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Asian Corporate Governance Association (ACGA)

“Creating Effective Boards in China”

Presentation by
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“Asian Business Dialogue on Corporate Governance 2009”
Workshop Track 2 (Company Issues)
Thursday, November 12, 2009
11.15am – 12.45pm

Agenda

1. ACGA China Board Manual – what, why?
2. Structure of the manual
 - Indicators of a healthy board
3. Broad findings
4. Creating effective boards
 - Organisational basics
 - Assessing the scope of board authority in China
 - The role of the chairman
 - The role of independent non-executive directors
 - The evolution of committees
 - Relationship with supervisory boards
5. Recommendations

1. ACGA China Board Manual – what?

■ Project Background

- Produce a practical manual for companies and directors on effective practices in mainland boards.
- Empirical, bottom-up research and interviews. NOT abstract or theoretical.
- Applicable to SOEs and private firms.

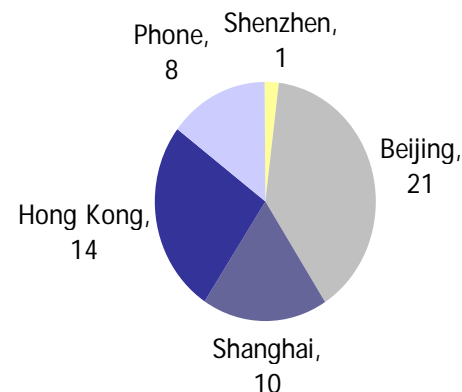
■ Candidates

- Interviewed 54 candidates to date (more to come).
- Chosen through recommendations and relationships of ACGA, members, brokers.

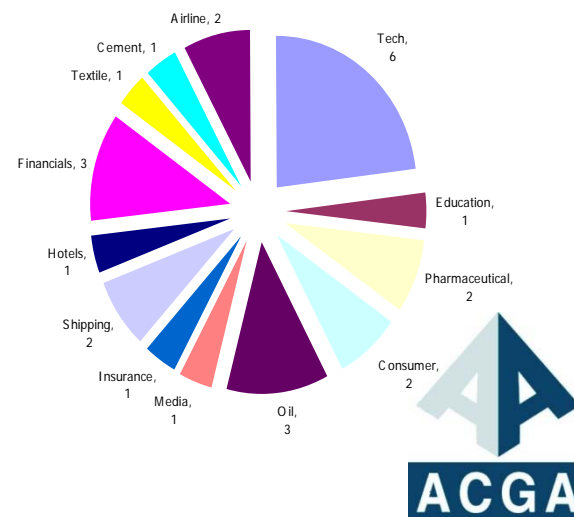
■ Interview approach

- Qualitative discussion, not surveys.
- Took place face-to-face in Hong Kong, Shanghai, Beijing, and Shenzhen or on the phone.
- Interviews off the record; will seek approval to quote in manual.

Geographical breakdown of interviews (Total = 54)



Breakdown by sector



Why?

- Why is there a need for such a manual?
 - **Modern boards are new in China:** CSRC guidelines on independent directors introduced in 2001. CBRC guidelines on bank directors only from 2004/5. SASAC focus from 2005.
 - **Growth of listings:** The big state banks only started listing from 2006. Expansion of SOE listings in recent years (also private PRC companies in Hong Kong, New York, etc).
 - **Director expertise:** Many executive and non-executive directors of IPOs have never been directors before.
 - **Pre-IPO preparation:** Prospectuses and market talk suggests that most new issuers, and their investment bank sponsors, take a minimalist approach to governance before listing.
 - **Education:** There appears to be a consensus that more director learning is needed.

2. Structure of the manual

1. What boards do	Given state ownership and control, what is the scope and authority of boards?
2. Effective directors	How can directors, especially independent ones, make a difference?
3. Becoming a director	Due diligence questions to ask before joining a board. The need to understand the company and its industry.
4. Board composition	Thinking about the right mix of skills for your company; the balance of independence and industry expertise.
5. Board committees	Ensuring they have a clear purpose, not just window dressing. What are the key areas of focus?
6. Emerging trends	What do boards need to know about emerging issues such as disclosure, risk management, and sustainability?

Indicators of a healthy board

A selective list of positive indicators:

- Do directors ask questions during board meetings (and does the chairman encourage them)?
- Do meetings flow naturally (rather than being scripted)?
- Do managers give presentations to the board?
- Are non-executive directors allowed access to mid-level managers?
- Are requests for information given the appropriate level of priority by the company?
- Are board meeting papers sent to directors in advance of meetings (eg, one week)?
- Do all directors come to meetings prepared?
- Can all directors read the accounts?
- Do all, or most directors, have a business background?

3. Broad findings – 1

■ “First generation” boards

- The “board” and the “director” are still relatively new concepts to most state enterprises and managers in China. Boards are still feeling their way, yet appear to be evolving quickly. Progress, however, is not always linear.
- Some private companies appear to have more efficient boards.

■ Legacy issues

- SOE boards, especially the larger and more strategic enterprises, operate under many government constraints (eg, in setting strategy, appointing directors and senior executives). The more active boards are working out the scope of their authority, what is possible, and how they can add value.
- Despite the “state”, the effectiveness of boards appears to depend in large part on the personality and views of the chairman.

■ Supervisory boards

- Although often criticised as duplicative, some supervisory boards appear to be playing a useful oversight role. In some SOEs, they are given defined tasks to perform that complement the board’s work. Would SOEs be better governed today without supervisory boards?

Broad findings – 2

■ Variations between SOEs

- We found variations in style, levels of state control, openness and overall board effectiveness among SOEs. Not all SOEs have the same corporate or governance culture. But again, much appears to depend on the chairman.

■ Organisational challenges

- Many SOE boards have difficulty doing the following: setting an annual schedule of meetings; getting board papers to directors early; keeping independent directors informed between meetings, and so on.

■ Private companies appear to be different

- Some young private companies, mainly those listed and incorporated overseas, and which have had backing from foreign VC funds, appear to have boards that operate like good boards in developed markets (ie, open discussion, pragmatic, business-like).

Board demographics

China	2009	2008	09/08 %
Number of board members	12	11	5

Source: Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2009 (Chinese Academy of Social Science, China National School of Administration, Protiviti Consulting)

	China	Hong Kong	Singapore	United Kingdom	Australia
Average number of directors	12*	13	10	12	9

Source: Watson Wyatt (2008), Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2009 (Chinese Academy of Social Science, China National School of Administration, Protiviti Consulting). All based on 2007 Annual reports. *Value is rounded up to single decimal.

	China	Hong Kong	Singapore	United Kingdom	Australia
Executive	25%	36%	23%	32%	19%
Non-executive (Non-independent)	40%	27%	21%	7%	5%
Non-executive (Independent)	35%	38%	55%	61%	76%

Source: Watson Wyatt (2008), Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2009 (Chinese Academy of Social Science, China National School of Administration, Protiviti Consulting). All based on 2007 Annual reports.

4. Creating effective boards

- **Organisational basics:** areas for improvement
 - **Scheduling of meetings:** Many boards have no calendar of meetings for the year ahead, only a rough schedule. This creates real difficulties for independent directors, especially those based outside China.
 - **Meeting materials:** Board papers are often delivered to directors late (ie, a day or two before meetings), can be voluminous, and lack effective summaries.
 - **Communication between meetings:** This varies a great deal between companies and depends in part on the quality of the board secretary.

Assessing the scope of board authority

- **Contrary to the image of an all powerful state, there is much for SOE boards to do:**
 - They may not be able to set high-level strategy or policy, but they can discuss the details of strategy, the timing of implementation and major transactions/investments.
 - Board committees can and do add value to companies in areas such as risk management, development of internal controls, budgeting, and board functioning.
 - Nomination committees may not be able to nominate and appoint key inside directors, but they can 'interview new board members, give them a sense of what is expected of them, and ensure they have a clear job description' (as one independent director told us).
 - Remuneration committees do have scope to discuss the details of executive compensation within broad frameworks.

The role of the chairman

- The chairman can make all the difference to the quality of board governance (even in SOEs):
 - Dynamic discussion in meetings—much depends on the character and open-mindedness of the chairman.
 - Less reliance on “pre-meeting special briefings”, where issues and differences are ironed out (so that arguments are not minuted).
 - The scope for voting against board decisions (all votes will be minuted).

The role of independent directors

- **Positive signs of independent directors playing a more active role**
 - Encouraged (or determined) to discuss strategy.
 - Raising questions, and raising more questions—on investment proposals, due diligence, appointments—but being careful about the issues they choose.
 - Investing time in understanding the company and its political / business context.
 - Voting against resolutions to send a signal. All votes are minuted.
 - Playing active roles in committees.
- **Shareholders could assist INEDs through voting and engagement**
 - Take a more active and informed view on director elections.
 - Is there enough information on directors in the AGM agenda?
 - Votes are counted in large PRC listed companies, so voting is worthwhile!

The evolution of committees

- **Focus on remuneration has been driven both by market pressures and government policy**
 - Competition for talent (often global at the CEO level)
 - Management practices becoming more integrated between multinationals, private firms and state-owned enterprises
 - Government advocating long-term incentives
 - Participation of private equity and venture capital firms

- **Remuneration committees are becoming less redundant**
 - Heated discussions apparent in companies with more than one major shareholder or that operate in competitive environments.
 - 3rd party consultants (often foreign firms) hired by committees have witnessed a boom in business in last three years.
 - Equity incentives are allowed for some state-controlled listed companies, but operate within and approved by SASAC framework.

- **New experiments signal further improvements underway**
 - SASAC experimenting with 19-20 firms to let them decide their own remuneration .

Data on committees

Companies	Audit	Remuneration	Nomination	Others
Air China	6	2*	2*	Nil
China Eastern	4	0*	0*	Nil
China Security Surveillance and Technology		4	2	Nil
China Chengtong Development Group Limited		1	0	Nil
China Mobile	4	3	1	Nil
China Unicom	6	2	Nil	-Independent Board Committee (5)
Gome	6	3	3	-Independent Board committee (4) -Special Actions committee (6)
China Railway Group Limited	5	2	1	-Strategy Committee (2) -Safety, Health and Environmental Protection Committee (1)
China Resources Power Holdings Company Limited		1	1	-Strategy and Development Committee (1)
Industrial Commercial Bank of China	5	5*	5*	-Strategy Committee (3) -Risk Management Committee (4) -Related Party Transactions Control Committee (2)
Bank of China	6	4*	4*	-Strategic Development Committee (5) -Risk Policy Committee (5) -Connected Transactions Control Committee (4)
Bank of Communications	4	3*	3*	-Risk Management Committee (4) -Social Responsibility Committee (0)

Source: 2008 Annual Reports

* Indicates that the company combines these two companies; and called "nomination and remuneration committee".

Relationship with supervisory boards

- **Supervisory boards add an extra layer of check and balance**
 - Given stronger legal powers over time (see 2005 company law amendment). But actual powers seem to vary from SOE to SOE.
- **In general, their oversight role is rather weak**
 - Supervisors often lack board and business experience.
 - Responsibilities are often not well-defined.
- **Clever boards appear to work out a modus operandi and a division of responsibility with their supervisory boards**
- **What if supervisory boards were not there?**
 - Would state entities find it harder to supervise and control SOEs that they own?
 - Would “agency conflict” problems increase (ie, management fiefdoms)?

5. Final recommendations

- Enhance transparency of the role of the state and state ownership.
- Clarify what the board does and does not do (ditto for committees).
 - These steps would enlighten investors and probably increase confidence in the work of boards and committees.
- Greater governance preparation needed before IPOs, including education of directors.

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