

SOE WHAT'S NEW?

A Communiqué From The SOE Forum

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II ROUND TABLE

SUMMARY REPORT

By

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Hosted by

THE FRENCH ASSOCIATION OF INSTITUTIONAL INVESTORS



A. Summary Report on II Round Table

Organized on the initiative of The SOE Forum, the roundtable focused on the roles and responsibilities of boards of directors and shareholders' meetings, in managing the strategic challenges faced by SOEs (for more details, see Appendix II, the introductory note to the round table).

In his introductory remarks, Jean-Aymon Massie, the Working President of the Forum, recalled the context in which SOEs operate and the main challenges they face. He underlined the meeting's main objectives: to identify the constraints faced by public enterprises in addressing the strategic challenges listed in the Introductory Note and jointly reflect on the solutions to be promoted, in order to improve their governance, which is essential to consolidate their role and effectiveness and ease conditions under which they operate.

In his message to the participants, the Founding-President, Y.R.K Reddy, recalled the Forum's primary objective: to serve as a platform for discussions, exchanges, proposals and trainings for the greater purpose of improving SOEs governance. He also stressed the importance of the round table's theme in the current international context. (See Appendix I)

The discussions were structured in two panels. The first panel focused on the specificities of the French public companies and the challenges they face. The second focused on the roles and responsibilities of the Board of Directors (or Supervisory Board) and the Shareholders' General Meeting in addressing these challenges.

Panel I: Characteristics of French SOEs and the challenges they face.

Introduced by Jean-Alain Taupy

In his introduction, Jean-Alain Taupy reminded the contributors that French public enterprise most frequent legal status is the Public Establishment of Industrial and Commercial character (EPIC). There are also other forms, notably Public Administrative Establishments engaged in commercial activity, National companies and Joint Public-Private companies. Only a small portion of these companies are under the authority of the State Participation Agency (APE), and a fair number are publicly traded.

The review of the French and European legal and regulatory texts¹ shows that the criteria for defining an SOE remain relatively unclear. This provides the State with some leeway, should it need to extend the scope of its intervention beyond the majority ownership of the subscribed capital and the majority of the votes (voting rights). Indeed, in France, even as a minority shareholder, the State may intervene in the course of a company's strategic decisions, on the basis of specific rules.

¹The reference texts are the European Directive of June 1980 on Transparency in the Management of Public Enterprises, a 2002 Judgment and the Ordinance of 20 August 2014.

In the discussions, several examples were mentioned, notably those of Elf-Aquitaine and ENGIE. In opposition with EU rules, ENGIE is not allowed to sell some of its assets, without the prior consent of the State. In these instances, the "Golden Share" principle continues to apply. Although it is more a "blocking" right than a pre-emption right, it can still greatly affect the future of the company.

Another example was discussed, the PSA Group status. Involved in the "Diesel Gate", a strict application of the trade rules would have led to legal pursuits and payment of substantial penalties by the Group. However, being under the "dominant influence" of the State, PSA was able to avoid the events.

The analysis conducted by Jean-Alain Taupy concludes that the French texts are somewhat not fully distant from the provisions of the OECD on the matter. They articulate the State's scope of intervention according to four axes:

- ✓ The exercise or the safeguarding of national sovereignty,
- ✓ Economic growth control,
- ✓ The rescue of a company in the event of high systemic risk and
- ✓ The management of the country's fundamental needs in terms of infrastructure.

Similar criteria are used in other countries to justify the State's intervention and the expansion of its field of influence. Despite their very strong liberal orientation, even the US and Britain drew on the same criteria on a number of occasions, including during the 2008 crisis. Prior to that in 2006, in the name of national security and for strategic considerations, the US Senate opposed the takeover by Dubai DP World of the British company P & O, which controlled six American ports on the Atlantic coast.

In the light of the above examples, the argument on State capital or shares ownership becomes subsidiary, whereas setting the boundaries of the State's scope of intervention turns out to be essential.

The discussions concluded that such an approach (i.e. not limiting the SOE definition to the capital owned by the State or its voting rights) is pertinent. A conclusion reinforced by the fact that, through their sovereign wealth funds, States have become major international financial players. They have the power to interfere in companies' investment policies, whether public or private, national or foreign. Focus should therefore be less on ownership and more that of the public authority's scope of intervention.

According to Michel Roux, the State should cease to be viewed as an investor with strategic objectives, and be treated as an agent at the "service of the public" instead. With such an approach, achieving the objective of sustainable development becomes more important to the State than the holding of capital or the management of assets.

On this basis, two questions were put forward:

- ✓ Should the reflection be restricted to corporate governance only for entities to which the State is a shareholder, or is it necessary to broaden the scope to all the companies operating in the "field of public intervention", including at local level (in

which case, companies built or operating under public-private partnership should also be considered).

- ✓ What level of autonomy in the definition of their policies and relationship with the State, do state-owned enterprises have? Two cases can be pictured.
 - The first covers the situation in which a public enterprise, by virtue of its role, its positioning and its economic and financial weight, surpasses the State in terms of capacity to intervene and perform.
 - The second corresponds to the situation in which the State imposes a specific policy and conduct on the company, as it recently happened to EDF. The French State commissioned Enedis, which is an EDF subsidiary, to carry out a nation wide households' electricity meters replacement. Another example is the State's decision to invest in EPRs in the UK. Although in this case the effects of such choices engage other economic operators, policy decisions can directly impact companies. The energy transition law for EDF, with the planned reduction of nuclear power generation also illustrates this occurrence.

In 2017, the role of public enterprises and the contribution of direct state participation in economic activities was the subject of three reports. Two emanate from the Senate and the Court of Auditors, which are official structures. The third is from the Montaigne Institute.

The Auditors Court's report highlights both public enterprises' limited efficiency and the additional costs associated with their management. It also stressed the lack of clarity in the objectives assigned to the decision-making bodies.

The report of the Montaigne Institute questions the relevance of state capital ownership, and describes inefficiencies in SOEs management. It also details the existence of conflicts of interests, insider trading practices and the distortions affecting fair competition.

The discussions highlighted the risk aversion and lack of agility of the State as a shareholder². Comparing their experiences, participants noted that state-owned enterprises are the place where multiple contradictions arise when it comes to the State's primary role: safeguarding social balance, defending employment and consumer interests. These three purposes do not always align with a company's best interests. Beyond its survival in a competitive market, the primary objectives of a company remain growth and profit to the benefit of its shareholders. This raises the question of the "benchmark" in the conduct of public enterprises, particularly in the face of the strategic challenges outlined in the note³.

The approach proposed by Michel Roux can serve as an anchor for a review of the governance of public enterprises and the challenges they face. They can be guided in their relations with the State by the principle of "serving the public", knowing that the State is supposed to be "neutral" vis-à-vis enterprises, whether public or private. Such an approach can be further explored, in particular by examining the practices of Sovereign funds (such

²They affect the ability of SOEs to have the flexibility required by the life of the enterprise

³*How to reconcile the paradoxical dual function of the public enterprise to be both "financially profitable", but also conformed in its conduct to the fact that it is the continuation of the state governed by three principles: "independence, benevolence and neutrality"?*

as the Norwegian Fund) and companies such as Orange (in which the French State remains a reference shareholder).

J.P Quaranta proposes to overcome the "consequential" ethic underpinning corporate governance in its traditional sense, especially for public enterprises. It is based on companies' compliance with conflicting rules. He suggests that CG be based on "compliance with a responsible ethic".

In the current international context, the need for compliance with a responsible ethic is in line with the principles set out in the Global Reporting Initiative or Integrated Reporting (which have broadened their scope beyond the environmental issues). The "Comply or Explain" principle tends to become widespread. This principle could serve as a first step in the development of the corporate culture that tends to underpin corporate governance. Corporate culture is a factor of internal cohesion; it is also the prime determinant in the success of corporate policies in such diverse areas as investment, social protection, environment, wages, dividend distribution, and so on.

According to the participants, good corporate governance helps to deal with the reputational risk that can affect the financial profitability and the competitiveness of any company. From this perspective, public enterprises should bestow more importance to a company's extra-financial ratings. Yet this approach remains marginal despite the echo of the Global Reporting Initiative and the EU's 2014/95 / EU Extra-Financial Reporting Directive (which applies in particular to public enterprises with more than 500 employees).

These are challenges for which awareness and reflection should be pursued

Panel II: Role and Responsibilities of the Board of Directors or Supervisory Board and the Shareholders' General Meeting

Introduced by Patrick Viallanex

In his introduction to the second panel, Patrick Viallanex recalled the first challenge faced by shareholders and the board of directors in the context of the competitive environment in which companies operate and in which actors neither have the same access to information nor the same capacity to react. How to comply with both the State's mission of general interest and the duty to promote the (financial and economic) integrity of the public enterprise?

The underlying issue relates to the independence of the strategic management bodies from the State. The review of past experience shows that the privatization of SOEs, presented as "THE SOLUTION", did not always work. Moreover, within the current international context, public-private partnership still has good prospects. Such conclusions are important in light of the challenges identified and discussed by the first panel.

Patrick Viallanex reminded that the review of the legal and regulatory provisions governing the State's relationship with the strategic management bodies of SOEs indicates that these structures⁴ have gained greater autonomy.

State's representatives in the GAs and the BoDs are increasingly more independent in their decision-making; and their role reinforced in the specialized committees. This has resulted in better communication and more transparency in the relationship between the State and the strategic decision-making bodies of public enterprises. Patrick Viallanex pointed out that the recent years have not only witnessed a more systematic separation between the functions of the Chairman of Board of Directors and that of CEO, but also the setting up and improved functioning of specialized committees as well as the introduction of "Regulated Conventions" to prevent latent conflicts of interest.

The role played by the Financial Markets Regulator (AMF) in such evolution has been instrumental. Since 2006, the AMF has been regularly dealing with various topics relating to corporate governance, and particularly of SOEs. The March 2016 report provides a comparison of CG codes across ten European countries. It highlights the wide disparities among countries, notably in terms of independence, separation of powers and executive compensation. It has contributed to a better awareness of the stakes involved in the governance of public enterprises.

Patrick Viallanex recalls three limits in the exercise of governance:

- ✓ The continuing confusion between the State's role of guardianship and its status as a shareholder of a legally and financially independent company,
- ✓ The opacity in the process of nomination (by decree) of the Executives and Representatives of the State to the BoDs
- ✓ The lack of a Directors' selection and appointment Committee.

Missing clarity in the respective roles of the State Participation Agency (APE), the Deposits and Consignments Fund (CDC) and the Public Investment Bank (BPI France) vis-à-vis SOEs further complicates the role of State's representatives. Better compliance with the market's good practices in the area of responsible investment should help addressing such issue.

Based on the discussions, five issues are to consider in order to achieve SOEs good governance:

Selection and appointment process of State representatives and their role within the GA: Opacity and absence of pre-established criteria in their selection can permanently affect the company good governance and performance. Inadequate qualification and potential allegiance of civil servants representing State to their supervisory authority is a serious handicap for public enterprises. Their role in the GAs and in the BoDs is also to be clarified: Do they have the duty of defending the interests and views of the State or those of the company for which they work? Should they share with their supervisory authority information on strategic decisions, the disclosure of which may affect the future of the company?

The weight of the State as shareholder, in the public enterprise: The State, even if it is a minority shareholder, can "take over" and "control" the decision-making power; and the rationale of guardianship may override that of shareholding. Numerous examples were mentioned: EDF, AREVA, ENGIE (sale of the mining

domain of GDF), AF-KLM and RENAULT. What are the limits to State intervention?

The weight of employee ownership: It is always marginal. Because employees' shares are not transferable, they remain a minority and are unable to influence strategic decisions. Is such a situation compatible with the objectives pursued by employee shareholding policy?

The shareholder's approach to strategic issues: It is largely enacted by the market's foreseeable evolution. The shareholder, with the exception of the so-called family shareholder, is the bearer of the interests of the company's owners, and tends to adopt a short-term vision and at most a medium-term view. On the other hand, because of its duty to defend the general interest, the State projects its actions and decisions more into a long-term vision. These two logics are not always compatible. Which should prevail and within what limits?

The company's strategic management bodies modus operandi. Often, decisions are made within Senior Management Committees and are endorsed by the BoDs before being approved by shareholders' meetings. This modus operandi is contrary to the principles of democratic functioning, as envisaged by the promotion of employee shareholding. Although it is not public enterprises specific, it is less acceptable in this case. What provisions should be included in the texts regulating public enterprises governance to address the issue?

Discussions, particularly on the basis of Dubois' long and rich experience, concluded on the importance of the work carried out by the specialized committees. Panelists recognized the crucial role that minority shareholders (especially employees) may play. The Audit Committee has a key role in the validation of the financial statements and in the preparation of the financial communication of the company. The Compensation Committee also plays a key role in maintaining some level coherence in the salary scale, including in setting the basis for the Chairman's remuneration.

In the functioning of the BoDs, it is important to ensure the independence of the Chairs of the Specialized Committees and their protection from all forms of pressure they may be subject to. Although there is no essential difference between public and private enterprises, directors of public enterprises are likely to be more exposed.

From this perspective, it is important to ensure the consistency of the performance indicators with the risks involved and the objectives of the company, in particular with regards to Corporate Social Responsibility. The case of sovereign wealth funds was raised, namely on the basis of the Santiago principles compliance and the growing role of "Sustainalytics" in the rating of large companies and investment funds.

Participants felt that the issue of sharing and controlling power as well as allocating and distributing the revenue generated by the company remains important. The balance of power between the governing bodies is essential. Strengthening the role of the Audit and Compensation Committees in making their decisions binding is critical.

In addition to implementing corrective measures, the question of the possible transposition of the governance model from private companies to public enterprises was also considered:

Is the private companies governance model the one which must prevail in public enterprises?

Based on a comparison of the power of minority shareholders in large public and private enterprises, participants concluded that the latter could not serve as a benchmark for good practice. Indeed, the control strategies implemented by minority shareholders in the private sector show that, despite their limited formal power, they can impose their vision and development strategy on the groups in which they invest. In the private sector (as shown by the case of Bolloré) there are practices, which are not substantially different from those observed in public enterprises; the difference concerns the choices which the State wishes to impose. Often, they are less assertive in terms of financial profitability and more aggressive in pursuing national and geostrategic interests.

The debates highlighted the irreducible diversity of situations in the governance of public enterprises. A typology of governance modes would be useful. It could result from a more in-depth sector analysis. Such an approach would make it possible to identify good practices and inconsistencies in the relationship between the State and its representatives, and lead to appropriate and practical recommendations.

Such an approach is all the more important as the performance of companies is no longer measured by the yardstick of the immediate return on investment but on the basis of long-term satisfaction of the client / user, which is the first criteria of appreciation of a company's sustainable growth.

One avenue to explore would be a comparative study of the practices across countries, including the designation of Directors and their relationship with the governing body or government.

The discussions were rich, thanks to the insights of participants, in particular René Dubois, Bernard Butori, Patrice Leclerc, Eugène Wope and Michel Cojean, who shared their professional experience, especially in public groups which have been privatized, such as ELF, which became Total (in 1986), Société Générale (privatized 1987), Airbus group and Dexia (Franco-Belgian bank). Stéphane Rosenwald has brought his enlightenment as a consultant specialized in Economic Intelligence and Compliance.

At the end of their discussions, the participants agreed to deepen the debates, focusing on some of the issues raised. The results will be exposed in a future note.

We thank all the speakers for their participation and the President of the Af2i, an association represented by Ms Emilie Balard, for their hospitality and the facilities made available to us.

The next Round Table is planned during the latter part of 2017.

B. Introductory Note to the II Round Table

SOEs are sharing strategic challenges with private companies. They are:

1. Digitization. Resulting in structural modification of the internal organisational structure of companies and working processes, it carries additional uncertainties and new risks for firms.

2° Energetic transition. Recent COP21 and COP22 recommendations call on firms to change their modus operandi with an impact on various governance issues, including on CSR.

3° Recent scientific developments, in particular in nanotechnology, biotechnology, neurosciences and robotics. They are generating new technology risks for firms.

4° New national and international legal and regulatory frameworks aligned with the globalisation process. They have direct impact on access of firms to markets and on their transaction costs.

5° Rapid growth of social networks and whistle-blowers. Their influence on firms' stakeholders is constantly increasing. They have direct impact on firms' reputation and performance. They represent a key source of reputational risk.

6° The increasing political and economic weight and role of institutional investors as a result of their positioning in financial markets. They serve as the worldwide reference shareholders for listed companies. Their decision has direct impact on companies' investment policies as well as on their CSR.

7° The need for companies to reconcile constant enhanced financial performance (to serve their shareholders), economic impact (on countries where they are located) and social responsibilities (vis-à-vis local stakeholders and end customers).

The above-listed challenges generate new opportunities for innovation and growth. They are also source of new risks that all companies have to consider in order to ensure their short and medium-term sustainability.

However, public enterprises, either partially or fully under the state control face additional constraints. They are called to comply with decisions undertaken by the State on behalf of national interests. Domestic and international country policy, including in areas such as investment, worker and shareholders remuneration, staff recruitment, etc. Depending on the area of intervention, SOEs have to:

- i) Play the role of public service provider in conformity with decisions undertaken by the State and in line with modalities the State agrees upon;
- ii) Lead investments in areas too risky or not yet enough profitable for private companies, or for geostrategic national considerations as the State deems;

- iii) Comply with rules related to CSR in public sector, in line with State policy;
- iv) Ensure that they are not source of market distortion or trade diversion.

Moreover, SOEs are sometimes called to play extra-ordinary role in full confidentiality, based on instructions received from Government authorities (as it was the case in the payment of ransoms for hostages).

Based on the above-listed conditions and constraints, one could not just consider that the same norms and rules of CG apply in the same way to publicly owned entities and to private companies.

Within such context, any easy way to think is to consider that privatisation of public entities and out sourcing of public services and missions are the solution. Historical experience, including from the most advanced economies, shows mitigated results and even total failure on the long-term. However, such options are still largely shared among policy makers and multilateral institutions. This is mainly due to the prevalence of liberalism ideology and the belief on the “invisible hand of the market”. Indeed, it is unlikely that privatisation of SOEs and outsourcing of public services will contribute to achieve, under all conditions and everywhere, sustainable growth, protection of large economic segments nowadays directly marginalized by the mode of current globalisation and achievement of the objectives of world recommendations on climate change and social protection.

Current international and national contexts, including technological, economic and socio-political changes indicate that the status quo and the use of past paradigms are not sustainable. One way to move forward is to think the future in terms of partnership between public and private sector entities while recognizing the specificities of each partner. Such partnership may take the form of joint venture in financing and developing innovative ways and technologies copying with current challenges like the ones related to climate changes, and of efficient and sustainable outsourcing of public services. However, to be successful, SOEs governance and modus operandi have to be revisited and adjusted to the new context. The General Assembly and the Board of Directors of SOEs have a strategic role to play and should be strengthened. In the last decade, their responsibilities and role have been significantly increased and their relationship with the State clarified. Clarifications are to be promoted in five areas:

- a) Selection of State representatives in the GA and BoD on the basis of criteria in line with the business area and responsibilities of the concerned SOE;
- b) Status of representatives (non executive and autonomy vis-à-vis State) ;
- c) Expected contribution of State representatives in decision-making SOE’s organs;
- d) Expected role of Specialized Committees and the status of their decisions (such as the Remuneration Committee);
- e) Relationships between the GA, the BoD and Management.

The Round-table : The Forum is holding a meeting to discuss these issues and envisage areas of actions and proposals aiming at strengthening SOEs Governance to improve their capacities in addressing the strategic challenges listed-above.

Participants : The Round table is open to SOEs representatives, policy makers and experts with established experience in SOEs governance. To ensure fruitful discussions, the number of participants is limited.

Format : Discussions will take the form of two panels. The first will focus on identifying the strategic challenges that SOEs are facing in France. The question that be addressed is: **what are they and what are the prerequisites to better address them?** The second will review the role and responsibilities of SOEs strategic organs, the GA and the BoD. The question that will be addressed is: **what are the changes to be introduced in their relationships and their functioning?**

Moderators: Mr. Jean-Aymon Massie, current President of the Forum, will make introductory remarks. Dr. Y.R.K Reddy will recall the context under which the round table is taking place and the expected outputs. MM. Patrick Viallanex and Jean-Alain Taupy will introduce and lead the panels' discussions. Dr. Naceur Bourenane, Secretary General of the Forum will provide the conclusion and final remarks.