

The Issue of Control in State-Owned Enterprises in Russia and China: The Board, Affiliation, and Independent Directors: Comparative Legal Analysis

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ABSTRACT

The author researches the institute of corporate control in Russia and China, the two countries excluded from the process of evolution of corporate law in the bigger part of XX century. The reception of Western corporate norms is, as it seems from comparative analysis, not an easy-going process in neither of the jurisdictions. State-owned enterprises, which play significant role both in China and Russia have their separate challenges, i.g. an ‘absent owner’ problem and the lack of minority shareholders’ rights protection. Such institutes as independent directors, disinterested directors, cumulative voting on elections of the Board members are compared and analysed.

Keywords: *comparative corporate law, China, Russia, board, independent directors, State-owned enterprises (SOE), political compliance*

1. INTRODUCTION

Comparative analysis of Russian and Chinese corporate law has an obvious research interest. The two countries going through a way from declaring corporations a hostile phenomenon to countries’ soviet / socialist systems to creating a whole legislative corpus brining corporation into existence. State-owned enterprises, SOE, have the most visible footprint of socialist law inheritance.

While seeing close into the regulation of the board of directors and the concepts of affiliation, it is especially interesting to find the similarities in adoption of Western legal corporate norms in these otherwise so different legal systems.

Initially grown in the US and the UK [15], the institute of independent directors has since been exported in all major jurisdictions and is widely accepted and implemented in most Asian jurisdictions [28]. Discussions on the effectiveness of the independent directors is still ongoing. However, this paper addresses two abovementioned jurisdictions merely to look into differences and similarities in legislation, keeping in mind that “the role that independent directors play is influenced significantly by each jurisdiction’s unique shareholder structure, functional substitutes, institutions, regulators, courts, history and culture” [15].

A majority of Russian companies are those with concentrated ownership structures, with either a private owner or the state being the controlling shareholder. Such companies face different corporate governance issues comparing to the companies with diffused ownership structures, particularly the listed companies. Between 2000 and 2010 the size of the state sector increased. In

particular, this was a result of state-owned companies having become active players in the market for corporate control. During the financial and economic crises, the state lent support to many companies, the consequence being that the state sector in the Russian economy became yet larger. The state also became the key player in the Russian stock market. The state’s share in the capitalization of Russian stock market was more than 30 per cent in 2006 and more than 40 per cent in 2008 [29].

However, at the last decade the process became reversed, and the share of SOEs decreases [13].

According to Rosstat, the amount of state enterprises in Russia of 2019 is 59,6 thousands of SOE, only 3,1 thousand of them are corporations, among which 1,1 thousand are listed companies and 1,3 thousand are non-public.

In China, according to the OECD data of 2015 [24], the amount of SOE is 159,2 thousands, among them are 0,5 thousand (483) listed companies, and the rest are non-public [24]. As noted by Yu-Hsin Lin & Yun-chien Chang, Chinese SOE are dominating in majority of industries, but “are believed to be inefficiently run and badly governed for two main reasons: political intervention and the “absent owner” problem” [20].

In companies with the concentrated nature of the shareholder body the main corporate governance problem is that between the controlling shareholder able to extract private benefits and the minority shareholders.

In this article we overview the institute of the board of directors, the concept of affiliation and further focus on the independent directors in Russia and China SOE. We

explore the alleged ineffectiveness of independent directors in companies with concentrated ownership structures which, as has been said above, are prevalent in Russia and China. In what conditions independent directors can perform important functions in such companies? The controlling shareholders are often no longer involved in the operative management of the company which is delegated to hired managers, the role of independent directors is to exercise control over the managers in order to prevent them from serving themselves rather than the company's shareholders.

The comparative research on how the institute of independent directors is regulated in both jurisdictions is also aimed to find the solution to a mentioned "absent owner" problem: could independent directors possibly fulfill the monitoring function better than the relevant state organs.

Methodology of the research is the legal comparison, which is not only the comparison of the text of legislation, but often that of economical historical and cultural background; and, where relevant, also the way the norms are executed in the compared countries. The method implies an inquiry "to what extent a legal evolution in one's own country finds parallel developments in other countries" [30].

The Article has the following structure. Chapter 2 provides an overview of the current regulation of the Board of directors in Russia and China, as well as the concept of affiliation. In Chapter 3 we consider the regulation of independent directors in Russian and Chinese SOEs. Conclusion is aimed to outline the results of the present paper.

2. THE BOARD OF DIRECTORS OVERVIEW OF RUSSIA AND CHINA

2.1. Appointing the members of the Board

In Russia, members of the board of directors are elected by cumulative voting, which is a method of voting whereby a shareholder has a right to cast its votes received by way of multiplying the number of the shares owned by the shareholder by the number of persons to be elected to the board of directors for one candidate for a position of a board member or to allocate its votes among two or more candidates [2]. Those candidates who received more than others are deemed to be elected to the board of directors. In China cumulative voting on the board appointing procedure is expressly set in Art. 105 of the Company law, providing that "For the purposes of the Law, the term "cumulative voting system" refers to that when a general meeting elects a director or supervisor, the number of voting rights attached to each share is the same as the number of directors or supervisors to be elected, and that the voting rights held by a shareholder may be exercised collectively" [6]. The use of this voting system used to be a prevalent practice in the first half of the last century,

especially in the U.S., being a consequence of applying the idea of representative democracy to profit-seeking corporations. In cumulative voting minority shareholders are given an opportunity to ensure the election of at least one of their nominees to the board, which would be impossible in the straight voting process. Through the directors elected to the board of directors due to their support minority shareholders are able to receive information on various policy issues that are being discussed on the board of directors and communicate their opinions on such issues. However, beginning from the 1950s there was growing opposition to cumulative voting (mainly from managers seeking to keep shareholder influence on director election process to a minimum) which led to nearly complete elimination of cumulative voting practices. The decrease in popularity of cumulative voting can also be related to the enactment of laws aimed at ensuring enhanced information disclosure by corporations because one of the key reasons for making cumulative voting provisions mandatory was the fact that minority shareholders commonly lacked adequate information on the corporation. If in the U.S. and other economically developed countries the trend is toward replacing norms obliging companies to use cumulative voting when electing members of the boards of directors with those that enable companies to choose whether to employ this voting system or not, in many post - Soviet states the opposite approach to cumulative voting became dominant [22]. Western experts who consulted the governments of post – Soviet states [11] on issues pertaining to the development of corporate law insisted on making cumulative voting provisions mandatory. This approach was based on the so-called self-enforcing model of corporate law developed by Prof. Reiner H. KRAAKMAN and Prof. Bernard S. BLACK who argued that when a judicial system was unable to effectively protect the interests of minority shareholders, the preference should be given to those legal mechanisms that could be used by shareholders without going to court [18]. This voting system is implemented in Russia in China specifically for the reason of concentrated ownership structures, including SOEs, as the most common pattern of ownership structures.

2.2. Affiliation and Disinterested Directors

According to the Art. 83 of the Russian Law on Joint Stock Companies, only those directors who are not interested in the transaction being entered into by the company ("disinterested directors") are entitled to vote on the transaction approval. Directors cannot vote if they, their close relatives and (or) directors' affiliated persons: (i) are a party, beneficiary, mediator or representative in the transaction; (ii) own twenty and more per cent of the shares in a legal entity being a party; (iii) hold positions in the governing bodies of a legal entity being a party, etc. The institute of independent directors appears in part 2 of the same Art. 83 of the Russian Law on Joint Stock

Companies, in connection with a related-party transaction (transaction with a conflict of interest).

On the contrary, China Company Law (2013) has no mentioning of independent directors, and gives that regulation to the companies' constituent documents (charters, etc).

Russian Law on Joint Stock Companies sets out that the directors are considered independent if they are not (i) a person exercising functions of a company's sole executive body, including its manager, a member of its collective governing body (ii) a person close relatives hold positions in the said governing bodies of the company, of a managing company or are managers of the company; (iii) an affiliated person of the company.

Russian law distinguishes "directors with no conflict of interest" (so-called disinterested directors), described above, and independent directors. These two should not be mixed, although both have the same function of control over companies' transactions. The independent directors exist only on companies with more than 1000 shareholders; apparently the concept of independence was familiar to Western investors, and its transplantation into Russian corporate law (along with other legal reforms which were aimed at increasing Russia's investment attractiveness) was suggested to be interpreted as evidence of the significance Russia attributed to the idea of protecting the interests of the minority shareholders.

Yet, this is an example of uncritical transplantation of foreign legal concepts into Russian law – a rather common phenomenon in the Russian legislation of the 1990s caused, in particular, by a lack in that period of lawyers who would have been equally well acquainted with domestic and foreign laws. Additionally, the way this provision is formulated gives rise to a number of practical questions. Particularly, many commentators draw attention to the fact that the phrase "a majority of independent directors not interested in this transaction being concluded" can be interpreted as meaning either a need for a majority of votes of all independent directors sitting on a company's board of directors or a need for a majority of votes of only those independent directors present in the board of directors' meeting whose agenda contains the issue of approving a related-party transaction. In the Russian judicial practice decisions in favor of both interpretations can be found.

In conclusion, it also needs to be added that if all members of a company's board of directors are deemed to be interested persons and (or) not independent directors the related-party transaction may be approved by the general meeting of shareholders.

Chinese Company Law addresses the problem of the conflict of interest without introducing the institute of independent directors and without setting too detailed procedural norms. The basic concept of "affiliation" is used in a following manner in Art.21: "The controlling shareholder, de facto controller, directors, supervisors and senior officers of a company may not use their affiliation to harm the interests of the company". Further, in Art. 124 can be found the provisions similar to Art. 83 of the Russian Law on Joint Stock Companies. However, in

Russian law the matter of the conflict of interest is limited with "transactions" of the company, meanwhile the Chinese law addresses any possible issues. Finally, the "affiliation" is defined as "the relationship between the controlling shareholder, de facto controller, director, supervisor or senior officers of a company and an enterprise directly or indirectly controlled by him as well as any other relationship that may lead to a transfer of the interests of the company. However, there shall be no affiliation between State-controlled enterprises merely due to the fact that the State has a controlling interest in them". Without any prejudice to actual effectiveness and justiciability of the corporate norms in both countries, admittedly the Russian Law on Joint Stock Companies have an overlap between "disinterested directors" and "independent directors" which itself an example of a 'sloppy' adoption of foreign law.

In the Western corporations mostly exist two models of the board structure: in a one-level board, as of Anglo-American jurisdiction independence is provided by independent directors, and two-level board, more widespread in continental law like Germany, has a supervisory board which "chooses the directors of the management board and monitors their performance".

Apparently, Russia adopted the former model, but with China the matter is more complicated. Whilst there is supervisory board for companies "limited in shares", for the listed companies the Chinese Company Law provides in Art. 122: "A listed company shall have independent directors. The specific procedures thereon shall be stipulated by the State Council". Thus, the Chinese model is a hybrid, and just as with the case of the excessive overlapping institutes of "disinterested" and "independent" directors in Russian company law, we may observe an excessive amounts of controlling bodies in Chinese corporate law.

And, just as the overlap of directors creates confusion in Russian judicial practice, the researches note, that "the supervisory board and the independent directors, the 'strange partners' in China's listed companies, have not significantly improved the overall corporate governance of those companies" [31].

However, the problem of implementations is, in fact, not so acute in Russia, as in China. Interestingly that some researchers name the approach based on "disinterested directors" who should be precisely defined on case-by-case basis depending on the transaction as more suitable for China corporate law as the broad definition of an 'independent director' taken primarily from the U. S [16].

3. INDEPENDENT DIRECTORS IN SOES OF RUSSIA AND CHINA

One of ways of solving this problem known as the "absent-owner" problem as well as other issues of the SOEs is to add professional directors, including independent ones, to boards of directors of state-owned companies.

The institute of independent directors itself is mostly regulated by normative acts in both countries.

For Russia, The Decree of the Federal Service for the Financial Markets № 13-62/pz-n dated July 30, 2013 “On Procedure for the Admittance of Securities to an Organized Exchange” (as amended) (hereinafter - the “Decree”) contains a list of corporate governance requirements compliance with which is a condition for the inclusion of securities in a quotation list of either the first or the second level. For an issuer’s securities to be included in a quotation list of the first (supreme) level the following requirements relating to corporate governance must be met: an issuer must form a board of directors which must include independent directors.

An independent director is defined as a director who is experienced and professional enough, independent from executive bodies of an issuer, separate groups of shareholders and other interested persons and who is able to render independent and impartial judgments. The Decree also provides that a member of the board of directors cannot be deemed as independent if they are connected with an issuer, with an issuer’s substantial shareholder or its substantial counterparty, with an issuer’s competitor, with the state (the Russian Federation and its subjects) or with a municipal formation. The criteria which a director must satisfy in order to be qualified as independent are established by a stock exchange on basis of the best international practices of corporate governance [5]. The number of independent directors must constitute not less than one fifth of members of the board of directors, but in any case the number of independent directors must be no fewer than three.

The China Securities Regulatory Commission (CSRC) has “Guideline for Introducing Independent Directors to the Board of Directors of Listed Companies” in 2001, and it required at least one third independent directors in the board . An independent director shall meet the following basic requirements: qualifications required to be a director of listed companies according to laws and regulations; basic knowledge on the operation of listed companies and familiar with the relevant laws and regulations; more than five years’ work experience in law, economics or other fields required by his or her performance of the duties of an independent director; and, of course, meeting the criteria of independence. In turn, they are the following circumstances:

1. the person who holds a position in the listed company or its affiliated enterprises, their direct relatives and major social relations (direct relatives refer to their spouse, father, mother and children etc.; major social relations refer to their brothers, sisters, father-in-law, mother-in-law, daughter-in-law, son-in-law, spouse of their brothers, sisters, and their spouse's brothers and sisters etc.) ;
2. the person who holds more than 1% of the outstanding shares of the listed company directly or indirectly, or the natural person shareholders of the

10 largest shareholders of the listed company, or such shareholder's direct relative;

3. the person who holds a position in a unit which holds more than 5% of the outstanding shares of the listed company directly or indirectly, or of the unit which ranks as one of the 5 largest shareholders of the listed company, or such employee's direct relative;
4. the person meeting any of the three above-mentioned conditions in the immediate preceding year;
5. the person providing financial, legal or consulting services to the listed company or its subsidiaries;
6. the person stipulated in the articles of association;
7. the person determined by the CSRC.

In abovementioned regulations that Chinese requirements are stricter than that of Russia, and the number of independent directors in the Board is higher. However, for the SOE in the both countries there are separate, more strict regulations.

For the SOEs, political independence is an issue of a special importance. China in the Regulation N 18 [9], introduced in 2013, prohibited all levels of government officials, current or within three years after leaving the position, taking any part-time position and (or) getting payment from companies. These provisions primarily influenced independent directors [33], and forced many politicians to resign from the boards. SASAC, which is an agency that governs state ownership in China, has established the “Guidelines on further improving Corporate Governance of SOEs” [23] to raise the responsibility of the SOEs boards while SOEs are in the process of “corporatization”. Also, the SASAC has “issued regulations and guidelines on establishment and operation of central SOE boards of directors on the basis of the Company Law and Interim Regulations on Supervision and Administration of State-owned Assets of Enterprises [8]. The Company Law leaves most of issues related to corporate governance for central SOEs to the corporate charter, which sets rules for nomination and appointment of directors” [25].

In Russian SOEs rules for independent directors can also be found in the Regulation of the Government of the Russian Federation № 738 dated 3 December 2004 (as amended) which contain an extensive list of independence requirement, This Regulation is devoted to the management of companies’ shares owned by the Russian Federation and to the use by the Russian Federation of a special right to participate in the management of companies (a golden share). According to Section 8 (1) of this Regulation for a person to be nominated by the Russian Federation to a state-owned company’s board of directors he as well as his relatives must meet certain requirements. In order to be eligible for nomination by the

Russian Federation to a state-owned company's board of directors as an independent director a person and his relatives must not during the last three years:

- occupy positions in governing bodies and be employees of a company or its subsidiaries or affiliated companies as well as occupy positions in governing bodies or be employees of the company's management organization or its manager;
- be affiliated persons of a company or of its subsidiaries or affiliated companies, except for members of the board (supervisory board) of a company;
- exercise functions of a company's auditor (including in the capacity of an audit organization's employee) as well as be affiliated persons of a company's auditor;
- discharge obligations or be an employee of an organization discharging obligations arising out from a contract entered into with a company provided the aggregate value of transactions made for the purpose of the realization of the contract is 10 or more per cent of the balance value of the company's assets;
- represent the interests of persons or organizations bound by obligations arising out from a contract with a company with which the aggregate value of transactions concluded during a year is 10 or more per cent of the balance value of the company's assets;
- receive from a company any rewards, compensations and other payments, the amount of which is 10 or more per cent of the aggregate annual income of the said persons except for payments related to the exercise of activities in the capacity of an independent as well as participate in share option programs.

4. CONCLUSION

As of a brief analysis of corporate norms of China and Russia, we may see the following:

1. The institutes of Westerns corporate law transferred to China and Russia are now closely integrated with both countries legal systems, From initial interception to current times the norms has been many times amended in order to adjust both to countries' legal systems and to its political, economical and cultural development.
2. However, the certain clumsiness and confusion in legislation still exists in both countries, such as

Additionally, a person nominated by the Russian Federation as an independent director must not:

- hold public civil offices in the Russian Federation or be an official of the Central Bank of the Russian Federation;
- during the past five years be a member of a company's board of directors to which they are elected;
- occupy positions in governing bodies or be an employee of another company in which any of persons occupying positions in governing bodies of the company to which board of directors the person is nominated as an independent director is a member of a nominations or compensation committee formed by the company's board of directors.

The final requirement is that the said person not be an independent director in more than three companies.

Thus, for the SOEs in both countries the set of rules are extensive and seem to embrace every possible case of the personal or political interest of an independent director as a limitation to be appointed as one.

However, as Chinese lawyers note, "In understanding China's Company Law one must also understand the unique political-legal environment in China. In China's one-party political system, the ruling party has the basic instinct to put everything, including business corporations, under its political control".

Probably, a Russian lawyer could give the advice to understanding Russian company law, that political-legal environment of Russia is eventually interconnected with one person and the closer circle of that person, and in concurring groups of elite they form.

overlapping functions, excessive control institutes, or, in the contrary, lacking functions.

3. Both Russian and Chinese SOE are a significant sector of economy. SOEs face a corporate governance problem which is different from that faced by companies with diffused ownership structures. It is therefore doubtful whether board independence can be seen as a solution to the problem of minor shareholders and of effective control over "people's property". Can the institute of "disinterested directors", or independent directors, or norms on affiliation, or cumulative voting, or, in Chinese SOEs, the representatives from workers elected to the board, or other

complex or single norms help to solve the ‘absent owner’ problem and protect minor shareholders’ interests? Do extensive limitations set out for government officials to be in the Board play significant role in reducing corruption in SOEs? We may only make limited conclusions out of this research, as the analyses of implementation of these norms is a topic for a separate research. However, as the studied norms developed through years, and considering the differences and similarities between the two countries’ legislation suggest that all these measures have their effect which even if limited continues to be significant in the contest of corporate law of the two countries excluded from the process of development of the corporate law for a great part of XX century.

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