senior managers and boards of directors.

- The chair of the board is the interface between the state, the board, and the executive. Its role in liaising with the ownership function is seen as an important channel of communication. The chair must understand the business and ensure compliance with all legal and statutory obligations. At minimum, the following roles should be assumed by the chair: set the board agenda; facilitate the flow of information and discussion; conduct board meetings and other business; ensure the board operates effectively; liaise with and report to the minister or ownership function; review board and organisational performance; and induct and support new board members. Since the role of chair requires a significantly greater contribution in time and workload this should be taken into account when considering the accumulation of board roles and in remuneration.

Recommendation 6*:* A systematic evaluation process is a necessary tool in enhancing SOE board professionalism. Evaluations can be useful tools to inform the board nomination process and can also feedback into the board nomination process. This process serves to highlight the responsibility of the boards and its members; it can be instrumental in identifying necessary competencies and board member profiles; and it is a useful incentive for individual board members to devote sufficient time and efforts to their duties. The evaluations could also be instrumental in developing effective and appropriate induction and (continuous) training programmes for new and existing SOE board members. At the same time, it is important that board reviews be performance based rather than simply focusing on mechanistic elements such as such as attendance levels and the number of interventions. Most countries adopt one of two approaches: either the ownership entity conducts an external review of board performance, or the board is tasked with evaluating its own performance under the stewardship of the chair. These can be characterised as follows:

- *Top-down reviews.* Where this approach is chosen the board evaluation is usually linked to the fulfilment of overall corporate objectives. Boards are monitored against their ability to deliver on agreed strategies. This is related to the earlier point about communicating clear objectives to individual SOEs. Absent such clarity there is no appropriate benchmark against which either a company or its board can be evaluated. Some jurisdictions use performance or shareholder contracts which are agreed with SOE governing bodies at the beginning of their term and can be used to feed back into the board evaluation process. Such contracts are ideally based on clear objectives and measurable indictors to measure performance of individuals in meeting financial results, dividend distribution, investment plans, process and product development, best practice implementation, and improvements in organisational management.

- *Self-evaluation.* In a number of countries SOE boards are required to carry out self-evaluations. Such board evaluations serve primarily the board itself, teaching the members to cooperate more effectively and perform better during the following fiscal year. National practices differ on whether boards are evaluated as a whole and/or whether evaluations are made of individual board members and the chair. In an increasing number of companies the process is under the responsibility of the chair and guided by third-pary professional "facilitators". In most cases the outcomes of the appraisals are communicated back to the ownership function. Good practice calls for it to make use of this information to serve as a key input to future board nomination processes.