Frankfurt School
Corporate Governance
Institute

Public Consultation on

Draft Revisions to the OECD Guidelines on Corporate Governance of State-Owned Enterprises

Response from

Corporate Governance Institute at Frankfurt School of Finance & Management

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Introduction

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Corporate Governance Institute
Frankfurt School
Adickesallee 32-34
60322 Frankfurt am Main

Prof. Dr. Julia Redenius-Hövermann
Director

Prof. Christian Strenger
Director

Dr. Gül Demirtaş
Senior Researcher

For comments and inquiries, please contact: g.demirtas@fs.de

The Corporate Governance Institute (CGI) at Frankfurt School of Finance & Management appreciates the opportunity to comment on the Draft Revisions to the OECD Guidelines on Corporate Governance of State-Owned Enterprises. CGI is a think tank and research centre that promotes research and best practice in corporate governance. Founded in 2020, the CGI builds on Frankfurt School's high-class faculty to generate insights from the connection between practice and theory.

The draft revisions aim to ensure that the SOE Guidelines reflect the substantial changes introduced in the G20/OECD Principles of Corporate Governance, including a new chapter on sustainability, and to update the Guidelines in light of other related OECD work and recent developments. We thank the OECD Corporate Governance Committee and Secretariat for undertaking this important revision to ensure the Guidelines' continued relevance and usefulness.

In this document we include detailed comments and suggestions on the points where we believe the draft could be further improved. The comments are presented in two sections: General Comments and Comments by Chapter. Our revision suggestions are indicated in blue text. We hope that our comments and suggestions will be of assistance to the OECD Corporate Governance Committee and Secretariat.

GENERAL COMMENTS

- The Draft Revisions to the OECD Guidelines on Corporate Governance of State-Owned Enterprises (the "Draft SOE Guidelines") do not provide clear guidance on the appointment of external auditors. Two references to this issue throughout the text are quoted below:

> ***Guideline II.F.6:*** *"Depending on the legislation, the ownership entity may be entitled, through the annual shareholders' meeting, to nominate and even appoint the external auditors."*
>
> ***Guideline V.B:*** *"Adequate procedures should be developed for the selection of external auditors and it is crucial that they are independent from the management as well as large shareholders, i.e. the state in the case of SOEs."*

The draft SOE Guidelines' approach contrasts with that of the revised G20/OECD Principles, which name (in its Principle II.A) the right to "elect, appoint or approve the external auditor" as one of the basic shareholder rights.

This approach also contrasts with the OECD Guidelines on Anti-Corruption and Integrity in State-Owned Enterprises (hereinafter the "ACI Guidelines"), which states that external auditors are "as a general rule appointed by the company's annual general meeting". As the Draft SOE Guidelines encourage the states and the SOEs to implement the ACI Guidelines to the fullest extent possible, this may mean that the SOE Guidelines indirectly recommend external auditors to be appointed by the company's annual general meeting. However, clearer and explicit guidance should be provided on such a crucial issue.

- The Draft SOE Guidelines frequently refer to the concept of materiality, e.g., material information, material interests, material risk factors, material transactions, etc. Nevertheless, there is no definition of materiality in the text, which may hinder the consistent application of the guidelines. Only within the context of sustainability (in Guideline VII.C.1) does the draft refer to the scope of materiality. We suggest that the SOE Guidelines include a discussion of what is to be considered "material", by adapting the materiality definition of the revised G20/OECD Principles to the case of SOEs.

- The definition of what constitutes an independent board member is made in three separate places in the text: In the Applicability and Definitions section (page 9), Guideline V.A.5 (page 52), and Guideline VI.D (page 62). While the first two definitions are identical, the third definition partly differs from them. For the sake of brevity and to ensure consistent application, the independence definition should be provided only once in the text and should combine the independence criteria currently put forth in different parts of the text.

- Given the recent emergency government support measures taken to address the challenges related to the pandemic and European gas shortages, we welcome the inclusion of "ad-hoc interventions" into the scope of Guidelines I.C and III.E.2. However, such interventions have been addressed here only with respect to their potential negative implications for competition and trade.

The state exercises the ownership of SOEs in the interest of the general public and, as the annotations to Guideline II.E state, the state ownership entity should be accountable to bodies representing the interests of the general public, such as the legislature. Therefore, the SOE Guidelines should also provide guidance on how the rationale of such emergency government support should be disclosed to the public and how it should be designed, implemented, and eventually unwound to ensure the safeguarding of the public interest.

COMMENTS BY CHAPTER

Applicability and definitions

The governing bodies of SOEs (p.9)

The definition of an "independent board member" provided on page 9 (and on page 52) is as follows:

> *Broadly speaking, independent board members are understood to mean individuals free of any material interests (including remuneration) or relationships with the enterprise (non-executive board members), the state (neither civil servants, public officials, nor elected officials), its management, and other major shareholders, as well as with institutions and interest groups with a direct interest in the operations of the SOE that could jeopardise their exercise of objective judgement. Independent board members should be in possession of an independent mindset and sufficient competencies to carry out the board duties.*

This definition should be refined by addressing the following points:

- The expression in parenthesis *"(including remuneration)"* is too succinct and may be misinterpreted. In alignment with Principle V.E of the revised G20/OECD Principles, we recommend it to be rephrased as "*(including remuneration, directly or indirectly, from the enterprise or its group other than directorship fees)*".

- We believe the requirement of possessing *"an independent mindset and sufficient competencies to carry out the board duties"* should apply not only to independent board members but to all of them. This is also supported by the annotations to Guideline II.C, which state: "*In the nomination and election of board members, the ownership entity should focus on the need for SOE boards to exercise their responsibilities in a professional and independent manner. It is important that when carrying out their duties individual board members do not act as representatives of different constituencies. Independence requires that all board members carry out their duties in an even-handed manner with respect to all shareholders*." Therefore, to avoid confusion the last sentence of the definition should be deleted:

> ~~*Independent board members should be in possession of an independent mindset and sufficient competencies to carry out the board duties.*~~

Stakeholders (p.9)

The term "stakeholders" is defined as "*persons or groups, or their legitimate representatives, who have rights or interests related to the matters of the Guidelines that are or could be impacted by the enterprise's activities*." We recommend a reconsideration of this definition to make it more specific. Its current scope appears too broad and could even include the competitors of the enterprise.

Applicability (p.10)

The addition of the phrase "*especially with regards to maintaining a level playing field*" into the sentence below may be interpreted as a de-emphasis of the guidelines other than those related to maintaining a level playing field. Therefore, we suggest the following amendment:

> *As a guiding principle, those entities responsible for the ownership functions of enterprises held at sub-national levels of government should seek to implement as many of the*

recommendations in the Guidelines as applicable~~, especially with regards to maintaining a level playing field~~.

Chapter I. Rationales for state ownership

Guideline I.C (p.25)

The revisions to Guideline I.C state, "*Any change in the ownership policy should be disclosed fully transparently, including the rationales behind the need for an update.*" It is unclear from this statement whether any deviation from the existing ownership policy should lead to an immediate update of the policy and its disclosure or whether the update should be postponed until the regular review of the ownership policy. Waiting until the regular review time is undesirable, particularly for stakeholders who make use of this disclosure, since in some countries the review takes place only every several years (OECD, 2021).

Chapter II. The state's role as an owner

Preamble (p.27)

We suggest the following amendment since the state -and not the government- is the owner of SOEs.

In order to carry out its ownership functions, the government should refer to private and public sector governance standards, notably the G20/OECD Principles of Corporate Governance, which are also applicable to SOEs when ~~it~~ the state is not the sole owner of SOEs, and of all relevant sections when it is the sole owner of SOEs.

Guideline II.D (p.29-30)

The draft revisions to Guideline II.D define five different state ownership models: "a centralised model, a coordinating agency model, a dual ownership model, a twin track model and a decentralised ownership model" and provide details only on the first two models. This may be due to the guidelines' strong recommendation to centralise the exercise of state ownership rights. However, a non-negligible percentage (40%) of surveyed countries continue to use the latter three less-centralised ownership models (OECD, 2021).

Furthermore, some countries may find it less desirable to adopt a centralised model if it is not easy to shield its operations from irregular practices and undue political interference. Adopting a decentralised ownership model in such cases could mean diversification of corruption risk. OECD has also recognised such concerns by stating, "In jurisdictions with weak rule of law and high corruption levels, pooling large amounts of corporate powers in a central agency could accompany regulatory risks" in a related report (OECD, 2021).

For the reasons above, we suggest that the Guidelines provide a description of the 3 less-centralised models, their advantages and disadvantages and address any concerns about centralising the ownership function.

Guideline II.D (p.30)

The annotations to Guideline II.D list the role and responsibilities of the central decision-making body in a centralised ownership model. This list, however, looks like it corresponds to the responsibilities of the ownership entity in general, irrespective of which ownership model is adopted.

As the responsibilities of the ownership entity are already detailed in Guideline II.F, we suggest the following amendment here:

> *A centralised ownership model is characterised by one central decision-making body acting as shareholder in the majority of all or certain categories of SOEs controlled or held, directly or indirectly by the state~~. Its role will include nominating directors, setting targets and tracking and evaluating SOEs' operations. The ownership entity is also responsible for setting and monitoring broad mandates and objectives for SOEs based on its ownership policy, coordinating (when relevant) its decisions with other government stakeholders, and defining applicable frameworks and important matters relating to the governance of SOEs.~~*

Guideline II.F.2 (p.33)

Guideline II.F lists the prime responsibilities of the ownership entity with Guideline II.F.2 focusing on this entity's role in the nomination of board members. It also addresses the disclosure of candidate profiles with the following phrase:

> *Proposed nominations should be disclosed in advance of the general shareholders meeting, with adequate information about the professional background and expertise of the respective candidates.*

The disclosure requirements stated here are narrower than those detailed in Guideline V.A.5 (page 51) of the Draft SOE Guidelines or in Principle IV.A.5 of the G20/OECD Principles. For instance, no disclosure requirement is mentioned regarding potential conflicts of interest that might affect the candidate's judgment, his/her membership in other boards or committees, other executive positions, or independence status. We recommend that either the above phrase in Guideline II.F.2 is enhanced to make it consistent with Guideline V.A.5 and Principle IV.A.5 or a reference is given to them.

Guideline II.F.4 (p.34)

According to Guideline II.F.4, *"[i]n order for the ownership entity to make informed decisions on key corporate matters, it should ensure that it receives all necessary and relevant information in a timely manner. The ownership entity should also establish means that make it possible to monitor SOEs' activity and performance on a continuous basis, including by making use of digital technologies.*"

This raises the question of whether such a continuous information flow supported by the use of digital technologies will also be available to other shareholders. A brief discussion of the measures to ensure an equitable treatment of shareholders in this context can be useful here, possibly with reference Guideline IV.A.2.

Chapter III. State-owned enterprises in the marketplace

Guideline III.C.2 (p.39)

Guideline III.C.2 states:

> *Net costs related to achieving public service obligations should be separately funded, proportionate and disclosed, ensuring that compensation is not used for cross-subsidisation.*

The expression "funded by the state" in the 2015 version (Guideline III.D in that version) is changed in the Draft SOE Guidelines, and no specific funding party is named in the Guideline or its annotations. The reason for this change or the other potential sources of funding in this context is not immediately clear. We recommend a clarification on the possible sources of funding other than the state.

Guideline III.G.1 (p.44)

The annotations to Guideline II.G.1 state the following:

> *All SOE economic activities that can affect trade and competition should be in accordance with commercial considerations and in line with OECD standards bearing on responsible business conduct. This includes the purchase and sale of goods and services, but also the reception and provision of loans, guarantees or equity investments domestically or internationally by SOEs. To avoid market distortions, SOEs should consider whether a private sector enterprise operating at arm's length would make the same business decision, for example granting a loan, under comparable circumstances and under similar conditions, to verify that it was provided on market terms.*

This phrase, especially its last sentence, implicitly rules out the use of related party transactions as related party transactions are unlikely to pass the decision criterion mentioned (i.e., "*whether a private sector enterprise operating at arm's length would make the same business decision").* However, as the G20/OECD Principles put it: "*Banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure."*

We suggest a rephrasing of Guideline III.G.1 to ensure that well-governed related party transactions are not banned.

Chapter IV. Equitable treatment of shareholders and other investors

Guidelines IV.A.3 & IV.A.4 (p.46-47)

Guidelines IV.A.3 and IV.A.4 advise SOEs to have an active policy of communication and consultation with all shareholders and to facilitate the participation of minority shareholders in shareholder meetings, ensuring equal access to information and opportunities for participation. We suggest that these two Guidelines explicitly refer to foreign shareholders, as they are likely to be more prone to communication and participation challenges. Equitable treatment of shareholders should be required as far as possible to ensure that foreign shareholders do not get the idea that they are not welcome.

Guideline IV.A.4 (p.46-47)

Guideline IV.A.4 and its annotations address the participation of minority shareholders in shareholder meetings, but they do not mention the ability of minority shareholders to place items on the agenda and propose resolutions. We recommend an alignment of this guideline with Principle II.C.4 of the revised G20/OECD Principles.

Guideline IV.C (p.48)

Guideline IV.C and its annotations require disclosure of public policy objectives of SOEs to non-state shareholders and, with the new revisions, also to the public. We suggest the changes below because: (i) the disclosure of public policy objectives to the public is already addressed in Guideline I.D, (ii) Chapter IV focuses on the equitable treatment of shareholders and not on disclosures to the public, and (iii) the disclosure of public policy objectives to the public does not depend on their effect on enterprise valuation.

> ***C. Where SOEs are required to pursue public policy objectives that may have a material effect on the company's performance, results and viability, adequate***

information about these should be available to ~~the public and~~ non-state shareholders at all times.

As part of its commitment to ensure a high degree of transparency with all shareholders, the state should ensure that material information on any public policy objectives an SOE is expected to fulfil, as well as on their rationales, is disclosed to non-state shareholders ~~and the public~~, in compliance with competition laws, insofar as this may affect the valuation of the enterprise. The relevant information should be disclosed to all shareholders at the time of investment and be made continually available throughout the duration of the investment.

Chapter V. Disclosure, transparency and accountability

Guideline V.A (p.49)

We recommend the following amendments to the annotations of Guideline V.A as disclosure in compliance with high-quality internationally recognised standards or national standards consistent with them is supposed to be an achievable goal for all SOEs.

All SOEs should disclose all material information~~, and large and listed ones should do so~~ according to high-quality internationally recognised standards such as the International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP), or national accounting standards consistent with these standards. ~~All other SOEs should apply these standards to the extent possible.~~

This change would also make this guideline consistent with the annotations to Guideline V.B, which state: "*In the interest of the general public, SOEs should be as transparent as publicly traded corporations. Regardless of their legal status and even if they are not listed, all SOEs should report according to best practice accounting and auditing standards*."

Guideline V.A.4 (p.51)

The disclosure of board and executive remuneration is less detailed in the SOE Guidelines compared to Principle IV.A.6 of the revised G20/OECD Principles. This is despite the very detailed requirements in Guideline VII.B.3 regarding linking executive remuneration to long-term performance, including sustainability-related criteria. Consistent with Principle IV.A.6, we recommend that Guideline V.A.4 require disclosures on the link between remuneration and the company's long-term performance, sustainability, and resilience; material changes on the remuneration policies; and liability insurance policies.

Guideline V.B (p.55)

Guideline V.B requires that the external auditors' "*direct reporting relationship and accountability should be to an independent audit committee*". This approach contrasts with both the revised G20/OECD Principles and the ACI Guidelines, the relevant parts of which are quoted below:

Revised G20/OECD Principles, Subprinciple IV.D: *"External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit in the public interest."*

ACI Guidelines: *"External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit."*

The statements above from the two documents are almost identical, except for the "in the public interest" part, which was added to the G20/OECD Principles during its recent revision. We suggest aligning the SOE Guidelines with the G20/OECD Principles.

Chapter VI. The composition and responsibilities of the boards of state-owned enterprises

Guideline VI.A (p.60)

Following the German Co-Determination Act, companies in Germany that are subject to an equal representation of employees and shareholders in the supervisory boards should have a supervisory board of 12, 16, or 20 members, depending on the number of employees. Although this leads to a larger average board size in Germany compared to many other countries, the effective functioning of the board can still be ensured.

To allow for diverse approaches in different jurisdictions, the expression (highlighted below) in Guideline VI.A, which views large boards in a negative light, should be reconsidered:

> *To encourage board responsibility and in order for boards to function effectively, the organisation of boards of directors should be consistent with best practices developed for the private sector. They should be limited in size, comprising only the number of directors necessary to ensure their effective functioning.*
>
> *Experience further indicates that smaller boards allow for real strategic discussion and are less prone to become rubberstamping entities.*

Guideline VI.C (p.61)

Guideline VI.C states: "*Boards members' professionality and independence should be ensured, for instance through competitive remuneration*." It is not clear in this sentence or in the annotations that follow how competitive remuneration could ensure the independence of board members. Such a link is counterintuitive since a common criterion for director independence, as also put forth in Principle V.E of the G20/OECD Principles, is the absence of remuneration other than directorship fees.

Please also ensure consistency of how Guideline VI.C is expressed on page 61 versus on page 19.

Guideline VI.D (p.62)

The below-quoted independence criterion listed in the annotations to Guideline VI.D is supposed to apply only to independent board members. Therefore, the newly added "like all board members" part should be deleted:

> *Independent board members~~, like all board members,~~ should be free of any material interests or relationships with the enterprise, its management or its ownership that could jeopardise the exercise of objective judgement.*

Guideline VI.E (p.63)

We welcome the new recommendation to introduce "appropriate cooling-off periods" for former politicians and public officials before their appointments to SOE boards. However, some guidance on what constitutes an "appropriate" cooling-off period would be useful, possibly with a discussion of best practices on the structure of such cooling-off periods. States should be discouraged from introducing too short cooling-off periods as these will not serve their purpose of reducing conflicts of interest.

We suggest a minimum cooling-off period of two years. If this cannot be achieved, a minimum of one year should be allowed for specific and well-reasoned cases. However, it would be better to have a cooling-off period of 2-3 years, depending on the intensity of the relationship between the SOE, the state, and the new board member, and the potential for conflict of interest.

Guideline VI.F (p.64)

Annotations to Guideline VI.F have been revised so that now it states: "*The head of the management board (where applicable) should moreover not become the Chair of the supervisory board upon retirement*." This was only stated as a "good practice" in the 2015 version of the SOE Guidelines.

Despite this strengthening of the rules for two-tier boards, the separation of the chair from the CEO in one-tier boards is still not required but only viewed as a "good practice". We recommend a reconsideration of Guideline VI.F to require CEO-Chair separation.

Chapter VII. State-owned enterprises and sustainability

Guideline VII.B.3 (p.74)

The sustainability-related criteria integrated into executive remuneration should be challenging to convince shareholders and other stakeholders that they were not just easy to reach targets that allow executives a guaranteed additional income. To assure shareholders and other stakeholders, it is also good practice to set sustainability-related targets in a way that they are rigorous, measurable, and objective.

Better alignment of executive interests with longer-term sustainability considerations should be achieved also by updating executive remuneration schemes and securing that these schemes reward longer-term performance for periods of no less than four years.

REFERENCES

OECD (2021), Ownership and Governance of State-Owned Enterprises: A Compendium of National Practices 2021, https://www.oecd.org/corporate/ownership-and-governance-of-state-owned-enterprises-a-compendium-of-national-practices.htm.

OECD (2019), Guidelines on Anti-corruption and Integrity in State-Owned Enterprises, https://www.oecd.org/corporate/Anti-Corruption-Integrity-Guidelines-for-SOEs.htm.