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This paper was produced as part of the Working Party's project on SOE governance reform. It serves as a first step in a process (which will involve the Asia SOE Network as well as the 2011 Global Network on Corporate Governance of SOEs) toward establishing a best-practice document for organising the boards of directors of state-owned enterprises.

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I. BACKGROUND

1. This paper differs in some respects from past OECD work on state-owned enterprise (SOE) boards. It reports on the challenges faced by SOE boards, but does so principally from the perspective of the board chair and board members. Its ultimate purpose is to identify challenges to SOE boards, the barriers to best practice, and what can be done to overcome these barriers.

2. The basic premise behind this approach is that one needs to get into the board to understand how to improve its function. The paper draws principally on a series of interviews conducted with active chairs and board members of SOEs and a smaller number of officials from ownership entities from OECD countries. Where the interviews either left gaps, or where the distribution of responding countries provided a skewed view, the paper draws upon extant literature on SOE governance practices, including on non-member countries.

3. The findings are entirely in keeping with what one might expect from SOE chairs and board members and their concerns: they are strategic. The paper does not provide detailed feedback on country practices on issues such as, for example, nominations or remuneration. Much of this has already been well-documented in other work of the OECD. But, in addition, it was felt that it would add more to the discussion on boards if the broader challenges, goals and strategies were identified. This would, in turn, set the groundwork for moving on to describing specific techniques.

4. Finally, in order to allow interview respondents to speak as freely as possible, strict confidentiality was promised. This means that there is no mention of specific SOEs, and that examples cannot be traced back to specific countries. In this respect, there may have been an excess of caution. Where specific countries are mentioned, the mention is based upon publicly available information or with the express permission of the interviewee.

II. INTRODUCTION AND OVERVIEW

5. The underlying interest in SOE boards is due to continued pressure to increase SOE performance. Even in countries that have long operated under the core expectation that SOEs will act commercially, the demand for better performance persists. The global crisis in 2008 has called further attention to SOEs as governments considered their impact on budgets and financial sector stability. Even where SOE performance is good or equivalent to the private sector, governments seek to better performance by further adjusting governance practices.

6. The report is structured as follows. The current Section II provides a contextual discussion. It discusses why boards are a priority issue, how SOE board practices are driven by private sector standards and where there are gaps. It also describes the link between good board practices and a committed and competent public administration. Section III goes on to discuss the principal challenges facing SOE boards. The section covers numerous challenges and priorities that differ considerably from one country to the next. Section IV begins to explore how a public administration can encourage the autonomous and professional boards that seem to be the shared goal. It does so by describing key strategic success factors in best practice countries.

Board performance is a priority issue

7. Private sector boards have evolved considerably over the last 10-15 years. SOE boards have as well. SOE boards have been made increasingly responsible for SOE performance. The key strategy to effect this change has been to provide them with greater powers and the autonomy to exercise these powers. Much attention has been paid to the composition of the board so that it has the necessary skills to achieve its goals. Attention has also been given to the independence of board members, board structures, incentives and performance evaluations. A crucial step to create the new SOE board has been to shield it from political or politicised intervention or, at a minimum, to properly channel such intervention.

8. These approaches have worked. Those countries that pursued a best practice model, report a heightened quality of board discourse, more professional boards, and improved SOE performance. Furthermore, better boards seem to protect governments from operational missteps, political fallout, and allow them to better gauge and manage the risks of operating an enterprise in a commercial environment. Yet, even where governance reforms have shown good results, expectations of SOE boards continue to grow. These expectations emanate from governments, the public, the financial markets and the SOEs themselves.

Expectations of board are increasingly high

9. As in the private sector, the expectations of SOE boards seem to grow inexorably. The most visible manifestation is the increase in the workload and the time commitment that board members face. Board members can now expect to work from 10 to 25 days per year, and the expectations of board chairs are much higher. A chair can expect his/her time commitment to run from 40 to 90 days of service per year.

10. The increased workload is a reflection of both the number and complexity of issues that the modern board needs to consider. Whereas it was not uncommon in the past to limit their work to an examination of the annual budget and financial statements, today, boards must consider increasingly difficult technical issues including risk and risk management, financial instruments, financial reporting, systems of control, etc. Other issues may be less technical but challenging from a conceptual perspective such as corporate social responsibility. Furthermore, boards are increasingly expected to look to the future and anticipate events. Taken together, this represents a “sea change” that requires better and broader thinking--but with the same available resources.

SOEs seek to emulate private sector practices

11. In SOE governance, the private sector usually defines the best practice standard. It is almost uniform practice for governments to seek to improve performance by emulating private sector practices. The hope is that by doing so, the SOE will achieve similar outcomes. This proposition has been shown to work. New Zealand, for example, has gone far in emulating private sector practices while retaining 100% state ownership. SOEs are instructed by the administration to model their governance as closely to listed company standards as possible.

12. On the other hand, Norway and other Nordic countries have decided that the best way to emulate private sector practice is to make the SOE partly private. They have opened up the capital of many SOEs. The evidence suggests that even modest share listings can significantly alter the quality and nature of governance. Listings force SOEs to comply with listing standards, disclosure requirements, securities regulation and governance codes. Ad hoc or unconsidered political intervention is thus significantly limited. Above all, it provides boards with powers, and forces all decision making to actually go through the board.

13. A number of countries including Australia, New Zealand, the Nordic countries and the United Kingdom have had considerable success with their models. The influence of government is measured, transparent and bounded by clear procedures. Boards have no civil servant or government officials. Boards have the needed authorities and operate autonomously. There is little if any government intervention, and very little to distinguish SOEs from private sector companies. Relations between the SOE and government are as they might be with any other major private shareholder and the state may have more in common with an activist portfolio investor than a traditional state owner. SOEs operate as effectively as private sector enterprises with private sector boards, and the issues and challenges that face SOE boards are very similar to those that face private sector boards.

The main differences between SOEs and the private sector

14. But, the above examples should not be taken to imply that OECD countries have similar practices or that they are uniformly successful. Much to the contrary, governance practices vary dramatically in the OECD not to mention non-member countries, and there are often enormous and visible differences between SOE boards and their private sector counterparts. Differences may be subtle in some countries, and large in others.

15. Often one points to differences in decision making rights such as, for example, the right of the board to appoint the CEO. This is, indeed, a substantial difference though, increasingly, what appears to distinguish best practice from less good practice, is not legal rights, or the number of issues on which the government may intervene, but rather the manner in which the government influences the course of the SOEs that it controls.

16. Under best practice, such influence is informed and considered, takes into account the SOE's objectives, goes through proper channels (including the board) and is not driven principally by political needs. It is usually infrequent. Under less good practice, government interventions may be frequent and considerably less circumspect. Such intervention can take the form of a directive in response to a government need, and may override the needs of the SOE. Often, such a situation puts boards in untenable positions, torn between their duty of loyalty to the SOE and the need to act on the behalf of owners and the state.

17. A final contextual point is that board practices are significantly influenced by the ownership and legal structure of the SOE. Limited liability SOEs that are listed follow private sector practices. Wholly-owned SOEs, particularly statutory corporations, are not subject to the influence of other shareholders and may not follow the company law framework. The development of any future recommendations would need to take into account not only the significant differences between countries but also differences stemming from the ownership structure.

III. THE PRINCIPAL CHALLENGES FOR SOE BOARDS

18. Twenty board members of SOEs from seven OECD countries were contacted as part of this stocktaking, and asked to respond to questions regarding the key challenges facing their boards. Approximately half were chairs of their boards. Five individuals were contacted from public administrations. This section describes the challenges that they identified. In many cases these challenges are similar to those faced by private sector boards such as, for example, improving the quality of board deliberations through better board composition. But, in all cases the challenges had an overlay that is specific to SOEs.

19. The preponderance of countries and SOEs that responded to this survey have strong SOE governance practices. Judging the challenges based upon their experience would skew the view of the challenges towards best practice countries. For example, most SOE boards that were interviewed reported sufficient powers and autonomy, whereas an absence of powers and autonomy is clearly an overriding priority in other countries. Wherever possible there is a discussion to illustrate how the situation between countries may differ.

3.1 The role of the board

3.1.1 Clarifying the role of the board

20. In recent years, the fundamental trend in SOE governance has been to clarify the roles of the state, ownership entities, boards and management. The goal has been to assign decision-making powers to those who are most capable of exercising them, and segregate decision-making responsibilities in order to avoid conflicts of interest and disincentives. All of this is to make decision making more rational, more focused, based on competencies, avoid confusion and, above all, reduce the potentially negative impact of politicisation.

21. The OECD Guidelines on Corporate Governance of State-Owned Enterprises (the “SOE Guidelines”) propose exactly this approach. They suggest a governance structure composed of three distinct layers, each with a distinct role: 1) a state ownership function which is responsible for defining the ownership policy and high-level objectives for SOEs (outcomes); 2) a board which is charged by the state with overseeing the development of a strategy to achieve the state’s objectives, and monitoring of progress; and 3) executive management who propose a strategy and who are accountable to the board for implementing the strategic plan.

22. Under this ideal schema, the board plays the central function in the governance of the SOE. It carries the ultimate responsibility for SOE performance, and it has the authority and autonomy to make decisions that determine performance. It also acts as the intermediary between the state and the SOE on behalf of the owners. In this sense, it is no different from a private sector board. A number of countries have implemented this model to good effect. However, there are a considerable number of countries where the ideal is challenged in reality (an illustration is provided in Box 1).

Box 1. The case of an air-traffic controller in a European country

The air-traffic controller is a statutory corporation. It is legally required to be profitable. It is also required by the government to provide free services to users for which it is not fully compensated. This results in a structural shortfall. The SOE is prohibited from financing its shortfall from other commercial activities since this would be considered a cross-subsidisation. As a result, the SOE is forced to resort to borrowing.

The board is not empowered to address certain fundamental problems. Only about half of the issues that determine the success of the SOE's operations are under its control. The other half is subject to external decision making and occasional political influence. There is a sense that contextual conditions (weak governance practices of the state, the influence of changing political currents, and gaps in the legal framework) prevent better performance.

An additional problem is short-termism. Though state ownership is often touted for bringing a long-term perspective, political intervention occurs on short-term issues. Ministers have, for example, intervened directly in labour conflicts. On the other hand larger long-term issues such as the structural shortfall remain unresolved.

Short-term thinking is exacerbated by the nature of the government's budgeting process. As with government departments, the SOE's budget is subject to parliamentary approval. There is little or no flexibility to adjust the budget in response to changing government directives or the needs of a dynamic business environment. Budgeting processes are annual and do not take longer term developments into account.

23. The principal impediments to best practice are: 1) the irreconcilable objectives issued by the state; and 2) how the state defines its role and the role of the board. The example of air traffic control cited above may not represent the typical commercial SOE. Nevertheless, such problems are comparable to other more commercially orientated SOEs and can be found in a number of OECD countries.

24. Though an empowered and autonomous board is the goal, certain decision-making responsibilities are usually retained by the state. These include: 1) deciding fundamental outcomes (including aspects of strategy); 2) appointment of board members; 3) appointment of the CEO and succession planning; 4) executive and board member remuneration and incentive schemes; 5) major investment projects; 6) mergers, acquisitions, and major changes in ownership; 7) raising capital; 8) dividends, etc.

25. Perhaps surprisingly, these limitations are not always significant impediments. Despite some limitations on decision making powers, in Nordic countries board members generally feel that their autonomy is sufficient and that boards are allowed to pursue best practice. The state operates through the board which is able to function with independence. And, even though ministers can, if they choose, issue directives, this is comparatively rare.

26. The Nordic success appears to result from a clear definition of roles, respect for the limits imposed by these definitions, and the exercise of restraint. Though the state may hold powers, it prefers to use encouragement. Government performance and governance expectations are well communicated. Board members then have the obligation to deliver on these expectations, but also the freedom to decide how. If ministers are dissatisfied, board members can eventually be voted off even if this may take some time.

27. This only works when government is fully committed to a system of autonomous control by boards. Such a situation is best achieved when the state and board have a clear and common understanding of their roles, in an environment of frequent communication and trust.

3.1.2 *Conformance versus performance*

28. The question of “conformance versus performance” refers to the two principal ways that boards may view their roles, as bodies that: 1) focus on conformity with rules and compliance with the directives of the state owner, versus; 2) focus on performance. Boards are, of course, concerned with both. However, before the heightened attention to governance in the 1990s, many boards of directors, even in the private sector, were heavily focused on compliance checking.

29. SOE boards have traditionally been prone to an even greater conformance mentality than private sector companies. This may have origins in direct state control where boards served to ensure that instructions from the state were complied with. It may also emanate from governance traditions where the setting of detailed quantitative performance targets and monitoring achievement against such targets was viewed as the best way to encourage and manage the SOE for results.

30. Certainly, the focus on conformance emanates from view that the role of the board is to prevent corporate excesses and political embarrassment from a misuse of public funds. Within the board, a compliance mentality often manifests itself through a preoccupation with the budget setting process and variations from budgets and plans. Often this attention is at the expense of larger issues such as the effectiveness of the overall business strategy. Focusing excessively on conformance can give boards and owners a false sense that they are fulfilling their fiduciary functions. A visible trend over past decades among both private sector and SOE boards is a greater concern for the drivers of performance.

31. This being said, there are SOEs in both OECD countries and elsewhere where the control environment is still not sufficiently developed for boards to safely shift their focus towards performance issues. Attention to compliance and control is often warranted. Certainly, the renewed attention to risks and risk management in the wake of the 2008 financial crisis show how important such issues can be. However, concern for a sound control environment is not the same thing as having a conformance mentality. The proper focus of the board should be on establishing a sound control environment, rather than a line-by-line compliance checking with budgets or ministerial instructions.

3.1.3 *Adding value*

32. Many chairs see one of their greatest challenges as getting the board to add value. The first step may be, as suggested above, for the board to recognise that it is responsible for more than just compliance. Another may be for the board to go beyond the next step which is performance monitoring (an example is provided in Box 2). Even competent boards that are keenly aware of performance issues, may not be adept at adding value.

Box 2. Crack testing as an approach that adds limited value

“Crack testing” means putting management’s proposals under such pressure that they eventually show flaws and crack. When crack testing, meetings between the board and management may be characterised as inquisitions, interrogations and/or grilling. Best practice suggests that the board should submit management to rigorous questioning. Such questioning is important. However, boards who limit themselves to crack testing may be missing opportunities to add value. Furthermore, crack testing can be deleterious to creating a collegial atmosphere and trust between board and management.

33. A properly constituted and managed board can help when management does not have all the answers. The characteristics of a value-adding board are: 1) responsiveness to management’s need for direction; 2) bringing skills and perspectives that management may be lacking; 3) encouraging the

development and examination of a range of options; 4) being objective; 5) encouraging and listening to in-house expertise; 7) looking forward to the future, and taking the long-term view; and 8) thinking strategically. Ultimately, adding value means developing more and better interaction with management, and working in partnership with the executive.

3.1.4 *Thinking strategically*

34. One of the most important ways in which boards can add value is to think strategically. Best practice guidance suggests that boards discuss and ultimately approve strategies proposed by management and monitor their implementation. In reality, strategy development is usually an iterative process in which the SOE and the state respond to proposals and jointly develop the strategy. In other cases, high level outcomes or expectations are defined by government, and a strategy is developed by the board and management to achieve these outcomes.

35. In practice, strategic thinking and strategic decision making are an enormous challenge. Strategic decision making is often confused with routine, operational decisions simply because it occurs at the level of the board. One of the challenges for SOE boards is to move away from the temptation of day-to-day decisions toward a more strategic view. This is of fundamental importance to add value at the highest level, and for the efficient use of the board's talent and time.

36. Complicating the challenge is that business strategy is not necessarily intuitive. Board members with technical backgrounds, who are highly task oriented, or who prefer quick and consequential decision making may have little patience for reflective processes. Furthermore, there are different approaches to strategy development, and the literature is both voluminous and complex.

37. Another implementation challenge is that strategic thinking at board level may require getting the state to think strategically as well. The tone of board discussions is set by the owner, and some governments and technocrats charged with SOE oversight tend to focus on issues of detail. This being said, there are also examples of the state taking the lead in encouraging boards to be more strategic. In either case, a shift in the focus of the board towards more strategic thinking needs to be accompanied by a similar shift in thinking in the public administration.

38. A further implementation challenge is that management may be reticent to allow the board to get overly involved in what has traditionally been their domain of expertise. These fears merit consideration since it is precisely executive insight that is needed to develop good strategy. The board needs to understand that it is a key contributor, but not the main driver of strategy. Involving the board in the strategy requires a clear definition of the roles of management, the state and the board with respect to their contribution to the strategy process.

3.2 *Improving board performance*

3.2.1 *Board composition*

39. Board composition is important to the function of the board and its performance. Best practice is for SOE board members to have skills and experience that contribute to deliberations and respond to the needs of the SOE. The type of board members that are typically sought out have industry experience, financial expertise and so on. At times SOEs require technical expertise such as, for example, mergers and acquisitions. Best practice SOE boards are also composed of a sufficient number of independent board members who are expected to contribute objectivity to board deliberations.

40. There appears to be a growing consensus that neither ministers, other politicians, nor in many cases civil servants should serve on SOE boards¹. Though they may represent “owner” interests, ministers and politicians can be expected to have governmental and political concerns at heart, which can constitute a conflict of interest that compromises them in their duty of loyalty to the SOE. Similarly, civil servants who are generally under instruction from the state are unlikely to contribute to open-minded discussions, and do not generally have the status or experience to function as peers of executives or other high level board appointments.

41. On the other hand, political skills on the board are not only useful but, in some cases, indispensable. The business of politics can be opaque to business people, and individuals with political and government experience can be very useful in helping executives and board members from business backgrounds to understand the workings of government, and the position of the state as an owner.

42. In addition, board members with political experience can be well-suited to communicate back to the state. Their knowledge of the SOE combined with their understanding of government is useful in establishing trust with owners. There are, of course, concerns that such board members would only serve to politicise the board’s work. However, whether or not they add value or are simply another conduit for political influence depends on their ability to be independent. Carefully selected individuals with political experience stand to add value to the SOE.

43. Independence remains one of the most sought after characteristics. Best practice has been to have a significant number—even a majority—of independent board members on the SOE board. A problem with achieving the benefits of independence is overly restrictive and mechanical definitions of independence that hinder finding individuals capable of the objective thought that should be the final outcome. Greater emphasis should be placed on the capacity of the individual to contribute in an objective and unbiased fashion, and searches should focus more on personality characteristics and not rely on a mechanistic evaluation of the CV compared to checklist definitions.

44. Private sector experience is viewed as essential. Most valuable are board members who have worked in a listed company environment, who are simultaneously on private sector boards or who are CEOs of private sector companies. Getting CEOs from other companies is proving to be a greater and greater challenge given the increasing time commitment that is required of board members. The increasing frequency of professional board members (who devote themselves full time to board duties) needs to be counterbalanced with up-to-date hands-on experience.

45. The importance of practical experience also arises with respect to the question of whether the CEO and other executives should be on the board. Under a two tier system, the question is moot, but some OECD countries have unified boards. In a unified board, the separation of the role of chair and CEO is broadly viewed as necessary to underscore the separation of oversight and executive functions². Irrespective of the board structure, the goal should be a positive interaction between the management and the board in order to build trust, help board members understand the issues and the qualities of the management team, and allow management to understand the concerns of the board.

46. Some of the classic views on board composition are being questioned, in particular, excessively narrow definitions of the desired board member profile. Certainly, there is a broad consensus that a diversity of views and skills is desirable. But, contrary to conventional wisdom, technical skills may not be imperative since such skills can be gained from external consultants. And, generalist board members (who have traditionally been considered less desirable), may be adept at strategic thinking and demonstrate a

¹ The SOE Guidelines militate against politicians on board, but does not address the issue of civil servants.

² This is also recommended as a good practice by the SOE Guidelines.

capacity for synthesis. Even people with non-classic backgrounds can be valuable, which may suggest the need to go beyond the CV and recognise the value of common sense and character.

47. Some OECD country boards have labour representatives. Where labour is represented, boards tend to assess employee and union representatives positively. However, the expectation that they behave in precisely the same fashion as other board members, as suggested in the SOE Guidelines, may be unrealistic. The concern is not their skills or educational level; they are often thought to be entirely competent to participate in board discussions. Rather the issue is that they are required as labour representatives to express a labour view. This view may be important. However, the expectation that labour act independently or in the same way as other board members in the interest of the SOE may pose an irreconcilable conflict.

3.2.2 Behavioural issues and group dynamics

48. Considerable attention has been paid to defining best practice on issues such as board structure, board composition and procedures in the faith that these will lead to better outcomes. There is, however, a growing recognition that behavioural issues are integral to the function of the board. In reality, board members are like any other people. They may be competitive and keen on proving themselves or, alternatively, distant and uninvolved, inclined to engage with the group or more comfortable working individually.

49. A board needs intangible qualities such as interpersonal skills, the ability to communicate, courage, diplomacy, and leadership. These qualities are rarely teased out in the appointment process even though it is possible to do so. In small countries where the population of potential candidates is limited and where people tend to know each other, these factors can be taken into account in the course of normal due diligence. Another technique is for the chair or other board members to be involved in the interviews of prospective candidates to help gauge their capacity to contribute to a team.

50. Beyond the behavioural characteristics of individuals, boards also have a team dynamic. Typologies of different types of private sector boards exist and these behavioural profiles find an echo in SOE boards. SOE boards can, however, be different from private sector boards in many ways. A typology developed specifically for SOEs might include: 1) *the operational board* for the board that runs the SOE as an extension of a government department; 2) *the conduit board*, which simply relays directions given by ministers; 3) *the symbolic board* which is circumvented and uninvolved; 4) *the subjugated board* which is dominated by a powerful CEO/chair, etc. *Rubber stamps* seem to be common to both SOEs and the private sector (sample typologies are provided in Table 1).

Table 1. Team dynamics on SOE boards

The Rubber Stamp Board	The Operational Board	The Symbolic Board
Approves without contest or consideration	Board makes operational decisions	Circumvented and powerless
Does not consider alternatives	Board has dedicated offices in the SOE	Not consulted on decisions by either management or owners
Limited role of non-executive board members	Board functions as an extension of a governmental department	Not privy to key discussions between owners and management with all decisions taken by owners
Dominated by executives	Focus on state expectations versus needs of the SOE	Often demotivated for lack of recognition, influence and impact
Relies on information fed by executives	Limited strategic focus	
Does not see its role as adding value	Limited role of non-executive board members	

51. Group dynamics are particularly important with respect to the value of independent board members. Expectations are high for independents, and best practice suggests that they should represent a significant portion of the board. The expectation is that they will think and behave differently and, in best practice countries, they do. Nevertheless, the group dynamic is often such that independents are cowed by other board members, or an imperial chair, and do not automatically contribute by dint of their status as independents.

52. Looking at behavioural issues and team dynamics is a new way of looking at boards that provides more insight and puts less emphasis on box ticking. Boards can stand to improve by a closer examination of how decisions are taken in practice with a view to creating a good team dynamic.

3.2.3 *The chair of the board as chief team builder and governance nexus*

53. The crucial element in creating an effective team is the chair of the board. It is the chair's task to build an effective team out of a group of individuals. This requires specific skills, including leadership, the capacity to build and motivate teams, the ability to understand different perspectives and approaches, the capacity to diffuse conflicts, diplomacy and personal effectiveness. The chair of the SOE must also interface between the state, the board, and the executive. As such, he needs to understand the positions and interests of each, and gain the trust of all. The role of the SOE chair is visibly more challenging than that of the chair of a private sector company given the differences between public and private sector cultures.

54. In countries where unified boards exist, there is continued discussion on whether the roles of chair and CEO should be separated. The argument in favour of combining is that it provides a better understanding of the operational issues, less decision making hurdles, better integration of strategy and tactics, clearer direction, and better decision making. Specific concerns with respect to the combination of the roles are that it is hard for other board members to challenge a powerful CEO/chair, independent board members can be cowed and neutralised, and the evaluation of SOE, board and executive performance becomes biased.

55. In summary, the argument for is to provide better checks and balances, the underlying issue being that there is an irreconcilable conflict between the roles of monitor and executor. The argument against is

that it creates two less effective positions, requiring strong communications and human interaction to achieve concerted action. In the end, there is a growing consensus that the benefits of separation outweigh the drawbacks. However, when the roles of chair and CEO are separated, the relationship between the two becomes crucial. In order for it to work, it must be a relationship of trust, based upon a clear understanding and respect of their different functions.

56. In some cases, SOE chairs are contributing in new ways. First, in some countries chairs are involved in conducting gap analyses of boards (i.e., in determining what board member profiles are required to strengthen the board), and in interviewing candidates to help assess personal and behavioural characteristics. Second, in some cases chairs have the capacity to express reservations regarding nominees and override government proposals based upon an expression of justified concerns. A final observation is that the role of chair requires a significantly greater contribution in time than that of other board members that needs to be taken into account when considering how many other board roles they should have and also in their remuneration.

3.2.4 *Building an effective team through the nominations process*

57. The ideal way to approach board member nominations is to appoint based on merit, and retain based on performance. What stands in the way of this ideal is the penchant for politicisation. Some of the classic effects of politicised nominations are: 1) the changing of the board with a change in political powers; 2) excessive turnover of board members; 3) or, alternatively, insufficient turnover, and lack of fresh blood and innovation on the board; 4) friend appointments and patronage; 5) changing members without good reason; and 6) the inability to get desired profiles. Another practical problem is delays in government decision making. When politicisation occurs, it does not yield the needed board member.

58. At the same time, it is widely accepted that new ministers have new ideas and that they want to have board members who (even if not politically aligned), share their thinking. And, in the end, there is always a political overlay to SOE board member nominations. The challenge is to not politicise excessively and not make nominations decisions for no other reason. What is important is that there be a formal process, that there are no surprises or ad hoc changes to boards, and that the nominations process be publicly transparent. (Some additional thoughts about nomination procedures are provided in Box 3.)

59. Such approaches can shield the process from politicisation and help ensure that needed profiles make it onto the board. They have proven effective in eliminating the most egregious problems associated with politicisation.

60. There are, of course, difficulties. In cases where it is understood that the government has the final say, a form of self-censorship can occur. Candidates will never appear on a short list because it is known that they stand little chance of ministerial approval. Troubled SOEs or troubled boards will inevitably garner more attention from government as will the critical position of the chair of the board.

Box 3. Techniques for getting good board members

Nominations procedures vary across OECD countries. Some SOEs have board nominations committees much like private sector enterprises. Others use committees that are attached to the AGM to nominate board members. In Norway, for example, nominations committees are composed of three independent members and one government representative and report to the AGM.

Removing the nominations decision from the board appears to insulate the process from a potential moral hazard when board members protect themselves from scrutiny by nominating friends or like-minded individuals.

In New Zealand, candidates can be proposed based upon a gap analysis of the board. A gap analysis is conducted, potential nominees are examined, these are considered, and a short list is developed which is then decided upon by shareholding ministers.

Some countries report great success in the use of external advisors who are able to expand the search base of candidates and apply professional techniques including initial assessments of the quality of the candidates. This stands in contrast to the often informal process that used to characterise board nominations.

In some cases, potential board nominees are disclosed to the public and the qualities of individuals are openly debated in the press.

61. In summary, nominations can be depoliticised successfully in different ways. No technique is fool proof, and all can be subverted by individuals who are intent upon getting their candidate on the board. A key factor in improving the quality of the nominations process is to have clear procedures. Some OECD countries have no specific procedures on nominations, do not define profiles, or search based on needs. In others, the “who nominates” is defined (such as a line ministry, the treasury or a council of minister) but not the “how”, or the process that they have to go through. Both are required. In addition, public transparency is a key success factor because it places nominations procedures and specific nominations under public scrutiny. But, the ultimate success factor appears to be a government that is genuinely supportive of an attempt to get the best quality people.

3.2.5 *Evaluating the board’s performance (and its needs)*

62. SOE board evaluation is increasingly common in OECD countries. Board evaluations are being encouraged by governments, presumably to maximise board performance and minimise risk. Government interest in evaluations is also heightened as a result of increasing board autonomy, which has left government less able to assess boards by sitting directly at the table.

63. Where performance evaluations are conducted, they range from informal evaluations conducted by a chair to more formal self-evaluations, to formal evaluations conducted by external experts and facilitators. The survey suggests that performance evaluations were conducted more frequently in SOEs than in listed company and that government may be a key factor in encouraging more formal approaches.

64. The challenges associated with evaluations are multifold. Personal feelings come into play, especially when the evaluations look at individual board member performance, or when a chair takes board evaluations as a measure of their personal performance. In addition, the ability to give and take constructive criticism varies among individuals, and is culturally based. Irrespective of cultural issues, public shaming is almost always counterproductive. It is important to focus on being constructive, and on how to improve performance versus focusing on whom to blame.

65. Another issue is the objectivity of evaluations. An abundance of checklists and scorecards (some of them developed specifically for SOEs) exist to address this concern. But, while checklists against hard and measureable criteria may be more objective, they generally fail to measure qualitative factors and the more important human element. For example, the ability to work as a team is notoriously difficult to assess quantitatively. Ultimately, a combination of hard and soft analysis is best.

66. The role of the chair in performance evaluations is also a concern. Clearly the “imperial” CEO/chair may not be best suited to exercise leadership of a board evaluation process. The likelihood of an unbiased evaluation seems limited. Furthermore, chairs can use performance evaluations to get their personal views or messages across, and even intimidate or otherwise influence team members. Performance evaluation loses all credibility and usefulness if it is not scrupulously fair. The solution may be to conduct performance evaluations with the encouragement of the chair but to assign the task of evaluation to an independent board member or an outside consultant.

67. External advisors can greatly assist in addressing all of these challenges. External services are widely available, and are typically well-versed in board issues and have the technical tools to provide a solid analysis and good feedback. External advisors may also be an excellent source of knowledge on best practice. Of course, external advisors are not perfect and need to be selected with care.

68. In summary, performance evaluations are useful when they are formal, well-designed, fair, iterative and linked to improvement plans. They are also enhanced when there is some element of feedback to the state, i.e. some element of external accountability. Finally, performance evaluations can be used as a means of identifying skills gaps to help guide the search process for new board members.

3.3 Special issues

3.3.1 Dividends

69. Dividends are probably the area of greatest potential conflict of interest between the board and the state. Both the national Treasury and the SOE have legitimate claims to the earnings of the SOE. In many countries, SOEs are automatically required to pay a certain percentage of their earnings to the state. In others, the level of dividends is negotiated each year, depending upon the needs of the SOE and those of the state. In a best practice context this negotiation is characterised by a sincere attempt of both parties to balance their interests.

70. But, often the interests of the state and the SOE diverge and it is unusual for there to be sufficient free cash flow to meet the needs of both. In such situations, the interests of the state tend to prevail, and needed investments in the SOE may be put off. When delay becomes a pattern, the result can be systematic underinvestment with pernicious results, particularly in capital intensive industries that require replacement of long-term assets and have long investment lead times.

71. Differences over dividends are not uncommon, and government reliance on SOEs to fund state coffers may be a source of moral hazard, particularly when money is needed to balance national budgets. This conflict is felt among board members who work in the interest of owners, but who also owe a duty of loyalty to the SOE.

72. The potential for dividend conflict may be moderated when governments hold portfolios of SOEs. Portfolio theory suggests that the free cash flow and dividend payment capacity of SOEs will vary and counterbalance each other and reduce variations in the total flow of dividends to the state. Similarly, the timing of cash needs of individual SOEs in a portfolio may counterbalance each other. In practice, however, many governments rely on one or a very limited number of SOEs that are more profitable than the rest for their funding. It is not uncommon for these SOEs to be in resource extractive industries and to be regular and disproportionate suppliers to state coffers.

73. Mixed ownership of SOEs and partial listings are a way to formalise dividend policy and subject dividend decisions to rigorous examination. Certainly, a formal dividend policy is useful to guide negotiations, reduce conflict, and reduce the potential for gamesmanship between the SOE and the state. Even when SOEs are obliged to pay more than they want, a predictable and stable dividend policy is superior to one that is subject to ad hoc decision making.

3.3.2 Remuneration

74. The remuneration of both executives and board members is another area where board views can conflict with the state. As a general rule, governments tend to regulate and limit the remuneration and incentive awards of both executives and board members of SOEs. Some countries have policies that seek to align pay with market rates but not be market leading. Others prescribe remuneration levels. These prescriptions may be supplemented by prohibitions on share options, or restrictions on bonuses.

75. The state's concern with pay issues can be understood from multiple perspectives. One is from the perspective of fairness. One of the goals of government is to create an "even playing field" i.e. fairness of opportunity within society. But another goal may be to encourage fairness in outcomes, and money is a clear indicator of outcomes. The choice of focus is very much country and culture dependent. Irrespective of the direction one takes, countries may tolerate high pay levels in the private sector, but generally wish to avoid public controversy over excessive pay in the public sector and in SOEs.

76. There are also substantive economic concerns regarding the effectiveness of incentive pay. The evidence showing correlation of pay to corporate performance is not strong, and even weaker with respect to individual performance. Such disjuncture between pay and performance is often visible in industries where performance is closely linked to commodity price movements such as the oil or airlines industries. But, it can also be the result of general market movements. Recent turmoil in the financial sector has also suggested that incentive compensation can encourage excessive risk taking particularly in financial institutions or SOEs who actively use financial instruments. Finally, the academic literature on the use of pay to motivate performance is mixed and arguably tending towards scepticism.

77. Regardless of the merits of incentive pay, the basic questions from the state's and the board's perspectives are: 1) whether pay levels are sufficient to attract the necessary talent; and 2) whether they are sufficient to motivate the desired level of performance. In the countries surveyed, there were no reports of being unable to get needed talent even if remuneration was lower than private sector levels. Attracting talent proves to be more difficult when the executive or board member is a foreigner coming from a different pay environment.

78. Responses to the second question are more subtle. Indeed, board members are motivated by their sense of duty and loyalty to country and the SOE, and the prestige of a board membership. However there are also indications that board member compensation sometimes borders on the limit of Herzberg's "hygiene level", i.e. that board members are not willing to put in quite as much effort in an SOE when the work is equally as demanding and the remuneration is less than in the private sector.

79. In summary, state ownership functions need to assess their remuneration policies with respect to their ability to find and motivate the talent they need. Ultimately, what is important is that remuneration be regarded as fair. The use of compensation consultants to achieve these goals was not explored during the context of the present document, but may bear further examination.

3.3.3 *Corporate social responsibility*

80. Corporate social responsibility (CSR) issues are increasingly on SOE board agendas. This is a general trend that is no different for private sector companies. However, expectations with respect to SOEs appear to be higher than for private sector companies. Governments are typically sensitive to the political implications of CSR. Some of the issues that arise on boards are: 1) the international impact of SOE operations on child labour; 2) respect for labour unions; 3) anti-corruption and anti-price collusion; 4) gender issues; 5) environment, and so on. Such heightened sensitivity to CSR issues may impose additional burdens.

IV. HOW A PUBLIC ADMINISTRATION CAN ENCOURAGE BETTER BOARD PRACTICES

81. The prior section of this report identifies the key challenges to SOE boards from the perspective of board members. Some classic corporate governance shortcomings are described as are some highly successful SOE governance practices. In general, it is relatively easy to describe good or best practices. On the other hand, it is considerably more difficult to describe how best practice countries got to where they are today.

82. This section of the report seeks to respond to that question and begin to make some prescriptions. It does so by defining the key contextual success factors that are in place in best practice countries that allow best practices to take root. Again, it builds upon the feedback from chairs and board members, and thus remains on a strategic level. In future, more detailed prescriptions could be identified that support the overall strategic directions.

4.1 Leadership and legal barriers

83. Private sector boards generally have considerable leeway to pursue best practice. The legislative framework is usually sufficiently flexible for the board to make changes, such as increasing the number of board members or establishing a board committee. On the other hand, SOE boards are not generally afforded the same flexibility. Limitations on their ability to determine their own governance can thus be added to the list of other limitations on board decision making described in Section 3.1.1 above.

84. Some of the limitations that may be fixed in law or practice are: 1) prohibition of private sector individuals, independents, and foreign board members on the board; 2) alternatively, requirements that civil servants, or representatives of specific ministries be represented; 3) committees may not be permitted or, alternatively, a number of unneeded committees may be required; 4) board size may be fixed at an unreasonable or undesired number; 5) rights to nominate board members may be assigned to specific government departments such as a ministry of finance, a line ministry, or other; 6) requirements that a minister chair the board; 7) reporting lines (such as internal audit/control), that do not pass through the board and go directly to the state, etc.

85. Such limitations may hinder the board in its function. On the other hand, an absence of limitations does not automatically imply best practice. In the same way that it is an error to assume that talented and well-intentioned board members automatically lead to an effective board, it is also an error to assume that an accommodating framework will automatically lead to better board practices. SOE governance is influenced by multiple factors that go beyond the law including unwritten rules, traditions, and informal understandings at the level of government and boards on how the SOE is to be run.

86. The implications are that: 1) the framework must permit better practice; 2) boards will only act autonomously and professionally when permitted to do so by owners or, better, when instructed to do so by owners; and 3) changes in SOE board practices require active engagement by owners and may require the state taking the lead.

87. *Key success factors: Best practice countries are proactive in setting the goal of better governance for their SOEs. They provide a clear vision of the outcome (such as emulating as closely as possible private sector practices). They take a leadership role, act as an advocate and demonstrate a commitment to professional governance through the board. Legal and other barriers to best practice at board level are removed.*

4.2 The importance of clear, considered and formal policies

88. Good governance practices often founder on a lack of clarity. Clarity means creating clear conditions under which the SOE and the board are able to operate. This clarity emanates from different levels of the policy framework. The overall ownership policy should set out the basic objectives of government ownership, and the main features of good governance. It defines what levers can be used by government to control the SOE and what levers cannot. Such general policy frameworks need to have broad political and ideally parliamentary support to avoid changes based upon shifting political currents.

89. These basic directions should, in turn, translate down into letters of intent where SOE-specific expectations are made clear. How to construct good letters of intent is a challenge. The experience with performance contracts has generally been negative with the trend moving towards lighter, more flexible and more strategic documents; governments should not “load” such letters of intent, i.e. weigh them down with too many or unnecessary expectations. Furthermore, clarity in letters of intent does not mean overdoing the detail. Focusing on the essential is key, and “no go zones” must be clearly defined. The greater the clarity of letters of intent, the lesser the potential for untoward interference.

90. In short, the rules of the game must be clear. The best practice countries that were consulted in the context of this survey all had clear visions of the goals of state ownership and the governance practices that would be used to achieve the overall vision. In all cases, the vision was to achieve performance comparable to the private sector by mimicking, to the extent possible, private sector governance practices including the functions of the private sector board. They also had clearly defined roles and responsibilities, and used statements of intent. In contrast, other countries had ownership policies that were vague, thus allowing for interpretation and permitting a variety of players to provide conflicting signals to boards.

91. *Key success factors: Best practice countries articulate clear policies at all levels. An overall ownership policy lays out the objectives of state ownership, in which the issue of sustainable financial performance is discussed. Such objectives and policies are translated into letters of intent or specific agreements going down to board level. Obtainable objectives are clearly communicated by the owner. Clarity exists on the distinct responsibilities of the state, the board and SOE executives.*

4.3 Respecting extant policies

92. Once clear rules are established, there must be a commitment to follow the rules. In some countries rules or procedures are applied partially, ignored or circumvented. Respect for rules does not come simply because they are formal. Neither clarity nor formality is sufficient. Even in best practice countries where formal policies exist, SOE governance depends on informal commitments and unspoken understandings between the parties engaged in the governance process.

93. For example, in best practice countries, ministers may have the legal authority to directly nominate their board candidates, but prefer to go through an independent nominations process and avoid acting by decree. Acting by decree exposes ministers to political risks and leaves them ultimately responsible. On the other hand, leaving this decision in the hands of others serves to professionalise decision making and protect ministers. At the same time, an independent nominations process is understood to benefit the function of the board and the SOE.

94. Such implicit understandings and informal choices can work in favour of good governance. But, they can also work against it. For example, in some countries, boards have explicit powers to decide certain issues, but only do the minimum knowing that these powers will ultimately be exercised by government. Any decision taken at board level could mean that board members take a significant risk. Thus, informal understanding can work against good governance.

95. Respect for rules is not the same as enforcement. Enforcement implies some level of compulsion and implicitly recognises that there is likely to be some resistance. In best practice countries the focus appears to be on respect for rules but not enforcement. Respect emanates from a shared understanding that a good set of rules is of benefit to all.

96. *Key success factors: In best practice countries all parties understand and respect the governance framework that has been put in place. There is a general commitment to play by the rules, and comply with their spirit and not just the letter. Such respect of the governance framework is created through a broad awareness of goals and policies among the public administration, boards and SOEs, a clear explanation of their rationale, and how policies contribute to the aims of state ownership.*

4.4 Awareness and training

97. Respect for the governance framework is created through a shared understanding and support of its goals, its rationale, and how policies contribute to the aims of state ownership. Essentially what is required is building human capital and building a consensus on how to govern.

98. In countries that are still far removed from best practice, where building commitment for reform is an immediate goal, awareness building on the role and function of boards and SOE governance more generally can be an important initial step. In one OECD country awareness building efforts were being pursued to counter limited knowledge of good governance practices and to better communicate a rationale for change. In this case, training focused on awareness building within the public administration. The training was successful in introducing new concepts though it fell short of creating big change. In best practice countries, what constitutes good governance is broadly understood within SOEs, the administration, among politicians, and even the public, and general awareness building is of lesser value.

99. With respect to board member training, perhaps surprisingly, board members in best practice countries tend to attribute little significance to training aside from induction programs. Most prefer to do their learning on the job. Clearly, many informal learning opportunities for learning exist including, for example, interactions with outside experts (such as board evaluation consultants), site visits, meetings with executives, etc. Memberships on other boards also provide excellent opportunities to learn from case experience. Even very technical issues such as accounting or financial instruments are learned on the job in meetings with SOE auditors rather than in formal outside venues.

100. Whether such training choices are, in fact, economically optimal may be questioned given the literature on the tendency for both individuals and organisations to underinvest in education. The state may, thus, have an important role to play in training, and best practice in board training may require further consideration. For example, government may have some role in encouraging a deeper knowledge of risks and risk management given the role that financial instruments and an improper assessment of risk had during the recent financial crisis

101. In addition, there are countries where the general context for improving governance is good (i.e. the value of general awareness training is low) but the knowledge of how to be a good board member is in short supply. This is often the case in developing countries. On the job training will likely be insufficient in such countries where skilled individuals are scarce. Here, the role of institutes of directors, private sector

trainers, consultants, universities, and government sponsored programs should receive further consideration. Once again, one size does not fit all. The training needs and approaches of countries defy generalisation and should be adapted to respond to local needs and circumstances.

102. *Key success factors: Best practice countries have well-educated boards, but they also have a well-educated public administration. In best practice countries, executives, boards and the public administration all share the same technical understanding of governance and the function of best practice SOEs. As a result, they all seem to talk the same language, appreciate and abide by the rules of the game, understand each other's motivations and pull in the same direction.*

4.5 Communications

103. CEOs are sometimes frustrated by lack of feedback from the board, or take the lack of feedback as an opportunity to rubberstamp decisions. The free flow of views and information between the CEO and the board is thus of great importance, as is the flow of views and information between the chair and the owners. The chair inevitably plays a central role. His/her role requires highly developed people skills. He/she needs to understand public administration and SOE executives, and has to win the trust of both.

104. In best practice countries the communications between the chair and the CEO can be frequent. The contact between the government and the chair should, on the other hand be less frequent. Constant communications between the administration and the chair, except perhaps in times of crisis, can be an indication of excessive involvement.

105. Boards in best practice countries often describe their communications with owners as just slightly more involved than what they might have with a major institutional investor. As with any other large investor, important decisions are made with the knowledge of the owner to ensure that their views are understood and that there are no unwelcome surprises, either from the SOE or on the part of the state. Striking the correct balance involves carefully focusing communications on strategic issues.

106. *Key success factors: Best practice countries have excellent communications between the executive and the board. They also have excellent communications between the chair and the owner. Good communications ensure that both the SOE's and the government's positions are known and understood. Best practice countries have talented chairs to fill this difficult role.*

4.6 Public transparency

107. Best practice countries use public transparency as a tool to drive greater SOE performance. Disclosure practices usually emulate those of the private sector. Traditionally the discussion of SOE disclosure has focused on financial reporting standards and the verification of financial reports through audit. Increasingly, disclosure covers governance practices and is used as a method to create checks and balances, in particular in the area of nominations.

108. Such disclosures are only of interest to a very small part of the public. Disclosure is much more effective at capturing the public's attention when it is on issues that directly affect the reader such as gas or electricity prices, environmental pollution, or when there is a scandal. Nevertheless, making information broadly available allows the public and civil society bodies to hold the SOE and the public administration to account.

109. In contrast, one of the most important pitfalls to avoid in SOE governance is "backroom dealing", or the opposite of transparency. Backroom dealing is defined as decision making that takes place outside of the public's scrutiny or outside of established channels. Backroom dealing in a situation when minority shareholders do not have access to the same information, or where their concerns are not treated fairly and

in a transparent fashion leads to a serious breach of trust. A lack of transparency is also damaging even when minority shareholders are not involved.

110. *Key success factors: Best practice countries are transparent in order to enhance the accountability of both the SOE and the accountability of the public administration. Best practice countries do not have SOEs that are accountable solely to themselves or to government.*

4.7 Privatisation

111. Some countries have achieved well-performing boards and SOEs by emulating private sector governance practices while retaining full state ownership. Key to success using this approach is to not just emulate the structural elements of the private sector, but to have the firm desire and commitment of the government that SOEs will be governed according to best private sector practices.

112. Other countries have sought to introduce private sector behaviours and practices directly by conducting partial listings of SOEs. Once an SOE is listed, the governance framework changes and new checks and balances come into play. The SOE is subject to scrutiny by the markets and all questions must be weighed from a shareholder perspective.

113. Partial privatisation is seen by many as the critical factor in transforming SOE boards and promoting SOE performance. The alternative, a successful emulation of private sector practices with full ownership is often considered to pose insurmountable long-term hurdles because of the need to significantly alter government administrative culture. On the other hand, countries that already have good SOE governance practices may consider the potential gains of opening up the ownership of the SOE too small to warrant the political costs. For all of its potential benefits, private ownership remains politically sensitive and is generally considered with caution.

114. *Key success factors: Not all best practice countries privatise. But, all of them consider the potential impact of privatisation; they regularly re-consider the rationale for public ownership as well as the rationale for ownership of individual enterprises.*

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