FUTUREGROWTH
ASSET MANAGEMENT

SOE Governance *Unmasked*

A learning journey

Save SA wants investigation into governance of SOEs

Parliament to investigate massive Transnet locomotive tender

Key asset manager drops state firms

Headless Umgeni Water worries large investor

State corporations on the brink of collapse

Sloppy board governance: Failing South Africa's critical executive leadership

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Foreword: The role of investors in society
Fixing governance standards

What is the role of investors in the degradation of South Africa's governance standards, and how can they help repair the damage? This preamble lays out some of the structural reasons why investors failed to buttress governance standards, and suggests some solutions.

The allocation of capital

Investors represent a vital part of a modern economy in that they allow their savings to be channelled toward productive enterprises. Asset managers often are entrusted to fulfill this key role of allocating capital. Investment should always be done in accord with risk-return principles and be based upon reasoned analysis. In recent years investors' research has moved beyond mere macro-economic, industry and financial analysis to include a range of indicators about the sustainability of businesses. We have learned that **environmental** failures, **social** mismanagement, or poor **governance** can destroy companies. While investors often rely on laws, codes and watchdogs (e.g. regulators, auditors, ratings agents) to give some comfort, a core problem remains that "bad actors" can, and regularly do, break the rules of law, ethics and sustainable practice in the pursuit of personal gain. Time and again we have seen the overarching pursuit of near-term profit leading corporate decision makers away from sustainable choices and onto the shoals of disaster.

Recent events in South Africa's state owned enterprises (SOEs) and some large private companies have shown us that the risks of governance failure - and therefore the need for governance checks and balances - apply equally to both public and private companies.

The problem with agents

We often employ professionals as "agents" who, in various degrees, are empowered to act in our interests. This can range from attorneys and asset managers to business managers who care for shareholders' assets. In fact, employees of the government or SOEs are "agents" appointed by citizens to care for the assets of the nation. However, where business managers are charged with looking after others' interests there is potential for conflict between what is good for the agent versus what might be best for their constituent investors. This is the well-known "agency problem" which must be managed with rules, reporting, contracts, oversight and culpability in order to maintain ethics, efficiency and trust.

The need for systems of **checks and balances** to address the "agency problem" is not new in human affairs: When, for example, governments are instituted to act on behalf of citizens, they are guided by constitutions; controlled by laws and regulations; overseen by a range of institutional watchdog agencies on alert for malfeasance; policed by a free and unfettered press that can make misconduct public; and are ultimately accountable to an alert and reactive populace who can institute change when necessary.

Likewise, investors are one of the pillars of oversight for the nation, but they often forget

that duty and they seem to operate in a flawed sub-system that impairs them from exercising their oversight role. We need to understand those impediments.

In overseeing companies the agency problem is subtle: While a CEO may own shares alongside other investors, she might argue for a corporate jet to satisfy her own desires, or may be driven by the structure of her bonus scheme to seek short-term gains or to take on undue risks. Thus, while **alignment** (e.g. through shareholding) may appear to solve many ills for shareholders, what is really required is a **"web" of oversight** by stakeholders and watchdogs.

In the realm of investing there is a chain of agents notionally acting for investors – but corporate managers, asset managers, auditors, ratings agents, and exchanges are all profit seeking parties who may not always hold investors' interests at the pinnacle of their concerns. Even among genuine fiduciaries – those who hold their investors' interests as paramount - there may be conflict between the need and desire to perform multiple layers of analysis and oversight while concurrently meeting investors' relentless demands for lower costs and fees.

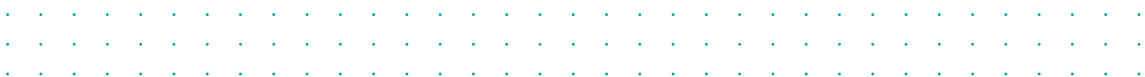
There is a general presumption that "someone" will create a protective environment for investors, but no party actually takes responsibility to ensure that such an environment exists.

Perhaps most pernicious, it is possible for well-intentioned agents to credibly act to protect their own specific clients' interests while failing to address structural problems in markets and regulations that hurt all their clients and all investors. For example, who is responsible for ensuring capital markets are fair, or ensuring the efficacy of standards of reporting on governance by entities with listed bonds or shares? The answer is that – even while exchanges, analysts and ratings agents earn fees, asset managers buy the instruments for investors, and regulators simply tag along - no one in particular takes responsibility for ensuring the overall market system is safe and suitable. As a result, it is **not** safe and suitable. Regulators – whose job is specifically to look after all investors - tend to be understaffed and overburdened by a system which has been shaped by the motives of various players who are able to deploy "divide and conquer" tactics for self-gain and to overcome the principles of fairness and accountability.

In sum, there is a general presumption that "someone" will create a protective environment for investors, but no party actually takes responsibility to ensure that such an environment exists. The belief that regulators, ratings agents, exchanges or others are overseeing the governance of companies – or that the well-intentioned King Code serves to protect investors - is simply untrue. Thus, the mantra of "caveat emptor" ("let the buyer beware") fails to protect investors when others are acting on their behalf or when there is a systemic insufficiency of standards, transparency or honesty.

Investors fail to learn from history

Governments are formed by initial negotiation between citizens, and then systematically improved over the decades and centuries with additional laws, court rulings, controls and oversight. By contrast, economic, corporate and market practices have evolved over time without a guiding vision and have systematically failed to embed the learnings from past failures or malfeasance. It has been observed that "progress in the field of finance is cyclical not cumulative" (James



Grant): Investors fail to learn from history, don't improve processes for learnings, and thus tend to repeat the mistakes of their forebears.

While investors now acknowledge that governance of investee companies is important, and that assessing governance is part of an analyst's job, the actual tools and methods deployed are relatively weak. For example, many investors employ governance checklists: "Does a company have an audit committee?", "Is the chair of the remuneration committee independent?" and so forth. Such tick-box, "yes/no", governance assessments are merely a beginning, and fail to address the real, deeper measures of sound governance - or to help in assessing the challenges of "governance policy" put into "governance practice".

Investors have been so placated that when governance failures occur these events can be palliatively attributed to a "once off", a "lone wolf", or a "bad actor", rather than being seen more truthfully as repeating systemic failures that can, and should, be addressed and remedied.

South Africa looks into the abyss
In recent years, South Africa has faced an alarming decay of governance in its government departments and its SOEs: It is now clear that there has been a systematic programme to capture and pillage the nation for personal financial gain. Worse, the plundered wealth of the people was actively used to subvert the nation! We have just witnessed the near-death of South Africa's young and legitimate democracy. Only the combined efforts of well-intentioned individuals - genuine national heroes - in politics, agencies, the SOEs and the judiciary, alongside participants in civil society, such as the press, academia, the public, and financiers, have allowed the darkness to come to light. South Africa has, not for the first time in its history, looked into the abyss and has chosen not to jump. But we may still be standing at the edge, and in the years to come we must not forget how close the nation came to the precipice.

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Poor governance has tangible costs
The systemic implications of poor governance are not merely academic or emotional, but have real-world, on-the-ground consequences. Any first year economics student can tell us that the three vital factors of production in an economy are **land** (resources), **labour** (skills), and **capital** (access to finance). To compete in the global economy for opportunities, growth and jobs requires accessing these three factors at a competitive cost. The cost-of-capital (the return demanded by investors) is a function of the risk investors take.

The notable governance failures by some SOEs and corporations is a clear sign that South Africa is a risky investment destination – which results in increases in the country's cost-of-capital, and that reduces economic growth and opportunity for all. While the economic theory may sound arcane, the damage is clearly demonstrable. It has been estimated that up to R100 billion[1], which is approximately half of our fiscal deficit, may

1 https://www.businesslive.co.za/bd/national/2017-08-03-pravin-gordhan-says-r100bn-lost-to-state-capture-could-have-doubled-social-grants/

have been misappropriated by government and SOE malfeasance. That means South Africa's government deficit spending (and government borrowing) is higher, and the national debt as a percentage of the economy is that much worse. Adding insult to injury, none of that stolen money has been invested for service delivery or for future prosperity. As a result, South Africa's global credit quality has deteriorated, confidence has been shattered, there has been a paucity of capital investment, and the cost of borrowing to fund houses, education, infrastructure and businesses has risen - for all South Africans. The economy is not growing, and is not globally competitive. The cost of governance failures is real, tangible and terrible.

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Can we improve governance?

With the learnings of recent history and a bona-fide national crisis, we can now marry the ideas of a) sustainable investing, b) the importance of robust governance, c) the necessity of governance checks and balances, and d) the inherent weaknesses of capital markets. We can now move to incrementally enhance governance standards and thus improve investor oversight and the capital allocation mechanism of the economy: This will be beneficial to all of society - citizens, communities, companies, markets and investors.

During the past 18 months, by direct engagement with some South Africa's largest SOEs, the Futuregrowth analytical team has undertaken a greenfields effort to understand what governance is - how it really works in practice - and ascertain how it can be reshaped and improved. We have learned to make governance "real" – to take it beyond tick-boxes and dig down into tangible governance in practice.

We believe that these learnings can be embedded in various regulations and, notably, market listing requirements: Governance reporting at present is remarkably vague, and should be vastly improved so that investors can play their suitable role in oversight and the allocation of capital to sustainable, well-managed entities.

We have identified the following broad categories for governance improvements:

- **The "who" matters:** An organisation can have all the trappings of governance such as a board, committees and policies - but if it has corrupt or ill-intentioned shareholders or leaders then policies and practices are all at risk. In the first instance, improving governance means improving the selection and appointment process of individuals on boards, board sub-committees, and executive management. In the case of SOEs, it also implies improving the selection process of shareholder representatives (e.g. ministers and their advisors). Thus, one has to look at the nomination and appointment processes: Does the company have a properly constituted board nominations committee? Does the candidate vetting process incorporate detailed fit-and-

proper checks? Are candidates vetted for personal or political connections or conflicts? Is candidate vetting done by a qualified, independent party?

Insiders invariably know the truth and it is self-evident that confidential whistleblowing mechanisms should always be in place, that such reports do not land in the hands of company managers, that regulators react with diligence, and that whistleblowers be properly protected (if not actually rewarded) by society.

- **Board of directors and board committees:** All corporate governance begins with the board of directors, so its composition and operations must be appropriate: Are there enough members and the right mix of skills to deal with the business complexity? Are there enough independent professionals? How does the board deal with skills continuity and turnover? Are the quorum requirements and voting thresholds sufficient? How are conflicts of interest dealt with? Are members recused appropriately? The board and committees should be structured to disable conspirators by dint of membership, experience, independence, and questioning. "High-risk" board committees - such as the audit, procurement, credit and remuneration committees - need particular attention.

- **Governance policies:** Any organisation should have governance policies covering the major business areas (e.g. procurement, lending) as well as key risk areas (e.g. remuneration, dealing with politically exposed persons (PEPs), conflicts of interest). Details of those policies must be interrogated for suitability: Can a CEO alone approve a billion Rand acquisition? Can an ex-employee tender for work one month after leaving the company? Under what circumstances can the company do business with a PEP?

- **Internal watchdogs:** Even the best governance arrangements will degrade without active oversight. There are always witnesses to poor governance - such as executives, auditors, employees, and suppliers - who almost universally fail to speak up. Insiders invariably know the truth and it is self-evident that confidential whistleblowing mechanisms should always be in place, that such reports do not land in the hands of company managers, that regulators react with diligence, and that whistleblowers be properly protected (if not actually rewarded) by society. Reporting lines are critical: For example, it is shambolic for an Internal Audit department to report to the Chief Financial Officer (yes, that happens!). A cursory review shows there is a raft of existing regulations in South Africa concerning whistleblowers, and yet those who are in the know are evidently not empowered to reveal the truth. Fear rules. Change is necessary.

- **Transparency and reporting:** Investors, bankers, ratings agents, regulators and the public are "always the last to know" when governance goes wrong, and are often surprised: "How could this have happened?" is the common refrain.

This may arise from wilful ignorance, but is compounded by an utter lack of disclosure and transparency about matters of governance. To stay alert, external parties need complete and timely reporting of details about the membership and operations of boards, committees and executives, as well as the governance policies and practices, and any (and all) changes to any of these items. The investment market standards of reporting on governance matters are pathetic and weak, seem designed to pull the wool over investors' eyes, and are overdue for radical improvement.

Everything on this list is simple corporate hygiene. Not a single item of governance policy, practice or disclosure could be construed as competitive information: Attempts to avoid better governance standards and greater transparency should be treated with jaded and cynical eyes.

Why this report?

Our work has led us into direct dialogue and negotiation with some of South Africa's largest SOEs and their shareholding ministers. While we have made some headway, it is evident that the task of reforming SOE and corporate governance is not something that should be done by one (or even a few) players, but by the concerted action of a wider group of engaged parties.

Thus, the broad purpose of this paper is to share some of our learnings, so that others who are concerned about protecting South Africa's young democracy, improving the standards and efficiency of South Africa's capital market, and creating an environment of prosperity and opportunity, can build on our work.

Empowering the good, disempowering the bad

The governance challenge was considered by Justice Albie Sachs in the drafting of South Africa's post-apartheid constitution. He describes having to envision, and plan for, the human capacity for **perfectibility** – for good people to actually accomplish noble and beneficial goals – as well as the human capacity for **corruptibility** – for bad people to do evil, cruel and self-serving things.

Governance standards are not primarily there to control the ethical, but rather to constrain the unethical.

Indeed, in our experience, people of good intent are happy to discuss and embrace reasonable governance standards which embody checks, balances, and transparency. By contrast, people of bad intent shun such standards, and rebel against openness. We must be clear: Governance standards are not primarily there to control the ethical, but rather to constrain the unethical.

The best outcome is to ensure governance standards and practices are principled, robust, and sustainable, such that they don't impair the work of the perfectible, but serve to emasculate the corruptible.

Andrew C. Canter
February 2018

Introduction and background

The essence of governance is oversight. For the best amongst us, oversight buttresses our integrity and helps us stay on the "straight-and-narrow". For the worst amongst us, oversight is a critical barrier to misconduct. Any discussion about corporate governance often begins and ends with the board of directors. That is a far too narrow view: Corporate governance is better understood as a "web" of oversight by various stakeholders (e.g. shareholders, directors, employees, regulators, suppliers, financiers, auditors, corporate secretaries) as well as a range of policies, practices, protections and disclosures. While this report focuses principally on the internal corporate governance of SOEs, we believe that there is a systemic need to deeply understand, assess, and strengthen the entire web of governance of both SOEs and private companies.

At the end of August 2016, Futuregrowth made a public statement that we would suspend lending to certain SOEs until we could conclude in-depth governance reviews. This followed a creeping sense of governance degradation at various SOEs as observed in worrying media headlines. While seen as controversial at the time, subsequent events have highlighted just how critical the issue of good governance at SOEs is.

In the 18 months since this announcement, Futuregrowth has been working with the six named SOEs (Land Bank, DBSA, IDC, SANRAL, Eskom and Transnet) to conduct a detailed governance due diligence. The public letters containing the results of our completed governance due diligence for Land Bank (26 September 2016), IDC (4 November 2016), DBSA (21 November 2016) and SANRAL (5 July 2017) are available on the Futuregrowth website.

We believe this is an opportune time to share some of our learnings after designing and implementing what we believe is a robust analytical response to the systemic governance risks inherent in the SOE sector. The events subsequent to our public announcement in August 2016 have re-affirmed our view that good governance is much more than a mere tick-box exercise. Crucially, the "who" and the "how" of governance deserves appropriate scrutiny and disclosure. Good governance is inextricably linked to Responsible Investing, and in our view, it is key to ensuring that public entities, mostly funded with public money, are sustainably managed for the long term and are able to deliver on their developmental mandates.

SOEs, by their very nature as publicly-funded entities, are not subject to the same market discipline or shareholder oversight as other entities.

As we began our detailed engagements with the SOEs, it became evident that no party had previously considered SOE governance in a detailed way: investors, rating agents, financiers and the public had all taken for granted that the legislative controls were robust and sufficient. In considering various analytical tools we found some "tick box" governance, but not a lot of deep analytical methods on which we could build. Thus, our work became a greenfields exercise in learning about SOE governance: It's been a learning journey. The Futuregrowth team is not forensic or governance auditors, and we were naturally limited in our ability to assess the veracity of the governance of the more troubled SOEs.

Issuers of listed equity and debt are subject to the discipline of markets as well as to public comment and opinion. By definition, issuing listed instruments means taking money from the public, and we believe that requires much higher standards of information, transparency and scrutiny.

We decided to avoid the thorny question of board remuneration, taking the view that such policies can be a quagmire requiring specialist information, and that the absence of share incentives in SOEs should, in theory, simplify the risks arising from director and executive remuneration. That does not imply that board and executive remuneration should not be broadly considered for efficacy, standardisation, and good sense. And, of course, directors' emoluments should continue to be fully and transparently disclosed.

We have often been asked why we chose to focus on these SOEs in particular. Our scrutiny of these six arose from them being regular issuers of debt on public capital markets. Issuers of listed equity and debt are subject to the discipline of markets as well as to public comment and opinion. By definition, issuing listed instruments means taking money from the public, and we believe that requires much higher standards of information, transparency and scrutiny. Futuregrowth, as a developmental investor acting on behalf of our clients' funds, has been a substantial funder of national development through the SOEs, and our clients are holders of SOE debt.

Further, SOEs, by their very nature as publicly-funded entities, are not subject to the same market discipline or shareholder oversight as other entities. The web of control governing SOEs is different from private firms in that participants' economic interests may be distorted for personal gain or patronage, and SOEs can easily be subject to political pressures. Each SOE has a unique mandate to fulfil, often occupies a near-monopoly position (e.g. water, electricity, transport), may be able to pass its costs onto consumers, and does not necessarily have to make a profit to stay in business. SOEs can become a burden on the state, and therefore all citizens. These

factors all serve to elevate the importance of appropriate governance policies, processes and procedures for SOEs.

Futuregrowth is a partner in funding national development. We have been proud to play a role in channelling South Africa's pension fund savings toward national development for the past twenty years. We fully recognise that South Africa's SOEs play various critical roles in national development. Notably, we believe SOEs should offer functions that the private sector cannot. Among these might be:

i. a subsidy by way of a lower required return-on-equity;
ii. the ability to take in, and channel, government funds towards specific desired outcomes;
iii. a longer time-horizon for returns;
iv. the ability to mobilise large-scale capital for developmental and infrastructure projects and initiatives;
v. the task of creating enabling environments for development;
vi. the cross-subsidisation to test new ideas; and
vii. the ability to take greater risks than any private company.

Clearly, the SOEs take on human, social and national imperatives. Without derogating from the SOEs' developmental goals, our analytical focus is on sustainability and efficiency. The simple fact is that every wasted or stolen Rand is a Rand which cannot build a road, buy a locomotive, electrify a house, or educate a child. It is untenable for investors to allow the nation's savings to be absconded, and it is incumbent on responsible investors to play their appropriate role in allocating capital to sustainable enterprises.

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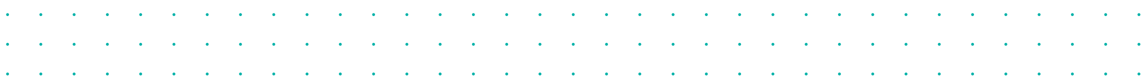
We remain grateful to those entities that productively engaged with us, and for their ongoing co-operation and willing assistance.



Our SOE journey

BEFORE AUG 2016

- Governance at SOEs had been on our radar for a while, specifically in relation to political interference, inter-departmental inconsistencies, policy confusion, etc.
- We have assessed and continue to assess the Boards and internal committees of the SOEs.
- We observed, and confirmed in our engagement with National Treasury, a lot of talk about plans to improve the governance at SOEs, including independence of Board members, ability to withstand political pressure, actions on corruption, fruitless/wasteful expenditure, tender irregularities, etc. but with no visible, concrete action.
- At the time, we tolerated this because, while there was no forward momentum, there was also no negative news.
- That changed in the last few weeks of August 2016, with media flow about, inter alia, tender irregularities at PRASA and Eskom, irregular payments to "consultants" by Transnet, board interference at SAA, etc. The trend was worrying.
- We highlighted this worrying trend at our credit committee meeting in the last week of August. Our concern was that political interference at SOEs was on the increase.
- On this basis, we had to formulate a forward-looking view.

EVENTS THAT LED TO INCREASED FOCUS ON SOE GOVERNANCE

25 AUG 2016
Cabinet Lekgotla announced the new SOE Coordinating Council, with no explanation for the role or mandate of this body.

29 AUG 2016
The broader investment team met to discuss two new upcoming deals (to IDC and Land Bank) and a rollover of an existing exposure to Land Bank that was maturing in the next few days.

In light of the media flow we asked the question "what (if anything) do we do given the latest news?". A robust discussion followed - particularly around our governance concerns about political uncertainty impacting the forward-looking view of the SOEs.

The flurry of information about political interference, lender irregularities, etc. gave us pause to reconsider our initial assessments of governance at six SOEs (Land Bank, DBSA, IDC, Transnet, SANRAL, Eskom) and we felt that we needed a body of evidence, which we did not have, to support continued investment in these entities. We could not recommend a new investment in any of the six SOEs with this uncertainty. This was a unanimous decision by all who attended.

We agreed on the following actions:

1. We would draft a letter to be sent to the CEO and Chairperson of the six SOEs highlighting our concerns and asked for specific engagement around our questions.
2. The analytical team would obtain the information we needed to assess the governance at these entities.

30 AUG 2016
We spoke to Land Bank and the arranging bank about our decision to no longer participate in the new deals.

We initiated a self-imposed embargo on the listed instruments of the six SOEs.

DUE DILIGENCE PROCESS STARTED

31 AUG 2016
A Futuregrowth press release and a client letter about our decision was released.

1 SEP 2016
Futuregrowth's analytical team converted our broad issues to a questionnaire and we engaged with those SOEs that were willing.

26 SEP 2016
A letter was released confirming the reopening of lending to Land Bank. (futuregrowth.co.za/newsroom/futuregrowth-confirms-it-is-to-re-open-lending-to-land-bank)

2 NOV 2016
Public Protector, Thuli Madonsela's State of Capture report was released.

7 NOV 2016
A letter was released confirming the reopening of lending to IDC. (futuregrowth.co.za/newsroom/futuregrowth-confirms-it-will-resume-lending-to-the-idc)

11 NOV 2016
Brian Molefe, who was implicated in the Public Protector's report, resigned from Eskom.

21 NOV 2016
A letter was released confirming the reopening of lending to DBSA. (futuregrowth.co.za/newsroom/futuregrowth-lifts-lending-suspension-on-the-development-bank-of-south-africa-dbsa)

26 MAY 2017
The report "Betrayal of the Promise: The Anatomy of State Capture" by the State Capacity Research Project, convened by Mark Swilling, with specific reference to Eskom and Transnet was released.

28 MAY 2017
Sunday Times and City Press issued the first of the #Guptaleaks emails and articles.

23 JUN 2017
Minister of Public Enterprises, Ms Lynne Brown, announced new interim Eskom board.

30 JUN 2017
Minister of Water Affairs and Sanitation, Ms Nomvula Mokonyane, unilaterally decided not to extend the term of the board at Umgeni Water.

5 JUL 2017
A letter was released confirming the reopening of lending to SANRAL. (futuregrowth.co.za/newsroom/governance-improvements-are-key-to-futuregrowth-s-funding-of-south-african-national-road-agency-ltd-sanral)

11 JUL 2017
Eskom's annual financial statements were released with a qualified audit report.

25 JUL 2017
Parliament starts preparations for its inquiry into Eskom and some of its dealings allegedly linked to state capture.

27 JUL 2017
Mr Anoj Singh, the Eskom CFO, was suspended.

4 AUG 2017
Minister of Finance, Mr Malusi Gigaba, appointed three DBSA directors - not in accordance with DBSA's normal nomination process.

17 AUG 2017
A Business Day article by Carol Paton about Umgeni Water governance worries was published. (futuregrowth.co.za/media/2259/headless-umgeni-water-worries-large-investors.pdf)

8 SEP 2017
A letter was sent to the Minister of Water Affairs and Sanitation from ENS on behalf of Futuregrowth expressing concern about the Minister's unilateral action in dismissing the board at Umgeni Water.

17 SEP 2017
A meeting was held between Futuregrowth, ENS and representatives from the Department of Water Affairs and Sanitation (DWS), Umgeni Water and the Minister's legal advisor.

18 SEP 2017
A meeting of concerned investors regarding Umgeni Water was held at the offices of legal firm ENS.

24 SEP 2017
A City Press article about Umgeni Water was published. (futuregrowth.co.za/newsroom/water-and-sanitation-ministers-meddling-could-cost-sa-r3bn/

27 SEP 2017
A meeting was held at the offices of ENS between certain investors, ENS and representatives from the DWS, Umgeni Water and the Minister's legal advisor.

29 SEP 2017
An interim board was appointed at Umgeni Water by the Minister of Water Affairs and Sanitation.

11 DEC 2017
Minister Lynne Brown appoints two new Eskom board members, leaving incumbent acting chair Mr Zethembe Khoza and six other board members in place.

21 DEC 2017
Eskom announces a delay in the release of its interim results for the six months ended 30 September 2017, following the finalisation of the NERSA tariff for the 2018/2019 financial year.

JAN 2018
The JSE gives Eskom until the end of January 2018 to submit its interim results, failing which Eskom bonds may be suspended; A new Eskom board is appointed, chaired by businessman Mr Jabu Mabuza; Eskom releases its interim results in time to avoid suspension of its bonds by the JSE.

FEB 2018
At Eskom, Mr Matshela Koko (former head of generation), Mr Anoj Singh (former CFO) and Mr Prish Govender (former head of group capital) resign.

Governance beyond the board of directors

The PFMA as the first line of defence

Boards and their sub-committees

Committees and decision-making

Conflict management

Reporting and disclosures

King IV and its use in bolstering governance at SOEs

Chapter 1: Governance beyond the board of directors

A typical governance review considers the governance structures and processes within a company and how these are managed and disclosed to stakeholders. There is a central focus on the board of directors and the manner in which it performs its fiduciary duties. Key considerations typically include:

i. how a board and its sub-committees are constituted;
ii. the authority levels of the board, sub-committees and members of executive management;
iii. how conflicts of interest are managed; and
iv. the level of transparency and disclosure of the above.

These considerations form part of our annual Environmental, Social and Governance (ESG) risk assessments performed on all our counterparties, where our starting position is that the board of directors is the primary governing body.

In August 2016, the announcement of a SOE Coordinating Council (following a Cabinet Lekgotla) raised numerous questions for us. It arguably also highlighted certain flaws in the market's and our own approach to understanding SOE governance.

While we understood that the creation of this SOE Coordinating Council arose from the recommendations of the Presidential Review Committee (PRC) on SOEs, which were approved by Cabinet in 2013, the mandate, terms of reference and decision-making powers of this SOE Coordinating Council were not clear.

KEY THEMES

1. SOE governance vests in Parliament, the executive authority, and the SOE board of directors.
2. Potential for conflicts arise between King IV principles and often nuanced and outdated SOE enabling legislation.
3. Responsible Investing implies allocating capital to those sectors and entities that adopt transparent, sustainable policies and practices.

We realised that a central focus on the board of directors in our governance reviews for SOEs was not appropriate, since the governance of SOEs is reliant on Parliament, the executive authority (i.e. the ministry responsible for that SOE) as well as the board of directors. Our analytical approach needed to evolve to consider these aspects more explicitly.

This chapter outlines our key learnings arising from extending our focus beyond the board of directors to the legislative governance framework in which each SOE operates. We also considered the layer of governance that exists between the board and its executive authority.

The key question we sought to answer was: Where does the decision-making authority and accountability for SOEs ultimately rest?

We looked at this from a legal as well as a practical perspective, given that responsibility for governance oversight vests in three distinct

areas, namely Parliament, the executive authority and SOE board of directors, which may or may not be aligned (see diagram on page 17).

An SOE's existence is established by entity-specific enabling legislation, which is promulgated when the SOE is first established. It may then be revised in subsequent years. We discovered that much of this legislation was promulgated some time ago.

A key learning has been how varied and nuanced these enabling legislations are across the various SOEs, and that they are not always aligned with good governance principles. This may be partly due to the fact that governance standards have evolved in the time that has elapsed since promulgation of the legislation.

SANRAL is the only one of the four SOEs we reviewed that has governing legislation explicitly stating that its board should comprise eight individuals. The enabling legislation of Land Bank, DBSA and the IDC requires that the boards comprise between five and fifteen directors.

One of our recommendations to SANRAL was to increase the skills mix on its board to include a greater depth of financial skills. However, due to the prescriptive wording of its enabling legislation, it will require a legislative process to allow for more than eight individuals to be appointed to the board.

Our review further revealed that each SOE's enabling legislation held a different view on the importance of a nominations committee. This committee comprises principally independent non-executive directors and is responsible for nominating appropriate individuals for appointment to the board. These nominations are then considered and approved by the executive authority (as represented by the minister in charge of that government department). A nominations committee is provided for in the IDC and the DBSA's enabling legislations, but not in that of SANRAL or Land Bank.

It may be argued that nuanced enabling legislation has always been a characteristic of the South African SOE sector, but our primary concern is when these nuances are not consistent with good corporate governance practices.

Most SOEs portray themselves as being separate from government - with separate decision-making bodies, separate annual financial statements and separate mandates and operations. Why should we not hold them to the same standards as other entities that seek funding from public capital markets?

As an example, SANRAL's enabling legislation provides the Minister of Transport, as the executive authority, the right to appoint and/or replace SANRAL's Chief Executive Officer (CEO) as well as the Chairperson of the Board. In the corporate world, these powers would normally be in the purview of a board.

Because the SANRAL Act[1] contains weak protections relating to the appointment

1 The South African National Roads Agency Limited and National Roads Act, Act 7 of 1998

of directors, the Chairperson and the CEO, we have recommended the establishment of a board nominations committee. This committee should be comprised of suitably qualified and independent individuals who would then be responsible for recommending board appointments to the executive authority.

One of the key challenges in looking beyond the board of directors to the overarching legislative framework is that of grappling with instances where the law is inconsistent with governance recommendations (which are voluntary by nature).

Being a Responsible Investor implies that we make decisions to allocate capital to those sectors and entities that adopt transparent, sustainable policies and practices.

In our view, the board of directors of the SOEs (and not institutional investors) is best placed to advocate for a stronger alignment of its enabling legislation with developments in corporate governance best practice.

The executive authority bears the primary responsibility for appropriate SOE oversight and accountability to Parliament. The layer of governance that exists between the board of a SOE and its executive authority is embodied in the shareholder compact.

The shareholder compact should enable the shareholder to monitor "...the extent to which the board as a whole and individual directors achieve the objectives and any specific performance targets set, and where necessary, effect any remedial action."[2]

We liken the shareholder compact to a performance contract, agreed between the executive authority and the board, and designed to hold the board accountable for delivery of the mandate. One of our key learnings here is that the terms, key performance indicators (KPIs), and measurements against set targets are not routinely disclosed as part of the Integrated Annual Report by all SOEs – even though they often form part of the SOE's strategic plan.

Further, not all SOEs are measured in terms of financial KPIs. As an example, none of SANRAL's KPIs are financial. And when SOEs do have financial KPIs, there are no specified implications for failing to meet the agreed targets. So how does the executive authority hold the board accountable when there is no specified remedial action for non-compliance with the shareholder compact?

In our view, the consideration of governance policies, practices and reporting is integral to any investment decision, regardless of whether or not the SOE issues debt with an explicit RSA government guarantee. Most SOEs portray themselves as being separate from government - with separate decision-making bodies, separate annual financial statements and separate mandates and operations. Why should we not hold them to the same standards as other entities that seek funding from public capital markets?

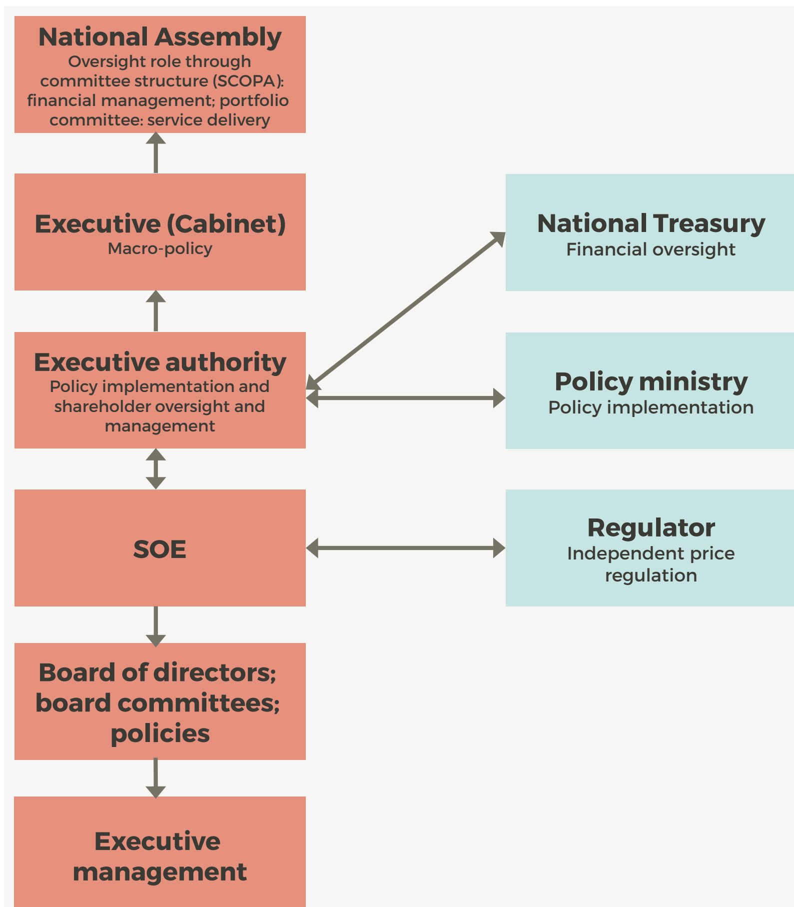
While we have a deeper appreciation for the fact that explicit government guarantees are nuanced and offer investors differing degrees of protection, being a Responsible Investor implies that we make decisions to allocate capital to those sectors and entities that adopt transparent, sustainable policies and practices.

2 Protocol on Corporate Governance in the Public Sector, Department of Public Enterprises

FOUNDING LEGISLATION OF VARIOUS SOEs

1. The South African National Roads Agency Limited and National Roads Act, Act 7 of 1998
2. Eskom Conversion Act, 13 of 2001
3. Development Bank of Southern Africa Act, 13 of 1997
4. Industrial Development Corporation Act, Act No 22, 1940 as amended
5. Land and Agricultural Development Bank Act, 2002
6. Legal Succession Act to the South African Transport Services Act, No 9 of 1989
7. Water Services Act, No 108 of 1997

OVERSIGHT OF SOEs



Chapter 2: The PFMA as the first line of defence

We did not explicitly consider the Public Finance Management Act No 1 of 1999 (PFMA) at the time of our SOE governance due diligences. This important piece of legislation has been effective from 1 April 2000, but in the almost 18 years since its enactment, it has not been utilised effectively to hold public servants accountable for how they spend public money.

The PFMA aims "to regulate financial management in the national government and provincial governments; to ensure that all revenue, expenditure, assets and liabilities of those governments are managed efficiently and effectively; to provide for the responsibilities of persons entrusted with financial management in those governments; and to provide for matters connected therewith" (PFMA preamble).

Notably, the PFMA details the extraordinary power vested in the Minister of Finance to hold the shareholder representative (usually the cabinet minister for the relevant ministry) and others in the entity to account.
At the inception of our governance due diligence process, our focus was on reviewing the internal governance and control mechanisms that ensure the SOE boards are appropriately constituted and discharge their fiduciary duties effectively. We initially failed to consider, however, the safety nets available when the board is not appropriately constituted, fails to discharge its fiduciary duties effectively, and/or the executive authority fails to hold the board accountable.

In considering this question, we found that this crucial piece of legislation is not always adhered to. And that, critically, very limited use has been made of the mechanisms within the PFMA to hold directors and members of executive management accountable.
For example, criminal cases could be made against transgressors, but to our knowledge, this has never happened.

This chapter will focus on those provisions of the PFMA that we believe deserve greater scrutiny when conducting a governance due diligence for an entity to which the PFMA is applicable.

THE PFMA APPLIES TO:

The role of internal and external audit in ensuring basic compliance with the law cannot be overestimated. As an outsider to the entity, reliance on these key control and oversight bodies is crucial and questions need to be asked about the role both play in monitoring and ensuring compliance.

Similarly, ratings agencies and funders can play an important role in covering, in more detail than they currently do, the extent of analysis and review undertaken by management and the board to ensure the company is compliant with the law.

The accounting authority of a public entity is usually the board of that entity, and has an overarching fiduciary responsibility. It has a "duty to exercise utmost care ..., act with fidelity, integrity and honesty and in the best interests of the public entity in managing the financial affairs" (PFMA, sections 49-50).

The role of an accounting officer as defined in the PFMA includes, inter alia, the responsibility to ensure there is an efficient and transparent system of financial and risk management and internal control. The accounting officer should also ensure that the SOE's procurement and provisioning system is fair, cost-effective, and transparent, and take appropriate steps to prevent fruitless and wasteful, or unauthorised expenditure (PFMA, sections 36-44).

Given the important roles of the accounting officer and the accounting authority, it is critical that the qualifications, experience and integrity of these individuals are interrogated and found to be beyond reproach.

The PFMA, if utilised appropriately, provides a measure of protection and certainty that public finances should be managed prudently and with a duty of "utmost care". It also provides guidelines on the disciplinary proceedings and penalties that should apply when accounting officers and accounting authorities are found guilty of misconduct or "willfully or negligently" not complying with the PFMA. Sanctions include disciplinary proceedings, suspension or dismissal, as well as criminal sanction, imprisonment for up to five years, and the imposition of fines (PFMA, sections 81-86).

Given the important roles of the accounting officer and the accounting authority, it is critical that the qualifications, experience and integrity of these individuals are interrogated and found to be beyond reproach.

Interestingly, if the accounting authority is the board of the entity, which is the case for the SOEs we reviewed, "every member is individually and severally liable for any financial misconduct of the accounting authority" (PFMA, section 83:2).

When conducting a governance due diligence, we believe it may be worth reviewing each board member's awareness of their responsibilities and obligations under the PFMA – and what education or training the entity provides in this regard.

Any board evaluation process should critically examine each member's conduct for the period under review, to ascertain the risk of joint and several liability of the board as a whole for financial misconduct.

We have two recent examples of material transgressions of the PFMA:

- Eskom's qualified audit report for the financial year end 2017 highlighted a number of instances of non-compliance with the PFMA in respect of irregular expenditure, procurement and contract management.
- At Umgeni Water, the Minister of Water Affairs and Sanitation's unilateral dismissal of the entire board and irregular appointment of an accounting officer is a clear transgression of the PFMA and the Water Services Act[1] (Umgeni Water's enabling legislation).

There appears to be a chronic lack of political will to enforce the provisions of the PFMA, and public officials are not being held accountable. This has contributed to the current perception of a culture of impunity in the governance of SOEs.

Both these examples raise an important question about the level of knowledge and compliance at the very top of the governance chain within each SOE and its shareholder ministry. In Eskom's case, this relates to the CFO, Mr Anoj Singh, who has recently resigned from Eskom, and the Minister of Public Enterprises, Ms Lynne Brown, and, in Umgeni Water's case, it relates to the Minister of Water Affairs and Sanitation, Ms Nomvula Mokonyane.

Further, the entire boards of both Eskom and Umgeni Water could be held jointly and severally liable under the PFMA. The act provides for a fine or imprisonment of up to five years, in instances where accounting officers and accounting authorities are found guilty of failing to comply with the PFMA (PFMA, section 86).

The mechanism to hold people to account is available. However, there appears to be a chronic lack of political will to enforce the provisions of the PFMA, and public officials are not being held accountable. This has contributed to the current perception of a culture of impunity in the governance of SOEs.

KEY QUESTIONS

We consider the following questions as a starting point in engaging SOEs on the PFMA:

1. What is the level of awareness of, compliance with, and responsibility for, the provisions of the PFMA within the shareholder ministry, the board, sub-committees and management?
2. What is the nature of internal and external audit testing relating to compliance with key legislation?
3. How are transgressions of law dealt with by the board and the executive authority?

1 Water Services Act No 108 of 1997

Chapter 3: Boards and their sub-committees

A board has oversight responsibility for the financial sustainability of the entity, as well as corporate ethics, social responsibility, strategy and stakeholder management. A well-functioning board is therefore critical to ensuring the long-term financial and operational sustainability of entities, be they private sector corporates or SOEs.

It is accepted market practice among JSE-listed equity companies to follow the practice of shareholders voting for board members. In contrast, SOEs do not have a wide body of public shareholders voting for incoming board members. Instead, SOEs are reliant on one individual shareholder representative in the form of the relevant responsible minister. South African history is littered with examples of cabinet ministers making wholesale changes to SOE boards, sub-committees and executive management which can, and have, become a gateway to malfeasance.

3.1: Board appointment process

It is important to re-iterate that although the appointment of board members remains the prerogative of the executive authority, we believe that a well-functioning nominations committee, as a sub-committee of the board, is beneficial. It is likely to strengthen board members' independence by providing input around skills deficits and giving the executive authority some guidance on appropriate candidates. After all, who is better placed to nominate incoming board members than the existing board, who know its own strengths and weaknesses?

There are a number of differences between the board appointment process at SOEs and that of listed corporates:

Mandate

SOE mandates typically have a developmental focus which needs to co-exist alongside commercial considerations, including the need for less reliance on the fiscus for support. This is particularly true in the current economic environment where the ability of the fiscus to provide bail-outs is severely constrained.

Corporate mandates, in contrast, have a clearer commercial focus.

> **There is also no disclosure from the various ministers about the process followed in making board appointments.**

The authority to appoint directors

The authority to appoint SOE board members lies with the executive authority. This is the responsible shareholder minister, and varies depending on the SOE and the sector it falls under. At Land Bank and DBSA, the Minister of Finance is the executive authority; at the IDC it is the Minister of Economic Development; at SANRAL it is the Minister of Transport; and at Eskom and Transnet it is the Minister of Public

Enterprises. During our reviews, we found that there is limited public notice of the board nomination and appointment process, and – with the exception of DBSA - it is not clear what criteria (skills, experience, qualifications, etc) are used in making board appointments.

In the case of listed corporates, directors are appointed by vote of a diverse range of shareholders, after public notice is given via SENS of any changes to the board. This is an established and regular practice and, in our view, should be adopted by the SOE issuers on the JSE, in the interests of good governance.

We identified a number of key issues to consider when assessing an SOE board. These are listed below.

The role of the SOE in the appointment process

Boards must be accountable to stakeholders but we believe that well-functioning boards are able to self-assess, self-plan and manage their requisite skills set, as well as select the Chairperson and CEO – rather than have their shareholder be the sole arbiter for the selection and appointment of these key positions. A well-functioning board should have a nominations committee which allows current (principally independent non-executive) board members to consider the requisite mix of skills, independence, and service terms that are needed, and to nominate appropriate individuals to fill these positions.

Our due diligence revealed that only the DBSA has a formal nominations committee, while the IDC has a Board Human Capital and nominations committee. At the other SOEs, the engagement that the incumbent board members have with the executive authority regarding board appointments is limited and often not formalised. There is also no disclosure from the various ministers about the process followed in making board appointments. This is a significant lack of transparency which erodes good governance practices.

Even with a nominations committee, as DBSA has, the process for appointing board members can be deviated from at the discretion of the relevant minister. This occurred as recently as July 2017, when certain board appointments were made to the DBSA board that did not follow the usual nominations process. Only three of the seven directors nominated for reappointment by the nominations committee were reappointed by the executive authority (in this case, the Minister of Finance, Mr Malusi Gigaba). An additional six new non-executive directors were appointed, of whom only two were nominated by the nominations committee.

What process did the minister follow in appointing these directors, and were appropriate fit-and-proper, background and conflicts checks done?

The question we have is why? Why did the Minister of Finance not follow the DBSA's own established policies and procedures for these six appointments? What process did the minister follow in appointing these directors, and were appropriate fit-and-proper, background and conflicts checks done?

As institutional investors, we are being asked to provide capital on a long-term view to the DBSA and other SOEs without having any insights or answers to these questions. In our view, good governance requires that deviations from the agreed policies and processes should be accompanied by additional disclosure of the reasons for such deviations.

Fit-and-proper, background and conflicts checks

A key weakness we identified was a lack of clarity and disclosure of the existence, extent and timing of probity checks (including confirmation of skills, experience, fit-and-proper checks and conflicts of interest disclosures) performed by the executive authority in appointing individuals to SOE boards. In our view, the timely public disclosure of the nature and outcome of probity checks is a key step towards rebuilding trust with the investor community. This disclosure is common practice in equity markets and, given that the bond market is also a public capital market, we believe the same standards should apply.

Director continuity

The maintenance of relevant skills and institutional knowledge is essential to ensuring the long-term sustainability of SOEs. The expiry profile of director's terms is thus a key consideration. Failure to appropriately stagger directors' terms could place the SOE at risk of high director turnover in a short time frame. This could result in a loss of institutional knowledge and, ultimately, in a lack of consistency in long term strategy. In our view, high director turnover is a sign of an entity in turmoil, which increases credit and governance risks.

Our reviews found that the expiry profile of directors' terms was generally well spread, with the exception of the DBSA and SANRAL. In SANRAL's case, five of the eight directors' terms expire on the same date (31 March 2018).

CASE STUDY: OUR FINDINGS FOLLOWING OUR REVIEW OF THE DBSA BOARD

What we like

1. A good-sized board, with 14 board members.
2. An appropriate mix of skills and experience, including experts in accounting (e.g. chartered accountants), law and development finance.
3. The Chair and Deputy Chair are independent non-executive directors.
4. Of the 14 board members, 12 members are considered independent non-executive directors.
5. An appropriate mix of diversity in terms of age, gender and race.

What can be improved

1. The Chair and Deputy Chair's terms expire on the same date (December 2018).
2. Better staggering of director's term expiry dates (e.g. 8 director's terms expired on the same day, 30 June 2017).
3. Appointments to the board were made by the Minister of Finance in July 2017 that did not follow the DBSA's own established nominations process.
4. The quorum requirements for DBSA is set at 5 board members, which we consider low for a board of this size.
5. Board decisions are made by majority which means as few as 3 board members can make decisions.

At the DBSA, we found that both the Chairman and Deputy Chairman's terms expire at the end of December 2018, and this is after seven non-executive directors' terms expired in June 2017. Subsequently, six new board members were appointed to the DBSA board in July 2017, signifying a potential loss of institutional memory and possible implications for the strategic direction of the entity. We continue to monitor the situation and will be alert for any signs of further governance weakening at DBSA and SANRAL.

3.2: Board and sub-committee decision-making

The board of any entity delegates specific functions to the various board sub-committees. These sub-committees report to the board of directors and are governed by clearly defined mandates, authority limits and terms of reference.

Principle 8 of King IV clarifies that the objective of these delegation arrangements is to promote independent judgment, assist with the balance of power, and to assist with the effective discharge of the board's duties.

Through our reviews of the SOEs, we noted that the nature and mandates of board sub-committees across SOEs vary. This may be informed by the fact that King IV does not prescribe the nature of board sub-committees – it merely recommends that there is minimal overlap and that these sub-committees promote effective collaboration and balance of power. Further, each SOE's particular enabling legislation may also inform the nature of board sub-committees, while the PFMA only requires the establishment of an audit committee.[1]

Based on the governance due diligences we undertook, our view is that SOE boards should establish, at a minimum, the following sub-committees to effectively discharge their duties and fiduciary responsibility:

WHAT TO LOOK FOR WHEN ASSESSING A BOARD SUB-COMMITTEE:

1. Appropriate number of members with a good mix of experience, skills and technical specialists.
2. A charter or terms of reference that indicate the committee's mandate, composition, roles, procedures, authority-levels and meeting processes.
3. Appropriate quorum requirements.
4. Appropriate approval and voting mechanisms and thresholds.
5. Appropriate Rand-limits of decision making authority, before escalation to the full board.
6. An established practice of referring complex, unusual, conflicted or very large transactions to the board for further approval or ratification as appropriate (e.g. transactions with PEPs).
7. Decisions made by executive management and sub-committees of the board that are high risk and/or high Rand-value require an additional layer of approval or ratification by the board.

i. Audit and risk

This committee provides a vital oversight and monitoring function over the internal and external audit function, financial reporting, statutory and regulatory compliance, and the identification and assessment of risk. The Treasury Regulations[2] require the board to

1 PFMA section 38(1)(a)(ii)

2 Treasury Regulation 27.1.1

establish an audit committee and it should be constituted with a majority[3] of non-executive members who are financially literate.

ii. Human resources and nominations

This committee oversees policies and procedures related to human resources and organisational structure. It is typically responsible for succession planning and executive management, performance management and other related matters. The nominations aspect of these duties includes identifying and proposing individuals to serve on the board and executive level. Only two of the SOEs we reviewed (DBSA and IDC) have an established nominations committee as a sub-committee of the board.

iii. Social and ethics

This committee supports the entity's role in ensuring that the code of ethics is applied at all organisational levels. This may include monitoring compliance with applicable policies, which may include fraud detection and management, and whistleblowing.

iv. Investment/credit

This applies to lending entities e.g. IDC, DBSA and Land Bank. This committee sets the overall credit strategy which includes risk management and ensuring that the investment mandate is appropriately applied. This committee is vital in monitoring the investment portfolio, overseeing large and complex transactions, dealing appropriately with conflicted transactions, and reporting to the board on portfolio performance and compliance matters. The investment committee should also be required to approve transactions over a specified threshold, which should be set at an appropriate Rand-level. This committee should further refer certain investments to the board for approval or ratification.

This committee should be composed of individuals with the appropriate financial, business, banking or related skills, and should have an adequate mix of members who are independent of management. Lending-related governance is covered more fully in chapter 4.1.

An example of limits of authority for the DBSA Board Credit and Investment Committee (BCIC)[4]

South Africa	MS1 -MS10[5]	Above MS10[5]
Municipal clients	R1 000 million	R500 million
Other public sector	R500 million	R250 million
State supported programmes	R500 million	R250 million
Private sector	All	All

What we like

There is an established practice of notifying the board of all BCIC decisions at subsequent board meetings.

What we don't like

The threshold for delegating decisions to management (at R1bn for MS1-10 and R500m for greater than MS10) is too high.

v. Capital projects and procurement

This applies to entities with large procurement budgets e.g. SANRAL, Eskom and Transnet. This committee's duties may include oversight of the implementation of the capital programme, monitoring compliance with procurement policy, reviewing procurement budgets, oversight and approval of large or complex procurement transactions, and oversight

3 Treasury Regulation 27.1.4

4 Source: DBSA Integrated Annual Report 2017, page 49

5 DBSA internal risk weighting: MS 1-7 is low risk, MS 8-13 is medium risk and MS 14 and above is high risk.

of asset maintenance, performance and requirements. This committee may also have the power to approve budgetary deviations up to a certain threshold. Governance related to procurement decisions is more closely examined in chapter 4.2.

Our governance review revealed that changes to the decision-making authority levels of sub-committees are usually only disclosed in the Integrated Annual Report. This means that a material deterioration in governance could occur, with investors only being notified when the Integrated Annual Report is released, often up to six months after year end. Our recommendation for all SOEs is that changes to decision-making authority levels (i.e. changes to the Rand-values that can be approved) should be disclosed as and when they happen, preferably via SENS.

Most of the boards we interviewed indicated that although decision-making practice is purportedly by simple majority, in practice they tend to apply a more consensus-based decision-making model. Our recommendation is that the application of a consensus-based model should be codified in the terms of reference of each sub-committee, and the voting threshold should reflect this. This allows all views to be taken into account and curbs power imbalances.

KEY QUESTIONS

We consider the following questions as a starting point in engaging SOEs on the board appointment process:

1. What is the appropriate sized board for this entity, considering the mix of skills, experience and technical expertise required?
2. What fit-and-proper, background, qualification, reference and conflict of interest checks have been done to ensure that the individuals appointed to the board meet the highest standards of ethics, integrity, independence and accountability?
3. Are the results of the probity checks publically available?
4. What are the reasons provided for the established board appointment procedures not being followed?
5. How has the expiry profile of directors' terms been staggered to ensure the retention of relevant skills and institutional knowledge?

Chapter 4: Committees and decision-making

4.1: Investment/credit

In any lending business, decisions taken around credit are important to understand the long-term sustainability of the business and the inherent investment risk therein. Bad lending decisions lead to losses and an impaired balance sheet.

In reviewing the lending practices of the lending SOEs, namely the IDC, DBSA and Land Bank, we had to recognise their developmental mandates and how these exist alongside risk and return considerations.

Central to our investigations was the initial framework of the lending mandate. We looked at how government policy influences investment strategy, how lending decisions are made, and how this influences the lending philosophy, processes and criteria.

The investment/credit committee composition and autonomy are paramount. Aside from a well-articulated mandate from both the executive authority and the board, we looked to assess critical processes such as conflict-of-interest disclosures and actions, decision-making thresholds, and how exceptions and challenges to the above are addressed, disclosed and ratified.

Key focus areas included:

- an assessment of investment/credit committee members' qualifications, experience and independence;
- how deals are sourced including whether deals are independently and appropriately sourced; and
- the disclosure and treatment of related party transactions, transactions with PEPs and potential or actual conflicts.

Cognisance has to be taken of deals with PEPs and evidence garnered as to the true independence of the decision-making. Documentation, disclosure schedules and escalation of concerning factors and conflicted decisions need to be evident.

We delved into the details of how credit and investment decisions are brought to the investment/credit committees, how the decisions are made, and who the decision makers are. We specifically sought to assess whether the processes are sufficiently comprehensive to ensure the mandates and governance in lending decisions are free of conflicts and done in accordance with the entity's policies and mandate.

The DBSA did not have a policy to manage the risks of lending to PEPs.

We found that, at the IDC, the current directors' Conflict of Interest Policy allowed directors to engage in borrowing from the IDC (e.g. via investments in entities or projects in which that director has an interest). At the time of our review, the board had already taken a decision to amend this policy, in acknowledgement that such practices create unacceptable conflicts of interest.

The proposed revised policy, which we have not had sight of, is currently being redrafted to prohibit directors from doing business with the IDC. Futuregrowth will assess the revised policy once finalised, to affirm that it supports objective decision-making and is in line with best practice corporate governance.

Land Bank agreed to entrench certain improvements to their bond loan documentation, their Domestic Medium Term Note Programme. A possible consequence of these improvements is that Land Bank has been able to issue longer-dated debt and at more competitive funding rates than before.

We found unique risks (both financial and reputational) that arise from the IDC concluding lending arrangements with PEPs. These risks have eventuated in the recent past, such as when the IDC loaned R250m to Oakbay Resources and Energy Limited (an entity that would be regarded as a PEP-related entity) to purchase the Shiva uranium mine. Subsequent events required the restructuring of the loan, including converting debt to equity, and also highlighted weaknesses[1] in the delegation of authority and approval processes at the IDC when purportedly, legal agreements were manually adjusted to delete key protection clauses for the IDC. The IDC's PEP policy, which has been in place since 2009, is intended to mitigate these risks, and our recommendation is that annual disclosure of all deals to PEPs should be included on the IDC website and in their Integrated Annual Report.

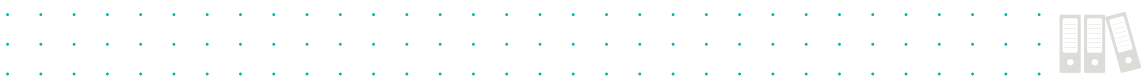
The DBSA did not have a policy to manage the risks of lending to PEPs. We recommended that an adequate policy, including appropriate public disclosure on an annual basis of all PEP deals, is implemented as a priority.

Another finding from our DBSA review was that the minimum composition of the board credit and investment committee, as per the terms of reference, was not being met. The terms of reference of DBSA's Board Credit and Investment Committee (BCIC) requires it to consist of nine directors, whereas DBSA's latest Integrated Annual Report reports that the BCIC comprises eight members.

Land Bank was the first SOE to which we re-opened lending. A key reason for this was their commitment to additional disclosures and reporting requirements - for example, regular public disclosure of directors' turnover, directors' dealings in contracts, and the management and disclosure of contracts with PEPs and other conflicts of interest. Land Bank agreed to entrench certain improvements to their bond loan documentation, their Domestic Medium Term Note Programme (DMTN). A possible consequence of these improvements is that Land Bank has been able to issue longer-dated debt and at more competitive funding rates than before.

Our Land Bank review identified certain areas for improvement which were discussed with and agreed to by the board. Although not exhaustive, these recommendations included:

1 https://www.fin24.com/Companies/Investment-Holdings/how-idc-was-forced-to-invest-in-oakbay-20171208



- lower Rand-approval limits at certain investment and credit committees;
- increasing the quorum requirements for the board and sub-committees;
- higher voting thresholds for decision-making on the board and the various sub-committees; and
- improved and more regular public disclosure of key indicators and information.

4.2: Procurement

Procurement spend is estimated at R1.5 trillion[2] across all spheres of government (former Minister Pravin Gordhan, Treasury budget vote, May 2016). The February 2017 Budget indicated that over R432bn of this was earmarked to be spent by SOEs over the medium-term expenditure framework, with the main line items being energy (R235bn), water and sanitation (R125bn), and transport and logistics (R327bn) (refer to the table below).

Infrastructure expenditure over the medium term (for the next three years, up to the 2019/20 financial year), per Minister Gigaba's October 2017 MTBS, is estimated at over R948bn[3], of which some R402bn will be spent by SOEs.

The numbers are big. As such, proper governance around procurement decision-making by national government, provincial government, government departments and SOEs is paramount in ensuring that this is in accordance with the entity's mandate and in compliance with legislation (including the PFMA).

The SOEs we focus on in this chapter include Transnet, Eskom and SANRAL, which all have large capex budgets. In addition to the capex requirements shown in the table below, Eskom, in the financial year ended 28 March 2017, also spent over R82bn[4] in primary energy costs. Although the IDC, Land Bank and the

2 http://www.thesait.org.za/news/287976/Opinion-Treasury-Dept-Budget-Vote-201617-.htm

3 M Gigaba, MTBS, 25 October 2017
4 Eskom Integrated Annual Report 2016/17, Chief Financial Officer's Report, page 74

Public-sector infrastructure expenditure and estimates

R billion	Outcomes			Estimates				MTEF Total
	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	
Energy	69.6	67.8	65.9	75.0	78.3	81.9	74.3	**234.5**
Water and sanitation	25.8	29.5	31.5	37.2	39.3	41.2	44.9	**125.4**
Transport and logistics	77.8	92.4	81.3	91.4	104.6	105.7	117.4	**327.7**
Other economic services	13.0	13.0	13.2	16.0	12.6	12.9	13.0	**38.5**
Health	10.0	8.7	10.3	11.0	11.2	11.9	12.5	**35.6**
Education	13.7	15.4	18.0	17.3	17.6	15.8	16.7	**50.1**
Human settlements1	17.0	17.1	18.3	18.3	20.0	21.1	22.3	**63.4**
Other social services	12.9	13.1	16.3	15.6	16.1	16.6	17.5	**50.2**
Administration services2	5.0	5.2	6.5	7.9	7.1	7.2	7.5	**21.7**
Total	**244.8**	**262.2**	**261.2**	**289.8**	**306.7**	**314.3**	**326.1**	**947.2**
National departments	11.9	13.5	14.5	16.6	16.7	16.0	15.0	**47.7**
Provincial departments	55.2	56.4	60.6	62.3	64.1	65.1	68.9	**198.2**
Local government	47.1	53.2	54.7	58.2	56.7	59.1	63.9	**179.6**
Public entities3	15.4	19.2	17.8	22.0	23.9	23.6	24.9	**72.3**
Public-private partnerships	3.9	4.0	4.3	4.8	5.1	5.5	5.9	**16.5**
State-owned companies3	111.2	115.8	109.3	125.8	140.3	145.0	147.5	**432.8**
Total	**244.8**	**262.2**	**261.2**	**289.8**	**306.7**	**314.3**	**326.1**	**947.2**

1. Human settlements includes public housing to households and bulk infrastructure amounting to R63.4 billion over the MTEF period. / 2. Administration services include infrastructure spending by the Department of International Relations, the Department of Home Affairs, the Department of Public Works, Statistics South Africa and their entities. / 3. Public entities are financed by capital transfers from the fiscus and state-owned companies are financed from a combination of own revenue, borrowings and private funding. / Source: National Treasury

DBSA do undertake some procurement spend, as lending institutions, our focus was more on the governance around their lending practices which is examined in chapter 4.1.

Our due diligence reviewed how government policy influences procurement strategy and process, and we examined the various procurement decision-making bodies and committees' mandates and authority limits. It was important for us to establish that there was a fair and transparent procurement process that complied with the law, particularly the PFMA and the entity's own procurement rules. In looking at the procurement policy, we also tried to assess whether the internal policies were adequate and appropriate, how exceptions were dealt with and whether there was adequate oversight and disclosure.

At the time of publication of this report, our governance reviews for Eskom and Transnet have not been concluded. The examples provided of improvements to procurement governance are from our SANRAL due diligence conclusions.

It seems trite to state that all procurement decisions should be made in the best interests of the company, should represent value for money, and should be for the company's benefit. However, we have many examples where this is not the case at SOEs. Further, all actual and perceived conflicts that could impede independent decision-making need to be appropriately disclosed and managed. As such, the composition of all procurement decision-making bodies deserves close scrutiny.

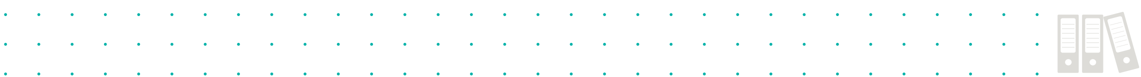
Procurement decision-making usually follows a tiered process with appropriate limits of authority – where lower amounts are approved by a variety or collection of individuals, and decisions are escalated to higher committees and ultimately the board, depending on the transaction size and complexity. It is usual to allow small Rand-value procurement decisions to be made by individuals, and then to require more decision-makers for transactions with higher Rand-values.

Material procurement decisions or decisions that require the application of broader input (as in the case of large or long-term supplier contracts or high-value fixed asset spend) should be reviewed and approved by a sub-committee of the board that includes a number of independent members.

"Sunlight is the best disinfectant" and, as such, we encourage increased public and timely disclosure of key procurement decisions, conflicts of interest, transactions with PEPs, and all deviations from policy.

Many SOEs make procurement decisions that require technical input, and we looked to assess if the people making procurement-related decisions had the appropriate technical skills. If they did not, we looked at whether this technical expertise was accessed from other well-known industry technical consultants or experts. PRASA's purchase of locomotives that allegedly[5] were not the appropriate size for our railways may have been avoided if technical input had been part of the decision.

5 https://mg.co.za/article/2017-06-23-00-hawks-slow-prasa-probe-slammed



In addition to technical skills, members of procurement decision-making approval committees should be financially skilled, given that contracts often include a forex or hedging component.

Naturally, people on these committees should have no conflicts of interest – either through their family members, their own other interests, or due to their other board or executive positions. In practice, this usually means that any conflicted decision-maker is recused from all decisions and information related to the conflicted matter. In addition, these decisions – when there is a conflicted member - should be reviewed by a higher approval body, with the ultimate authority for material transactions being the board. This is to ensure that the appropriate information is disclosed and used in making the decision. In addition, a good practice is to disclose the transactions concluded with conflicted individuals in the entity's Integrated Annual Report. One of our recommendations to SANRAL is that they adopt this practice.

It is important to have independent members (i.e. people who are not involved in an executive function at the entity and who are truly independent) on any board sub-committee tasked with procurement decision-making.

It is not considered good governance when one of your so-called "independent" board and sub-committee members is also a director at one of your major suppliers. This was the case at Eskom, where Mr Mark Pamensky, a member of Eskom's board and Investment and Finance Committee until his resignation in November 2016, was also a board member at Oakbay Resources. Until August 2017, Oakbay Resources owned Tegeta Exploration and Resources which was a key supplier of coal to Eskom. The conflict of interest that this presents is clear.

Large procurement decisions are required to be made by tender, and good governance requires that the tender process is not manipulated to achieve a predetermined outcome, and that transparency, fairness, and value for money criteria are applied. Public disclosure of all procurement that is done outside of the usual tender processes should be a requirement – together with the rationale for deviating from the usual policy and confirmation that National Treasury approval has been obtained for the deviation (when required under the PFMA).

Another key reporting item to monitor is amendments to contracts after the initial award (e.g. deviations to quantity or price, or the addition of another supplier or adviser to the deal). At the very least, such amendments should be approved by a higher approval body (preferably the board sub-committee) and disclosed in the Integrated Annual Report.

The recent REIPPP Programme stands as an example of how a transparent and well-run procurement programme can be run. To date, over R200bn of procurement has been completed through this programme and to our knowledge, there has not been a single allegation of inappropriate decisions or corruption.

An interesting development to watch will be the centralisation of all government procurement through the Office of the Chief Procurement Officer within National Treasury. The individual holding this position, and the governance around decision-making at this level, needs scrutiny to ensure that the requirements of the PFMA are met.

Because individuals can be influenced, we believe that procurement decision-makers should declare all gifts, hospitality, and entertainment provided by suppliers on at least an annual basis. Good governance

demands that the company has a policy limiting such gifts. This usually means setting a nominal Rand-value threshold for each employee and supplier, and ensuring that employees disclose any and all such gifts or entertainment to internal audit or the company's compliance department. We also believe that this disclosure, for directors, executives and other key procurement decision makers, should be made in the Integrated Annual Report.

"Sunlight is the best disinfectant" and, as such, we encourage increased public and timely disclosure of key procurement decisions, conflicts of interest, transactions with PEPs, and all deviations from policy. We will continue to require this of all public capital market debt issuers.

At SANRAL we found that this area of procurement governance needed some improvement. Specifically, we agreed with SANRAL that they would disclose trends in all "emergency, non-competitive" procurement (i.e. procurement that does not fall within the usual tender requirements and processes). It is noted that the regulations related to emergency procurement have since changed.

SANRAL also did not have a policy for dealing with procurement with PEPs. We believe that this is vital to cover potential risks associated with SANRAL's large-scale procurement programme. After our review, SANRAL agreed to disclose, annually, all transactions with PEPs. SANRAL also agreed to implement a "cooling off" period of 12 months, during which ex-directors and managers would be prohibited from doing business with the company. These policies were previously not in place.

Due to the large sums involved, procurement is an area where weak governance practices could expose an entity to significant risks.

In an era where alleged SOE procurement transgressions are the subject of daily headlines, investors and funders to these entities want to ensure that the money borrowed from public capital markets (essentially your and my pension fund) is appropriately spent. With the public eye increasingly on this key item, governance processes around procurement will continue to be scrutinised, and calls for better and more timely disclosure will continue to grow.

KEY QUESTIONS

We consider the following questions as a starting point in engaging SOEs on committees and decision-making:

1. How does the executive authority influence investment/credit and procurement strategy and process?
2. What is the investment/credit and procurement committee's autonomy in setting and executing their mandates?
3. What is the composition of the investment/credit and procurement committees? Are they adequately comprised of appropriate independent members and with appropriate financial skills and experience?
4. How are exceptions to established policies and governance dealt with? Are these publically disclosed?
5. How are conflicts managed, reported and disclosed?
6. What is the quantum (Rand-amount) of decisions that can be made by the various investment/credit and procurement committees? Is this level appropriate? Do large complex or unusual transactions require Board approval/ratification?

Chapter 5: Conflict management

Why is conflict management so important? For a private corporate, the chairperson, board and shareholders will have an economic interest in seeing the company succeed. Furthermore, the company must remain profitable for it to survive. Companies Act requirements and the company's focus on profitability will often, although not always, mean that conflicts are appropriately identified and disclosed.

SOEs are different, in that political appointees may be in charge of decision-making and patronage may skew decision-making away from what is in the best interests of the entity.

SOEs are different, in that political appointees may be in charge of decision-making, and patronage may skew decision-making away from what is in the best interests of the entity. Reliance on the public purse may also lessen the board and management's focus on sustainability, as there is the possibility of a government bailout or a tariff adjustment if decisions made by the board and management result in negative profit and cashflow consequences.

Alignment of interest ensures that directors and management, as fiduciaries, act in good faith and in the best interest of the entity they serve. Conflicts of interest arise when private interests or personal considerations affect, or are perceived to affect, a decision-maker's judgment. A lack of impartiality may result in financial loss, and legal and/or reputational damage to the entity and its board of directors. Thus, as a part of our governance review, it was critical that we examined how the entities manage, mitigate and disclose conflicts – both actual and perceived.

Conflicts in SOEs may arise in various ways:

- Employees/directors or their relatives could have direct or indirect interests (in the form of ownership, kick-backs or other incentive arrangements) with companies transacting with the SOEs. These transactions include supplier relationships as well as lending and investment relationships between the SOE and the company in which the employee or director has an interest.
- Directors could have cross-directorships with other entities transacting with the SOE. This situation arose in the case of Eskom, where one of the directors (Mark Pamensky, now resigned) was also a director at a major supplier of Eskom. Ideally, before board and sub-committee appointments are made, the appropriate conflicts checks should be done. Where conflicts are unavoidable, appropriate disclosure and recusal from decisions with the conflicted entity should be rigorously

adhered to. It could be argued that sometimes this is not enough to mitigate the conflict, and the best course of action is for the conflicted member to resign.

- PEPs may act in accordance with a political agenda that is not in line with the best interests of the SOE. Transactions with PEPs therefore deserve greater scrutiny, transparency, appropriate controls, and detailed, timely and public reporting.

The primary way to detect conflicts is via employee or director declarations and disclosures. These should be updated at least annually, and this control demands a heavy reliance on employees' and directors' integrity in disclosing all conflicts of interest. It also requires a rigorous internal compliance system that can, on a regular basis, verify and check for conflicts that may exist but not be disclosed. This review function should check whether there are any linkages between employees/directors, their families, and vendors and suppliers. All conflict checks should include a director or employee's spouse, direct family members and extended family (including step-family members).

It seems obvious to state that conflict of interest checks should be conducted prior to any board or executive appointments. And while it may be obvious, our work has revealed that this important step is either not done at all, or done in such a way that conflicts are not uncovered before the appointment is made.

When assessing disclosed conflicts, one would usually review the materiality of the amounts involved, relative to the individual's wealth and/or income. However, given the nature of SOEs and the large quantum of money involved in lending and procurement decisions, any conflict is likely to be material for the individual concerned.

The appropriate management of all conflicts is an important piece of the information investors need, to assess whether decision-making at an entity is indeed "in the best interests of the entity".

Qualitative factors that may influence whether a relationship is considered material include its strategic importance, the competitive landscape, the nature of the relationship and the contractual or other arrangements governing it.

Furthermore, while there may not be an actual conflict, the perception of one could be enough for an entity to avoid the transaction. Perception is influenced by whether an independent observer would question whether a director or executive's professional actions were influenced or motivated by a potential personal financial gain.

A further shortcoming we found at the time of our governance reviews, was that certain entities (IDC and SANRAL) did not have a "cooling-off" policy. This is a policy which prevents an outgoing director or executive from transacting with the entity for a set period of time. This is another example of an inappropriate conflict as the outgoing director may possess internal information that could inappropriately advantage a future transaction between them and the entity. We recommend that all entities implement an appropriate

cooling-off period. SANRAL has subsequently done so.

If a conflict is identified and it is considered material, there are ways to mitigate the risk. For example, by implementing a requirement that conflicted executives or directors recuse themselves from the decision-making process, or implementing a cooling-off period. Disclosure of all contracts with directors and management is standard practice in JSE-listed entities. We believe that this discipline should be extended to all debt capital market issuers, which includes the SOEs we reviewed.

Many of the internal governance policies at the SOEs we reviewed state that they require directors and executives to act with integrity, fidelity, honesty and in the best interests of the entity. Headlines over the past two years indicate otherwise. Our governance review highlighted that the implementation of these policies is important – specifically how issues are escalated, what remedial action is taken, and an assessment of whether the action and reporting was adequate to mitigate the conflict.

Generally, we found that the SOEs do not provide adequate transparency, disclosure and reporting of conflicted transactions in their Integrated Annual Report. We believe that appropriate conflict management, including detailed and timely disclosure, is an important tool that to date has not been adequately used. We were able to agree on varying degrees of improvements to the public reporting on conflicts at the DBSA, Land Bank, SANRAL and the IDC. This is an important step in ensuring that decisions made are in the best interests of the entity and in line with the law.

The six SOEs we reviewed are all debt issuers in the public capital market, and it is our view that bondholders need access to reliable, timely and detailed information in order to allow for appropriate long-term investment decisions. The appropriate management of all conflicts is an important piece of the information investors need to assess whether decision-making at an entity is indeed "in the best interests of the entity".

KEY POLICIES A SOE SHOULD HAVE TO MITIGATE POTENTIAL CONFLICTS:

1. Conflicts of interest policy which defines what conflicts are for that entity and how these are managed, disclosed and reported.
2. A PEP policy which defines what a PEP is, and how transactions with PEPs are managed, reported and disclosed.
3. A "cooling-off" policy which prescribes that a period of time must elapse before outgoing directors and executives of an SOE can conduct business with that SOE. The policy should also detail how these instances are reported and disclosed.
4. A policy which details the delegation of authority limits. This should specify an appropriate Rand amount of deals/transactions that certain individuals and committees can approve. For example, it is wholly inappropriate for a CFO to be able to sign-off on deals valued at hundreds of millions of Rand without investment/credit or procurement committee and board approval.
5. A contentious issue policy that describes the management and escalation of contentious matters and decisions.

Chapter 6: Reporting and disclosures

The SOEs and corporates that raise capital on the public capital market (the JSE) are bound by the JSE Debt Listings Requirements (DLR). It is our view that the disclosure and reporting requirements detailed in the DLR are woefully inadequate, fail to promote governance standards and make long-term investment decision-making difficult.

The lack of liquidity in the South African bond markets, and the stale pricing, means that the decision to invest in SOE and corporate bonds has to be made with a long-term view, as exiting these investments is not easy.

It has long been Futuregrowth's mission to improve the DLR and align its requirements more closely with the JSE Equity Listings Requirements (ELR), which are comprehensive and have established practices of disseminating information via SENS. This chapter will provide some background to the DLR, our view of the short-comings and some of our recommendations.

While not strictly part of our governance review at the SOEs, our initiatives in this space are aimed at an overall improvement in the standards governing South African debt capital markets. To the extent that they are implemented, our recommendations will strengthen reporting and disclosure requirements, which will give all investors relevant information that is currently not available to the market.

The South African Debt Capital Markets operate in terms of the Financial Markets Act No 19 of 2012 (FMA). Through this, the JSE "provides for the listing, trading, clearing and settlement of debt securities in a transparent, efficient and orderly market place"[1].

To achieve this, the JSE has a set of rules and procedures governing new applications for entities wishing to raise capital on debt capital markets. These rules detail the ongoing obligations of issuers and are contained in

KEY THEMES

1. The rules governing debt capital market issuers are weaker than those governing equity market issuers.
2. Repeated attempts by investors to improve listings standards and public disclosure requirements have been met with resistance.
3. In order to access public capital markets, issuers should subject themselves to a higher degree of scrutiny and commit to a greater level of transparency and disclosure than is currently happening – they are borrowing from people's pension funds!
4. The JSE has been slow to support debt investors' calls for better protections.
5. The JSE has not been proactive at monitoring issuers to ensure compliance with requirements.

1 Debt Listings Requirements, Objectives

the DLR. Its main objectives are to "contain the rules and procedures governing new applications and continuing obligations applicable to issuers of debt securities. They are furthermore aimed at ensuring the business of the JSE is carried on with due regard to the public interest."

Issuers on the JSE equity markets are subject to a different set of requirements, the ELR.

Our over-arching view on the DLR, as amended in October 2017, is that it remains skewed in favour of the issuers, has very weak reporting standards, and fails to provide adequate investor protections to allow for long-term investment decisions. For example, the ELR requires a much higher level of disclosure from directors, management and advisers, and any changes to directors' declarations must be made publically available within a specific timeframe. Schedule 13 of the ELR also includes extensive questions that must be answered on the directors' experience and integrity. These provisions do not exist in the DLR.

Our view is that flexibility for issuers and access to the debt capital markets have historically taken precedence over ensuring that appropriate investor protections and rights are embedded in the requirements.

Furthermore, the investor community is fragmented. A central tenet to this fragmentation remains the role of the banking sector in the initial set-up, and also in terms of the development and continued functioning of the bond market.

Banks have been instrumental in setting the ground rules for the debt capital markets over the years, but they are inherently conflicted as they are (individually and collectively) amongst the largest issuers of debt on the bond market and they often act as market-makers and placement agents for other issuers' bonds. Simultaneously, banks are large lenders directly to corporate entities and it is globally recognised that bank loans have stronger protections and more security than listed bonds. In short, banks are quite willing to sell bonds to pension fund investors that they themselves would not buy. The inherent conflict of the banks' role in capital markets is an open secret. The opaque nature of the debt capital markets plays in their favour, despite repeated attempts by investors to demand better protections and increased disclosure.

Futuregrowth has been active in this space for more than a decade, attempting to illustrate the shortcomings of the debt market, with specific reference to its functioning and the inadequate legal protections afforded to investors.

Banks are quite willing to sell bonds to pension fund investors that they themselves would not buy. The inherent conflict of the banks' role in capital markets is an open secret.

We have provided input on how to improve market standards, made recommendations as to what would improve investor rights and protections, and highlighted how this would benefit both the issuer and the market as a whole. Improving market standards would be beneficial to all, not only in terms of giving investors a platform for voicing their concerns, but also to allow for a more transparent transmission mechanism for investor/ issuer dialogue.

Despite taking time to gain traction, we have started to see the beginnings of a subtle shift in thinking by the asset management industry. An increasing number of investors are calling for a fundamental change in how the debt capital markets operate and are demanding better investor protections and disclosures.

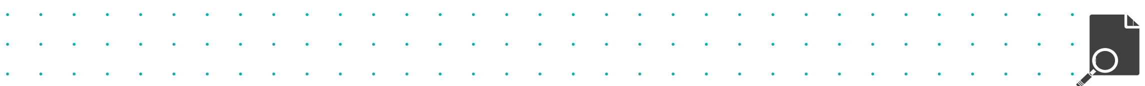
In recent years, we have engaged with the various role players, primarily the Association for Savings and Investment South Africa (ASISA) and the JSE, to improve market standards from various angles. This includes our participation in the proposals for standardised legal terms, whereby we, along with other asset managers, proposed standard terms for the legal documentation used by bond market issuers. During the public participation process on the recent changes to the DLR, investors (through ASISA) have engaged with the JSE (through its Issuer Regulation Division) with the view of setting the appropriate reporting and disclosure standards for a well-functioning bond market.

Our view remains that the listing requirements are the appropriate platform for embedding adequate investor protections and disclosures. This will ensure that all issuers are subject to the same standards of reporting, and that all investors have equal access to information to make investment decisions.

DISCLOSURES

Disclosures we believe should be a requirement for public capital market issuers (and thus part of the regular disclosures required by the DLR):

1. Annual public disclosure of the board and all sub-committee's charters, including terms of reference, mandate, decision-making levels, and quorum requirements.
2. Annual public disclosure of all current and previous directors' and executives' dealings with the company.
3. Disclosure of all board and sub-committee (including all procurement and investment/credit committee) member changes via SENS at the time of the change, including reasons for the changes, details of CVs, experience, results of conflicts and fit-and-proper tests for incoming members.
4. Annual disclosure of board and sub-committee nomination and appointment processes and who the decision makers are.
5. Annual public disclosure of the entity's conflicts of interest policy, contentious issue policy and PEP policy, including details of how these policies have been applied, deviations from the policies, and remedial action taken to address deviations.
6. All public disclosures to be made via SENS.



Chapter 7: King IV and its use in bolstering governance at SOEs

The King IV Code on Corporate Governance provides a framework based on a principle-and-outcome based approach to apply good corporate governance practices. While the King Code is embedded in the Companies Act and the JSE-listings requirements, its principles based approach does not provide any detail on the best practice application of these principles. Thus, we consider that the King Code is a well-intentioned and sound foundation on which stakeholders can build much more detailed governance practices and policies.

The shift from King III to King IV includes an increased focus on integrated businesses and risks, and a need to satisfy ALL stakeholders, including employees, the providers of capital, the environment and others. According to the recently amended DLR, new issuers of debt on the JSE must disclose how they have implemented the King Code. However, this requirement is currently not included as part of an existing issuer's continuing obligations. We believe this reporting should be an ongoing obligation of all capital market issuers[1].

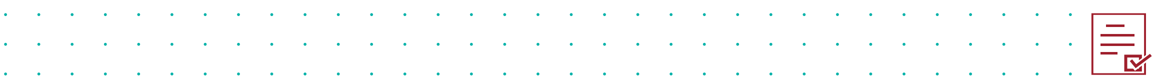
King IV includes a sector supplement specific to SOEs. In the table below we attempt to link the principles applicable to SOEs to the work done in our governance review, and the conclusions and recommendations made in previous chapters of this document.

The sector supplement applies to all public entities listed in Schedules 2 and 3 of the PFMA and hence includes all entities that currently issue debt on the JSE.

1 DLR section 4.12(h)

Leadership, Ethics and Corporate Citizenship	Principle	Futuregrowth comments and references to previous chapters
Principle 1	The accounting authority should lead ethically and effectively.	This is reinforced by the PFMA and the over-arching idea that SOEs should be managed in an ethical and effective manner in order to execute on their mandate. The executive authority and the board are responsible for leadership, ensuring accountability, and for providing the correct tone from the top. Refer chapters 1, 2 and 3.
Principle 2	The accounting authority should govern the ethics of the SOE in a way that supports the establishment of an ethical culture.	Similar to Principle 1, the executive authority and the board are responsible for establishing an ethical culture. Part of this, in our view, requires an unrelenting drive to ensure accountability and for appropriate sanction for breaches and transgressions. Refer chapters 1, 2 and 3.
Principle 3	The accounting authority should ensure that the SOE is and is seen to be a responsible corporate citizen.	A responsible corporate citizen seeks to ensure that all stakeholders are considered. The executive authority and the board need to ensure compliance with the PFMA, the shareholder compact, the entity's mandate and all other applicable legislation. Refer chapters 1, 2 and 3.

Strategy, Performance and Reporting	Principle	Futuregrowth comments and references to previous chapters
Principle 4	The accounting authority should appreciate that the SOE's core purpose, its risks and opportunities, strategy, business model, performance and sustainable development are all inseparable elements of the value creation process.	Key tools to ensure this principle is adhered to include ensuring PFMA compliance, ensuring the shareholder compact includes appropriate KPIs and, importantly, corrective action to be taken for non-compliance and under-performance. Refer chapters 1, 2 and 3.
Principle 5	The accounting authority should ensure that reports issued by the SOE enable stakeholders to make informed assessments of the SOE's performance and its short, medium and long-term prospects.	We believe that in addition to appropriate financial and Integrated Annual Reporting issued by the SOE, timely SENS notices for public capital market issuers are an accepted norm for disseminating potentially price-sensitive information to the market in a fair and transparent manner. Refer chapters 2 and 6.
Governing Structures and Delegation		
Principle 6	The accounting authority should serve as the focal point and custodian of corporate governance in the SOE.	We believe that this includes the board and sub-committees, and the appointment processes to ensure that appropriately qualified, experienced, non-conflicted and ethical people are appointed. Crucially, an understanding of the roles and responsibilities of Parliament as well as the executive authority are a key part of assessing the accounting authority. Refer chapters 1, 2, 3, 4 and 5.
Principle 7	The accounting authority should have the appropriate balance of knowledge, skill, experience, diversity and independence for it to discharge its governance role and responsibilities objectively and effectively.	This is covered in more detail in chapters 3, 4 and 5 where we detail the considerations that should be given to the composition of key decision-making bodies.
Principle 8	The accounting authority should ensure that its arrangement for delegation within its own structures promotes independent judgment, and assists with balance of power and the effective discharge of its duties.	Processes and procedures around decision-making and delegation of authorities are key to ensure compliance with this principle. Refer chapters 3 and 4.



Principle 9	The accounting authority should ensure that the evaluation of its own performance, and that of its committees, its chair, and its individual members supports continued improvement in its performance and effectiveness.	This responsibility requires clear accountability and corrective action taken for transgressions and missed targets. Targets need to be clear, measureable, and have regular feedback loops to ensure adherence with this principle. We would argue that the executive authority has a large role to play here and should take the appropriate remedial action if the accounting authority is not fulfilling this function. Refer chapter 2 and 3.
Principle 10	The accounting authority should ensure that the appointment of, and delegation to, management contributes to role clarity and the effective exercise of authority and responsibilities.	Similarly, the board and sub-committee delegation, decision-making, authority thresholds, composition and experience have a clear role to play here. Refer chapters 3 and 4.
Governance Functional Areas	**Principle**	**Futuregrowth comments and references to previous chapters**
Risk governance		
Principle 11	The accounting authority should govern risk in a way that supports the SOE in setting and achieving its strategic objectives.	In terms of legislation, there are differences in board and sub-committee requirements for the SOEs based on their individual founding legislations. The PFMA requires the board to form an audit committee[2] but does not go further. We would argue that the executive authority needs to set the SOE's strategic objectives via the shareholder compact and manage delivery thereof, through a series of appropriate and measureable KPIs for the board and executive management. We believe the executive authority and National Treasury (via the PFMA) need to use the tools available to ensure that boards and executive management are held accountable for their actions. Apart from the statutory requirement for an audit committee as per the PFMA, King IV does not put forward specific requirements for the range of "must have" committees. Through our governance review process, we have found that in order to effectively discharge their duties and fiduciary responsibilities, SOE boards should establish sub-committees in addition to an audit committee. These would include committees to oversee board and sub-committee nominations and appointments, procurement decisions, lending decisions and remuneration decisions. This is further detailed in chapters 3, 4 and 5.
Technology and information governance		
Principle 12	The accounting authority should govern technology and information in a way that supports the SOE setting and achieving its strategic objectives.	Although technology did not form part of our governance review, we believe that there should be clear KPIs to ensure that the governance and risk management for technology is outlined, to support the SOE in meeting its strategic objectives.

2 PFMA sec 38(1)(a)(ii)

Governance Functional Areas continue	Principle	Futuregrowth comments and references to previous chapters
Compliance governance		
Principle 13	The accounting authority should govern compliance with applicable laws and adopted, non-binding rules, codes and standards in a way that supports the SOE being ethical and a good corporate citizen.	A key shortcoming for the SOEs we reviewed is a chronic lack of accountability and enforcement of sanction when laws, codes and internal processes are not complied with. We discuss this in chapters 1, 2 and 3. We believe the SOEs can do better at disclosing any breaches and non-compliance, corrective action taken, and the results of any Auditor General, external audit or external consultant findings and recommendations. We also believe the executive authority, National Treasury and the Minister of Finance should better use the sanctions available to them in the PFMA to hold directors and executive management accountable.
Remuneration governance		
Principle 14	The accounting authority should ensure that the SOE remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term.	We did not focus on remuneration, but we believe that the shareholder compact should have measureable KPIs for the board and executive management, which are linked to their remuneration. Provision should be made for bonus claw-backs in the event a board member or executive management member is guilty of material breaches of governance.
Assurance		
Principle 15	The accounting authority should ensure that assurance services and functions enable an effective control environment, and that these support the integrity of information for internal decision making and of the SOE's external reports.	The roles of internal and external audit are key to ensure an effective control environment is maintained. To the extent matters are raised by internal and external audit, the board and executive management need to take action. Our view is that this is not addressed with the degree of urgency it deserves – as an example, and following Eskom's recent qualified audit report, it appears as if a lender had to demand accountability from the CFO for the qualified audit. Our view, supported by King IV, is that the board should have taken this action independently of, and prior to, any demand from a lender. This is covered in chapters 2 and 3.
Stakeholders		
Principle 16	In the execution of its governance role and responsibilities, the accounting authority should adopt a stakeholder-inclusive approach that balances the needs, interests and expectations of material stakeholders in the best interests of the SOE over time.	Throughout this process, we have emphasised the importance of transparency and appropriate, timely and public disclosure to enable appropriate decision making by funders to these entities – this is covered in chapter 6.

Chapter 8: SOE Reform and what's next?

Many countries have conducted reviews of their SOEs with a view to clarifying the appropriate balance of roles played by the state, the appropriate ownership policy and implementation thereof, and the state's role in the corporate governance of these entities.

South Africa's Presidential Review Committee on SOEs (PRC) was established in May 2010 and conducted a 24-month macro review of all 715 SOEs. The PRC's preliminary findings were submitted in July 2011, and 21 principles guiding SOE reform were accepted by Cabinet in 2013. To date, no meaningful SOE reform has been implemented.

In our view, the financial, operational and overall governance environment of SOEs has deteriorated materially since 2013. The need for meaningful, and prompt, SOE reform is now significantly more acute.

One of the key areas of reform that our governance due diligence has highlighted is the lack of a standardised director appointment process. In our view, all SOEs should apply probity tests and conflict of interest checks that ensure board appointees are suitably qualified, ethically-minded and independent. Importantly, this vetting process should be applied consistently by all SOEs and the results should be made public.

We did not explicitly focus on remuneration in our governance due diligence, but the development of standardised policies dealing with board performance and remuneration is another key area of SOE reform we will be monitoring. This should include a better alignment of remuneration to performance outcomes and the possibility of bonus claw-backs when governance is breached or performance does not meet the agreed criteria.

SOEs IN OTHER COUNTRIES

China: A State owned Assets Supervision and Administration Commission of the State Council (SASAC) is responsible for overseeing the ownership, supervision and monitoring of SOEs.
Singapore: A state-owned holding company, Temasek Holdings, is the central ownership and monitoring agency for SOEs and can be characterised as a national wealth fund.
France: The Agence des Participations de l'Etat is an agency of the government responsible for managing the State's holdings in 70 firms.
New Zealand: A semi-autonomous body attached to the Treasury, Crown Company Monitoring Advisory Unit, monitors the performance of SOEs and provides advice to line ministers.
Canada, Sweden: An overarching legislative framework for SOEs sets out objectives for the management of SOEs.

Conclusion

Looking back over the past 18 months, we have realised that our concerns around SOE governance, as expressed in August 2016, were but a scratch on the surface. We had no way of knowing the extent of the allegations revealed by the information that emerged subsequent to our announcement. This started with the release of the "State of Capture" report by the Public Protector and continued in 2017 with the #Guptaleaks revelations, the publication of the document "Betrayal of the Promise: How South Africa is being Stolen" by a team of academic researchers, and the ongoing Parliamentary and other enquiries. New revelations and allegations are released almost daily in the press and on social media platforms.

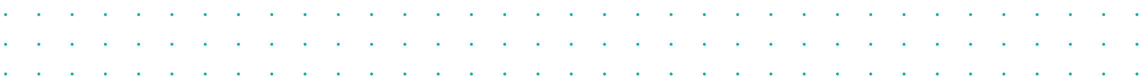
For governance to be properly effected, South Africa's SOEs need the appointment and retention of people of the highest competence and unimpeachable integrity.

SOEs have a unique mandate: they are responsible for the deployment of large sums of money, and they are at the forefront of ensuring sustainable development for South Africa and its people. As lenders to these entities, our view is that they are borrowing public money and therefore should be open to the scrutiny of public capital markets, and to the standards of transparency and disclosure that investors demand.

Significant improvements in SOE governance practices are urgently needed – not only to the disclosures made, but also to the standards of accountability, transparency, compliance with the law, and oversight by the executive authority. The inconsistencies in standards between various executive authorities (as represented by different ministries) need to be urgently resolved, and a common understanding of acceptable practices, transparency and behaviour needs to be adopted, and practiced across all entities.

We hope that this document has shed some light on the questions investors should be asking more consistently of all entities that access public capital markets. More crucially, for governance to be properly effected, South Africa's SOEs need the appointment and retention of people of the highest competence and unimpeachable integrity. They also need greater accountability, more effective consequence management for transgressions, and much higher standards of transparency and public disclosure.

We can and must do better, our future demands nothing less.



Summary of our governance review outcomes

	Land Bank		DBSA		IDC		SANRAL	
Outcomes	Did they already have this?	Did they agree to implement this?	Did they already have this?	Did they agree to implement this?	Did they already have this?	Did they agree to implement this?	Did they already have this?	Did they agree to implement this?
Amendments to legal documentation								
DMTN amendment to protect the stability of the relationship with the shareholding ministry	☒	☑	☒	☒	☒	☒	☒	☒
Board structure and composition								
Appropriate board size	☑	n/a	☑	n/a	☑	n/a	☒	☒
Balanced and appropriate mix of skills on the board and sub-committees	☑	n/a	☑	n/a	☑	n/a	☒	☒
Sufficient members on the ARC (including people with specific auditing skills)	☑	n/a	☑	n/a	☑	n/a	☒	☒
Staggering of director terms	☒	☑	☒	☒	☒	☒	☒	☒
A nominations committee	☒	☒	☑	n/a	☑	n/a	☒	☒
Board decision-making								
Appropriate quorum and voting thresholds for board and sub-committees	☒	☑	☒	☒	☒	☑	☑	n/a
Regular public reporting on changes to key policies, terms of reference for board and sub-committees	☒	☑	☒	☑	☒	☑	☒	☑
Regular public reporting of all conflicts of interest of board members and management	☒	☑	☑	n/a	☒	☑	☒	☒
Annual disclosure of the number and quantum of deals approved at the various credit, investment and procurement committees	☒	☑	☑	☑	☒	☑	☒	☒
Limitations to the delegated authority of particular credit, investment and procurement committees	☒	☑	☒	☑	☒	☑	☒	☑
Timely and public reporting (via the website, Integrated Annual Report and SENS) of all changes to the board and sub-committee terms of reference, mandate and authority levels	☒	☑	☒	☑	☒	☑	☒	☑
Conflict management								
A conflicts of interest policy that prevents current directors (directly or indirectly via their investments or projects) from borrowing from the SOE	☒	☑	☒	☑	☑	☑	n/a	n/a
An appropriate PEP policy	☑	n/a	☑	n/a	☒	☑	☒	☑
Disclosure of all transactions with PEPs in the Annual Integrated Report and/or website	☒	n/a	☒	☑	☒	☑	☒	☑
A cooling-off period restricting former directors from conducting business with the SOE	☒	☒	☒	☒	☒	☑	☒	☑
Governance reviews								
3rd party governance assessments, the results of which are made public	n/a	n/a	☒	☑	☒	☑	☒	☑
Relationship with executive authority								
Public reporting of KPI's, shareholder compact and targets	☒	☑	☒	☑	☒	☑	☑	n/a

Glossary of terms & references

Glossary of terms

Accounting authority	Defined in the PFMA as being the board (if the entity has a board or other controlling body), or the CEO (if there is no controlling body for that entity). National Treasury has the ability to appoint an accounting authority in exceptional circumstances. Refer to section 49 of the PFMA.
Accounting officer	Every department and every constitutional institution must have an accounting officer. This is identified as either i) the head of department must be the accounting officer for that department; or ii) the CEO of a constitutional institution must be the accounting officer.
ASISA	Association for Savings and Investment South Africa
Constitutional institution	Includes the Human Rights Commission, the IEC and the Public Protector.
Corporate plan	A detailed three-year plan detailing the strategy of the SOE, how it hopes to achieve the stipulated strategic objectives, as well as its vision, values and mission statement.
DBSA	Development Bank of Southern Africa
Enabling legislation	The legislation that provides for the establishment, control, functions, power and funding of a SOE.
Executive authority	The cabinet member who is accountable to Parliament for the SOE or in whose portfolio it falls, and/or the member of the provincial executive council who is responsible for exercising financial and operational oversight on behalf of the shareholder (the Government of the Republic of South Africa). The powers of the executive authority are prescribed in the PFMA, as well the enabling legislation of the respective SOE.
Fruitless and wasteful expenditure	Expenditure which was made in vain and would have been avoided had reasonable care been exercised. (PFMA)
IDC	Industrial Development Corporation of South Africa Limited
Irregular expenditure	Expenditure other than unauthorised expenditure, incurred in contravention of or that is not in accordance with a requirement of any applicable legislation, including a) the PFMA, or b) the State Tender Board Act, or any regulations made in terms of that Act, or c) any provincial legislation providing for procurement procedures in that provincial government. (PFMA)
JSE	Johannesburg Stock Exchange
Land Bank	Land and Agricultural Bank of South Africa
MNPI	Material Non-Public Information is information not generally disseminated to the public that a reasonable investor would likely consider important in making an investment decision. (i.e. to buy, sell, or hold securities).
PEPs	Politically exposed persons and their affiliates.

REIPPP	Renewable Energy Independent Power Producer Procurement
Responsible investing	Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns[1].
SANRAL	South African National Road Agency SOC Limited
SENS	Stock Exchange News Service
Shareholder compact	An agreement between the relevant executive authority at national or provincial government level, as the majority shareholder and the entity.
Shareholder executive	(a) In relation to a national department, means the cabinet member who is accountable to Parliament for that department; (b) in relation to a provincial department, means the member of the Executive Council of a province who is accountable to the provincial legislature for that department; (c) in relation to a national public entity, means the cabinet member who is accountable to Parliament for that public entity or in whose portfolio it falls; and (d) in relation to a provincial public entity, means the member of the provincial Executive Council who is accountable to the provincial legislature for that public entity or in whose portfolio it falls. (PFMA)
Unauthorised expenditure	Refers to a) overspending of a vote or a main decision within a vote; b) expenditure not in accordance with the purpose of a vote or, in the case of a main division, not in accordance with the purpose of the main division. (PFMA) In this context, a vote means one of the main segments into which an appropriation act is divided and which a) specifies the total amount which is usually apportioned per department in an appropriation act; and b) is separately approved by Parliament or a provincial legislature, as may be appropriate, before it approves the relevant draft appropriation as such.

References

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- JSE Debt Listings Requirements
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- Public Finance Management Act, No.1 of 1999
- State-owned companies: The new Companies Act, PFMA and King III in perspective (PWC, August 2012)
- King IV Report on Corporate Governance for South Africa, 2016

References to Ministers and the Budget numbers were accurate at the time of writing this report and have subsequently changed with the February 2018 Budget and cabinet reshuffle of 26 February 2018.

1 https://www.unpri.org/about/what-is-responsible-investment

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