FOREIGN INVESTORS COUNCIL IN LATVIA

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Position Paper on Competitiveness of State-Owned Enterprises

1. Executive Summary

The state is a shareholder in numerous companies. These state-owned enterprises (SOE) play an important role in Latvia's economy: SOEs generated 18.2 percent of GDP in 2009. Typically SOEs have both social and commercial goals. This often presents a problem.

The involvement of SOEs in purely commercial activities may constitute unnecessary and, under certain circumstances, even unfair competition to private companies. An SOE charged with social goals may have difficulties balancing social and commercial roles: the ability of the SOE to deliver financial results suffers from its involvement in the fulfilment of social goals. Also, treatment of SOEs as a part of the public structure impairs the ability of the state to regard SOEs as managers of public wealth that must deliver adequate return on the assets entrusted.

SOEs are often managed by the state as public institutions. This approach ignores the companies' commercial nature and bypasses good corporate governance principles. SOEs must be managed in accordance with the same principles as any other corporation. To improve competitiveness and uphold good corporate governance standards, there must be a decisive break with the practices of utilizing political principles in companies' governance, disbursing dividends on the basis of political decision making, utilizing a non-transparent donation policy, failing to use key performance indicators (KPI) analyses and other such practices. Instead, the state should implement market-based principles with a partially centralized (dual) model of governance, institute independent and professional boards, disburse dividends according to growth plans and performance results of SOEs and embody other good corporate governance principles.

2. Recommendations

2.1. Fair Competition

Fair competition is a key element in the whole EU landscape. It is an obligation of EU Member States to maintain the fair competition between SOEs and private companies. Therefore, it is very important to create and maintain a "level playing field" between public and private business, where no entity operating in an economic market is subject to undue competitive advantages.

> *See Organisation for Economic Co-operation and Development Report: Competitive Neutrality: Maintaining a level playing field between public and private business (27.04.2012),*
> *http://www.oecd.org/document/4/0,3746,en_2649_34847_50250564_1_1_1_1,00.html*

In order to ensure fair competition between SOEs and private companies, and to improve governance so that SOEs can carry out their social role more efficiently and bring adequate return

Foreign Investors' Council in Latvia
Elizabetes iela 2, Room 539
World Trade Center "Riga"
Tel. +371 67217201; Email: ficil@ficil.lv
Web www.ficil.lv

on investment, a number of steps have to be taken by the government:

- Define goals to be achieved via state shareholding in capital companies. SOEs should operate only in areas in which there is a market failure, or to fulfill strategic goals of the state; the Government shall formulate clear guidelines for identifying these strategic goals to avoid the excessively wide interpretation of the term;
- Compile a list of companies to be held by the state and charged with the fulfilment of the defined goals (SOE List); conduct periodic review of the defined goals and revisit the SOE List;
- Define KPI for each company on the SOE List in respect of:
  - non-financial goals to be reached
  - commercial goals based on production/profitability indicators of private companies operating within the same sector;
- Develop a methodology for assessment of SOEs and their management against the defined KPI;
- Articulate a strategy for disposal of shareholding (privatization) in SOEs that are not included in the SOE List;
- Where public needs for certain goods and services can be satisfied via purchase from the private sector: ensure that purchases are made at the best possible price through fair and transparent public procurement procedures.

2.2. Corporate Governance (CG)

2.2.1. Legal Framework

- Adopt a new law on management of state shareholdings in companies;
- Establish basic principles of CG for SOEs:
  - management of SOEs to be carried out in accordance with general CG regime applicable to all companies, except as expressly stated otherwise under the law; any deviations from the general regime must be substantiated and carefully considered prior to their introduction;
  - prohibition for the state and its representatives to intervene in day-to-day management of the SOE;
    "Direct involvement of the state in operational decisions is a bad practice." (Baltic Corporate Governance Institute Study "Governance of State-Owned Enterprises in the Baltic States," May 2012)
  - prohibition for the state and its representatives to intervene in financial matters of SOEs.
- Strengthen the transparency of SOEs.

2.2.2. Management of state shareholdings

- Establish a partially centralized (dual) governance model with a central management institution (CMI) and, where necessary, responsible line ministries; delegate primary responsibility to line ministries only over SOEs financed from the state budget and performing public administration tasks that may not be performed by the private sector; companies that are profitable or have potential to operate at a profit must be run by a CMI;
- establish clear rules to ensure independence of the CMI: appointment by the Cabinet of Ministers for fixed term, recall on the basis of the recommendation of an independent

committee and for cause only;

- The CMI must have all the powers and duties of the general meeting of the SOE, except for decisions on continuation or termination of SOE activities, increase or decrease of the share capital, reorganization, issue and conversion of securities;
- Formulate clear principles for choosing the form of corporate entity of SOEs, whether limited liability companies (SIA) or joint stock companies (AS).
- Establish a transparency policy defining quality and timeline for disclosure of financial information of individual SOEs: quarterly and annual reports. Quarterly reports to be published no later than two months after end of quarter and annual report to be published no later than four months following the end of the financial year. This information must be published also on individual companies' web pages.
- Publish aggregated annual financial report on all state assets including detailed information on the financial performance of companies that are fully or partly owned by the state.

2.2.3. Management Boards (MB) and Supervisory Boards (SB)

- Re-institute SBs as supervisory institutions in large SOEs;
- Abolish the status of state officials for SB members in order to attract professional candidates from the private sector;
- Appoint professional SB and MB members. Institute a selection and appointment procedure to avoid political influence (for example, by a Nomination Committee including independent professionals from the private sector);

  "*Independent board members fulfil a special function in SOEs. The purpose of an independent board is to make sure that board members and executives are not influenced by personal interests. They are there specifically to help the SOE run honestly and efficiently. […] Increasing board independence is arguably the single most visible goal of governance reforms in developed markets over the past decades.*" (*Baltic Corporate Governance Institute Study "Governance of State-Owned Enterprises in the Baltic States," May 2012)*
- Create a database of competent candidates for both SB and MB positions; establish criteria for disqualification;
- Align the liability of MB and SB members of SOEs with that of MB and SB members of private companies; ensure strict enforcement of liability provisions to address abuse of powers;
- Institute a system of regular internal performance evaluation of individual MB and SB members and boards as a group; issue annual report on the results of evaluation; mandate periodic (once every three years) evaluation by independent experts;

  (See EC Green paper on the EU corporate governance framework, item 1.3.)
- Provide for the right to recall underperforming MB members of SOEs, for instance, for failure to fulfil KPI;

  Under the SOE Law, MB members can be recalled only if there are substantial grounds for it. Default rule under the Commercial Law is that no cause is required to recall MB member of a limited liability company (SIA).
- MB member compensation must be competitive and linked to performance, i.e., fulfilment of KPI, taking into account short-term and long-term goals. Abolish components of compensation unusual in the commercial environment (such as "sociālās garantijas, t.sk. pabalsti");
- Ensure regular and mandatory education and training of board members on various matters, including CG; CMI shall be entrusted with the task of organizing education and

training of board members;

- Consider the necessity to set up any standing SB committees; avoid formation of committees that will function only formally;

  The experience of Latvian private companies reveals that usually no committees of SB are formed due to the limited size of Latvian boards, and other factors. The 1st edition of NASDAQ OMX Riga CG rules called for formation of the SB Audit, Nomination and Remuneration Committees. Currently those recommendations have been modified and no longer call for formation of such committees.

2.2.4. Financing

- Reasonable dividends shall be projected and declared based on predetermined short-term and long-term operational and financial goals of each SOE. It is not acceptable to determine dividend amounts by administrative means or to impose on the SOE the obligation to make any other payments to the shareholder (or CMI) apart from dividends;
- The dividend policy of SOEs shall ensure a balance between the state's interests to receive adequate return on capital and the operational goals of each individual SOE;
- The financing model of the CMI must effectively segregate state funds and the funds of SOEs.

3. Rationale

Legal Framework

The Law on State and Municipal Shareholdings and Capital Companies (Par valsts un pašvaldību kapitāla daļām un kapitālsabiedrībām) ("SOE Law") was enacted in 2002 and has become largely outdated. Numerous ad hoc amendments have been made to the SOE Law to address passing needs and issues. This process has resulted in the loss of clear direction and structure, fragmentation and unsubstantiated deviations from the general corporate governance regime. Enactment of a new law on management of state shareholdings in companies is necessary to replace the current SOE Law.

Shortcomings in corporate governance of SOEs are largely fuelled by lack of understanding on the part of decision-makers of basic principles of corporate governance. Therefore, apart from devising technical rules for operation of SOEs, it is important to reinstate in the law basic principles of operation. Any technical rules introduced under laws, regulations and other acts must be tested against those basic principles.

Management of State Shareholdings

Choice of Entity

Under the Commercial Law ("CL") *sabiedrība ar ierobežotu atbildību* ("SIA") is a form of establishment for closed companies. *Akciju sabiedrība* ("AS") may go public. Both forms (SIA and AS) are available under the SOE Law, however, no principles for choice between two forms are spelled out.

In practical terms, currently SOEs of similar size, operating within the same sector and with 100% direct shareholding by the state can be established either as a SIA or an AS.

Currently the SOE Law includes two sets of CG rules: rules governing SIA and rules governing AS. It is difficult to see rationale for two different sets of CG rules. In addition, CG rules

applicable to SOEs in certain aspects deviate from the general CG regime as stated in the Commercial Law without a clear need for it.

Examples:

a) Issues within the competence of general meeting ("GM") under the SOE Law:

SIA (Art. 48)	AS (Art. 76)
Appointment of MB members and Chairman of MB (Under CL: members of MB appoint the Chairman from among themselves)	Appointment of MB members (Under CL: SB appoints MB members and the Chairman)
Decisions on bringing an action against the member of MB, appointment of the company's representative to represent the company at the court in such cases	Decisions on bringing an action against the member of MB or auditor, withdrawal of claim against them, appointment of the company's representative to represent the company at the court in such cases
-	Entering of transaction between the company and MB member

b) Under the SOE Law, the MB of a SIA is required to obtain a prior approval of the GM in respect of two types of issues, the MB of an AS is required to obtain approval in respect of eight types of issues. For example, decisions on granting loans to employees of company are subject to approval of GM in an AS but not in a SIA.

Management Boards and Supervisory Boards

Supervisory Boards

There is a clear necessity to re-institute Supervisory Boards at least in the largest SOEs to avoid further governance failures in the future. The Baltic Corporate Governance Institute in its study "Governance of State-Owned Enterprises in the Baltic States" (May 2012) noted:

> "*While the move to abolish supervisory boards may have been a sincere response motivated by real problems, Latvia ultimately threw the baby out with the bathwater. The result has been to leave its SOEs and SOE executives without effective oversight structures. […] While the Latvian state appears to pursue its goals of SOE monitoring with some diligence, the officials tasked with SOE oversight are clearly stretched beyond the limits of their technical and physical capacity.*
>
> […]
>
> *It is hard to conceive of achieving a reasonable standard of governance in the absence of a professional board.*"

Liability

Currently there are subtle but important differences in the standard of conduct imposed on MB and SB members of SOEs as compared with general regime under the CL:

Commercial Law	*State-Owned Enterprises Law*
MB and SB member is not liable for damages caused to the company if she/he has acted in good faith within the framework of a decision of the GM. (Art. 169, Part 4)	MB members are not liable for damages caused to the company if acted in accordance with lawful decision of the shareholder or holder of capital shares. (Art.34, Part 1)
MB and SB members bear joint and several liability for damages caused to the company. (Art 169, Part 2)	If MB members are held liable in case provided under Part 2 of this Article [approval of MB action by SB], they bear joint and several liability. (Art. 34, Part 3)

Liability rules of MB and SB members of SOEs must be aligned with the general rules of liability of the members of management institutions of private companies.

Financing

One of the main benefits of carrying out commercial activities in the form of capital companies is separation of liability of the company and its shareholders. Limitation of liability is conditioned upon the shareholder having set aside financial resources for operation of the company and establishment of management institutions of the company to manage finances and commercial activities of the company. Comingling of assets of shareholder and company or intervention by the shareholder in daily activities of the company may result in loss of the privilege of limited liability.

Examples:

a) Art. 37 of the SOE Law provides that the state shareholder of an SOE may determine principles of profit distribution (peļņas izlietošanas principus) of the SOE taking into account applicable laws, regulations, as well as aims and tasks established under sector development conceptions, strategies, etc. It follows that:

- The state shareholder acts as a driving force behind decisions on principles of profit distribution (normally the General Meeting decides on the distribution of annual profit based on recommendations of the management board (Art. 180, Commercial Law);
- decisions by state shareholders are taken outside the corporate framework (not within the competence of the GM);
- SOE funds are treated as monies available for addressing wider public needs.

b) On 21 April 2009 Prime Minister Dombrovskis issued an executive order requiring that all ministries report twice monthly to the Ministry of Finance on planned public procurements by SOE for sums in excess of LVL 100,000. The Ministry of Finance was required to review information submitted and provide an "opinion" within the term of 5 business days from the date of submission.

This order is an example of disregard of corporate procedures and intervention by the shareholder in the daily management of SOE.

The approach proposed under the Policy for Management of State-Owned Shareholdings (*Valsts kapitāla daļu pārvaldības koncepcija*) approved by the Cabinet of Ministers on 15 May 2012 ("Policy") offers only partial solution for the existing situation regarding SOE disbursement of

dividends (currently dividends payable are established by the Cabinet of Ministers as a fixed percentage of profit of each SOE). Under the Policy it is proposed to leave the decision on dividend payable by each SOE to the CMI to take a decision in consultation with responsible line ministries and the Ministry of Finance. If agreement between the CMI and the Ministry of Finance cannot be reached, a final decision shall be taken by the Cabinet of Ministers. The role of SOEs and their management institutions is limited to provision of the draft budget only.

In order for interests of the state and SOEs to be balanced and account for operational independence of the management institutions of SOEs, as a minimum, the CMI shall be required to determine dividend policy of each SOE in consultation with its MB and SB. Ideally, dividend policies shall be elaborated by the MB and approved by the SB of each SOE. The Ministry of Finance and responsible line ministries shall be involved only to the extent it is necessary to define financial and sector goals of the state.

Under the SOE Law, SOEs are entitled to transfer funds to state shareholders for payment of remuneration to representatives of state shareholders and to responsible employee (atbildīgais darbinieks) in the amount determined by the Cabinet of Ministers (Art. 36.1.) General corporate laws prohibit any payments by a company to any shareholder, apart from dividends. Shareholders shall finance expenses related to shareholder activities from their own funds.