

## Policy Dialogue on Corporate Governance in China

Beijing, 19 May 2005

### Synthesis Note

The 2<sup>nd</sup> OECD – China Policy Dialogue on Corporate Governance took place in Beijing on May 19, hosted by the Enterprise Research Institute of the Development Research Center of the State Council (ERI/DRC). Discussion focused on corporate governance of state-owned assets and was based on the *OECD Guidelines on Corporate Governance of State-owned Enterprises*, which were presented for the first time outside the OECD after their adoption by the OECD Council on April 28 2005. The meeting was opened by **Mr. Liu Shijin**, Vice President of the DRC.

#### Session 1

The first session was devoted to recent developments on corporate governance in China, as well as a presentation of the OECD Guidelines by **Mr. Lars-Johan Cederlund**, the Chair of the OECD Working Group on Privatisation and Corporate Governance of State-owned Assets. **Dr. Chen Xiao Hong**, Director of the ERI / DRC drew the broad picture and presented the main current issues related to the governance of SOEs as well as undergoing reform efforts. Current issues include the absence of boards in SOEs registered under the Enterprise Law or the non-clarity of rights and obligations of boards in SOEs registered under the Company Law. Typical issues also include the relationships between solely state-owned parent companies and their listed subsidiaries, with frequent abuses of the subsidiary's shareholders' rights. As for current reforms, the consolidation of the recently set-up SASAC and the revision of the Company Law were briefly discussed.

This presentation was complementary to that given by **Dr. Hu Ruyin**, Director of the Research Center of the Shanghai Stock Exchange, which highlighted the general corporate governance difficulties deriving from the characteristics of the ownership structure of Chinese listed companies and from the insider control or "key person model". Dr. Hu also mentioned the weak shareholder protection and low quality of disclosure, as well as the appointment of chairs and CEOs of state controlled listed companies directly or indirectly by the Party as serious weaknesses of current corporate governance practices. Main efforts, recent and current, undertaken by both the SSE and the CSRC to improve corporate governance include the diversification of ownership, the introduction and development of independent board members, the improvement of the legal and regulatory framework and the strengthening of enforcement, including for example public reprimands of listed companies violating listing rules. As another interesting example regarding boards, the SSE has drafted a Code of Conduct for Board Chairmen.

#### Session 2

The second session focused on the role of the state as an owner and on the organisation of the ownership function within the state administration, discussing the Chinese, French and Thai cases. **Dr. Zhang Delin**, director of the SASAC, presented the organisation and functions of the SASAC, the State Asset

Supervision and Administration Commission, set up in March 2003 at ministerial level directly under the State Council, as well as of the local SASACs at provincial levels. Since then, all performance indicators related to the supervision of SOEs have significantly improved (the value of asset and equity, profits, rates of return, labour productivity, etc.). The presentation also highlighted the complexity of the legal framework, as 257 laws, regulations and regulatory documents relate to the supervision and administration of SOEs, a number of these being currently subject to amendments.

**Mr. Jean-Louis Girodolle**, the Vice-Director at the French Government Shareholding Agency, presented the recent re-organisation of the ownership function within the French administration, highlighting its main positive outcomes in terms of reinforcement of the ownership function, clear separation with other state functions and increased transparency (including consolidated financial statements and a dedicated website). The main elements of the ownership policy were also discussed, such as the empowering of SOE boards, the greater transparency of SOEs, the active role of the agency as an owner and the focus on shareholder's value.

**Dr. Pallapa Ruangrong**, from the State Enterprise Policy Office of the Thai Ministry of Finance then presented the Thai state sector, its importance for the economy and how the governance of SOEs has become a top priority for the government. She also exposed the different laws and regulations concerned as well as the roles of the different administrations involved in the ownership function. She finally discussed a current proposition to establish a state holding company and which could be the various advantages of such an organisation for a better exercise the ownership function in the Thai context.

### **Session 3**

Session 3 focused on the operation, composition and nomination of SOE boards. **Dr. Lu Tong** presented the results of a corporate governance assessment of Top 100 Chinese listed companies in 2005. This assessment showed that actual corporate governance practice was "at most mediocre", with no significant difference between companies listed in Shanghai and Shenzhen versus those listed in Hong Kong and no correlation with the price premium. More particularly, companies scored badly regarding board issues as existing boards, their committee and internal regulations seem to be still mainly formal. One main recommendation from this assessment is that improving the effectiveness and independence of boards is still key to improve the corporate governance of Chinese listed companies. To achieve this, training should be provided through setting up an IOD, a cumulative voting system for electing board members should be developed and effective evaluation of board performance should be carried out.

The presentation by **Mr. Li Zhaoxi**, vice president of the ERI / DRC, made clear that setting up boards in SOEs registered under the Enterprise Law is a top priority for the SASAC. To achieve this, four issues must be carefully considered in the Chinese context: the definition and responsibilities of independent directors as well as those of "state representatives" within SOE boards, the role of specialised committees and the relationships between the board and the general manager. This includes allowing boards to nominate general managers, even if this will still have to be coordinated with the remaining Party role in nominating "executives". Finally, some clarification and transfer of responsibilities between the SASACs and SOE boards has still to be performed. A pilot project to set up boards in seven SOEs was also described, with the focus on the nomination and selection of independent directors (one third) who would allow the SASAC to "fade out from its role of mother-in-law and reassume a role of boss". The project of similarly setting-up boards with independent directors for an additional 170 SOEs under SASAC's responsibility will necessitate the recruitment of a large number of new independent directors.

The presentation and discussion of the Canadian practice by **Mr. Ronald Robertson**, Chairman of the Board of the Canada Deposit Insurance Corporation, gave useful references regarding the responsibility

and accountability of SOE boards. Following a number of scandals and accusation of patronage, a recent review in Canada called for a more formal appointment process for SOE boards, asking the boards themselves to define selection criteria and competency profiles and calling for an open competition process which might also include a Parliamentary review of proposed appointees. Moreover, enhanced responsibilities for SOE boards include in particular the responsibility to nominate CEOs, even if the Minister still has the final decision on these appointments. The adopted model for such nomination is “board search”, i.e. where the board or its nomination committee prepares a job description, an accountability profile and selection criteria and is also involved in the final selection and interview processes. Proposals are then passed on to the Minister and proposed candidates appear before a Parliamentary committee. Even costly, the whole process proved to be efficient and avoids favouritism or patronage. An additional comment was made by Mr. Robertson on the recommendation to limit the number of civil servants on SOE boards, as they might face conflicts of loyalty and have an undue influence *vis-à-vis* other board members.

#### **Session 4**

This session focused on disclosure and transparency issues. **Mr. Ma Zhengwu**, Chairman and CEO of one of the seven pilot enterprises in which the SASAC is setting up boards, explained how improving information disclosure is key to the reform of SOEs and requires a complete overhaul of the corporate culture. To achieve this, attention should be paid to internal information and control systems and more comprehensive instructions and implementing guidance should be provided by the SASAC regarding disclosure requirements. Extensive training should also be developed at all levels within the SOEs and, most importantly, boards should be made responsible for disclosure. This should be a key component of the seven board setting pilot projects. Finally, a sensitive aspect of the transition to a more transparent corporate culture is that some might fear that it could lead, at an intermediate stage, to the blaming of the most transparent companies who report in good faith.

The presentation by **Mr. Philip Smith**, from the Australian Department of Finance and Administration, showed how the Australian government has developed a culture of high transparency and strong accountability for its SOEs, and how this is considered as a building block of good governance and thus of SOE efficiency. Transparency and accountability of SOEs are promoted in Australia through three main channels: firstly, a clear definition of roles and responsibilities of the various stakeholders; secondly, a prescriptive reporting and planning regime; thirdly, open correspondence and strong relationships between the SOEs, responsible Ministers and Departmental officials. This open policy of intense and informal interaction allows avoiding surprises and providing timely and informed advice to Ministers.

Finally, the presentation by **Mr. Tariq Kirmani**, Chairman and CEO of Pakistan International Airlines, described the complete paradigm shift being implemented in the governance of SOEs in Pakistan in order to deal with the traditional obstacles to good governance in SOEs, namely and mainly excessive interference in day-to-day management. The reforms include the setting up of independent boards, with a majority of board members coming from the private sector, and mandatory audit, finance and human resources committees. These reforms also include the implementation by SOEs of the Code of Corporate Governance issued by the Securities and Exchange Commission for listed companies, which includes strong disclosure requirements, such as disclosure of all material changes according to GAAP and IAS, and provides strong protection for minority shareholders. Mr. Kirmani also described recent measures to enhance minority rights, including for example news alerts on websites along with financial results as well as availability of managers and board members to answer any queries during general shareholders meetings. He also proposed a series of recommendations to further improve the situation and ensure the effective equitable treatment of minority shareholders, such as the possibility to include items on the agenda of the AGM or the disclosure in the Annual Report of any dissenting board decisions.

## **Session 5**

Session 5 focused on the role of the ownership entity and its relationship with other state bodies. **Mr. Roberto Ulissi**, Director General at the Italian Ministry of Economy and Finance, described the role and tasks of the different agencies involved in regulation and supervision of SOEs in Italy, including the Ministry of Economy and Finance, other Ministries, the CONSOB, other independent authorities with a detailed description of the allocation of responsibilities and assessment of difficulties in practice.

**Mr. Jia Xiaoliang**, Deputy Director General of the Bureau of Enterprise Reform of the SASAC, described the main functions of the SASAC. These include appointing and dismissing CEOs, assessing performance and “administrating” key events. The overall functions of SASAC seem to still include some regulatory responsibilities, as well as some strategic responsibilities which should be born by SOE boards, such as developing the SOE strategy or establishing the accounting and auditing systems, besides the already discussed nomination of CEO and high level management. Thus, two types of separation are not yet fully achieved, first the separation of the regulation from the ownership function within the state administration, and secondly, and more fundamentally, the separation between the SOE itself (including its board) from the state administration, in this case its “supervisor” the SASAC.

The presentation by **Ms. Xu Yan**, (who represented **Mr. Yang Hua**, Director of Listing Companies Department of China Securities Regulation Committee) aimed at clarifying the role of the CSRC in promoting better corporate governance in Chinese state-owned listed companies. It first described the major measures taken by the CSRC to promote corporate governance, such as the promotion of independent directors in SOE boards and the improvement of the legal and regulatory framework, including the CSRC / SASAC Guidelines for Corporate Governance of Listed Companies, based on the OECD Principles of Corporate Governance. “Inspections” on the effective implementation of these Guidelines have since been carried out jointly by the CSRC and the former State Economic and Trade Committee. Efforts also focused on improving information disclosure through a series of regulations released since the 1990’s, the latest one being the requirement in 2002 for all listed companies to disclose quarterly reports, which are non audited but endorsed by boards of directors, and a revision of the regulation on Annual Reports in 2004. A more recent regulation “on strengthening the protection of social public stockholders’ rights and interests”, from December 2004, aims at enhancing the protection of minority shareholders, including some super majority for approval of major transactions and increased independent directors’ responsibilities for their supervision, or online information and voting systems.

Current policy orientations of the CSRC include further expanding the “QFII regime” to promote increased foreign institutional investment and better supervising the active merger and acquisition market to promote its transparency. In parallel with the revision of the Company Law and the Securities Law, the CSRC also focuses on implementing accounting and auditing reforms, while striving to improve the enforcement regime related to information disclosure. More generally, the CSRC has significantly increased its supervision capacity in 2004, which has already translated into a higher number of inspections, cases being investigated, public denunciations and de-listings.

However, in spite of all these reform efforts, the CSRC recognises the inherent weaknesses of the Chinese stock market, mainly related to the low quality of the state-owned enterprises initially listed, the lack of clear separation and arms length relationship between the listed companies and their wholly state-owned parent companies, resulting in excessive powers of dominant shareholders, pervasive abusive related party transactions, and in fine uncontrolled insider power. Regarding this issue the CSRC and the SASAC jointly issued a Notice “on standardising capital intercourse between listed companies and associated parties and the issues of external guarantee provided by listed companies”. Furthermore, regarding the efforts to set up

effective boards, the independent directors are yet for many not really independent or in some cases, even worse, non competent. Moreover, there is still confusion about the role of independent directors within boards of directors, particularly about their role within audit committees. Finally there seems to remain overlapping between the functions of independent directors and those of the supervisory directors, the functioning and tasks of whom in general should be clarified and made transparent.