The Evolution of External Director System in State-owned Enterprises

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Abstract. Strengthening the construction of the board of directors of state-owned enterprises with external directors as the majority is an important part of the implementation of the new round of state-owned enterprise reform and improvement and is also a key measure to improve corporate governance and accelerate the construction of world-class enterprises. The system of external directors has a long history. Based on the analysis of the concepts related to external directors, this paper systematically summarizes its emergence and development in the global scope, as well as the establishment and development of state-owned enterprises in China, trying to provide a starting point for strengthening the construction of standardized boards of directors of state-owned enterprises, enhancing the effectiveness of state-owned enterprise reform and improvement, and improving the modern state-owned enterprise system with Chinese characteristics.

Keywords: State-owned Enterprise External Director Evolution

1 Introduction

Strengthening the construction of the board of directors of state-owned enterprises is an important part of implementing a new round of deepening and upgrading the reform of state-owned enterprises. It is also a key measure to improve corporate governance and accelerate the construction of world-class enterprises. It is of great significance for better leveraging and amplifying institutional advantages, enhancing the vitality of enterprise operation and development, and promoting high-quality development of enterprises[1].

At present, the key content of the construction of the board of directors of state-owned enterprises is to establish and improve the board of directors of state-owned enterprises with the majority of external directors, which has become an important part of the modern state-owned enterprise system with Chinese characteristics. External directors have a long history, sorting out and clarifying their emergence and development in the global scope, as well as the establishment and development of state-owned enterprises in China, has important reference and practical significance for further strengthening the construction of the standardized board of directors, enhancing

M. F. b. Sedon et al. (eds.), *Proceedings of the 2024 3rd International Conference on Social Sciences and Humanities and Arts (SSHA 2024)*, Advances in Social Science, Education and Humanities Research 851,
https://doi.org/10.2991/978-2-38476-259-0_70

the deepening and upgrading effects of state-owned enterprise reform, and improving the modern state-owned enterprise system with Chinese characteristics.

2 External director related concepts

According to the definition of the Working Rules of the Board of Directors of Central Enterprises (Trial), an outside director refers to a director who is held by a person other than the enterprise, and does not hold other positions other than the board of directors and its special committee in the enterprise. Related to it, also involves the concept of executive director, non-executive director, internal director, independent director, non-independent director and so on. The logical relationship between them is shown in the figure 1.

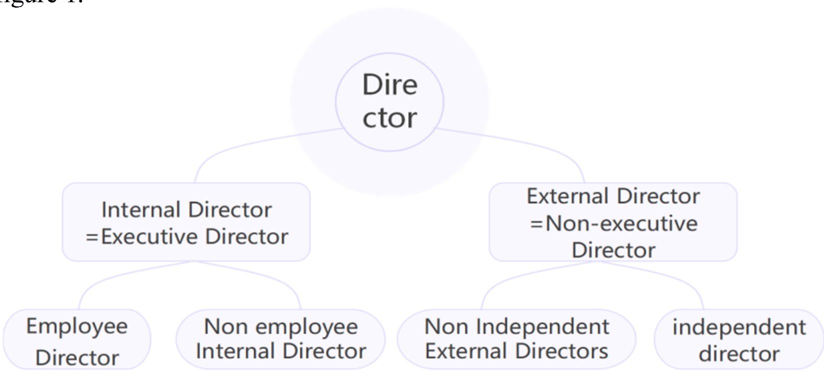

Fig. 1. The relationship between different directors

Specifically, directors can be divided into two categories: internal directors and external directors. In some countries (such as the United Kingdom), internal directors are also called "executive directors", which refers to directors who are held by corporate insiders, including managers, ordinary employees and shareholders' representatives of listed companies, such as the company's chairman, general manager, full-time deputy secretary, staff directors, etc. In addition to the identity of directors in an enterprise, Those who also hold other positions are classified as internal directors. For some small scale, single business type, investment matters, often do not set up a board of directors, only set up an "executive director" as the legal representative, this type of "executive director" can be understood as a proper term, can also be regarded as "a board of directors", from the large classification, he still belongs to the internal director.

An external director, basically synonymous with a non-executive director, is a director who is held by a person outside the company, and does not hold other positions outside the board of directors and its special committees in the company. Independent director is a more independent type of outside director, which is a unique concept of listed companies. It emphasizes not only independence from the company, but also independence from the shareholders. Independent directors focus on supervising related transactions of enterprises and safeguarding the legitimate rights and interests of minority shareholders. Therefore, compared with ordinary external directors, independent directors of listed companies have higher requirements, greater responsibilities and stricter supervision.

3 Evolution of external director system in global corporate governance

As one of the important institutional arrangements for China's central enterprises to strengthen the construction of the board of directors and improve corporate governance, the external director system originated in Britain, the United States and other countries, and gradually spread to Germany, Japan and other countries and even the world[2].

3.1 Embryonic stage (1930s)

In the 1930s, many fund companies in the United States failed because of illegal operations. The reason was that related party transactions occurred frequently, and the interests of fund managers and shareholders of fund companies had great conflicts and contradictions. In order to ensure that the interests of investors (shareholders) are protected, the United States Congress passed the Investment Company Act in 1940, requiring that at least 40% of the members of the board of directors of investment companies must be independent of the investment company, investment advisers and underwriters[3]. The introduction of this document laid the foundation of the modern external director system. However, during this period, the mandatory requirements for outside directors were limited to investment fund companies in the United States, and the legal provisions were relatively simple, only reflected in the number and certain functions.

3.2 Establishment stage (1970s)

With the acceleration of the mega-development trend of modern companies, the equity is becoming more and more dispersed, and the board of directors is gradually manipulated by the manager led by the CEO. The situation of "insider control" and board failure of the company is becoming more and more serious, especially after the "Watergate incident", the directors of many famous companies are involved in bribery scandals, and the public's distrust of the company management continues to intensify.[4] For this reason, the American theoretical and practical circles try to strengthen the externality of the company's board of directors to achieve effective supervision of the company's management. In the relevant judgment, the court forced the suspected company to change the structure of the board of directors, requiring the board of directors to be composed of a majority of independent external directors; The SFC requires each listed company to establish and maintain an audit committee composed of independent directors. This led to a wave of outside directors in all kinds of American companies.

3.3 Stage of development (1980s - 1990s)

At this stage, countries around the world began to reflect on the problems existing in corporate governance and realized the global popularity of external (independent) director system by learning from each other: The legislation and judicial system of the United States began to get involved in corporate governance in part, and clearly stipulated the independence of outside directors and the transaction of conflict of interest. The most representative one is the Michigan Corporation Law revised in 1989. In order to ensure the fairness and transparency of the operation of the board of directors and restore the confidence of investors, some well-known companies in the UK have been closed down one after another after many years of prosperity. By drawing lessons from the practice of the United States, external directors have been introduced and the basic framework of the external director system has been established through three reports on corporate governance[5]. Faced with a series of exposed related party transactions, insider trading, and the Asian financial crisis, companies in Germany and Japan have learned from the experience of external director system and embarked on corporate governance reform.

3.4 Further improvement stage (after 21st century)

Affected by the financial events of Enron Corporation in the United States and the financial crisis in 2008, countries have continuously improved the external director system[6]: The United States issued the Sarbanes Act, which amended the rules of the stock exchange, making it clear that independent directors must account for the majority of the board of directors of listed companies, and the majority or all of its subordinate committees. Meanwhile, the independence, powers and responsibilities of independent directors are more stringent. The United Kingdom revised the joint guidelines to clearly require independent non-executive directors to account for more than half of the board of directors of large companies, and added more professional requirements in addition to independence. Germany tends to adopt a mixed governance structure, emphasizing professionalism at the board level, while emphasizing independence and professionalism at the supervisory board level.

4 Establishment and development of external director system in state-owned enterprises

Looking back at the history of the reform of state-owned enterprises, from the "factory director (manager) responsibility system" to the present "board of directors with a majority of external directors", the leadership system of state-owned enterprises has also experienced a gradual modernization and market-oriented exploration process[7]. Specifically, it can be divided into three stages, and take the power industry as an example to elaborate.

4.1 Initial stage (before 2003)

In 1986, The State Council issued the "Decision on Several Issues on Strengthening the Management of Industrial Enterprises", which proposed for the first time that the factory director (manager) responsibility system should be implemented in state-owned enterprises under the leadership of the Party Committee. At the end of 1993, the National People's Congress passed the first Company Law of China, clarifying the transformation of state-owned enterprises from factory system to company system, and successively establishing the board of directors and the Board of supervisors. During this period, the members of the Board of directors were all insiders, and the Party committee (Party group) and the manager were highly overlapping, "three sets of teams and one set of people". Later, due to the impact of the Asian financial crisis, state-owned enterprises suffered massive losses, the reform of government institutions was slow, and most of the original boards of directors were abolished.

From the perspective of the power industry, during this period, the power system experienced changes from the Ministry of Power to the National Power Company (1998), and then to the separation of the plant network (2002). In 2002, after the separation of the plant network, the State Grid and the five major power generation groups implemented the general manager and the Party secretary "shoulder to shoulder", and the Southern Power Grid implemented the management system of the general manager and the party secretary. The governance of the central electric power enterprises has taken a big step to the modern enterprise system, but there is still no board of directors.

4.2 Board of Directors construction restart stage (2003-2016)

The establishment of the State-owned Assets Supervision and Administration Commission of the State Council in 2003 was a milestone in the history of state-owned enterprise reform, and the central enterprises have since had a unified "shareholder". In 2004, with the approval of the central government, SASAC restarted the pilot exploration of the central enterprise construction standard board of directors, and the first seven enterprises were selected as pilots, such as Baosteel, Shenhua, China Chengtong, CITS, Sinopharm, Tietong, and Gaoxin[8]. The biggest difference from the pilot in the 1990s is the introduction of an external director system and the establishment of a board of directors with a majority of external directors.

During this period, the leadership system of several major electric power central enterprises has experienced changes from the general manager and Party group secretary to the separate establishment of the Party and government. In 2008, the three major power generation central enterprises (Huaneng, Huadian, Guodian) for the first time broke the tradition of Party secretaries and general managers of power generation central enterprises, and implemented the separate establishment of party secretaries and general managers. Although the corporate governance mechanism is further modernized, at the micro level, the problem of "one word" of the general manager and "mutual constraints" of the general manager and the secretary is quite prominent. Corporate governance mechanism is in urgent need of further reform and improvement, and the construction of the board of directors has become the only way.

In the central power enterprises, the earliest to establish a standardized board of directors is Datang, followed by Guodian. In 2015, the State Grid Corporation set up a board of directors, and equipped with four external directors, forming a "3 (inside) +4 (outside)" board structure. In 2020, the board structure will be adjusted, and the number of external directors will be increased to 5, forming a board structure of "4 (inside) +5 (outside)".

4.3 Development stage of modern enterprise system with Chinese Characteristics (2016 to present)

The National Conference on Party Building of State-owned Enterprises held in October 2016 is an epoch-making meeting in the history of the development of state-owned enterprises. 2021 is also a year of great significance in the process of improving corporate governance of central enterprises. The Central Office and the SASAC issued two very important documents, "Opinions on Strengthening the Party's Leadership in Improving corporate Governance of Central Enterprises" and "Working Rules for the Board of Directors of Central Enterprises (Trial)", which put forward new requirements and clarified specific measures for further promoting the construction of the Board of directors of central enterprises[9]. During this period, the construction of the central enterprise board of directors has entered a new stage from "pilot exploration" to "comprehensive promotion", from "there is no" to "good", and from "the group level" to "covering important sub-enterprises".

5 Conclusion and enlightenment

Since its evolution, the external director system has been adopted by most countries in the world, including our country, and different explorations have been made in combination with the specific conditions of their own countries within its inherent framework. The reasons are as follows: first, it helps to make up for the drawbacks of supervision in the original corporate governance model. For example, countries adopting the "single committee system" such as Britain and the United States lack independent supervision; countries adopting the "double committee system" such as Germany and Japan have no obvious supervision effect; Second, it helps to realize the effective separation of ownership and management, decision-making and executive power, and protects the interests of shareholders to the maximum extent. Third, it is helpful to make full use of the independent third-party perspective and experience of external directors to maximize the value of the company with scientific and effective decision-making. The root cause is the result of market competition and the inevitable result of better coping with market development. From another point of view, the more market-oriented enterprises, the more to build a sound, standard, efficient board of directors, the more the need for a professional, responsible, high-quality outside directors team, which also points out the direction for our country state-owned enterprise board of directors construction.

Acknowledgments

This paper is a phased achievement of Science and technology projects of State Grid (Research on key technologies application of power grid management mode reform under the new power system, 1400-202257465A-2-0-ZN).

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