

How to Establish Professional Supervisory Boards in State-owned Enterprises (SOEs) in Latvia

Recommendations to the Latvian Government, Ministries and Other Institutions that are Shareholders of State-owned Enterprises (SOEs) for Organizing the Selection Process of Supervisory Board Members



Baltic Institute of Corporate Governance (BICG) is a non-profit, non-governmental initiative with strong involvement from Baltic businesses and political leaders. BICG is leading the way in the Baltic business universe by helping to create better governed public and private companies. BICG provides studies and guidelines on corporate governance for private sector entities and state-owned enterprises, and implements education programs for top managers, business owners, members of supervisory and management boards.

INTRODUCTION

Given the significant role of state-owned enterprises (SOEs) in the Latvian economy, their effective corporate governance is a matter of key importance. International practice evidences that professional and well-organized supervisory boards are the most effective instrument for supervising activities of management boards in companies. Supervisory board is responsible for designing development strategy for a company and monitoring its implementation, for selecting management board members and evaluating their performance, for overseeing company finances and risk management system. It is also accountable to shareholders and society for company operations. One of the preconditions to having a successful supervisory board is professionally organized selection of supervisory board members.

Shareholders of SOEs (mostly ministries) organize the selection of supervisory board members in accordance with government-approved procedures¹. Currently, these procedures leave plenty of room for interpretation, therefore a large variance of practises are possible across SOEs, depending on the understanding of corporate governance principles and role of supervisory boards as well as knowledge in organizing supervisory board members selection.

To improve the selection process in accordance with the best international practices, the Baltic Institute of Corporate Governance (BICG) has developed recommendations for the government and shareholders of SOEs (mostly ministries) on how to organize the selection of supervisory board members.

These recommendations are based on international practice² and on the monitoring of the currently existing practices (during the period from January till May 2016). BICG has also made use of ideas voiced during the public debate “*How to Create Professional Supervisory Boards in State-Owned Enterprises?*”, organized in March 2016 in partnership with Citadele banka, a corporate member of BICG. Representatives from ministries and SOEs as well as entrepreneurs and experts on best governance practices participated in the discussions.

The following recommendations have been grouped along four directions and should be approached in the context of the BICG *Guidance on Board Effectiveness*, which is a handbook for SOEs (in Estonia, Latvia and Lithuania)³, as well as with *Baltic Guidance on the Governance of Government-Owned Enterprises*⁴.

Four directions of the recommendations

Strategy for the selection of supervisory board members: changing the approach

Composition and effectiveness of the nomination committee

Defining the requirements for the potential candidates

Communicating effectively with potential candidates and transparency in the selection process

BICG nevertheless encourages to use these recommendations on a much broader scope: they are equally suitable for selection of candidates to the supervisory boards of municipality-owned companies or in cases when a company has no supervisory board and is looking for management board members. Likewise, the following recommendations can well be applied for the enhancement of governance at ports, when selecting members to the boards of the ports.

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¹ <http://likumi.lv/ta/id/278668-kartiba-kada-nomine-kandidatus-valdes-un-padomes-loceklu-amatiem-kapitalsabiedribas-kuras-valstij-ka-dalibniekam-akcionaram>

² This includes OECD, for example, http://www.keepeek.com/Digital-Asset-Management/oeed/governance/board-of-directors-of-state-owned-enterprises_9789264200425-en#page1

³ <http://www.bicg.eu/wp-content/uploads/2016/02/Guidance-on-Board-Effectiveness-LV.pdf>

⁴ <http://www.bicg.eu/wp-content/uploads/2016/02/Baltic-Guidance-on-the-Governance-of-Government-owned-Enterprises-LV.pdf>

A. Strategy for the selection of supervisory board members: changing the approach

Formal approach to the selection of supervisory board members should be avoided

Shareholders of an SOE and the appointed nomination committee should allot sufficient time and resources for selecting supervisory board members. Selection of supervisory board members should be approached as an important exercise of top priority, with an aim to arrive at the best possible composition of a supervisory board.

A single, binding strategy for selection of supervisory board members should be defined on the government level, detailing a model for how to act during different stages of selection process:

- *Preparations for selecting members of supervisory board:*
 - Setting up a nomination committee
 - Reaching an agreement on the role of a recruitment company and hiring it
 - Allowing for the nomination committee to study the situation in the company, understand its strategy and objectives
 - Defining requirements for candidates and outlining their profiles
 - Coming to an agreement in the nomination committee about communication strategy – how to reach potential candidates and to ensure transparency in the selection process
 - Reaching an agreement in the nomination committee on procedures for evaluating candidates
- *Attracting candidates to supervisory boards:*
 - Reaching potential candidates via a wide range of communication channels, including media, recruitment company, etc.
- *Evaluating candidates to supervisory boards:*
 - Reviewing applications and evaluating candidates against requirements, compiling a long list of candidates
 - Shortlisting candidates and conducting due diligence on them
 - Interviews
- *Closing supervisory board member selection process:*
 - Recommendation by the nomination committee to the shareholder of an SOE for election by the general meeting of shareholders
 - Evaluation of selection process
 - Communicating selection results to candidates, media and society
 - Induction of supervisory board members subsequent to the decision of the general meeting of shareholders⁵, support from shareholders in order to secure effective functioning of supervisory board at initial stage (e.g. provide all appropriate information)

⁵ See the BICG Guidance on Board Effectiveness <http://www.bicg.eu/wp-content/uploads/2016/02/Guidance-on-Board-Effectiveness-LV.pdf>

Organizers⁶ of supervisory board selection process should have knowledge about corporate governance, about the role of supervisory board in a company, and about organizing the selection process. This can be achieved through different education programmes, sharing experience with other institutions as well as via consultations with experts and recruitment companies.

Discussions about the organisation of selection process should be a part of a nomination committee's activities. Shareholder of an SOE should issue a mandate for the nomination committee for selection process, including an agreement on how to conduct the selection, a definition of requirements for candidates and drawing up a recommendation regarding the most appropriate applicants.

Personnel recruitment companies should be engaged

Recruitment companies should become an integral part of supervisory board members selection process. Such companies may be hired in various capacities, yet the most important thing is that they are capable of greatly expanding the potential range of candidates. Recruitment companies would encourage putting private sector professionals (as independent members) on the list of potential candidates who, most likely, would otherwise refrain from participating in such competitions. Recruitment companies can lead the entire selection process or, for example, evaluate competencies of potential candidates.

Shareholders of an SOE and members of the nomination committee should have an understanding about the company and its strategy

Nomination committee needs to be familiarised with the existing situation in a company, its strategy, goals and challenges. Situation in a company influences supervisory board selection process, supervisory board member candidate profile and requirements set forth. Supervisory board selection process is influenced by market situation, financial standing of a company, its objectives and strategy, company culture and future development directions. Nomination committee can get a better understanding about the situation in a company by meeting representatives of the shareholder, management board members and top executives, and by studying information about company strategy, annual reports, and (where necessary) by having consultations with trade associations.

Shareholders of SOEs should put a system in place that enables a supervisory board to effectively perform their functions set forth in the law

Shareholders of SOEs should allow supervisory board to perform functions set forth in the Commercial Law and other laws. Shareholders of SOEs would often have their own vision about certain matters in a company, yet they should be aware that a shareholder must not directly interfere with company's day-to-day operations, and this refers also to not giving any written or oral guidance about decisions that should be taken by the supervisory board or management board. The law stipulates a division of roles, authority and responsibilities between the shareholder, supervisory board and management board. When this division is respected in everyday operations, it determines the model for how to act in situations when society (including media) demands that a minister or administration of a ministry get themselves involved in addressing a problem that is the competence of company's

⁶ Officials and employees of the shareholder of SOE as well as members of the nomination committee

management board or supervisory board. The same is true about acting in situations when decisions have to be taken that are crucial for development and existence of a company.

B. Composition and effectiveness of nomination committee

Supervisory boards of SOEs should be selected in a centralized manner

When adopting the best practices in selection of state secretaries and other executive officers of public administration bodies⁷, amendments need to be introduced to laws in order to centralize supervisory board member selection function. If selection of supervisory board members for all SOEs is done in a centralized manner, this would ensure a unified and professional approach to implementation of selection strategies; moreover, there would be a continuous knowledge spillover to other selection processes. Contrary to existing procedures, there would be a single body that prepares all the documentation required for selection process, ensures communication with all parties involved and provides support to the nomination committee. Similar as it is now, shareholders of SOEs would hold a significant role in the work of a nomination committee.

Experts should comprise a majority in a nomination committee, politicians should not be involved

Composition of a nomination committee should allow for managing the process in an unbiased and independent manner. Members of a nomination committee should possess knowledge and experience in business, selection of executives and board members, governance of enterprises and conducting interviews. "Talents attract talents", and this is why a majority of a nomination committee should be composed of entrepreneurs and independent experts with a good reputation⁸. A nomination committee does not need to be comprised from more than 5-7 people, as all members should be able to allocate sufficient amount of time for their work, including for listening to all candidate interviews, in order to be able to evaluate them and compare their suitability. Secretarial function of a nomination committee (drafting of documents, e.g. circulation of information) should be provided by an organisational unit of the ministry in charge of governance of SOEs or human resources management but not by enterprise itself.

Politicians or persons related to politicians should not participate in a nomination committee or else it increases the risk of undue influence of politicians on the selection process and on day-to-day operations of supervisory board thereafter. Politicians and government ministers in particular, as well as persons related to them should improve or initiate improvements in government-approved procedures with regard to selection of members to supervisory boards (and also management boards) of SOEs in accordance with internationally recognised practices.

⁷ <http://likumi.lv//ta/id/274668?&search=on>

⁸ In accordance with the government regulations, the nomination committee should be composed of representatives appointed by the holder of state capital shares, a representative appointed by the government coordinating entity of SOEs, independent experts and, where necessary, observers in an advisory capacity, with the purpose to assure the transparency of the compliance evaluation process.

This would also make it possible to have an agreement on a single procedure (approach) for selection of supervisory board members. A procedure that is binding for all shareholders of SOEs and details a model for how to act during different stages of supervisory board selection and nomination process.

Members of a nomination committee should ensure that their *declaration*⁹ about absence of conflict of interests is maintained valid throughout the entire selection process. Overseeing compliance with these signed declarations shall rest with the shareholder of an SOE as well as with other authorities.

8-10 weeks should be given for the selection process

Work of a nomination committee should not be rushed or unduly stretched in time. Work of a nomination committee that is unduly rushed or stretched in time raises concerns about formal approach or unjustified political pressure on members of the committee and about possible information leakage regarding potential candidates, which is unacceptable. Usually, selection process would take 8-10 weeks, including all stages of selection process.

Interviews with candidates should be structured and conducted by professionals

An interview should be led by the chairperson of a nomination committee or an engaged expert who has such experience. An interview may be led by a representative from a recruitment company. Nomination committee should agree on the structure and plan of the interview. Interviews can be organized on several levels, for example, starting with a recruitment company interviewing a candidate to check compliance with requirements. It would take from 40 minutes to one hour for a nomination committee to interview a candidate. If a recruitment company has been hired, it should initially perform due diligence on the potential candidates, then an interview may be made shorter.

Interviews should not be formal: they should focus on the evaluation of a candidate's suitability as well as on the candidate's vision for the development of the company and solution of its problems. It is important that questions for an interview be prepared in advance. Candidates should not meet each other during interview process. Also arranging interviews as a face-to-face competition between two or more people is not a good practice.

Nomination committee should agree on candidate evaluation procedures and have a common understanding how the requirements will be applied

Nomination committee should agree on how candidates are going to be evaluated, including a decision about assigning weights to each individual requirement in overall scoring, an understanding on the concept of impeccable reputation (and facts that suggest a bad reputation), on who is in charge of screening a candidate in respect to compliance with requirements stipulated by law (for example, a prohibition to engage in certain or all types of commercial activities). It is important that during candidate evaluation process focus be on testing actual knowledge and proven experience.

⁹ See Annex 3 <http://likumi.lv/ta/id/278668-kartiba-kada-nomine-kandidatus-valdes-un-padomes-loceklu-amatiem-kapitalsabiedribas-kuras-valstij-ka-dalibniekam-akcionaram>

Nomination committee should make sure that a candidate to the supervisory board is able to work in a team with the rest of the supervisory board members. One of the board members will have to assume a leadership role and become the chairperson of the supervisory board, by being elected by the rest of the members.

Nomination committee, while issuing its recommendation on the most suitable candidates, should consider the overall composition of a supervisory board

The output by a nomination committee should be a decision (preferably unanimous) about candidates to be nominated for the supervisory board. If a nomination committee recommends several candidates (or even several sets of supervisory boards), they should be ranked according to priority. **Recommendations on candidates should also reflect their compliance with the initially defined candidate profile**, in order to have the necessary mix of experience and knowledge in a supervisory board.

C. Defining requirements for potential candidates to a supervisory board

Composition of a supervisory board should offer the necessary set of competencies, skills and experience

A supervisory board will be effective if it works as a well-functioning team. As a rule, a supervisory board will be composed of professionals with different backgrounds – experience in private sector, competences in finance and strategic management, knowledge and understanding in the industry, risk governance, IT and e-business related competence, competence in corporate governance, etc. Considering the composition of a supervisory board and its dynamics, one should also take into account other individual characteristics of candidates, for example, their collaboration and interpersonal skills (which are paramount when dealing with the management board), diplomacy and leadership. Gender diversity in a supervisory board, maturity as well as conceptual and analytical thinking of a candidate are other aspects that need to be assessed. One should make sure that a candidate is able to devote sufficient amount of time for fulfilling his or her duties as a supervisory board member. Commercial Law nevertheless stipulates that an entire supervisory board should be elected, also in cases when only one member of supervisory board has either been revoked or resigned. Consequently, it is important to approach candidate selection process with an idea that all members of a supervisory board will have to work as a team, built up from already existing and newly elected supervisory board members.

It is critical for a nomination committee to agree on the potential candidate profile. Current practice in respect to competitions for positions of supervisory board members shows that candidates are being sought by defining universal requirements for the entire supervisory board. It is important for a nomination committee to agree on the potential candidate profile, such as competence in financial and strategic management, knowledge and understanding of the industry, competence in corporate governance, risk governance, IT and e-business related competence etc., in order to have the necessary mix of experience and knowledge in a supervisory board.

Requirements for supervisory board members should be clear and reasonable

Nomination committee should define and publish clear requirements for potential candidates to a supervisory board, taking into consideration the preferred candidate profile.

Already right now, government regulations¹⁰ include key criteria for selection of supervisory board members, which are language skills, education, work experience, impeccable reputation and other skills and competencies. It is important to ensure that these requirements be reasonable; also, as far as possible, it should be arranged that a candidate, when applying for a vacant position on a supervisory board, is not asked to supply unreasonable amount of documents (copies of diplomas, proposals on the company's strategic direction etc.), which can be requested in further selection stages.

Any restrictions for engaging professionals from private sector should be removed

Requirements for members of supervisory boards should encourage attracting professionals from private sector. If a supervisory board needs a professional in finances, then formulating a requirement that a candidate should possess financial management experience in the industry of a company would significantly narrow down the range of candidates. This increases the risk of compiling a supervisory board from people that are only related to the shareholding ministry or to other SOEs formally owned by that ministry (a closed circle of candidates).

Government should consider reducing obstacles for attracting professionals from the private sector. Requirement to have a command of the official language (Latvian) as well as requirement to disclose personal data (income, assets etc.) are top two discouraging aspects for professionals, including those coming from abroad, to serve in supervisory boards. As to the command of the official language, a possibility to use an interpreter should be provided for. As to the publishing of personal data, disclosure of supervisory board member remuneration and other benefits in annual and quarterly reports of SOEs might be a potential solution, instead of the current situation (currently, supervisory board member has a status of a "public official" and all public officials in Latvia must submit special declaration once per year, thus disclosing data including income, assets etc.).

In recent years, engagement of experienced foreign professionals to leadership teams of Latvian companies has been gradually increasing, which is associated with their competencies (knowledge and skills). This practice should be introduced in SOEs as well, and supervisory board members should be compensated for their eligible costs (travel, accommodation etc.).

¹⁰ <http://likumi.lv/ta/id/278668-kartiba-kada-nomine-kandidatus-valdes-un-padomes-loceklu-amatiem-kapitalsabiedribas-kuras-valstij-kadalibniekam-akcionaram>

D. Communication practices: reaching potential candidates and transparency in selection process

Shareholders of SOEs should be proactive in informing potential candidates about vacancies

Nomination committee, together with a representative of the shareholder of an SOE, should agree on communication activities. Posting an advertisement on the website of a ministry without taking other publicity measures is not enough to reach potential candidates. Communication activities should include a wide range of communication channels for informing potential candidates, including:

- Websites and social media accounts of the shareholder of an SOE and possibly other institutions (e.g. , Cross-Sectoral Coordination Centre, State Chancellery)
- Advertisements in business media
- Press release, distributed for news agencies and media,
- Other publications (including interviews with ministry officials) in the media
- Information for trade associations and experts with a request to forward it to potential candidates

Recruitment companies are able to reach potential candidates from the private sector, who, otherwise would most likely refrain from participating in such competitions. At least half of a supervisory board should be composed of independent supervisory board members. Independence may be defined in a number of different ways¹¹, while the concept "independent board" should be understood as a capability of independent judgements, ideas and expressing own opinion.

Provided that candidates who have participated in the selection process agree to it, **it is possible to compile a pool of potential candidates that can be used in other search processes for vacant positions of supervisory board members.**

Potential candidates need to be informed about terms and conditions of their contract and status of a public official

A potential candidate to a supervisory board should know what terms and conditions can be expected to be in the contract and what are the duties and obligations arising from the status of a public official. **Shareholders of SOEs should advise potential candidates about a number of key issues,** including:

- Organization of the selection process and timing
- What are the rules for combining their present professional position with that of a member of a supervisory board?
- What are the restrictions on sources of income and on commercial activities in other professional positions?
- What are the duties imposed by the status of a public official?
- What are the continuing obligations after the expiry of the office of a supervisory board member?

¹¹ According to OECD independent board members are those who are not employed by the company or its affiliates and not closely related to the company or its management through significant economic, family or other ties, while independence from controlling shareholders or another controlling body need to be emphasised in case where, for example, the protection of minority shareholders is of importance

- What is the planned remuneration? Is remuneration a subject for approval by the general meeting of shareholders?
- Approximately how much time would working in a supervisory board take?
- Will a supervisory board member be covered by any D&O insurance?

This information can be made public by posting it on the website of the shareholder of an SOE, under a relevant link in the advertisement text about a vacancy. In addition, if professionals from abroad are to be attracted, this information should be translated to English.

Work regulations of a supervisory board is a document outlining work organization at a supervisory board, including conducting meetings, preparation of materials, work of committees, etc. If these rules are made publicly available before supervisory board selection process, it enables a candidate to be aware of his or her rights and obligations prior to being elected.

Media and society should receive information about announcement of competition, selection process and results

Shareholders of SOEs already have an obligation to publicly disclose information about the selection process (including timing), results of candidate evaluation, composition of a nomination committee, etc. However, on some occasions, it is impossible to get particular information about the selection process, members of nomination committee. There is also a lack of information for identifying which members of a supervisory board are independent, or why only 3 members have been elected where laws envisage supervisory board consisting from up to 5 members. Information provided for the media and society should give a comprehensive understanding of the selection process, its stages, as well as of its results: recommendation by the nomination committee and decision of the general meeting of shareholders regarding the election of supervisory board. For example, selection process could be finalised with public event where a representative of the shareholder of an SOE informs the media and society about both selection process and results

Persons involved in the process are prohibited from disclosing names of potential candidates

It is not good practice if during the selection process names of potential candidates get leaked to the media. **The shareholder of an SOE that is organizing the process has an obligation to provide information about the selection process, but at the same time, it has an obligation to keep names of candidates confidential.** Any leakages of information are discouraging for professionals, when they consider competing for a vacant positions in other SOEs. Therefore shareholders of SOEs should take all necessary precautions for safeguarding this information in order to reduce the risk of unauthorized disclosure of candidates' names.