Policy Dialogue on Corporate Governance in China

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"Why and Where Independence Matters"

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Good Afternoon Ladies and Gentlemen.

In order to establish why board independence is important, let me begin by sharing with you a diagram which helps clarify the role of the board. In the broadest of terms, the board is responsible for resolving the structural conflicts and tensions that may arise between the conflicting, but equally valid, goals of management and shareholders on the following issues:

- Control
- Capital Structure
- Compensation of Senior Management
- Nomination of Directors, and
- Shareholder Rights.

As the fulcrum that balances management and shareholder interests, the board helps assure that an outstanding management team can pursue business success while respecting the interests of shareholders, employees and other stakeholders. Similarly, the board protects management from undue interference by stockholders—especially family shareholders or important individual or institutional stockholders—who may have an agenda that is at odds with the general interests of the company.

In some ways, the role of the board is similar to that of the US Supreme Court in the US government. The court's role is to help preserve the balance of power between the executive arm of the government, the president and his officers, and the legislative bodies which represent the interests of the people.

The significance and impact of board independence varies depending on the type of corporation and the role that board assumes. Looking at the slide on corporate evolution and the role of the board, we see three factors underlying the impact of the board. The first is the nature of the corporation itself. The top continuum depicted covers the range from an individually-owned or state-owned entity to a publicly-held company. The second continuum covers the relationship between owners and managers. The more one moves towards a fully publicly-held company, the clearer the distinction should be between owners and managers. The bottom continuum shows the changing role of the board. What begins as an essentially advisory role evolves in the public company to a role that requires the board to guide and monitor company management on behalf of the shareholders. Generally, the farther one moves to the right on each of these three lines, the greater the significance and importance of an independent board.

Now at any point along either of first two continuums—the board can intervene to balance or curb the excessive interests of one group. For example, if family shareholders are exercising too much

authority at the expense of the general shareholder population, the board can check their influence. In the same vein, when the state or family owners are exercising undue influence over management, the board can intervene and assure the appropriate separation and independence of owners and management.

Yet, for the board to maintain its authority and credibility as this fulcrum that balances some conflicting interests, it needs to be independent itself.

"Independence" is hardly a new concept in terms of business ethics and practices. As an auditor at Deloitte, it has been an every-day reality for as long as I can remember. Nevertheless, the attention focused on independence—like all ethical values—varies according to the environment in which we operate. Today, because of the business failures of the last three years, independence is commanding renewed attention. The basic notion behind independence is clear enough: to make impartial and tough decisions, any business advisor—from the auditor to the board member—must be free of any personal or vested interest that might affect his or her thinking.

There are a variety of codes or guides that address issues of board independence. They stretch from principles or "guideline-based" corporate governance, which prevails in Europe, to a "rules-based" notion of corporate governance and independence in the US. For example, in the UK, the best practice code recommends that a board have one-third non-executive directors. And the majority should be independent. In France, the majority of the board must be independent. Whereas in Germany, the number of independent directors is unspecified. It is noteworthy that worldwide—with the exception of the US—compliance with the guidelines is <u>not</u> mandatory. It is simply recommended. In most instances, when the guidelines are not followed, the company only needs to provide a short explanation of why it has chosen not to comply.

In the US, in an effort to preserve the role of the board and assure its ability to maintain a balance of power, stringent new rules have been put in place. The New York Stock Exchange adopted new listing rules last November which set out the conditions for the independence of board members. The Exchange has tightened its definition of independent director to encompass several stipulations including the following:

1. The independent director can have no material relationship with the listed company—that is to say he cannot be a partner, shareholder or officer of a company that has a relationship with the company on whose board he or she serves.

2. A director who receives—or whose immediate family member receives—more than $100,000 direct compensation from the listed company is not independent.

3. A director or family member of the director who is affiliated with or employed in a professional capacity by a present or former internal or external auditor is not independent. There must be a five year waiting period.

4. Non-executive independent directors must meet at regularly scheduled sessions <u>without management</u>.

With these rising standards on independence, US companies are now going to great lengths on their websites to introduce their board members, explain their backgrounds, and clarify their expertise and their status regarding independence. For example, MCI, the reconstituted company created from the defunct Worldcom, has made a point of establishing the most stringent rules to assure board independence.

1. With the exception of the CEO, 100% of board members will be fully independent.

2. MCI's CEO will not be allowed to sit on any other corporate boards and MCI's independent directors can sit on a maximum of three boards.

3. The board is required to meet at least eight times a year and to hold an annual strategic review.

4. Board members are required to visit company facilities each year, independently of board meetings.

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If independence for board members is not prescribed by rules in most of the world, then what value can be assigned to independence? What incentive does corporate management have to make certain that its board is indeed independent?

Deloitte's research shows that the value of independence is in good measure determined by the investment environment. In today's marketplace—with corporate failure having manifested itself in the Americas, Europe and Asia—the primary value of the independent board lies in its ability to enhance public trust. Enhancing public trust in the good name and brand of any corporation is essential. An independent board adds to the credibility of corporate management and the company's brand. Second, if a company is willing to be transparent and independent with respect to its board, then the investing public will be more likely to forgive any short-term underperformance. From a more speculative angle, one might argue that there may be an added benefit for the company: independence and transparency of the board may help reduce the volatility of the stock price when results are disappointing.

Third, in more developed economies, institutional investors play a significant role in shaping the market. They tend to be strategic and longer-term investors. And for them, issues of independence, compliance and regulation are important given the constituencies to whom they are accountable. They see value in independence; for them it is a measure of corporate responsibility. In less developed markets, smaller investors tend to be less-strategically minded and hence issues of independence are less significant.

Fourth, independence brings value and credibility to the board's appointments to the committees which oversee CEO compensation, succession planning, and the appointment of the audit committee. In all these instances, independence is crucial to the functioning and credibility of these bodies. In fact, the independence of these committees is a by-product of the board's own independence.

The final benefit or value—and here I am returning to one of the main tasks of the independent board—is maintaining the balance of power so that no single group or force can dominate the strategic course or operations of a company. Dominating parties or forces are not always top management. As we suggested earlier, they might be shareholders, especially large institutional shareholders, who pressure the company for certain types of reform which may not be in the interest of all shareholders. Whatever the case, a strong and independent board can serve to check the undue influence and pressure of both external and internal groups.

The question now confronting us is: given the benefits of an independent board, are there any shortcomings or possible dangers of independence? The only danger I can see is that of concentrating on independence to the exclusion of other important factors that make for an effective board.

Together, these other factors affect the interaction or chemistry among the board members and are as important as independence to the success of a board.

The first factor is respect, trust, and openness. It is essential for board members to respect their colleagues and appreciate the experience, insight and expertise their colleagues bring. In that sense, board members must be active participants in the meeting; they must be well-informed; they must study the issues before the board; and they must be able to exchange views with full frankness and candor. The board's ability to engage in open discussions will avoid a number of pitfalls—such as the creation of back channels between individual board members and top management or line managers in the company. Openness will also help ward off the creation of factions on the board. In some cases, the existence of factions plays into the hands of a politically-capable CEO. Indeed, it can allow him or her to neutralize the board and deprive it of its role as the fulcrum of power and the independent monitor and guide over management.

Finally, just as important as independence, is the fostering of a culture of dissent. Boards need members who are knowledgeable and capable of challenging management decisions about strategy and operations. The interests of management and shareholders alike are best served when independent board members feel comfortable about challenging basic assumptions about the direction of the company. And the CEO and Chairman of the Board must make clear that they appreciate the difference between constructive criticism and disloyalty.

Having now considered the guidelines, values and attributes of an independent board, let me briefly consider some of the challenges facing China as in modernizes its enterprises and enhances their corporate governance.

The first issue is one of availability. In Europe and the US, many board members are either active or retired CEOs, CFOs, or senior executives. In that sense, there is a large pool of potential board members. In China, while there are many corporate leaders with vast experience, much of it was gained from administrative rather than corporate experience. Hence, finding qualified executives to be independent board members will at the outset not be an easy task.

The second challenge is to create a system for the continuing education of board members. One area worth pursuing is the creation of a professional association modelled after the US National Association of Corporate Directors. The NACD provides a forum for directors to discuss a wide range of issues affecting boards, including specific issues relating to corporate governance. As an independent association, it is free to make suggestions and offer advice on a host of issues that it sees as central to the mission of corporate directors.

The third challenge is the cultural one. How does one foster a culture of independence in an environment where relationships—Guanxi—are at the very root of many transactions. In China—and I am confident many of my Chinese colleagues would agree—relationships are often more fundamental to the conduct of business than say the intrinsic value of a business idea or the legal dimension of the transaction. The impact of cultural traditions and practices will need to be weighed carefully as Chinese companies develop independent boards.

The fourth challenge is the level of sophistication of investors. Today, many public investors do not yet have the experience with investing to demand or expect certain standards of transparency and independence. As investors gain in experience—and institutional investors emerge as an important group—there will greater expectations about board independence and expertise.

In closing, I want to reiterate three points:

1. The value of independence lies in helping the board to maintain its authority and credibility and thereby balance the interests of management and shareholders. Even if the market attaches limited value to it, board independence is essential for maintaining this balance of power.

2. Creating an independent board is not merely an issue of ticking the boxes and fulfilling certain rules or regulations. The right chemistry and interaction between board members is vital.

3. Creating a business culture that fosters independent boards is a matter of time and accumulated experience.

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For our part at Deloitte, we are committed to helping China succeed as it fosters a new corporate governance culture. We are committed to investing significantly to deepen our understanding of the Chinese marketplace, business environment, and traditions of commerce. We look forward to building on our work with Chinese authorities and clients and to continuing to participate in this exciting economic transformation.