

## **The Practice of Setting Board of Directors in Large-scale State-owned Enterprises**

In March 2003 the 1<sup>st</sup> conference of the 10<sup>th</sup> National Congress discussed the scheme for reform of organizations under the State Council and established the State-owned Assets Supervision and Administration Commission (SASAC). The central government as well as provincial and regional (municipal) governments successively set up new organs for the administration of state-owned assets to fulfill the responsibilities of the owner and gradually established the 3-layered state-owned assets administration system of state-owned assets administration organ—intermediate holding companies—state-owned enterprises (SOE), which promoted the reform of state-owned assets administration system.

By that time, among the 189 enterprises directly under the central government in which SASAC exercised shareholder's right of the state, only a dozen of them established BOD that was non-normative. In June 2004, SASAC issued the Notification on Pilot Establishment and Sophistication of BOD in Central SOEs and selected 7 SOEs directly under the central government to conduct the pilot project. These 7 pilot enterprises included: Shenhua Group Co., Shanghai Baogang Group Co., China Tie Tong Group Co., China Pharmaceutical Group Co., China Gaoxin Investment Group Co., China International Travel Service Group Co., and China Chengtong Group Co. The pilot enterprises would establish BOD of their own in line with modern corporate system and per the requirements of Company Law, obtain experience by the pilot efforts and gradually sophisticate the governance structure for SOEs.

### **I. The necessity of establishing and sophisticating BOD for large-scale SOEs**

In the past, in China no BOD would be set in large-scale SOEs which were established according to Law of Industrial Enterprises Owned by the Whole People and the factory head or general manager would be responsible. In some large SOEs which were registered in compliance with Company Law, the BOD did not play its role indeed. As directors did not assume personal responsibilities and duties of board chairman and general manager were usually mixed, the board chairman became the one responsible in a company, and similar to the system of general manager being responsible, this was a system under which the sole person was responsible.

In SOEs or companies where the system of general manager or board chairman being solely responsible, the general manager or board chairman played the roles of strategic supervisor, formulator and implementer at the same time, thus there will be not only conflicting roles and interests, but also the two cases as follows: first, the state-owned shareholder is kept away from the enterprise and it is difficult to maintain shareholder's right and the ultimate control right, resulting in "control by insiders" being out of control ; second, if it is stipulated that strategic schemes and decisions put forward by the general manager shall be approved by state-owned assets administrative authority, then what this authority assumes will be BOD responsibilities rather than shareholders meeting responsibilities, which may result in unjustified interference or lost commercial opportunities due to this authority's inability to make timely decision.

In our country, many businesses of large SOEs are competitive and these enterprises are also

burdened with the arduous task of structural adjustment and reform. It is impossible and inappropriate for the general manager alone to make relevant strategic decisions and assume corresponding responsibilities. Besides, according to Interim Regulations on the Supervision and Administration of State-owned Assets, what state-owned assets administrative authority assumes is supervision, rather than strategic decision-making. In some large companies, the context for decision-making is complex and the responsibility for decision-making is vital. The establishment of BOD and the collective decision-making on the basis of directors' personal responsibilities helps make cautious decisions, control risks and also ensure decision-making and managerial efficiency in large companies as well.

According to Prof. D.Jackb, a famous specialist in corporate governance from USA, the former president of Kellogg School of Management, Northwest University for 20 years and the former board chairman of a large USA state-owned railway company, the BOD of a SOE simultaneously has such functions as supervision, consultancy, guidance on handling public relation and reduction of political interference etc. In foreign countries, BOD is set in all state-owned companies (including solely state-owned companies) that are established in accordance with Company Law, including Special Company Law. The BOD is responsible for the company's strategic decision making and supervision, financial monitoring, appointing and dismissing top management such as the general manager etc., deciding their salaries and so on, while the general manager is responsible for implementing strategies and making decisions in daily management.

The governance structure stipulated in Enterprise Law is not in accordance with the mechanism of large companies, as the relationship between strategic supervision and implementation is blurred. For enterprises registered according to Enterprise Law, especially those large companies with complex strategic tasks, the governance mechanism shall be gradually transformed. To set up BOD in large SOEs so that directors will assume personal entrusted responsibilities for state-owned assets administrative authority and assume decision supervision responsibilities for the company shall be the top priority for state-owned assets administrative authority to sophisticate the governance structure of large SOEs. All denatured enterprises shall set up BOD, including SOEs. The practice of decision-making by BOD shall be sophisticated and the BOD shall be burdened with entrusted responsibilities. Integrating the entrusted responsibilities of the BOD into a system helps the implementation of the entrusted responsibilities.

## **II. Some issues to be clarified for large SOES to set up BOD**

### **1. Setting outside directors such as independent directors etc.**

As stipulated by the Notification on Pilot Establishment and Sophistication of BOD in Central SOEs, SASAC will designate some "outside directors" and "independent directors" to enterprise BOD.

The BOD of SOEs must include outside directors and independent directors so as to solve problems of control by insiders and interest conflict etc. which may be caused by the blurred strategic decision-making or supervision and strategic implementation and the combination of the managers and the decision makers.

Outside directors are those who do not work in the company, while inside directors are those who are top managers of the company at the same time. Independent directors fall into the category of outside directors, but unlike non-independent outside directors, they shall not have relations of

employment, transaction and stock right etc. with the company within certain years, or any relation that may possibly affect their independent judgement when fulfilling a director’s responsibilities.

The proportions of outside directors and independent directors in BOD are stipulated differently in laws of different countries. In European countries, the majority of directors in SOEs are outside directors and the number of independent directors is also quite big (see table 1).

Inside director and outside director are terms from USA, while in UK they are called executive director and non-executive director, respectively. In our country it is necessary to unify the meanings relating to director, but it is of more importance to clarify the true meaning and obligations of various directors and to make clear the legal responsibilities and objectives common to them as board members, and all of them shall be loyal and dutiful to the company and shall have related knowledge.

**Table 1 BOD composition for 3 European state-owned companies (unit: person)**

Company	Country	Ratio of state-owned shares (%)	Industry	Outside director			Inside director	Total
					Public servant	Recommended by the labor union		
Renault	France	Relatively holding	Automobile	16	3	3	1	17
Vattenfall	Sweden	100	Power	14	2	6	2	16
V&S	Sweden	100	Liquor	11	2	2	1	12

Source of data: summary of questionnaires by Enterprise Research Institute (ERI) of the Development Research Center of the State Council, Sept. 2003.

Key points for designating outside directors to large SOEs are as follows:

- 1) Understanding the meaning and corresponding requirements of outside directors from the aspect of BOD system:  ordinary responsibilities of a director;  special responsibilities (such as reporting etc.) of the key trustee by SASAC (major shareholder);  implementation responsibilities (such as personnel, salary and auditor) that shall not be decided by inside directors.
- 2) Two key tasks: absorbing global experiences and at the same time taking national conditions and transitional arrangements into account, for instance, director responsibilities. Experience from foreign countries shall be referenced in the employment and meanwhile there shall be some special requirements.
- 3) According to different conditions with solely state-owned companies and holding companies, corresponding administrative measures shall be set down respectively, and contents relating the relationship between outside directors, inside directors and top management shall be added to embody the principle of “cooperation and check”, neither one shall be neglected.
- 4) Outside directors include two types, one is outside directors who are specially responsible to SASAC (for instance, the so-called dedicated directors, who shall report to SASAC before making vital decision-making statement, depending on the authorization, and shall obtain approval concerning some issues). The second one is independent outside directors as recognized by SASAC who acts as the share holding organ, i.e., independent directors, who also assume responsibilities as entrusted by SASAC, but it is neither necessary nor obligate for them

to communicate with or obtain approval from SASAC when presenting their opinions. As proved by experiences at home and abroad, even for state-owned companies (SOC), independent outside directors are meaningful. The determination of independent directors' fulfillment of duties and obligations by SASAC is mainly based on the evaluation of directors etc.

- 5) Both outside directors and inside directors shall assume responsibilities of a director. As a result, basic responsibilities of outside directors shall be clarified first, namely responsibilities to the company, and second is special responsibilities to SASAC (e.g. the responsibility of reporting under certain condition). It shall be pointed out that directors' special responsibilities to SASAC are no substitution of their personal legal responsibilities.
- 6) With reference to foreign experience, reasonably determining the duties and requirements of inside and outside directors and introducing the "commercial judgement principle"<sup>1</sup> for directors.
- 7) The main body for the list of recommended outside director shall be clarified. Regarding the approver of outside directors, for SOCs, it is SASAC, for holding companies, it is shareholders meeting. BOD may also act as the key recommender, but reporting to SASAC for filing (in case of SOCs) or communication beforehand (in case of state-owned holding companies) is necessary. The process of filing and communication is also the process of intervention and political check by SASAC and organizational authority.

## **2. State-owned assets administrative authority can designate some directors acting as representatives of state-owned shareholders**

As the issue of whether it is necessary to designate directors by state-owned assets administrative authority is concerned, views vary greatly. According to Company Law of our country, public servants shall not be directors. However, if state-owned assets administrative authority is recognized as a special organ, rather than an administrative organ, and its staff is not public servants, then it can designate directors. Otherwise, it can designate employees of its own as directors only after Company Law is revised, or employ appropriate persons from nongovernmental departments and with practical experience in enterprises as designated directors. Nevertheless, this kind of directors directly designated by state-owned assets administrative authority shall be as few as possible.

Directors designated by state-owned assets administrative authority usually assume special responsibilities of reporting and communication to the designator and, similar to the nominated director or related director who has special relationship with the shareholders in ordinary companies, are non-independent outside directors. Nevertheless, rights and responsibilities etc. for these designated directors are exactly the same to other directors. According to Company Law, designated directors shall also assume director responsibilities and enjoy no special or specific power. In some European countries such as Sweden and France etc., the system of designating directors by state-owned assets administrative authority is also practiced, some of these directors are public servants, also known as representative of state shareholder, who generally cover a small proportion of outside directors. In countries such as Sweden etc., the BOD of SOEs is cutting the number of

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<sup>1</sup> Commercial judgement principle: in case of losses due to directors' risky decisions, all or part of directors' responsibilities can be exempted under conditions as follows: ① not for personal interest; ② in making decisions, due responsibilities of a director are fulfilled and universally recognized commercial principles are complied with.

directors designated by state shareholder and directors of many enterprises, even the board chairman, come from private enterprises.

Concerning designating directors to large enterprises by state-owned assets administrative authority, so long as responsibilities and obligations are clarified and the number is strictly controlled, it may help promote the communication between major shareholder and the company and the BOD pilot project. Consequently, based on opinions from various aspects, including enterprises, designating directors to some pilot enterprises can be tried. It is necessary for state-owned assets authority to set down corresponding administrative rules such as position qualifications etc.

**3. It is necessary for the BOD to establish committees of nomination, salary, auditing and strategy etc**

Director committees under the BOD in SOCs enables directors or BOD to have a deeper discussion of some technical issues, which helps share responsibilities among directors and reduce interest conflict, and this system is generally practiced. In USA, listed companies are required to set up the 3 committees of salary, nomination and auditing. In China, it is recommended to set up 3 committees of nomination and salary, auditing and strategy at first, among which, members of nomination/salary and auditing committees shall be mainly comprised of independent directors, while the strategy committee may include more inside directors. Duties of the salary and nomination committee may be assumed by a salary committee and a nomination committee respectively. In most countries, key duties of the salary committee are to design and even decide upon authorization the salary scheme for the company's top management and directors. The strategy committee is mainly responsible for company strategies and the preliminary examination of relevant investments of importance. In case of a board of supervisors existing, the auditing committee may be unnecessary, or it is mainly responsible for the establishment of internal auditing system and the implementation of supervision. In foreign countries, the director committees can make resolutions upon BOD's authorization, and to ensure BOD's supervisory power, stipulations of forbidden issues against the authorization are set down in the law.

**4. Clarification of responsibilities of and the relationship between BOD and the general manager**

Regarding the relationship between BOD and the general manager, in terms of duties, the former assumes the responsibilities of strategic decision-making/monitoring and financial/assets supervision, while the latter assumes the responsibilities of strategy implementation and the company's daily management; while in legal terms, the two sides have a mandate relationship, in which both check and cooperation exist. According to Company Laws of foreign countries, BOD and the general manager are both deemed as company body, burdened with corresponding duties respectively.

The appointment and dismiss of the general manager shall be determined by BOD. During the early stage of BOD pilot project in SOCs, some transitional approaches can be adopted, for instance, reporting to state-owned assets authority for filing prior to the appointment/dismiss of the general manager by BOD, or state-owned assets authority may make recommendations, but evaluation and recognition by the BOD shall be available and so on. How to coordinate this system with the principle of "cadres under control by the Party" is a question to be explored. "Cadres under control by the Party" mainly refers to the check of cadres' political qualifications by the Party and it will not be a tough task so long as relevant principle is transparent. When the BOD determines the

candidates for the general manager, they shall be examined by the nomination committee. With active exploration, the system of determining the general manager by the BOD in SOCs can well be established.

Once the BOD is established, the general manager and board chairman of SOCs shall be gradually separated. In case of board chairman and the general manager being acted by the same person, there shall be quite a few outside directors with strong power, especially independent directors. Salary of the general manager shall be proposed by the salary committee and determined by the BOD.

Salary of senior managers below the general manager shall be nominated and determined by the general manager and approved or certified by the BOD. This is because the general manager is the person responsible for the company's strategy implementation and daily management (the so-called chief executive officer, CEO), if the management team is appointed directly by the BOD, the efficiency of the general manager will be affected. To get connected with current personnel system, the company's leaders of vice general manager level can be filed at the state-owned assets authority and even examined, if necessary.

#### **5. Sufficient authorization and sophisticated systems and rules are the basis for BOD's effective operation**

Responsibilities of state-owned assets authority as stipulated in the Regulations on the Supervision and Administration of State-owned Assets include part of BOD duties, which is due to the fact that state-owned assets authority supervises SOEs of different types at the same time. In the long term, however, for the purposes of BOD being able to operate effectively and transitioning from the practice of the general manager being responsible to set up of BOD, it is necessary to provide BOD with reasonable structure with sufficient authorization so that basic conditions are available for directors and the BOD to be truly responsible. Sufficient authorization for the BOD to assume entrusted responsibilities does not mean reduction of responsibilities of state-owned assets authority, instead, it is to require state-owned assets authority to speed up the establishment of capital and stock right administrative rules in accordance with the market-oriented economic system and to put more efforts in the improvement of corporate governance.

In addition to authorization, an effective working system of the BOD shall also be set down, which includes clarified duties of directors and BOD (to be jointly formulated with duties of the general manager), resolution rules for the BOD and BOD committees, rights and obligations of BOD committees, qualifications and conditions for various directors, salary and rewards for directors, working system for board secretary and so on. Responsibilities of BOD in aspects such as strategy (including financial budget), auditing and internal control, nomination of managers and salary (including evaluation), information disclosure and reporting and public relation etc. shall be gradually clarified and corresponding fundamental rules and system shall also be gradually formulated.

### **III. Preliminary experience from pilot enterprises**

C Group is one of the pilot enterprises under SASAC's pilot project of BOD reform. C Group was formerly comprised of some enterprises belonging to a certain Ministry. In 1992, prior to the disorganization of this ministry, these enterprises were incorporated into a group by administrative order. This group corporation which was comprised of some dispersive enterprises set up a BOD and

most of the directors were acted by the general managers of previous enterprises. C Group tried to introduce outside directors in 1998, but anticipated effect was not realized. This is because the outside directors introduced were not dedicated ones, most of them were merely nominal and they even could not spare the time to attend BOD meetings.

According to the Notification on Pilot Establishment and Sophistication of BOD in Central SOEs, C Group volunteered to be one of the pilot enterprises and established a complete system of corporate governance in the parent-subsidary regime which was centered on C Holding Co. By the second half of 2004, C Group began to design the scheme for establishing BOD in this SOE and ERI/DRC of the State Council participated in the design of pilot scheme in the whole process.

### **1. Guiding ideas for C Group's pilot scheme**

In accordance with Company Law and relevant requirements for the BOD pilot project by SASAC, with loyally representing the owner's benefit, being responsible for the financier and enhancing the company's market competitiveness as the fundamental tenet for construction of BOD and through the establishment and sophistication of BOD, forming a corporate governance mechanism with reasonable structure, clear rights and obligations, effective check and coordinated operation, so as to accelerate the establishment of a modern enterprise system in the group, speed up the pace in reforming and restructuring the joint stock system and promote construction of the group from all sides.

### **2. Research tasks and objectives of C Group's pilot scheme**

By sophisticating BOD structure and BOD operating system, realizing the BOD's effective strategic control and supervision of the company which is centered on development strategy, vital investment and financing, internal reform decisions and the employment, evaluation, appraisal and awarding/punishment of the general manager to fulfill the tasks of the pilot project as assigned by state-owned assets authority.

- (1) Evaluating the evolvement of C Group's corporate governance and the current developments;
- (2) Designing a scheme of corporate governance structure and operating mechanism which complies with requirements of SASAC, caters to features of the group and leaves room for exploration for C Corporation;
- (3) Researching C Group's parent-subsidary system and proposing a scheme of governance and management system for the group;
- (4) Formulating some normative documents concerning the operating of C Holding Corporation's BOD as well as some systems to normalize the relationship of governance structures between the group's parent company and its subsidiaries.

### **3. Steps for researching C Groups' pilot scheme**

- (1) Evaluating C Holding Co. and group governance;
- (2) Proposing the scheme for governance of C Holding Co. and the group;
- (3) Revising the charter of C Holding Co.;

- (4) Formulating rules for normalized BOD Operating, including:
  - Examination rules for the BOD;
  - Examination rules for the auditing committee;
  - Examination rules for the nomination and governance committee;
  - Examination rules for the auditing and appraisal committee;
  - Examination rules for the strategy and control committee;
  - Working instructions for board secretary;
  - Working rules for the general manager.
- (5) Setting down the company's management system for information disclosure
- (6) Formulating C Corporation's governance principle.

#### **4. Submitting the company's charter and related documents to SASAC and ready to receive outside directors**

After submitting and revising the company's charter and determining the candidates for inside directors, per the requirements of SASAC, C Group is reporting its requirement for speciality of outside directors to be designated to the enterprise, and these outside directors shall be complementary to inside directors in terms of professional background and experiences etc.

It is pointed out by SASAC that, "the nucleus of the BOD pilot project is the system of outside directors" and this is the precondition for SASAC to fade out from the role of "mother-in-law" and reassume the role of "boss". SASAC issued Measures for the Administration of outside Directors concerning the 7 pilot enterprises, providing detailed stipulation of the source, qualifications, selection and employment procedures, duties, rights and obligations as well as evaluation mode and rewards etc. for outside directors. According to the Guiding Opinions, board members of the pilot enterprises shall be no less than 9, among whom at least 2 shall be outside directors. The pilot enterprises basically adopted the proportion of "6+3", namely 6 inside directors plus 3 outside directors, while the 6 inside directors also included 1 employee director. Among these directors, the candidates for 5 inside directors were selected by related enterprise and then reported to SASAC for approval; the candidate for employee director was elected by the employee representative meeting; while the candidates for other 3 directors were appointed by SASAC. On the basis of this, the pilot enterprises would file their requirement for the speciality of outside directors to SASAC and the candidates were to be appointed by SASAC.

According to the timetable by SASAC to establish BOD in all central enterprises within 3 years, and calculated on the basis of the existing 170 central enterprises, several hundreds of outside directors are needed. "It is difficult to find excellent general managers, while it is even more difficult to find an excellent directors and board chairmen, and this is a key reason why the establishment of BOD can not be accelerated". In future BODs, there will be more outside directors than inside ones, so even more outside directors will be needed by central enterprises. After the experience in establishing BOD in the pilot enterprise is obtained, more outside director will be generated by the 2 approaches of direct selection/appointment and public recruitment according to the market principle.

By mid 2005, the 7 pilot central enterprises will have established new BODs and corporate governance structure as well as sophisticated corresponding operational system and working rules and thus established a sound mechanism of entrusted responsibilities and accountability, so as to meet the requirements for socialism market-oriented economy and for further promoting the reform of SOEs.

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