State Shareholders Should Become an Active Force in Promoting and Establishing Effective Corporate Governance

By Mr. Chen Qintai

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At present in China, corporate governance is the most important system development project in the field of microeconomics. The effectiveness of corporate governance has a bearing on the success or failure of state-owned enterprise reform. Corporate governance standards affect economic growth and financial security. Corporate governance affects corporate decision-making mechanisms and risk levels, profitability and financing capability; it is the most important fundamental software for corporate competitiveness.

I. The Strength of Distorted Corporate Governance

Corporate governance primarily protects shareholder rights. However, if one observes the poor governance of Chinese companies, one will discover that it is associated with the abnormal conduct of state shareholders, including state shareholders with a controlling interest. China lacks a corporate governance culture; after state-owned enterprises have been restructured into corporations, the government does not retire to the position of shareholder. A good many government departments remain as the masters of their houses, so that intervention beyond authority levels and lack of ownership rights exist in tandem. From the perspective of reform direction, many acknowledge that a separation of ownership and management must take place, but some do not quite trust the role of corporate governance, and lack the enthusiasm to promote and establish effective corporate governance. There are reasons of awareness and understanding for this, and it is also limited by the system and driven by interests. Some have even more faith in strong intervention by owners outside the enterprise, while others attempt to gain improper short-term advantages from distorted corporate governance. This has resulted in some state-owned enterprises restructuring as corporations, with some having already offered their shares publicly, but the phenomenon of distortion of corporate governance still has certain universality. This is primarily exhibited in:

(1) The entrusted agency system for state-owned holdings, which remains unsound. A vague holdings management system and an equity agency relationship with unclear rights and responsibilities result in the lack of a centralised state-owned "boss" for companies in which the state has invested and owns shares. Concurrent with the enthusiasm of each and every department for executive intervention, there is no institution willing to make efforts to establish effective corporate governance. Multiple managers imply multi-layered objectives. On the one hand, business managers are at a loss as to what to do; on the other, room is left for business managers to do as they please. Without the encouragement and reining in of ownership, the acts of internal personnel will often diverge from the interests of the owners;

(2) After state-owned enterprises restructure and are listed on the market, resources of the "continuing company" to solve continuing problems go into the publicly-listed corporation; as controlling shareholder, there is always a tendency to use overlapping positions and affiliated transactions with senior management of the public corporation to obtain special advantages, in order to solve "continuing

problems." This creates two consequences: First, the board of directors loses independence, and second, the corporation loses independence of commercial interests;

(3) Government intervention and the conduct of shareholders with government backing and singularly large holdings are irregular, often resulting in corporate decision-making authority acting through informal mechanisms, so that it is very difficult for the board of directors to assume its rightful responsibilities; the severing of the responsibility chain essentially puts the company in the situation of having nobody in charge;

(4) State shareholder intervention in personnel arrangements, beyond the scope of the *Corporation Law*, disrupts the deployment of corporate control authorities, resulting in the destruction of the decentralisation/division of responsibility/balance system among the rights structure, the decision-making structure and the implementation structure of the corporation;

(5) State-owned shares and corporate shares do not circulate in capital markets, so that there is no threat of a transfer of control of the corporation. As long as business managers are able to ingratiate themselves to major shareholders, they are even more likely to operate in brazen violation of regulations, which leads to the trend toward human manipulation of corporate governance. Creditors have limited influence, and they often become victims; small shareholders are powerless, and turn away from investment toward speculation.

(6) Improper affiliation relationships between listed companies and parent companies for the purpose of creating false information, particularly information concerning affiliated transactions, provide a strong interest driver.

Experience proves that when corporate governance is distorted, the first victims are small shareholders, and the biggest victims are large shareholders. Public corporations are the forerunners and file leaders in China's establishment of a modern enterprise system. If public companies are unable to form complete corporate governance systems and mechanisms, it will have a direct impact on the progress of reform and economic growth in China.

II. Important Breakthrough in State-owned Asset Management System Reform

The Sixteenth Party Congress in 2002 presented guiding principles for state-owned asset management system reform, and in 2003, the new government established a special department to oversee state-owned asset management and issued regulations for state-owned asset supervision and management, bringing the state-owned asset management system into an operable stage.

Principles for establishing and running the new state-owned asset management system are as follows:

1. The central government and provincial and municipal governments respectively represent the state in fulfilling the functional responsibilities of capital investors;
2. The three levels of government are to establish special departments to oversee and manage state-owned assets and fulfil the functional responsibilities of capital investors;
3. With respect to enterprises in which they have investments and share holdings, the oversight agencies "combine asset management, personnel management and affairs management," exercising ownership rights in a centralised, uniform manner;

4. State-owned asset management system reform is combined with adjustments in the distribution of state-owned assets;
5. Capital investor institutions are to exercise shareholder rights in accordance with the *Corporation Law*, implementing a separation of ownership rights and operating rights.

When compared with the past, the new system creates major breakthroughs in at least two areas:

First, **with the state as an owner, the object of supervision and management has shifted from enterprises to capital.** In the past, state-owned enterprises and the government had a bound relationship, and the unchanging owner of the enterprise was the state; the capital of the state in the enterprise could not be withdrawn. Thus, to exercise its ownership rights, the government had to manage the enterprise, and not the capital. This immobile, rigid combination was the equity foundation for government intervention in enterprise, and the lack of separation between government and enterprise.

The delineation of the basic functional responsibility of state-owned asset departments as "fulfilment of the functional responsibilities of capital investor" has important significance, and delivers many important messages:

- The object of capital investor supervision and management should be the capital rather than the enterprise. Capital investor institutions have no executive rights, their relationship with the enterprise is that of shareholder to corporation, and ownership and operating rights are segregated;
- Capital investor institutions act in accordance with standards of conduct for investors; they have no bias toward individual enterprises, and the focuses of their concern with respect to corporations in which they have investments and share holdings are capital security and investment returns;
- Capital investor institutions are investors, and exercise shareholder rights in accordance with the *Corporation Law*; the primary means of capital operations are participation in corporate governance and the investment and withdrawal of capital.

Second, **capital investor institutions exercise ownership rights in a centralised, uniform manner.** An important issue to be resolved through state-owned asset management is the effectiveness of entrusted agency relationships for state-owned holdings. For a long time, state-owned enterprise asset planning belonged to the state, but there was no clear, pursuable entrusted agency system for equity liability. Multiple government interventions from outside the enterprise existed in tandem with a lack of owners within the enterprise, so that the enterprises found themselves in a situation in which nobody was in charge.

Centralised, uniform exercise of ownership rights is an arrangement that raises the efficiency of the key entrusted agency system for state-owned equity; this has considerable significance in that it:

- Firmly establishes systems and mechanisms for identifying equity liability, which will improve the effectiveness of the entrusted agency for state-owned assets;
- Builds a state-owned capital operations principle. Exclusive centralised and uniform exercise of ownership rights will strengthen equity constraints, creating a "state-owned boss" that is accountable.
- Centralised and uniform exercise of ownership rights implies the end of overlapping management and multiple objectives for state-owned assets. This will prove beneficial in focusing the objectives of state-owned capital operations on investment returns.

When compared with the past, the new state-owned asset management system represents fundamental change, whether with respect to the principals in the supervision and management process, the objects of supervision and management, operating objectives, or the means or acts of supervision and management. This strengthens the equity liability system and arranges for the separation of government from capital and the separation of government from enterprise. The establishment of effective corporate governance creates fundamental conditions for the segregation of ownership rights and operating rights.

III. State Shareholders Should Become an Active Force in Promoting and Establishing Effective Corporate Governance

The fourth meeting of the Fifteenth National Congress in 1999 expressly stated, "The corporate entity governance structure is the nucleus of the corporation system." However, the shift from the traditional government-managed enterprise to the establishment of effective corporate governance under conditions in which the two types of rights are segregated is an extremely profound systemic reform that is extremely difficult to implement. For example, many obstacles of understanding are very difficult to overcome. One often hears these kinds of questions: Without government intervention, review and approval, how will the board of directors be able to make major decisions? If the rights of major shareholders are nothing more than voting with their hands or their "feet," how can the state shareholder's controlling position be guaranteed? It goes without saying that state shareholders must firmly control the right to appoint the chairman and directors; but if they do not directly control the appointment of managers, assistant managers and persons in charge of major departments, how can the interests of the state be guaranteed? In fact, the understanding of a good many people has remained at a level where the greater the government's direct management of enterprise business decisions, the more reliable [such decisions are], and the broader the direct control of state-owned shareholders over business managers, the more secure [the investments are].

In modern large business institutions, the fields of decision-making, operations and management are all highly specialised. Institutions and individuals with investment capabilities are not necessarily masters of business management and decision-making. Professional, specialised management will increase returns, but because the interests of managers and owners are not entirely consistent, entrusted agency costs may result. Only through effective corporate governance, with the safeguards of laws and a series of contracts and articles of association that allow entrusted agency costs to be controlled within an acceptable range, can owners attain greater returns. We will now discuss "the corporation entity governance structure is the nucleus of the corporation system" from this perspective.

Effective corporate governance primarily protects the interests of shareholders. Therefore, the primary force for promotion and establishment of effective corporate governance is the shareholder. If shareholders lack enthusiasm for establishing effective corporate governance, then internal personnel are even more willing to preserve their positions of control. The special nature of state-owned capital requires two layers of entrusted agency—i.e., the entrusted agency within state-owned equity, and the entrusted agency in corporate governance—in order for the capital investor to assume its position. The longer entrustment chain naturally brings with it even more risks and agency costs. Therefore, the establishment of effective corporate governance at the end of the entrusted agency process has even more important significance for the security and efficiency of state-owned capital.

However, in practice, a paradox does exist: Establishment of effective corporate governance is primarily for the protection of shareholder interests, but the power of distorted corporate governance comes primarily from shareholders, particularly where the improper conduct of state shareholders is concerned.

Reform of state-owned enterprises through public offerings of shares requires the express and unmistaken confirmation of two objectives: The first is to enable enterprises understood to have good prospects to have the opportunity to raise capital, achieve faster growth and allow shareholders to benefit; the second is the use of equity diversification to alter the government-enterprise relationship, establish and standardise the corporate governance structure and convert business mechanisms. The phenomenon of lack of concern on the part of some government departments for establishing effective corporate governance and converting business mechanisms, and an even greater unwillingness to rein in their own rights in accordance with the *Corporation Law*, while at the same time having enthusiasm for utilizing the corporation's financing function to resolve difficulties on behalf of the state-owned enterprise, must be changed.

At present, restructuring of state-owned enterprises through public offerings of shares primarily involves the segregation and packaging of high-quality assets of the state-owned enterprises for public offerings. All of the former state-owned enterprises that have not been thoroughly restructured and have taken on redundant personnel and bad assets have become controlling shareholders with singularly large holdings in the public corporations. This type of enterprise structure exhibits three major problems:

First, these controlling shareholders remain state-owned enterprises; strong government intervention and lax government constraints make it impossible for these controlling shareholders to become "true bosses." Additionally, because the core businesses and high-quality assets have gone into the public corporations, government departments generally tend to reach their hands further into the public corporations.

Second, the objectives of the controlling shareholders are diversified. Enormous pressure to resolve continuing problems makes controlling shareholders unable to focus their objectives on maximisation of shareholder interests.

Third, the resources of controlling shareholders to resolve continuing problems are all in the public corporations, and there are too many affiliate relationships between the controlling shareholders and the public corporations. Apart from dividends, shareholders also hope to use overlapping positions of senior management, affiliated transactions and other such abnormal channels to individually obtain greater short-term benefits, in order to resolve continuing problems. Clearly, short-term, improper advantages gained in this manner vastly exceed the returns of ordinary shareholders. At this point, the controlling shareholders would rather distort corporate governance and strengthen channels for abnormal gains. Under these circumstances, they do not wish for the public corporations to preserve their independence, and they lack the initiative to implement "separation of assets, personnel and finances."

This kind of multi-channelled affiliation facilitates covert operations on the part of large shareholders, who can even treat the public corporation as an automated teller machine, transferring assets, falsifying disclosures and bleeding the company dry. This phenomenon has a certain universality, which demonstrates the existence of a structural defect.

One key to improving corporate governance is to improve the relationships between public corporations and holding corporations.

In order to enable state shareholders to become an active force in promoting and establishing effective corporate governance:

First, intensify state-owned asset management system reform

State shareholders include state capital departments and state-owned holding companies. Not only do they control enormous resources that do not compare in scale to those

of ordinary shareholders, but they also have the government behind them. During the initial stages of establishing corporate culture in China, they should exhibit good shareholder conduct and become a fundamental force in promoting and establishing effective corporate governance, and should not act as a distortion factor in corporate governance. There is considerable significance in making a good example of themselves. One important task of state-owned asset management system reform is to develop state capital departments into "state bosses" that comply strictly with the *Corporation Law* and are accountable. When state capital departments are established, it must be expressly stated that they have no executive authority, but they must assume equity liability; moreover, apart from special corporations, they must strictly review return on capital. Apart from investment and withdrawal of capital to perform necessary adjustments to asset allocations, the primary means by which state capital departments safeguard state capital investment returns is to encourage the establishment of good corporate governance in the corporations in which they have investments and stock holdings, to form a mechanism whereby state capital departments can only safeguard returns on capital through active participation in corporate governance.

Second, state-owned asset management should be divided into two models

In the final analysis, the state is a special shareholder, and state-owned capital is a special resource. Government investment is not entirely for the purpose of capital growth; more importantly, it is a supplementary means of maintaining state control and exercising the functions of government. It cannot be denied that capital investor institutions must assume two types of responsibility in state-owned capital management and operations: The first is to achieve policy objectives in the areas of support for economic growth and protection of national security; the second is to raise the efficiency of state-owned capital operations and maintain and increase the value of capital. Because of this, the capital investor institution can divide the objects of supervision and management into two categories. The first category is special companies in certain special industries that assume or partially assume public liability. With respect to this type of company, the capital investor institution should directly hold stock, control stock or own and operate them wholly and outright. State-owned capital cannot be withdrawn lightly in order to maintain control over this type of enterprise. In other words, this is the enterprise model of supervision and control. The other category is competitive companies with a profit objective. For these companies, "enterprise management" should gradually convert to "capital operations" in pursuit of return on investment. The purpose of this division into two models of supervision and management is to strictly distinguish the objectives and means of supervision and management and the governance mechanisms for each. The two models must not be confused.

Third, promote diversification of share equity

The use of adjustments in equity structures to prevent and correct the abnormal conduct of state shareholders and focus enterprise objectives on economic performance is an important lesson of state-owned enterprise reform. Experience proves that there is much abuse when state-owned enterprises are restructured into wholly state-owned corporations or state holdings are "singularly large." "Allowing a mixed-ownership economy with stock ownership as the foundation to become the primary embodiment of public ownership" and "state control of key [enterprises]" are already the common view. In other words, state-owned enterprises not only must restructure into "mixed-ownership" corporations; in addition, the state must be able to have a controlling or non-controlling share in ordinary enterprises. The introduction of diversified shareholders, including other state shareholders, and especially non-state shareholders and foreign investors, benefits the positioning of ownership rights. The balance of a diversified shareholder pool will make it easier to separate government from enterprise and form a standardised corporate governance structure.

Fourth, explore new restructuring modes, and promote public offerings of state-owned enterprises as a whole

An important topic for study in improving the corporate governance structure for public corporations is how to enable state shareholders with a controlling interest to exhibit normal shareholder conduct and establish normal relationships with public corporations. Once state-owned enterprises are divided in two, and their core businesses and high-quality assets are packaged for public offerings, the thorny issue of the remaining portions is left to the controlling companies to handle directly, and there is much abuse in the restructuring plans. We must actively explore programs involving the stripping of remaining portions of state-owned enterprises for disposal by trustee companies, and public offerings of the remaining state-owned enterprise as a whole. State shareholders should not be a concerned party in the disposal of remaining portions, but will be in a supervisory position, benefiting the generation of normal shareholder conduct.

Fifth, the government must create an environment for the establishment of effective corporate governance

New mechanisms for the selection and employment of personnel that are adapted to company systems and legal requirements must be explored. Party management cadre principles should be consistent with the provisions of the *Corporation Law* for the selection and hiring of directors by meetings of shareholders, the selection of business managers by the board of directors, and the exercise of employment authority by business operators. The government must provide many of the basic conditions for the establishment of effective corporate governance: First, the *Corporation Law* must be further perfected, in order to establish a sound legal foundation for effective corporate governance; second, sound capital market functions must be established, information disclosure systems must be strengthened, non-circulating shares in full circulation must present meeting agendas, and mechanisms for the transfer of control rights in corporations must be established; third, intermediary service institutions must be developed in order to bring to full effect the roles of notaries, as well as monitoring, information transmission and services; fourth, a management market must be developed in order to create conditions for the exercise of employment rights by meetings of shareholders and boards of directors. Fifth, bankruptcy mechanisms and shareholder litigation mechanisms must be perfected in order to establish a last line of defence to punish poor corporate governance.