Governing China's boards: An interview with John Thornton

The ex-president of Goldman Sachs talks about his experiences as a reformer of board governance in China.

Dominic Barton
and Richard He Huang

As a banker at Goldman Sachs in the 19805 and 1990S, John Thornton made his mark blazing new financial trails with clients in Europe and Asia—trails that eventually led him to the presidency of that prestigious investment bank. Three years ago, Thornton set out on a radically different path: he retired from Goldman to start up a leadership program at Beijing's elite Tsinghua University.

That path has taken Thornton deep into the heart of the world's most intriguing business environment. He spends five months of the year in China, where his teaching duties put him in contact with top students, government officials, and China's emerging business elite. Yet this activity is just a part of Thornton's diverse efforts to assist China's bold but challenging march toward economic development and reform; he also advises government officials and business leaders in China, Europe, and the United States. Thornton is one of the few Westerners to serve as a director on the boards of several major players in China's economy, including telecom giant China Network Communications (China Netcom) and the Industrial and Commercial Bank of China (ICBC), which completed a $zi-9 billion initial public offering in October zoo6. Thornton also serves as a director of Ford Motor, Intel, and News Corporation, giving him a unique vantage point on the workings of Chinese boardrooms and how they compare with their Western counterparts.

Article at a glance

Investment banker John L Thornton retired as president of Goldman Sachs in 2003 to start up a leadership program at Beijing's elite Tsinghua University.

Thornton now spends five months each year in China teaching as well as advising companies and government officials. After joining the board of telecom maker China Network Communications (China Netcom!, he initiated an effort to establish a corporate-governance committee—the first of its kind at a Chinese state-owned enterprise.

In this interview, Thornton describes the state of board governance reform in China, including the challenges that Chinese companies face in tailoring Western board governance principles to their own unique situation?

Thornton shares anecdotes about his experiences serving on the board of China Netcom and of the Industrial and Commercial Bank of China, which completed a $21.9 billion initial public offering in October 2006.

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Upon joining China Netcom's board, Thornton initiated an effort to establish a corporate-governance committee—the first of its kind for a major Chinese state-owned enterprise. The committee's establishment has since led to a broader effort to redefine how the company relates to its stakeholders, including the Chinese government. Today Netcom stands at the vanguard of a fledgling movement among China's state-controlled companies to understand Western governance standards and tailor them to the country's unique circumstances. Thornton recently sat down in his New York office with Dominic Barton, a director in McKinsey's Shanghai office, and Richard Huang, an associate principal in the Beijing office, to discuss China's corporate-governance landscape and the country's reform challenges in general.

The *Quarterly:* *Let's start with some context: how should outside investors and executives think about corporate governance in China?*

John Thornton: China today faces a set of challenges—many unprecedented in complexity and scale in the history of any nation—that need to be better understood and appreciated by the outside world. The Chinese government is trying to maintain a degree of social stability that is the essential foundation for the country to achieve anything, while at the same time growing and transitioning what was, until not long ago, still essentially a command economy. And the government is doing all of this in the context of an incredible rate of change. Pick an issue: the health care system, environmental degradation, energy needs, mass urbanization, or poverty in the rural population. Any one of these challenges would be a formidable task for a country and its leaders. China has dozens of problems of this magnitude. Clearly, a key factor in raising the odds that the broad economic transformation underway can succeed even in the face of such challenges is

to ensure that the managers of the economy's core enterprises are focused on the right issues. This is where corporate governance can play a critical role.

The *Quarterly*- *How does that play out at the level of individual enterprises?*

John Thornton: There are 163 large state-owned enterprises that are overseen and controlled by one Chinese ministry: the state-owned Assets Supervision and Administration Commission. They are the enterprises that senior officials focus on the most because they have the broadest impact on the economy and employment. They are the ones that, historically, the Communist Party has been responsible for managing in the fullest sense. These very large companies are also meant to serve as models for smaller state-owned enterprises. There is also, of course, the rapidly growing Chinese private sector, which is hard to generalize about in terms of corporate governance. Finally, there are the joint venture companies and Western subsidiaries, which in terms of governance are doing more or less what Western companies do anywhere in the world.

John L. Thornton

Vital statistics
Born January 2, 1954
Married with 4 children

Education
Graduated in 1976 with degree in history from Harvard University

Received BA and MA in jurisprudence from Oxford University in 1978

Earned master's degree in private and public management from Yale University in 1980

Career highlights
Brookings Institution (2003–present)
- Chairman

Tsinghua University, Beijing (2003–present)
- Professor, director of global leadership program

Goldman Sachs
- President (1999–2003)

Fast facts
Serves on numerous boards, including Brookings Institution, China Network Communications (China Netcom), Ford Motor, Industrial and Commercial Bank of China (ICBC), Intel, and News Corporation

Serves on the board of trustees of Asia Society, China Institute, China Securities Regulatory Commission, the Eisenhower Fellowships, Financial Services Volunteer Corps, The Hotchkiss School, International Advisory Committee of the China Reform Forum, Morehouse College, National Committee on US-China Relations, Tsinghua University School of Economics and Management (Beijing), and the Yale School of Management

Serves as member of the Council on Foreign Relations

The *Quarterly:* *Historically, the management of these large state-owned companies has reinforced the notion that the party is all powerful. What is the incentive for bringing in a more Westernized approach to corporate governance?*

John Thornton: I can tell you, from the many conversations I've had, that officials at the highest levels recognize the need to put in place what might be called a modern system of corporate governance. They know that they'll be required to meet certain standards when they list their major companies in public markets in Hong Kong, London, or New York. They're also increasingly convinced that better corporate governance leads to better business results, greater efficiencies, wealth creation—all of those things that are good for companies, people, and the country. They have seen that even nontraded corporations like Saudi Arabia's Aramco have adopted leading corporate-governance practices.

Yet for nearly all senior Chinese officials and corporate leaders, up until now they have had no personal experience with this, no frame of reference. They know they need to do it, but most don't know exactly how to go about it.

The *Quarterly:* *You serve as an independent director on Chinese company boards. What do the efforts to establish better governance look like from the inside?*

John Thornton: The China Netcom project is a very interesting example. The topic of corporate governance first arose when the chairman asked me to join the board. I said I would but suggested that he create a corporate-governance committee. It would be the first ever in a Chinese state-owned enterprise, and I thought if it succeeded it could become a model that works for the 162 other largest ones. This obviously could be a tremendous force for good within the Chinese system.

What is fascinating about the Netcom project is its attempt to recognize reality. The reality is this: the Chinese want to adopt state-of-the-art corporate-governance practices that pass the Western tests. On the other hand, they also want to do this in a paced manner and to build a system that works for China. In China the government controls nearly all of the largest companies, and that's not going to change anytime soon. Maybe in Western parlance, we could conceptualize the government as the majority shareholder for all of these companies. Like any majority shareholder, it's not about to give up its primary levers of influence just because someone else wants it to. The goal is to build effective corporate governance within this reality.

The *Quarterly.* *What, specifically, did you focus on?*

John Thornton: In Netcom's case we focused on putting in place the right structures, processes, and interactions. We defined specific roles for the Communist Party and left the rest to the board—for example, the party participates and votes on key matters through nominated directors on the Netcom board, but fewer than half of the board members are party designees. We clearly defined the boundaries of party mandates for senior-executive appointments, company strategy development, and key investments. We gave authority to nominate and approve CEO and CFO candidates back to the board. The CEO now owns the strategy-setting process and is supported by a newly created strategy department.

We also set up formal channels to communicate better with Netcom's stakeholders and to provide its unions with more appropriate involvement in governance. We defined the roles and duties of the board committees and secretariat, including responsibility for managing risks.

The *Quarterly:* *What were some of the tough issues that Netcom had to grapple with, and what do the end results say about the pace of reform?*

John Thornton: At the top of the list was shifting mind-sets, particularly regarding the role of the board and minority shareholder protection. In the past the boards of most Chinese state-owned enterprises have been seen as more of a rubber stamp rather than as an organ that is able to add real value to a company. While it is still very much a work in progress, we are making headway on changing the perceptions of people—not only at the top, but throughout Netcom—so that they understand that a well-functioning board can be a real asset. Similarly, there is greater cognizance that, for listed state-owned enterprises like Netcom, minority interests must be taken into account.

As you might expect, it has been quite challenging to carve out a meaningful role for the board while at the same time allowing the party to influence key decisions as appropriate. Formalizing clearly the roles for each and developing the processes to arrive at key decisions was a significant achievement. For example, the board set up a detailed system for selecting top executives and evaluating their performance. The nominating committee comprises five directors, three of whom the party designates and two who are external. In this way the party, as the majority shareholder, is able to veto candidates in committee, but external directors are able to provide significant input to all directors before the board discusses any candidacy. The experience at Netcom suggests that the government genuinely wants to proceed in a principled manner but is treading carefully as it moves

forward. The chairman of Netcom likes to say that he does not see a contradiction between party influence and the protection of minority shareholders because the goals of the two are the same—namely, Netcom's success as a business. No one wants Netcom and all the other state-owned enterprises to succeed more than the Chinese government and Communist Party do, because the success of these businesses will better allow the party and government to tackle the myriad problems the country faces, which I mentioned before.

The *Quarterly:* *What do changes at Netcom mean for other Chinese state-owned enterprises?*

John Thornton: Netcom is without a doubt a pioneer of the governance transformation. As a key player in the telecom industry and a pillar of the Chinese economy, its governance reforms will have a significant impact on other large state-owned enterprises. Perhaps more than anything else, Netcom illustrates that practical and balanced solutions acceptable to both the investing community and the Chinese government are achievable. The reforms there can also change the attitude of Chinese authorities toward corporate governance, from one of complying with minimum legal requirements to aiming for best practices to advance the business interests of all the shareholders.

The *Quarterly:* *What of the broader swath of companies?*

John Thornton: When you get to the second category of state-owned enterprises—that is, below the 163 largest—I think almost by definition the story becomes both more disparate and less clear. Any one party secretary in a small city can have a huge impact.

The *Quarterly:* *What's the operating style of Chinese company boards?*

John Thornton: In the case of ICBC—China's largest commercial bank—a board meeting can feel almost more like an internal operating meeting than a Western board of directors meeting. So the topics of conversation, the level of detail, and the honest interchange are quite impressive. There's very little formality, and if directors have disagreements they argue it out right in front of you.

There is, of course, always room for improvement. The other day I was asked to be on a board committee call at 9:00 PM here in New York—9:00 AM Beijing time. The call ended at 10:30. Then I was told, "By the way,

we're going to call you back at 5:00 AM your time to have a board meeting to discuss with the whole board what we just discussed." So at times, basic operating practices need to be improved: notification of meetings, timely provision of succinct and useful information, a good chair to run the meeting and ensure that members have their say.

The *Quarterly:* *How do Chinese company executives regard Western governance standards?*

John Thornton: One of the trends I've seen recently is a reluctance on the part of Chinese companies to list in the United States because of the very high standards being imposed by Sarbanes-Oxley and other rules that they feel they can't or don't want to meet. Instead they're listing in Hong Kong and perhaps London, where the standards are very high but the way those standards are posed relates more to the spirit of the rules rather than the statute-based, legal-based system that exists in the US.

The *Quarterly:* *Does the West send the wrong signal to China on this kind of issue?*

John Thornton: I tend to think that high-level conceptual advice actually isn't all that valuable. Senior Chinese leaders have all heard the expression "corporate governance." They've all heard the expression "transparency." What they really need is people who can actually make these things happen in a way that is effective and that works in the Chinese system. That goes to the question of internal training programs at companies, to the question of university education in China, to the kinds of real experiences that Westerners have inside China, and to the question of not just taking a conceptual framework that works somewhere else and trying to impose it. I'm very sympathetic to the Chinese desire to build a system that works for them, because I think we have to acknowledge from experience, especially over the past few years, that there's no one system that's perfect.

The *Quarterly:* *What needs to happen to feed and advance the momentum that has built up for governance reform?*

John Thornton: Improving what might be called the national human-resources system is one key. You find an outstanding person, he's put in to be the chief executive of the XYZ Chinese state-owned enterprise. He's there for three to five years, does a good job, and is then snatched away to be the party secretary in XYZ province, the mayor of a city, or the chief executive of a competing firm. From the standpoint, as it were, of the ultimate shareholder—the government—these are all human resources to be deployed in whatever way they need to be deployed. This clearly needs to be changed.

The *Quarterly:* *How can a foreign director be most helpful on a Chinese board?*

John Thornton: First, ask thoughtful questions and be willing to challenge management in a constructive way. As I mentioned earlier, it is not that Chinese directors don't do this. They do. Foreign directors, however, can bring a fresh and different perspective that is often extremely valuable. Second, they can leverage their experience and personal networks and serve as a window to the Western business world. Finally, having gained an understanding of China-unique issues and company culture, it's important for them to be a catalyst for real change.

The *Quarterly:* *Do you have any tips on the dos and don'ts of being a foreign director on the board of a Chinese company and how to be effective?*

John Thornton: I think one of the dos would be, absolutely, to have a very close personal relationship with some people on the board, preferably including a senior executive. It's always difficult as an outside director to truly understand what goes on inside a company, in any country. And in China I think it's that much more difficult for a whole variety of reasons, including language, culture, and some of the issues we've discussed today. To be an effective director in a Chinese company takes a lot more work because every day can pose a different challenge. Your Chinese colleagues on the board are also learning, and they themselves are looking for real advice. You cannot assume that even things you consider to be basic are being done in ways that are familiar to you. And one other thing: the quality of translation can vary widely. So another good piece of advice is to have your own translator.

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The *Quarterly:* *Obviously, your presence on Chinese company boards must be reassuring to Western investors. Do you personally face higher risk in an environment such as this?*

John Thornton: I think by definition there has to be more risk, yet I really don't think about it in those terms. I do think that Western investors should have a deeper, more realistically grounded understanding of the complexities involved in these state-owned enterprises. By doing so, they would be doing themselves a favor—that is, knowing better what they were investing in. But also they could be forces for positive change because they could be talking to the management in a way that was more honest and realistic.

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Dominic Barton is a director in McKinsey's Shanghai office, and **Richard Huang** is an associate principal in the Beijing office.

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