

Conclusions and Key Findings

THE THIRD OECD-CHINA POLICY DIALOGUE ON CORPORATE GOVERNANCE

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This third OECD-China Policy Dialogue on Corporate Governance was hosted by the Shanghai Stock Exchange, in cooperation with the China Securities Regulatory Commission (CSRC), the State-owned Assets Supervision and Administration Commission (SASAC) and Enterprise Research Institute of the Development Research Centre of the State Council of China (ERI/DRC) with the support of the Japanese Government, the Global Corporate Governance Forum (GCGF), and Millstein Center for Corporate Governance and Performance at the Yale School of Management. The dynamic discussion among senior officials, business leaders and scholars from China and OECD countries provided stimulating debate on boardroom challenges and recent corporate governance policy developments.

KEY ISSUES AND NEXT STEPS

- ◆ Chinese decision-makers expressed their long-term commitment to improving the corporate governance framework and practices, as illustrated by the depth and scope of recent reform initiatives. They noted that the OECD Principles of Corporate Governance and the OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) have become the benchmarks in China.
- ◆ Recent capital market developments in China are highlighting a growing need to raise investor confidence and improve corporate governance practices. This was stressed in a comprehensive report presented by the Shanghai Stock Exchange on Corporate Governance of Listed State-Owned Companies. The report demonstrates the leading role played by the CSRC, the Shanghai Stock Exchange and SASAC in governance reform.
- ◆ The board of directors is at the heart of SOE reform in China. An overriding challenge is to find the appropriate balance between the government's responsibilities to be an active owner, while refraining from undue political interference in the management of the company. This is critical particularly in the boardroom.

- ◆ Universal principles on the role and responsibilities of the board are applicable in China but national circumstances largely determine how these principles are adopted and implemented in practice. For example, to define the role and responsibilities of the board in a context where companies are majority controlled, primarily by the state, either directly or indirectly.
- ◆ All directors and the board collectively have a responsibility to act in the interest of all shareholders. But this duty to serve with objectivity and integrity can be more difficult in a controlled company environment that may require particular effort and provisions to ensure that minority shareholder interests are looked after.
- ◆ China will continue to be actively involved in regional initiatives organized by the OECD, such as the Asian Roundtable on Corporate Governance and its Asia Network on Corporate Governance of SOEs. A senior official from the Shanghai Stock Exchange will report on this third Policy Dialogue meeting and recent corporate governance developments at the April 2007 meeting of the OECD Steering Group on Corporate Governance. The next Policy Dialogue meeting will take place in 2008.

I BOARDROOM PRACTICES

Participants shared their perspectives on the “universal” key functions of the board as follows: enhance shareholder value, act in the best interest of the company, protect stakeholder interests, be responsible to all shareholders, ensure corporate performance, have a long-term focus with attention to risk, improve corporate image, ensure transparency between the board and management and set compensation. However, while the responsibility of bringing independence, objectivity and integrity to duties as an independent director is universal, these duties can be more difficult in a controlled company environment.

Exercising objective and independent judgment: role of independent directors

Chinese participants described the role of independent directors as having gone through four stages: 1. "beautiful vase" of non-functioning directors; 2. "cheap labor experts" who offer perspectives to the board, such as lawyers and accountants; 3. "representatives of minority shareholders"; 4. Focus on "stewardship". Although there was a consensus that the board is accountable to all shareholders, there was considerable debate on whether independent directors have a particular 'responsibility' to minority shareholders in controlled companies.¹² This issue is especially relevant in China, where there is ownership concentration and frequent misappropriation of funds by majority shareholders. It was recommended that particularly in these cases, directors need to ensure that the interests of all shareholders are reflected in the board's decision, including minority shareholders that tend to be more easily ignored. However,

² The OECD Principles provide some useful guidance “In others [jurisdictions], independence from controlling shareholders or another controlling body will need to be emphasised, in particular if the *ex ante* rights of minority shareholders are weak and opportunities to obtain redress are limited. This has led to both codes and the law in some jurisdictions to call for some board members to be independent of dominant shareholders, independence extending to not being their representative or having close business ties with them.”

no director is there to act in the interests of only the minority shareholders since the board is not a parliament.

Participants identified “independent-mindedness” of directors as a key quality but without getting stuck on legal definitions and guidelines. The discussion illuminated that acceptance of “independent mindedness” in the boardroom is also a function of the national context and culture.

There was a heated debate between participants on how the concept of ‘independence’ is perceived in China. Some believe that independence has not been valued during the history of China’s political system as there have been few mechanisms for checks and balances. For example, the judiciary is not independent and one person could be at the same time the rule-maker, executive and judiciary.

Most Chinese participants consider independent directors can nevertheless play an important role in China by introducing transparency and debate in the boardroom, whether independence is part of the tradition or not. One Chinese business leader admitted that although unexpected questions from independent directors may “cause a headache”, independent directors need to be brave enough to speak out and insider directors need to understand this. This demonstrates that the notion that independent perspectives and questioning can be “good” for the company is gradually becoming more understood in China.

In order to support this trend, participants suggested that awareness needs to be raised about the benefits brought by independent directors to the boardroom, particularly when a company goes public or is seeking fundraising. When independent directors demonstrate a concerted effort to add value to the company, it shows that they are taking their responsibilities seriously. Rather than being too concerned about compliance, independent directors can become the key to building investor confidence. Independent directors can also be used by the company to add leverage when change needs to take place by fostering a winning mentality and possibly increasing workplace satisfaction. Participants suggested that developing terms of reference or some sort of board policy can provide a process that helps clarify the role of independent directors.

Monitoring management: understanding the different roles of the CEO and the Chair

Participants discussed one of the board’s key functions - to monitor management, including hiring and firing the CEO and more broadly executive appointments. Chinese regulations recommend that the roles of CEO and Chair be separated but they are not required to be. Even when these roles are separate, in practice there is considerable confusion on their respective responsibilities. The Chair of Chinese companies is often the former CEO and plays a powerful role, even though not directly responsible for day-to-day operations. In these cases, the new CEO can act as an “assistant” to the Chair. Also, when the Chair is part of the strategic committee this can lead them to take on the role of the CEO. Particularly in SOEs, where the CEO and Chair are nominated by the state, their respective rights and responsibilities need to be made very clear. There appears to be a tendency to appoint Chairs who intervene in daily operations. Participants suggested that further discussion of the respective roles of the CEO and Chair of the board is needed in China, in order to clarify their responsibilities.

Supporting the board to act with due diligence: information and communication

Participants discussed the practical steps that directors can take – especially the non-executive independent directors - to assure that they have the necessary information to make the best possible decisions. Some participants noted that expecting directors to be “fully informed” is misleading because directors are not able to do all the necessary analysis themselves while “analysis paralysis” should be avoided. There was some debate on who is responsible for providing the board with information. In practice, Chinese directors obtain information from the board secretary and vote based on this information. Participants suggested that a communication mechanism between the board and management be established to ensure that these issues are properly addressed, in a timely manner. The point was that the board should hold management accountable for the information they provide. The role of the board then is to ask the right questions, seeking an external second or third opinion when necessary. Participants also suggested efficiently organising the work of committees, which could provide further information support to the board.

II SPECIFIC CHALLENGES RELATING TO SOES

Participants discussed the complexity of reforming corporate governance of SOEs in China, as elsewhere. A major challenge is to resist the temptation to impose undue political interference in the management of an SOE while finding a balance between the state’s responsibility for actively exercising its ownership functions, such as the nomination and election of the board. There may also be a dilution of accountability for performance of SOEs, which involves a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly identifiable or remote, principals. Another difficult issue is to ensure a level-playing field in markets where private companies can compete with SOEs and that governments do not distort competition in the manner they use their regulatory and supervisory powers.³

Participants agreed that state ownership should not be perceived as a political tool but rather as an investment, in order to increase shareholder value. In the boardroom, when “representatives of the state” are on the board, directors need to act in a professional way that builds trust at the board and ownership levels. Key board decisions such as hiring/firing a CEO or on material related party transactions can be made more efficiently when the state trusts the board. Experience from other countries demonstrates that directors on the boards of SOEs should not act as political appointees and must be able to make decisions without asking “superiors” first. This may even lead to the threat or sometimes to actual resignation, an example was provided of an independent SOE director in China who resigned in advance of a decision that could favor the state but not all shareholders.

³ OECD Guidelines on Corporate Governance of State-Owned Enterprises (2005, OECD)

III THE WAY AHEAD – SUPPORTING GOOD BOARDROOM PRACTICES IN CHINA

Participants shared their views on board effectiveness in China, which is perceived as being a matter of structure, process, culture, and art form that cannot be universal. Each company has its own decision-making culture so the same policy could be implemented differently, based also on the personalities of individual directors. The role of the board may also change according to different stages of the company's operations (for example, the board of a company in crisis may act more aggressively).

In encouraging good faith and diligence in the boardroom, some participants suggested that the board be composed of directors from diverse backgrounds. This may be the most effective manner of preventing very influential directors from dominating discussions and impeding other members from voicing their opinions in the Chinese boardroom. However, an effective communications mechanism is required in order to generate trust and openness in the boardroom among these different directors.

Some participants noted that the process of developing and debating policies can be used to clarify the role of the board, and in particular that of independent directors. However, establishing policies may be useful only if they can be implemented, which may require directors to be able to express themselves openly in the boardroom. To facilitate a more "open board culture", based on experience in Thailand where most boards act on consensus, it was suggested that independent judgment and the right to dissent be recognised. Alternative ways to dissent include 1) stating an opinion and having it recorded, 2) objecting, 3) objecting and abstaining, 4) objecting and voting no and having it recorded and 5) objecting and resigning.

IV ACADEMIC PERSPECTIVES

Participants benefited from insights of scholars on what might be an achievable model of better corporate governance in China, based on recent research.

The discussion on driving forces of corporate governance reform in China illuminated that pressure from the market is needed to stimulate further development, as other mechanisms are presently weak. For example, Chinese courts appear reluctant to protect shareholder rights or promote better corporate governance, particularly in companies where the state holds a large equity stake. There also appears to be a strong correlation between freedom of the press and capital market development; in China, the media is forcing companies to behave according to the law but it is difficult for media companies to hold a strong and independent position because it is relatively easy to sue a media company and win. Plans to establish a Chinese corporate governance index comprised of companies with high evaluations based on a scorecard for Chinese corporate governance are encouraging. The purpose is to determine whether investors are paying a premium for sound corporate governance and what the nature of that premium is.

Research indicates that the actual behavior of listed companies in China has progressed less than rules and regulations, which may imply that it takes time to implement rules and regulations. It was also argued that there is a trend of polarization of corporate governance, with good companies getting better and bad companies getting worse. Corporate governance reform seems to be moving away from mandatory requirements to market-driven initiatives, which is more

likely to lead to improved practices. However, state-owned enterprise monopolies face considerable obstacles to improving governance.

With respect to enforcement and litigation, it was noted that while the CSRC is actively pursuing enforcement, decisions tend to be directed towards securities companies rather than listed companies. There are also some complications at the judicial level, where courts tend to hear cases primarily focused on misleading disclosure and when a government body such as the CSRC determines that a violation has occurred (need to get “a key to the courthouse”); very few “keys” are given out. It remains to be seen what the implication of the recent introduction of derivative actions and new law with respect to punishment for misleading disclosure will be.

V RECENT POLICY DEVELOPMENTS

Participants presented and discussed corporate governance policy developments in China and OECD countries.

In terms of SOE reforms in China, SASAC outlined important steps that are being taken to transform large SOEs into modern corporate entities. A key priority by the Chinese government is to determine what SOEs will remain controlled by the state and where ownership would be diversified. In the latter case, diversification of ownership implies that SOEs move away from the former insider system where the “big boss” decides everything. In order to succeed in this reform process, there is a need to establish a “buffer zone” between the party, management and the board because company leaders are appointed by party supervisors with party interference in management. SASAC is in the process of setting up boards in 18 pilot companies, where at least 50% of the board is comprised of external directors. SASAC plans to delegate considerable responsibility to the board, including decision-making on large investments/financing decisions, performance assessment, remuneration and appointment/removal of senior executives, with committees to be led by outside directors. There are also plans to recruit more professionals in management roles from outside SOEs. This process has just started and it will take time to build the basic institutions.

The Shanghai Stock Exchange provided an overview of its comprehensive 2006 Corporate Governance Report on Listed SOEs. The report demonstrates the leading role played by CSRC, the Shanghai Stock Exchange and SASAC in governance reform. Recent capital market developments are highlighting a growing need to raise investor confidence and improve corporate governance practices. They noted the following significant changes: (1) SOEs are becoming listed companies, requiring major changes to how they are governed, (2) increasing participation in the Chinese market by international and institutional investors, (3) more bond issuances into public markets and (4) heightened need to educate investors about their role and responsibilities with respect to corporate governance. Suggestions for reform of corporate governance in SOEs include: 1) professionalize top management (rather than assigning top officials), 2) adopt a strong board, 3) enhance transparency by disclosing policies on state assets and financial reports and 4) establish good laws and enhance enforcement through a stable legal infrastructure.

The European Union presented several initiatives focusing on improving boardroom practices. The EU approach is focused on voluntary measures by companies and the market

encouraging companies in the right direction, rather than prescriptive rules. In 2003, the EU issued recommendations to include an “appropriate balance of executive and non-executive directors” on the board, establishing committees, board evaluations, disclosure and voting on compensation. A few weeks ago, the EU agreed upon a binding “shareholder rights directive” requiring member states to introduce legislation to promote shareholder rights. For example, the right to put items on the AGM agenda, table resolutions, ask questions and have them answered, and cast informed votes from anywhere in the world. Future reform initiatives will include proportionality between capital and control as well as disclosure of investor identity.

The United States presented recent developments and trends in corporate governance. The U.S. continues to actively consult the public on regulatory reform issues. In particular, authorities have conducted extensive consultations on Section 404 of the Sarbanes-Oxley Act and issued new guidance and related auditing standards in December. The SEC has also issued a new rule on executive compensation disclosure to ensure that shareholders can fully understand executive pay packages. And finally, new rules will go into effect in July this year on e-proxy -- the first steps toward a regime that modernizes shareholder voting and communications, which could enhance shareholder access to the proxy process. Another recent trend in the United States is voluntary adoption of majority voting to replace plurality systems, with over 50% of S&P 500 companies adopting such provisions by Feb 2007.

Korea presented recent milestones in corporate governance reforms, notably the new class action law that became effective from April 2007. Also, the Korea Corporate Governance Fund was just established with the aim of creating value with active corporate governance engagements. Based on the Korean experience, corporate governance change can be expedited through 1) voluntary adoption of global standards, the optimal approach but difficult in practice, 2) enforcement of regulations, but this requires an effective system, 3) a fair and effective court system, difficult when there is no incentive for shareholders to bring derivative lawsuits because awards go back to the company, evidence is tough to secure and there is no mechanism to compensate lawyers (contingency fee) and 4) the market, through pro-active investment. Public pressure through the media is also important.