



Policy Dialogue on Corporate Governance in China

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*“Some Views And Suggestions On The Setting-Up Of Boards Of
Directors At Large Solely State-Owned Companies*

by

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I. Need to set up boards of directors at large solely State-owned companies

Over a relatively prolonged period there are likely to be a number of large solely State-owned enterprises operating in China, at least under the auspices of the central and provincial authorities. There are many reasons for this, i.e. the need for State control over certain areas, financial factors or transitional arrangements relating to corporate reform.

Abroad, all large State-owned companies (including solely State-owned companies) set up under company law (including under special company law) have boards of directors. A board of directors is responsible for deciding or monitoring corporate strategy, financial monitoring, appointing and dismissing the managing director and other senior executives and determining their salaries and bonuses etc. Large solely State-owned companies in China either have no board of directors, being registered under the law on enterprises, and implement the "managing director responsibility system". Or, if they do have one, being registered under company law, it does not necessarily exercise its proper functions. Where owing to the frequent confusion arising over the roles of chairman of the board of directors and managing director, the rules stipulate that the board chairman is the company's legal representative, the company is often effectively run under a "board chairman responsibility system", similar to the "managing director responsibility system". In either case responsibility lies with one individual.

Why does a large company need a board of directors? Because decision-making by a board of directors operates according to the "one man one vote" and "resolution by majority" rule. Decisions are taken collectively on the basis of the directors' individual responsibility. Decision-making by the managing director is decision-making under a "one-man leadership system" subject to control by the board of directors and receipt of full authorisation. Decision-making in large companies is a complex operation and a major responsibility. If the two systems are combined, this is conducive to prudent decision-making at large companies, it helps to control risks and it can ensure efficient corporate decision-making and administration.

Foreign large solely State-owned companies also have boards of directors. Prof. D. Jacobs, for 20 years Dean of Northwestern University's Kellogg School of Management (and formerly Chairman of the Board of Directors of one of America's large national railway companies) argues that this is because boards of directors of solely State-owned companies at the same time have supervisory and consultative roles and they provide guidance on public relations management and reducing political interference.

China's solely State-owned companies implement a system of responsibility vested in a single individual in the person of the managing director (or chairman of the board of directors). This is equivalent to allowing the managing director to take on simultaneously the roles of supervising, formulating and implementing policy. Not only does this involve a conflict of roles and interests. It can easily lead to two kinds of situation arising. Firstly, the State agencies do not accept responsibility for monitoring policy (with the result that insiders take control and, even if a key figure in the company absconds, this fact is kept secret). Secondly, if it is stipulated that policy plans proposed by the managing director must be approved by the State agency, then the latter is assuming the responsibility of a board of directors, rather than the responsibility of the general shareholders' meeting. As a result, it is inappropriate to intervene or, because the State agency is unable to take decisions in time, business opportunities may be lost.

In the case of small companies, where the business environment and the tasks are simple and the shareholding institution accepts substantial managerial responsibilities, the board of directors' policy-monitoring role will probably be smaller, while the role of the "single manager" will be greater. However, much of the business of China's large solely State-owned companies is competitive, and the companies are engaged in major tasks of structural adjustment and reform. It is not possible and not desirable for a managing director to be the only decision-maker and bear sole responsibility for policy-making in this area. Moreover, according to the Provisional Regulations on the Supervision and Administration of State-Owned Assets (hereafter referred to for short as the "State Assets Regulations"), apart from the task of capital restructuring, the State agency's main responsibility is supervisory, not policy-making.

Setting up boards of directors at large solely State-owned companies and imposing on directors individually a fiduciary duty vis-à-vis the State agency and a policy-monitoring responsibility vis-à-vis the company are important and priority tasks for the State agencies in the process of improving the structure of corporate governance at large solely State-owned companies.

The structure of governance provided for in the law on enterprises is not suited to the organisational structure of large companies. It obscures the relationship between policy monitoring and implementation. Enterprises registered under the law on enterprises, especially large companies with complex policy tasks, must all gradually change their system of governance.

If large State-owned companies create boards of directors, this can also help to promote an improvement in the governance of China's enterprises and to smooth the process of further adjustment in the structure of corporate governance at large State-owned companies following the organisational changes.

II. Some issues that need to be clarified concerning the setting-up of boards of directors at large solely State-owned companies

1. Appointing outside directors, including independent directors

The boards of directors of solely State-owned need to have outside directors and independent directors, in order to resolve problems such as the non-separation of functions between policy making or monitoring and policy implementation, insider control and the conflicts of interest that can arise when managers and directors are the same people. The term "outside director" refers to persons who serve as directors, but do not otherwise work for the company, whereas "inside director" refers to persons working for the company who also serve as directors. "Independent directors" belong to the category of outside directors, but they differ from non-independent outside directors insofar as they may not, within a fixed period of years, hold a post in that company, have dealings with it or own shares in it nor may they, during the time that they serve as director, maintain any relations with the company that could influence their independence of judgement.

Legal requirements concerning the proportion of outside and independent directors serving on the board differ from country to country. In European State-owned enterprises (SOEs) the great majority of directors are outside directors. There are also a relatively large number of independent directors (see Table 1).

The terms "inside" and "outside" director come from the United States. In the United Kingdom they are referred to as "executive" and "non-executive" directors. But the meanings are similar, with inside directors essentially corresponding to executive directors and outside directors to non-executive directors. China needs to standardise its terminology for directors. But it is even more important to clarify the precise meaning and responsibilities implied by each type of director and to clarify their legal duties and objectives as members of the board of directors, in other words loyalty to the company, conscientious fulfilment of responsibilities and appropriate expertise.

Table 1: Make-up of boards of directors at three European State-owned companies
(unit = number of persons)

Company	Country	State holding (%)	Sector	Outside directors		Inside directors	Total	
				Civil servants	Trade union nominees			
Renault	France	Controlling interest	Auto	16	3	3	1	17
Vattenfall	Sweden	100	Electricity	14	2	6	2	16
V&S	Sweden	100	Drinks	11	2	2	1	12

Note: 1 out of 3 persons come from State-funded institutions.

Source: State Council Development Research Centre; company reports and interviews, September 2003.

2. The State agencies might consider nominating directors as representatives of the State as shareholder

There is no general consensus on whether or not the State agencies can and ought to nominate directors. Generally speaking, foreign law does not prohibit civil servants from holding directorships at State-owned companies. European State-owned companies generally do have civil servants as directors. In Japan and the United States it is very rare for serving civil servants to hold directorships. But there are former or retired civil servants who do. Company law in China stipulates that civil servants may not hold directorships. But if a State agency were held to be a special agency and not an administrative agency and its employees not civil servants, then (and only then) could it nominate directors. This, however, would imply a reform of the personnel system. Otherwise, the State agency would have to wait for a revision of company law before it could arrange for its own employees to hold directorships or find other suitable persons for such posts.

A director nominated by a State agency will usually have special reporting and communication duties vis-à-vis the nominating agency, in the same way that ordinary companies have nominated directors or related directors with a special relationship with their shareholders. These are non-independent outside directors. However, a director nominated by a State agency will have exactly the same powers and responsibilities as the other directors. Under company law, a nominated director must also assume the responsibilities of a director, with no special or specific powers. Under the system of directors nominated by State agencies in Sweden, France and other European countries, such directors are often civil servants and they are called "representative state shareholders". Ordinarily, representative state shareholders make up only a minority of the outside directors. In some countries, like Sweden, the boards of directors of SOEs are in the process of reducing the number of directors nominated by the State. The directors of many SOEs, including even the board chairman, come from the private sector.

Provided that their responsibilities and duties are made clear and their numbers strictly controlled, nomination by the State of directors at large enterprises can facilitate links between the large shareholder and the company and give an impetus to the pilot scheme of setting up boards of directors. Therefore, there is support from all quarters, including the enterprises, for nominating directors at a small number of companies. The State agencies need to draw up suitable administrative regulations governing the terms and conditions of tenure etc.

3. Boards of directors need to set up salary/appointments, audit and strategy committees

By setting up directors' committees, the boards of directors at solely State-owned companies will enable the directors or the board to go more deeply into a number of technical issues, thus helping to share out directorial responsibilities and reduce conflicts of interest. This is a system common to boards of directors in all countries. Listed companies in the United States are as a general rule required to set up salary, appointments and audit committees. In China salary/appointments, audit and strategy committees could first of all be created. The members of the salary/appointments and audit committees should ideally be made up chiefly of independent directors, while the members of the strategy committee could be mostly inside directors. Or, the responsibilities of the salary/appointments committee could be respectively assumed by a salary committee and an appointments committee. In most countries the main responsibilities of salary committees are to design and even, within the limits of their authority, to fix the salary structure of the company's senior executives and directors¹. The main responsibility of the strategy committee will be to conduct the preliminary examination of the company's strategy and major investment projects relating thereto. Under the existing regime of external supervisory boards, there are either no audit committees or the audit committee is mainly responsible for monitoring the setting-up and implementation of the internal system of controls. Abroad board of directors' committees are able to pass resolutions within the limit of the authority conferred on them by the board. But in order to safeguard the board of directors' monitoring powers, the law contains certain prohibitions relating to the conferral of powers.

4. Clarifying the responsibilities of and relations between the board of directors and the managing director

As regards the relations between the board of directors and the managing director, the former is responsible for deciding or monitoring policy and for financial and asset monitoring, while the latter is responsible for drawing up and implementing policy and for the day-to-day running of the company. From a legal point of view they both exercise an agency by mandate, under a system of checks and balances and a division of complementary responsibilities. Under foreign company law the board of directors and the managing director are regarded as company organs with their respective responsibilities, but usually the law does not define the checks and balances operating between the two.

Responsibility for appointing and dismissing the managing director must rest with board of directors. During the initial period of the pilot scheme to appoint boards of directors at solely State-owned enterprises, we might adopt an interim arrangement whereby the appointment or dismissal of a managing director by the board of directors is first notified and submitted to the State agency, or the State agency might make a recommendation which would, however, have to be assessed and approved by the board of director. How such a system could be made to square with the principle of control by Communist Party cadres is a question that needs to be looked into. This principle mainly refers to the Party ensuring the political soundness of the cadres. The system of personnel management whereby people are investigated for their suitability to the enterprise is a policy already set by the Party. Provided that the principles underlying this "political stage" are transparent, it should not be difficult to handle. If we have properly integrated procedures for examining the candidates that must be followed by the board of directors when selecting the managing director, the issue of the "political stage" can be resolved. Provided that it is properly investigated, a system of appointment of the managing director by the board of directors is feasible at solely State-owned companies.

After a board of directors is set up, it is desirable that the roles of managing director and board chairman at solely State-owned companies should be gradually separated. When the posts of board chairman and managing director are held concurrently by the same person, the outside directors on the board, and particularly the independent directors, need to be more numerous and more powerful. The managing director's salary also needs to be fixed by the directors.

Senior executives below the rank of managing director should be nominated and have their salaries fixed by the managing director, subject to ratification or approval by the board of directors. This is because the managing director is the executive in charge of drawing up and implementing policy (the so-called CEO). If the board of directors is directly responsible for appointing all the executive staff and fixing their salaries, this might affect the managing director's efficiency. In order to link up with the current personnel system, the deputy-level cadres could be required to report to the State agency and even submit to necessary examinations.

5. Full powers, a sound system and sound rules are the foundation of an effective board of directors

The responsibilities of State agencies laid down in the "Regulations on State Assets" include some of the duties of boards of directors. This reflects the fact, for example, that State agencies simultaneously oversee different types of SOEs. However, in the long-term perspective, in order to ensure that boards of directors act really effectively and to encourage the transition from a "managing director responsibility system" to the creation of boards of directors, the boards must always be fully vested with proper directorial powers, so as to ensure the basic conditions in which the directors and the board can genuinely assume their responsibilities.

In addition to providing the board of directors with powers, it is also necessary to work out effective arrangements under which it can operate. The basic arrangements will include a definition of the duties of the directors and the board (and how they are to be coordinated with those of the managing director), the rules governing the passing of resolutions by the board of directors and its committees, the powers and responsibilities of the board of directors' committees, the qualifications and conditions for exercising the various directorial functions, the system of directors' salaries and bonuses, the functions of the secretary to the board and so on. It will also be necessary to gradually define the board of directors' various responsibilities in the areas of e.g. strategy (including the financial budget), auditing and internal controls, executive personnel management and salaries and bonuses (including appraisal), public information and reporting and public relations etc and gradually work out the appropriate basic rules and arrangements.

6. Preventing boards of directors through too much responsibility being given to the State agencies

Abroad there have been many cases of ineffective boards of directors that fail to carry out their responsibilities properly. This can happen not only because unsuitable people are appointed to the board or owing to imperfections in the system of corporate governance. It can also have to do with how the shareholders or their representatives understand their role and behave. By allowing boards of directors full powers so that they can assume the responsibilities entrusted to them, we are not so much reducing the responsibilities of the State agencies, as asking the State agencies to accelerate the process of setting standards for the management of capital and shareholdings that are appropriate to a market economy. But there is even more to be done to improve corporate governance

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ⁱ In some countries, like Sweden, some experts believe that directors' salaries should be fixed by the general meeting of shareholders. However, provided that salaries and bonuses are submitted to the shareholders' meeting (including the State agencies) and are published in full, we believe that it is permissible to allow boards of directors to fix directors' salaries and bonuses, because it makes the system of salary fixing simpler and more specific to company needs.