

Institutionalising good governance tools for state-owned enterprises: Governance Code, Regulation on the Nomination and Evaluation of Boards

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State-owned enterprises are facing major corporate governance challenges that are eroding the efficiency of state assets management. Political interference in the management of companies, often insufficiently trained board members, formalism, lack of independent board members are just a few examples that go against the principles of good governance. So far, the institutionalisation of good governance instruments has been slow and fragmented, but the current context calls for efforts to be mobilised. The Government's commitments with development partners, in particular the EU and the IMF, foresee strengthening the management of state-owned enterprises. The management of state-owned enterprises can be improved by adopting and implementing properly codes of governance, adopting regulations that foresee competitive procedures for the selection of boards' members and set up a clear evaluation framework, aimed at enhancing the accountability and motivating boards.

The role of good governance is to facilitate effective management that can ensure a long-term success of the company. According to the principles of corporate governance developed by the Organisation for Economic Co-operation and Development (OECD)¹, state has to ensure that the governance of state-owned enterprises takes place in a transparent and accountable manner, with a high degree of professionalism, integrity and effectiveness. To this end, the state must have in place mechanisms that would guarantee an objective and transparent selection of executive management and boards, to ensure that these positions are held by persons with appropriate professional training, while holding governing bodies accountable for their decisions, and offering transparency to the public.

The state-owned enterprises sector of the Republic of Moldova faces many problems in terms of good governance, which have been repeatedly highlighted by World Bank² and IMF reports³. Thus, the main constraints in this respect are the following:

- Non-compliance with the national regulatory framework on corporate governance, namely the National Commission for Financial Markets Decision approving the Corporate Governance Code⁴. According to this decision, adopting Governance Codes is mandatory for entities of public interest, including large state-owned enterprises, and recommended for other companies. However, many of the state-owned enterprises subject to this provision have not adopted Governance Codes.

¹ https://read.oecd-ilibrary.org/governance/ghidul-oecd-privind-guvernanta-corporativa-a-intreprinderilor-de-stat-editia-2015_7bd54fe4-ro#page14

² https://cfr.worldbank.org/sites/default/files/2019-11/Moldova_SOE_Diagnostics_RO.pdf

³ <https://imf.md/press/wpia2022050-print-pdf.pdf>

⁴ https://www.legis.md/cautare/getResults?doc_id=104772&lang=ro#

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- Even where a Governance Code has been adopted, in many cases companies do not follow and apply Codes' provision. Companies have not continued with the development of secondary reporting tools to demonstrate how corporate governance is adjusted to the provisions of the Code and to what extent it complies. Thus, in the absence of a firm commitment coming from the Board to enforce the implementation of good governance principles, the adoption of the codes is largely limited to a 'tick-box exercise' and is seen as a formality rather than a strict compliance framework.
- The national legislation does not stipulate any formal procedures for selecting board members of state-owned enterprises, which would establish clear selection criteria, therefore decision-making is characterised by an acute lack of transparency. At the same time, this opens the door to appointing members by political criteria or favouritism to the detriment of meritocracy.
- Board membership is made up almost exclusively of state representatives, with no procedure for co-opting independent members.
- There is a conflict of interest triggered by the overlapping of assets ownership and policy making function, which arises when state representatives on boards have direct responsibility for policy making in the sector where state-owned enterprise operate.
- There is no clear and comprehensive framework for board performance evaluation linked to a remuneration mechanism, which on the one hand would make board members more accountable and on the other encourage attracting qualified individuals.

Although attempts have been made in the past to introduce a regulation on organising competitions to select and appoint board members, they have not been successful and the problem has been perpetuated over the years. At the same time, the adoption of governance codes is slow and fragmented. But the current context calls for firm and irrevocable actions on this dimension. Thus, one of the conditionalities attached to the EU⁵ pre-accession process relates to comprehensive reform of state-owned enterprises, specifying in particular (i) the development of a state-ownership policy and (ii) the improvement of the regulatory framework for the governance of state-owned entities in line with OECD principles. At the same time, improving the corporate governance of state-owned enterprises is also an objective assumed by the Government in its Letter of Intent to the International Monetary Fund⁶. An important step in this regard has already been taken. At the end of 2022, the *Strategy on the state property management in state-owned enterprises and companies with full or majority state capital for 2022-2030*⁷ was adopted. It sets out the state's strategic and coherent vision for the state-owned enterprise sector and establishes clear indicators for its monitoring and evaluation. Thus, three measures are set for enhancing the accountability and professionalism of boards, namely:

- approve Corporate Governance Codes in state-owned enterprises;
- approve regulations on nominating, evaluating and dismissing board members of state-owned enterprises;
- adjust the legal framework to allow delegating other individuals than representatives of public servants as board members;

The legislation does not currently prohibit co-opting independent members to boards. However, as the above-mentioned strategy requires that at least one third of board members of state-owned enterprises

⁵ https://mfa.gov.md/sites/default/files/plan_cnie_04.08.2022.pdf

⁶ https://www.imf.md/press/LOI_MEFP_TMU_Dec22-rom.pdf

⁷ <https://gov.md/ro/content/sedinta-guvernului-din-21-decembrie-2022-ora-1100-or-stefan-voda>

be independent members, the regulatory framework in force should be adjusted to reflect the new board configuration.

Governance Code – the framework instrument for good governance

A Corporate Governance Code is an essential tool of good governance, committing companies to apply and comply with high governance standards. It is a comprehensive document that establishes a set of rules and principles governing the system of management, supervision and control in a state-owned enterprise, and sets out the relationships that arise between the governing bodies and other stakeholders in the company's management process. Thus, as a rule, a governance code includes the following framework sections: shareholder/founder rights; structure and obligations of the governing bodies; remuneration policy; system of values and conduct; management of conflicts of interest; role of stakeholders; transparency; audit, internal control and risk management. The Governance Code is, de facto, an umbrella document, which forms the basis for developing the company's other internal governance documents.

By implementing the Governance Code, state-owned enterprises ensure:

- ✓ clarification of the roles of the governing bodies;
- ✓ protection and efficient use of state assets;
- ✓ the promotion and protection of the rights of all stakeholders;
- ✓ adequate risk management and business compliance;
- ✓ implementation of a working environment based on integrity and ethical values;
- ✓ transparent and fair remuneration policy;
- ✓ competent, honest and reputable leaders;
- ✓ transparency and disclosure of information of public interest.

The Governance Code introduces new elements to strengthen the management of state-owned enterprises. It provides:

- New powers for boards. The Corporate Governance Code recommends setting up specialised committees alongside the board to examine the most significant issues in the company's business (nomination committee, remuneration committee, etc.);
- It stipulates that the company's board should consist of a sufficient number of independent members, at least one third of its members; and also introduces a set of criteria for assessing the independence of board members;
- Remuneration principles. Criteria for setting the level of remuneration for members of the board, the executive body and the audit committee are introduced;
- The need to approve the company's Code Corporate Ethics;
- Additional measures to identify and make correct decisions in case of conflict of interest transactions.

The Governance Code places particular emphasis on the accession of independent members, who will ensure that the following functions are carried out:

- support independent decision-making on matters relating to strategy, performance, risk management, conflicts of interest, key appointments and standards of business conduct;
- contribute to an objective performance assessment of the company's key management personnel;

- review the performance of the executive body in meeting objectives, achieving and reporting results;
- ensure the integrity of financial information and the adequacy of risk management systems;
- protect the interests of all stakeholders;
- manage impartially conflict of interest situations between stakeholders;
- counteract pressure from the founder/shareholders;
- act in the interests of the company as a whole;
- ensure the implementation of best corporate governance standards.

Every company that adopts a Corporate Governance Code must ensure compliance with the provisions of the Code, and inform the public in a clear and accurate manner of the extent to which the governance rules are applied and complied with. Thus, state-owned enterprises should include in their annual management reports a separate section containing a self-assessment of how the Governance Code is implemented and the measures taken to ensure subsequent compliance with the provisions that are not met at this stage. This will be accompanied by a corporate governance statement, based on the “apply or explain” approach, which will provide evidence of compliance with the governance rules, or justify, in a detailed manner, the actions or decisions taken which deviate from the provisions of the Code. Note that most state-owned enterprises that have previously adopted a Code of Governance have not started implementing it systematically. Hence, beyond the actual adoption of the Code, particular emphasis needs to be placed on the de facto implementation of its provisions. Within the company, the responsibility for ensuring an effective corporate governance framework rests with the executive body and the board, therefore these two bodies should embody and demonstrate a governance model based on high professionalism, functionality, integrity and full accountability for good governance – dimensions that are currently lacking.

Formal nomination procedure – a mechanism to professionalise boards

According to the legal framework (Law No 246/2017 on State and Municipal Enterprise and Law No 1134/1997 on Joint Stock Companies), board members have broad and complex duties, thus calling for the need to attract professionals. The Board is the main decision-making body of state-owned companies, which makes it imperative that its members are selected in a professional and transparent manner, based solely on meritocratic criteria. Appointing professionals of high integrity to the governing bodies of state-owned enterprises demonstrates the Government's commitment to being an accountable, transparent and credible owner. The election of board members should therefore be based on a formal, rigorous and transparent procedure. The purpose of establishing such a procedure is to provide a regulatory framework that guarantees a competitive and transparent selection process from a decision-making point of view, based on criteria of competence and integrity, thus ensuring the professionalism and independence of the state-owned enterprises boards.

The nomination procedure of board members must be applicable to both public servants and independent members. As a rule, board members of state-owned enterprises are representatives from the Ministry of Economy, Ministry of Finance, Ministry of Infrastructure and Regional Development and/or Public Property Agency, as well as sporadically some independent or non-public sector representatives. Thus, participants in the competition could compete separately for the quotas allocated to each category

of board members of state-owned companies. As a result of legislative changes in autumn 2021⁸, board members of state-owned enterprises can also be the advisers to the he members of the executive or the presidency. This approach is contrary to OECD best practice and to the provisions of the Strategy passed at the end of last year, as it generates risks of political interference in the work of companies. Therefore, this rule should be abolished.

The following description outlines the main principles and provisions of the procedure for nominating board members that should underlie the drafting and adoption of the given Regulation.

➤ **The selection process**

Candidates for the position of board member of a state-owned enterprise should be selected through a competition organised by the entity acting as Founder. The competition shall be conducted in accordance with the principles of non-discrimination and equal treatment, taking into account the candidate's profile. It is recommended that the evaluation and selection of board members to be carried out by a Nominating Committee composed of representatives of the Public Property Agency, Ministry of Finance, Ministry of Economy, the line ministry responsible for the policy area of the state-owned company, and representatives from outside the public sector (civil society, academia, private sector, corporate governance experts). The members of the nominating committee must refrain from any actions that could give rise to a conflict of interest.

➤ **Candidate profile**

The competency framework underpinning the candidate selection needs to be diverse, ensuring a mix of skills required for the position of board member, as well as the need to build a diverse team. The selection process for board members should therefore be guided by the candidate profile, which is drawn up separately for each position. The candidate profile basically sets out what is expected from the potential candidate for the position of board member. When developing a candidate profile, the following aspects should be taken into consideration: the organisational context, the strategy, the goals and the expected results of the state-owned enterprise, the requirements in relation to the board to ensure a successful operation of the state-owned enterprise, condition to ensure an optimal mix of competencies among the board members, the expectations of the Government derived from the mandate documents (for companies where such a document is developed).

➤ **Stages and evaluation criteria**

For candidate selection, the competition process should consist of two stages: (i) application evaluation, resulting in a shortlist of candidates qualified for the second stage - (ii) interview. The criteria applied at the application evaluation stage should essentially focus on 3 dimensions that characterise the overall qualification of the candidate:

- i. skills – theoretical knowledge, qualifications, professional experience;
- ii. reputation – lack of disciplinary record, sanctions, conflicts of interest;
- iii. financial behaviour – financial performance of the companies in which the candidate had a management position or a major financial interest;

It is important to recognise that boards differ in size, complexity and social impact. Therefore, the relative importance for each of the 3 dimensions and sub-dimensions mentioned above may vary depending on the type of board for which individuals are selected. Thus, based on the profile of the board,

⁸ https://www.legis.md/cautare/getResults?doc_id=128488&lang=ro

the specific competency requirements will be determined – how many people need to be competent in a particular area of specialisation and at what level of expertise.

At the interview stage, candidates should be assessed against the following criteria: professional and personal qualities, knowledge of the market in which the company operates, motivation, managerial skills, knowledge of corporate governance mechanisms, etc. Thus, the competition process will allow selecting people who have a good knowledge of both the area of activity of the state-owned enterprise, being able to contribute pro-actively to the establishment and achievement of the company's strategic objectives of growth, development and efficiency, as well as of the economic, investment and management field as a whole. After completion of the competition, the selected candidate(s) are to be presented to the Founder/General Meeting of Shareholders for appointment to the Board.

➤ **Eligibility criteria and additional requirements for independent members**

In line with the Decision of National Commission for Financial Markets on approving the Code of Governance, and the OECD principles of good governance, non-eligibility conditions with the position of board member of a state-owned enterprise shall be established. Thus, a board member of a state-owned company may not be:

- the head of a central public authority;
- a person who has less than 3 years of total employment;
- the administrator and chief accountant of a state-owned company;
- member of the censor committee of the same company;
- a person convicted, by a final and irrevocable court judgment, for offences relating to property, offences of corruption in the private sector, corruption, influence peddling, abuse of office or breach of trust, forgery, false testimony, giving or taking bribes.

Additional eligibility criteria are set for independent members. Thus, the independent member of the board of a state-owned company may not be:

- a person who in the last 3 years has held a position or had any professional responsibilities or had an interest in, or was in business relations, directly or indirectly with a state-owned enterprise;
- an employee of a state-owned enterprise or a company controlled by it or who has had an employment contract with them in the last 3 years;
- a person who is a public servant;
- a person employed in the office of persons in positions of public dignity;
- a person who works or has worked in the last 3 years in a private company with a similar field of activity as the state-owned enterprise.

The nomination procedure should also regulate the competition extension and appeals, and list the principles of confidentiality and protection of personal data.

For a judicious and sound allocation of resources, it is proposed that the broad nomination procedure, with the presence of independent members, to be applied for the largest state-owned enterprises only, while for the other companies the members to be nominated considering the same evaluation criteria. Given that the top 15-20 state-owned enterprises by turnover account for about 80-90% of the value created by the state-owned corporate sector, it is a priority to focus efforts particularly on these companies, by setting minimum thresholds in terms of turnover and number of employees in a way that would make these companies subject to the apply the nomination procedure. For the other state-owned enterprises, board members shall be promoted on the basis of specific regulations of the Ministry of

Economy, the Ministry of Finance, the Public Property Agency and the relevant line ministry. These regulations are to be approved by the order of the Minister/Director of PPA, subject to the same evaluation and eligibility criteria as for large enterprises.

Board evaluation procedure – a mechanism for accountability and motivation

Another defining principle of good corporate governance requires the adoption and implementation of a clear and comprehensive framework for monitoring and evaluating the performance of governing bodies. It must be geared to empowering executive management and board's members to be proactive and to act in the interests of the company and public interest. According to international practice, the evaluation of boards places particular emphasis on good governance, transparency and integrity.

The importance of the evaluation of boards:

- allows analysing the extent to which board members are fulfilling their responsibilities;
- aims to improve the work of board members by ensuring that they comply with the best corporate governance practices and act in line with the company's objectives and strategy;
- helps identify vulnerabilities and risks affecting the work of the board, and aspects that need to be improved;
- introduces clarity on the role of the board in the decision-making process and in enhancing the effectiveness of corporate governance processes;
- increases awareness and accountability of board members;
- allows setting up an objective mechanisms to establish the remuneration level of board members.

The current national legal framework addresses very vaguely the aspect of board evaluation, and does not impose any comprehensive procedure of the evaluation method and its criteria. This shortcoming often leads to board members being passive and not fully performing their duties. Therefore, adopting and formalising an evaluation procedure, would ensure that the process of evaluating the performance of boards is clearly regulated. The regulation should set out the purpose of the evaluation, the evaluation method, the frequency and the criteria for evaluation.

The basic principles and provisions of the Evaluation Regulation should take into account the following aspects:

The Regulation should provide flexibility to choose between several types of evaluation, depending on need and context. The decision on the evaluation method will be left to the Founder/GMS. The evaluation methods can be: (i) internal evaluation (in-house); (ii) outsourcing the evaluation by involving external consultants specialised in corporate governance; (iii) using a mixed approach: in-house evaluation, with the process being coordinated by an external consultant.

The evaluation should cover both the evaluation of the board as a whole and the evaluation of individual members:

- evaluation of the board's collective performance – is usually carried out based on self-assessment using the questionnaire method. The self-assessment focuses primarily on governance, including communication and cooperation between the board, founder/shareholders and the executive body.
- evaluation of individual board members' performance – aims to assess each board member based on their actions during board meetings and their overall contribution. The evaluation is carried

out on the basis of cross-evaluation (evaluation of the other members) using the questionnaire method, while ensuring confidentiality.

Criteria for evaluating the board and its members. The Evaluation Regulation should set the framework of evaluation criteria for the board as a collective body, but also establish criteria and parameters for the individual evaluation of board members.

Parameters that should guide the evaluation of the board collective performance:

- how board meetings are prepared and conducted, their regularity;
- involvement of board members in the development of the company's strategies and business plans and the correct application of internal procedures and policies;
- oversight of financial reporting and risk management procedures;
- oversight of the work of the CEO;
- how the board ensures the proper representation and effectiveness of the relationship between the executive body and the founder/shareholders;
- the ability to assess the current position of the company and its prospects and visions for development;
- implementation of the Corporate Governance Code and other governance standards.

Parameters that should be applied to evaluate the individual performance of board members:

- attendance at meetings;
- preparation for meetings;
- teamwork;
- knowledge of the company's specific activity;
- strategic vision;
- personal involvement and overall contribution.

Board evaluations are designed to increase the effectiveness in the governance of state-owned enterprises, which ultimately will translate into better financial and operational performance. Thus, the purpose of evaluations is to identify strengths, constraints and potential for collective and individual board development, and to enable appropriate enforcement actions to be taken. Therefore, the results of the evaluation shall be translated into: action plans aimed at remedying the identified issues in order to improve the board functionality or recommendations for enrolling in specialised courses/training for board members. The results of the evaluation will be taken into account when preparing recommendations to the Founder/GMS on the composition and structure of the board. At the same time, the results of the evaluation should serve as a benchmark for the level of remuneration of board members.

Conclusions and Recommendations

The corporate governance problems that currently characterise the state-owned enterprise sector will not be overcome without consistent leadership at state level that recognises the importance and impact of good governance and enforces a sound regulatory framework in this area. Thus, building on the commitments made in the Strategy on the state-owned enterprises, and guided by international good governance practices, the state has to develop and implement instruments that would strengthen the corporate governance of state-owned enterprises. The following intervention instruments can be suggested on this dimension:

- According to international best practice, the state as founder/shareholder should develop mandate documents for the largest (strategic) state-owned enterprises, explaining the rationale for owning the company, the company's mission and objectives, and detailing specific expectations from the company. The mandate document will also serve as a basis for establishing the framework of competences necessary for the selection of board members.
- It is very important that state-owned enterprises adopt a Code of Governance, adjusted to the latest rigours of good governance. The Code of Governance is a framework document, which sets out the commitments to the company's business and internal processes and specifies the responsibilities and relationship of interaction between the governing bodies: Founder/GMS, Board and Executive. Clear demarcation of the roles of each of these bodies is essential to eliminate the risk of overlapping ownership, supervisory and executive functions. When the roles of these stakeholders are not defined clearly enough, this can lead to a shifting of roles, preventing accountability.
- Adopting Governance Codes should not be a tick-box exercise, as currently happens in most cases. Effective implementation of the Code provisions and systematic and detailed reporting is required to demonstrate the extent to which the company is complying. In this case, the board needs to play a much stronger role and assert its authority in ensuring good governance.
- The full potential of the role assigned to the boards cannot be tapped without ensuring a competitive procedure for selecting its members. Thus, state representatives in boards should be selected on a competitive basis, ensuring the principle of meritocracy while following the imperative of integrity and transparency.
- The selection of board members should also ensure accession of independent members (at least one third), who are selected according to strict eligibility criteria. The role of independent members is to support impartial decision-making and counteract the pressure from the founder/shareholders that can come when boards are made up entirely of public servants.
- In order to strengthen the role of the board, stimulate their involvement and increase accountability it is also necessary to evaluate the work of boards on a regular basis. The evaluations will allow for a fair assessment of how the board complies with the principles and good governance practices of transparency, accountability, integrity, and oversight. Adopting an Evaluation Regulation will therefore establish clarity on the evaluation parameters and requirements, as well as the measures that can be taken based on the evaluation results. At the same time, the results of the evaluation will serve as a benchmark for determining the remuneration of board members.
- **The current framework for remuneration of board members is not able to support the aspiration to professionalise boards and strengthen their role in ensuring good governance.** Considering the maximum permissible level of remuneration for board members, capped at a minimum salary (MDL 4,000 for 2023), it becomes clear that this position is used more as an additional form of remuneration for public servants. Thus, if the transition to functional boards is truly desired, it becomes imperative to establish a new remuneration mechanism, one that is sufficiently motivating and capable of attracting qualified, honest and independent people. While this will involve relatively higher expenses for the state-owned enterprise, the opportunity cost is clearly higher when choosing higher compensation for a professional and engaged board over a less expensive but passive and poorly prepared one. In addition, capping remuneration at such a low level may run the risk of not having sufficient and qualitative demand for board positions in

large companies where the level of responsibility is commensurate with the importance of the positions. On the one hand, potential professional independent members might not find it attractive to participate in the competition and get involved, and on the other hand, public servants might choose to apply only for smaller state-owned enterprises, where they can get the same pay for much less effort and responsibility.

- There is a need to improve the transparency of the management and operational activity of state-owned enterprises, by communicating clearly to the public the company's mandate and objectives, and the extent to which they are met, the costs of achieving the public policy objectives or other non-commercial objectives, transparency in remuneration, transparency in decision-making, etc.
- At the same time, achieving the objective of strengthening corporate governance in state-owned enterprises is inseparable from strengthening/restructuring the corporate management capacities of the Public Property Agency.