Programme of Dialogue and Co-operation with China

CHINA GOVERNANCE PROJECT

REFORMING STATE ASSET MANAGEMENT AND IMPROVING CORPORATE GOVERNANCE:
THE TWO CHALLENGES OF CHINESE ENTERPRISE REFORM

Paris, 3 February, 2005

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JT00176427
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REFORMING STATE ASSET MANAGEMENT AND IMPROVING CORPORATE GOVERNANCE: THE TWO CHALLENGES OF CHINESE ENTERPRISE REFORM

1. Reform of the Chinese enterprise sector is now at a critical juncture. Previous methods of enterprise control have continued to show weakness and signs of abuse, while more market-based instruments of corporate governance, including effective commercial banks, financial discipline of enterprises, effective shareholders and more widespread competition are still developing. The challenge for the Chinese authorities is to negotiate the transition to a new system of corporate control with its associated checks and balances as quickly as possible.

2. The present situation arises in part from the programme for partial flotation of large-scale state-owned corporations and the ensuing expansion of equity markets which has taken place since 1990-1991. This has left the state as a dominant shareholder in many listed firms. But the objective to improve corporate governance at the same time has not been fully accomplished. Corporate governance issues are thus becoming of critical importance for the success of enterprise reform and further capital market development that will also include the private sector. Meanwhile, the majority of enterprises and banks remain under full state ownership with resulting tensions between this sector and partially privatised or fully private firms which needs to be resolved.

3. The authorities have been active in under-taking reform measures over the past two years. With respect to corporate governance, the “Code of Corporate Governance for Listed Companies in China” was issued by the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission in January 2002. This Code is based on the OECD Principles of Corporate Governance and the authorities have been taking steps to enhance its implementation through special inspections. A first report on corporate governance, published by the Shanghai Stock Exchange in 2003, highlights not only the progress to date but also the significant challenges that remain. China’s accession to the World Trade Organisation in 2002 also underpins the need for continued enterprise reform since competition is expected to intensify in a number of sectors.

4. In parallel, the 16th Communist Party Congress in late 2002 concluded that better management of state-owned assets would be one of the top priority areas for the current government in order to curtail continued managerial abuse of power, which could challenge the political legitimacy of the reform programme. It also reflected the decision that full privatisation will take quite some time and that the state will remain active, if not dominant, in a number of sectors and enterprises. A commission was set up in 2004 to manage state-owned assets, the SASAC (State Assets Supervision and Administration Commission) and represents a crucial step in separating the ownership function from the regulatory one within the administration.

5. Enterprise reform in China is thus now facing two main but interwoven challenges: on the one hand, to establish the state as a full or part-owner of enterprises rather than a manager, and on the other

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1 Decree of State Council of the People’s Republic of China (N°378) “Interim Regulations on Supervision and Management of State-Owned Assets of Enterprises”, May 27, 2003, provided the SASAC with its basic mandate.
hand, to improve corporate governance in general and of listed companies in particular. This chapter will
give an overview of main issues and trade-offs with respect to these two major challenges. It will first
discuss the reform of state asset management, underlining the challenges faced by the SASAC in defining
the state’s ownership role. The chapter then considers the current situation in the corporate governance of
listed companies and examines some priority areas for improvement of practices, which are all the more
necessary given the need to further reduce state ownership. Some concluding remarks and
recommendations are presented.

Reforming the Governance of State Owned Assets

Background

6. The reform of state-owned enterprises has proceeded in several phases each of which could be
characterised as seeking to improve or to introduce modern management, and to simulate market
mechanisms (Box 1). More recently, policy has turned to focusing state control on four main types of
firms, while “diversifying” ownership through partial privatization to domestic and foreign shareholders.
Diversification, or partial privatisation, it was thought, would lead to greater market discipline of
management. These reform steps, while moving in the right direction, have been on reflection
disappointing. In the words of one observer, “instead of state sector enterprises being made more efficient
by being forced to follow the rules of the private sector enterprises (the original ambition), potential private
sector enterprises are hamstrung by having to follow rules that make sense only in a heavily state-invested
economy (Clarke, 2003, p.2-3)”, and which are themselves not effective. Corporatisation has clarified
central and local governments as *de jure* owners, but it has also blurred further the lines of responsibility,
while allowing at the same time multiple interference at different levels. Such state intervention has been
especially heavy in personnel issues. It is important that the state take on the responsibilities of real owners
in a market if the reform programme is to be internally consistent. This is even more important given the
governments goal to reduce the proportion of state-owned shares in enterprises from 68% to 30% in two
stages. The authorities have therefore taken the timely action to set up SASAC.

<table>
<thead>
<tr>
<th>Box 1. Simulating markets: A gradual move towards autonomy, corporatisation and partial flotation</th>
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<td>The main steps in the enterprise reform in China since the 1980’s have been:</td>
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| **A/** The contract system (Contract Responsibility System) developed in the second half of the
80’s aimed at giving responsibility for profits and losses to SOEs. It resulted for a while in increased
efficiency, but also in rent seeking behavior and short term opportunism due to imbalances in residual
risks, the high costs of supervision and asymmetries in information. Administrative and political
interference remained strong, including the selection by the state of SOE management. Following
these mixed results, many small firms were sold, leased or even closed. |
| **B/** In the 90’s, the reform of state enterprises was pursued and deepened by transforming the
status of large SOEs through “corporatisation”. The objective was to create a “modern enterprise
system” by transforming SOEs into corporate entities that would behave like privately owned
corporations, subject to the newly adopted Company Law, while maintaining state ownership and
oversight. Other objectives included the need to raise equity capital for SOEs and the expansion of
state control in some sectors through leverage. |
| By the end of the 90’s, more than half of the SOEs had been transformed into joint stock
companies, reinforcing in the process the status of the central and local governments as *de jure* |

owners. The results of corporatisation in terms of management autonomy and the introduction of new corporate checks and balances were disappointing. Corporatised SOEs remained subject to extensive day to day state intervention while increased autonomy allowed managers to more easily expropriate the state as an owner, sometimes in collusion with the supervisory and administrative authorities, especially at the local government levels. SOE boards were filled by local politicians with no business experience or other relevant expertise and thus did not act as a check on management (Chen, Fan and Wong, 2003).

C/ Another crucial step in transforming SOEs was the decision by the State Council in 1996 to promote the public issuance of SOE equities and the development of stock markets. This move aimed at mobilizing private savings to finance resource-poor SOEs, while at the same time instilling “market” discipline to improve their efficiency through public listing. Another underlying concern was also to ease the pension funding problem. A frequent approach has been to “corporatise” former SOEs in two parts, a parent and a subsidiary. Typically the subsidiary acquired the productive assets and was incorporated as a joint-stock company and listed. The parent retained the debts and non-productive assets, including redundant staff and either remained a traditional SOE or was also corporatised. It thus has had every incentive and the possibility to expropriate the minority shareholders in the listed firm.

D/ A new approach to state control was finally developed and approved in 1999. It was decided to concentrate state control on four main types of enterprises (state security, natural monopolies, important goods and services, high and new technology industries), while withdrawing progressively from other areas. Moreover, a diversification of ownership was approved for enterprises over which the state decided to maintain control. This diversification of ownership was also called “partial privatization” as private domestic and foreign shareholders were becoming shareholders of “corporatised” SOEs, along with the state and state-controlled bodies.

Source: OECD (2002), “China in the World Economy, the domestic policy challenges”.

Expected role and functions of the SASAC

7. Whatever the scale and speed of the announced partial or full privatisation of state assets, it is realistic to assume that the state will remain a dominant or at least significant shareholder of many companies for the foreseeable future. The crucial challenge is thus how the corporate governance of SOEs can be enhanced. When exercising its role as an owner and shareholder, the state usually faces two challenges. On the one hand, it should avoid being a passive shareholder but rather act as an owner, making its views about the governance and objectives of the enterprise known. On the other hand, the state should also avoid using its considerable powers to make undue interference in the day-to-day management of SOEs.

8. Corporatisation in the 1990’s has reinforced the status of the central and local governments as de jure owners. But, combined with the more general decentralization of state administration, it has also resulted in a complex scheme for the effective exercise of this state ownership. The state has been represented by a multitude of different ministries and administrative bodies at different levels of government. There has been no clear indication regarding how to resolve potential conflicts between claims emanating from different state entities or agencies, increasing significantly the capacity for insiders to abuse and divert state assets.

9. The Guiding Principles for State-Owned Assets presented by the Sixteenth Party Congress in 2002 and the creation of the SASAC have marked a crucial turn and an important step towards reinforcing
the role of the state as an owner and shareholder. This move represents an additional step in separating more clearly company management from the ownership and the regulatory responsibilities of the state. The decision has also been accompanied by adjustments and a redistribution of state-owned assets. The SASAC is to oversee the largest and centrally owned non-financial SOEs, altogether 197 entities. Local supervisory bodies will be established to oversee locally-owned SOEs. By February 2004, 12 provinces and municipalities had established such agencies and other provinces or cities are expected to do so before the end of 2004.

10. The SASAC is under the direct authority of the State Council, and its main duties are defined as follows: i) to carry out its responsibilities as investor and to guide and promote the reform and reorganization of the SOEs; ii) to represent the State on supervisory boards at some large enterprises; iii) to appoint, dismiss and assess senior executives and assign rewards and penalties on the basis of performance; iv) to monitor the extent to which SOE value is maintained or enhanced; v) to draft laws and regulations on the administration of SOE and set related rules and regulations; vi) to direct and supervise the administration of local SOEs in conformity with the law (Ling, 2004).

**Challenges for the SASAC**

11. The fundamental idea underpinning SASAC is to exercise ownership rights in a centralized and unified manner, and according to the Company Law. One breakthrough is that the objective of supervision has shifted from direct intervention in enterprise management to capital oversight, although objective (iii) above could prove quite intrusive and counterproductive. The SASAC and its regional and local affiliates have the objective to “fulfil the functional responsibilities of capital investors”, which means a clear separation of ownership from management, a focus on investment returns, and the use of legal means and mechanisms for shareholder intervention, as defined in the Company Law (Chen, 2004). Centralization can also lead to a uniform approach to the exercise of ownership rights and thereby improve the effectiveness of asset management.

12. Three priorities for action by the SASAC should be as follows:

13. a) **Creating and enhancing the role of boards in SOEs:** the SASAC has first to set up boards in the largest wholly state-owned companies in strategic sectors, which may still have a “managing director responsibility system”\(^2\). Establishing boards will be a critical first step in curbing insider control and decreasing power concentration. Until now, only a quarter of the 189 SASAC enterprises have boards, while up to 80% of second and third tier enterprises\(^3\) have been transformed into the corporate form. As long as SOEs do not have boards, the SASAC remains responsible for the audit process and for the integrity of financial reporting. It is only once they have their own board that enterprises set up audit committees which become responsible for this critical pillar of good governance. Furthermore, once SOEs have boards, empowering and giving them the full responsibility for strategic guidance and monitoring of management will be a central element of reforming the governance of SOEs, as evidenced both within OECD and non-OECD countries\(^4\). However, the promotion and compensation of managers in key state-owned and state-controlled enterprises, whether or not they are corporatized and listed, remains under the

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\(^2\) The “management responsibility system” is where the responsibility is vested in one individual, the managing director. Chinese large solely state-owned companies either have no boards of directors, being registered under the law on enterprises, and implement the managing director responsibility system; either do have one board, being registered under Company Law, but in this case it does not necessarily exercise its functions and the company implement effectively a “board chairman responsibility system”, the chairman being the legal representative of the Company (Chen, 2004).

\(^3\) Subsidiaries and subsidiaries of subsidiaries of centrally SASAC supervised SOEs.

control of the Communist Party evaluation committees at the central, provincial and municipal levels. This very traditional control channel deprives SOE boards from exercising one of their critical functions, i.e. nominating and eventually dismissing the CEO and top management. “Without the crucial role of nominating, and in case of poor performance, dismissing the CEO, it is difficult for the board to fully exercise its monitoring function and feel responsible for the company’s performance. Therefore, SOE boards should nominate and remove the CEO. In some cases, this might be done in concurrence with the ownership entity, as this is usually the case with major investors in joint stock companies. SOE boards should also be in a position to have a major influence on CEO remuneration”5.

14. b) Improving recruitment procedures for SOE managers and board members as well as performance evaluation: In many SOEs without boards, SASAC will continue to appoint managers. Much will depend on what kind of targets the agency sets for the managers and how it evaluates their performance. The SASAC is currently elaborating plans to reform the nomination, evaluation and remuneration process for top management of SOEs. In November 2003, the State Council issued a Decree6 detailing the criteria by which the SASAC should appraise executive performance and determining their remuneration. Such actions should remain restricted if boards are to develop. More importantly, SASAC will need to develop procedures for selecting and remunerating board members.

15. c) Restricting irregular behaviour by the state as a shareholder: It is important for the state to set the tone of corporate governance practices since it is by far the most important controlling shareholder. Moreover, under the Company Law it has important powers as the controlling shareholder and this does not change with partial privatisation. It is therefore important to eliminate abuses by the state as a controlling shareholder. To this end, together with the CSRC, the SASAC issued in August 2003 a “Notice on certain issues relating to standards for regulating listed companies’ dealing with related funds and external guarantees offered by listed companies”. However, the SASAC has yet to elaborate a clear policy on how it will exercise its ownership rights, and on how it will behave as an institutional investor acting as a fiduciary for the Chinese people. Once SOEs do have outside minority shareholders, it is then critical that the state applies fully the provisions of the Company Law regarding the protection of minority investors. “It is in the State’s own interest that other shareholders do not perceive the State as an opaque and unpredictable owner and feel that they are treated equitably. The state’s track record in terms of respecting minority rights will have a significant impact on share values and on its future capacity to sell further shares on the market. Finally, having other shareholders introduces market pressures and may become an important means of monitoring SOE management”7. SOEs could thus, following international best practice, aim at applying the more comprehensive protection provided by the Code for Listed Companies in this regard.

16. The SOE Code mentions that the board should have an active role in guiding the company and in selecting management, and recommends the nomination of independent directors and the separation of the Chairman from the role of the CEO. The Decree 378 gives authority to the SASAC to nominate boards, but most board members were appointed before it received this authority. Consequently, the SASAC is currently carrying out a pilot project on board nomination in 7 SOEs, and is reviewing its criteria for board member selection. In this regard, it should adopt international best practice, i.e. base this selection on competency and experience criteria, while ensuring a necessary degree of independence with the presence of both non-executive and fully independent board members, including in relevant cases foreigners. The

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SASAC is also developing Codes of Good Behaviour for SOE board members, as well as Guidelines for SOE Boards. It should also undertake a major training effort.

**Improving the legal and regulatory framework for state asset supervision**

17. To improve state asset management, the legal and regulatory framework needs further development regarding its coverage, completeness and consistency.

18. Firstly, SOEs under SASAC supervision are not all covered by the existing legal and regulatory framework regarding corporate governance. The company Law and Decree N° 378 apply to all SOEs, while it is not clear at which point the “provisional” SOE Code\(^8\) is binding on all SOEs. Moreover, most SOEs are not covered by the Code for Listed Companies. Indeed, none of the 189 companies directly under the SASAC control are listed, and only a minority of their partially owned subsidiaries.

19. Secondly, regarding consistency, Decree 378 specifies that the SASAC should act as an investor to represent the interests of the state and its function should be clearly separated from those of management. However, the same Decree includes conflicting provisions giving the SASAC quite significant decision making powers and leverage on many critical issues (appointment of directors, selection of managers, auditing and disclosure…).

20. Finally, regarding completeness, the Code on SOEs does not cover a number of issues which are deemed critical for the corporate governance of SOEs such as, for example, which responsibilities should be exercised by SOE boards and the SASAC respectively. This Code should be significantly revised and refined. Alternatively, a new Code for unlisted companies could be drafted, bearing in mind that its provisions should remain globally consistent with the Listed Company Code, as many unlisted companies will eventually list.

**Improving corporate governance of listed companies**

**Background**

21. The Shanghai and Shenzhen stock markets have developed strongly\(^9\) but are distorted since they have been used more to support SOEs than to allow the development of private business. Consequently, they are dominated by state-controlled listed firms\(^10\), and only one third of shares issued by SOEs (geren gu) are publicly issued and freely tradable by individuals and institutions. The ownership structure resulting from these series of reforms is problematic as it is characterized by a low level of free float, an excessive concentration of non-tradable shares, combined with a highly dispersed ownership of tradable shares and a lack of a robust institutional investor base. These weaknesses are well described in the Shanghai Stock Exchange Report on Corporate Governance in China. The largest shareholder is in general an SOE. At the end of 2002, 41% of listed firms had as their largest shareholder almost always a legal entity (i.e. an SOE), holding more than 50% of their equity, and another third where the dominant shareholder controlled between 30% and 50% of the equity.

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\(^8\) The Fundamental Code on the Modern Corporate System Establishment and Management of State-Owned Large and Medium Enterprises, 27 October 2000. This former Code includes a strong commitment to grant SOEs with autonomy and provide recommendations regarding board independence.

\(^9\) The two Chinese stock exchanges, having been formerly created in 1990 and 1991, have market capitalization rising that rose to 57% of GDP in 2000. If only tradable shares are taken into consideration, the market remains however relatively small, under 17% of GDP, by the end of 2003.

\(^10\) 95% of the 1300 listed firms at the end of 2003 are former SOEs and remain largely controlled by the State. The non-state sector has been *de facto* almost excluded.
22. The evidence regarding the performance of listed firms is mixed (Wang, Xu and Zhu, 2004), as an effective regulatory framework has been slow to develop. The oversight previously exercised by line ministries has declined with listing, as new oversight bodies such as the CSRC have been slow in establishing an effective regulatory framework. Moreover, the divergence of interest between local and central governments has also been marked, and effective enforcement underdeveloped.

23. The market has been extremely narrow, dominated by small retail shareholders and short term speculative trading, with valuations considered as grossly inflated. There have been many instances of malpractice and abuse in IPOs, combined with poor disclosure and transparency standards that have led to markets being perceived as sometimes even “worse than a casino” (Greene, 2004). These problems of the Chinese stock markets have been characterised as resulting from “ownership without constraint”, and has resulted in huge losses for individual shareholders in recent years. The most widespread abuse is asset stripping by controlling “legal entity” shareholders at the expense of the firm itself and its minority shareholders through abusive related party transactions among firms of the same group, intra-group lending or guarantees, and excessive cash dividends. Indeed, the parent company will typically transfer productive assets to its listed subsidiary, retaining liabilities and redundant staff, and remaining an SOE (Green, 2004). This makes it almost inevitable that, lacking a proper fiscal system to socialise such burdens, the parent company will exploit the subsidiary to meet its commitments.

Proposed measures to improve the situation

24. Under the circumstances it is hardly surprising that the China Corporate Governance Report 2003 identified a number of issues concerned primarily with limiting abuse by controlling shareholders and with improving minority rights including controversial proposals to ensure their representation on the board (see Box 2). Another main corporate governance problem underlined by the report is the poor quality of information disclosure which is regarded as emphasising form over substance. This is due to the lack of proper internal control systems and lack of effective legal sanctions for bad disclosure.

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11 Firstly, the listed firms were all from the most problematic economic sector in terms of profitability (the state owned sector), even though the one selected to be listed were the best in their class. Some argue that listed firms compare favourably both to unlisted Chinese firms and to their foreign peers (Daochi, 2003). But more convincing and opposite evidence shows that the performance of listed firms, in terms of profitability, efficiency and sales, has declined after listing. De facto ROEs and EPS all declined in the 1990’s, except for utilities, transport and finance sectors.

12 Malpractice has frequently occurred in the presentation of the accounts in the underwriting process. Underwriters, established by SOEs or by government organs have disguised the firms’ accounts with the assistance of local officials in order for the firm to meet the CSRC requirements and thus to get listed (Greene, 2003).

13 Parts of the report have been discussed during the “Policy Dialogue on Corporate Governance in China” hosted by the Shanghai Stock Exchange and the OECD in February 2004, in co-operation with the ERI / Development Research Center (DRC). The proceedings of this meeting are available at the OECD website, http://www.oecd.org/document/32/0,2340,en_2649_34795_31173536_1_1_1_1,00.html
Box 2. Summary of the Shanghai Stock Exchange proposals to reform corporate governance of listed companies

- Reduce conditions restricting the exercise of minority shareholders’ rights
- Introduce a system of compulsory cumulative voting
- Representatives nominated by holders of tradable shares to serve on board of directors
- Independent directors to be banned from concurrently holding a position of independent director at more than two listed companies
- Non-executive directors to make up more than half the number of board members
- Strengthen the board of directors’ function of collective decision-making
- Restrict the chairman of the board from also being the managing director
- Introduce audit, remuneration and nomination committees within the board
- Tighten the obligation of controlling shareholders, directors and the senior managers to act in good faith
- Introduce a system of liability insurance for directors
- Set up a national self-regulating organisation of company directors
- Introduce sound share-ownership incentive schemes for senior managers
- Disclose remuneration packages of both directors and senior managers
- Encourage newly listed companies to adopt the full listing model
- Introduce sound procedures for company take-overs, bankruptcy protection and liquidation mechanisms
- Promote the introduction of corporate governance rating systems

Recent initiatives to improve corporate governance

25. The Company Law together with the Securities Law, the Securities Investment Fund Law and the Labour Law forms the legislative basis for corporate governance of listed companies in China. According to the CSRC, the objective of the legal framework is to protect the interests of the investors based on the principles of “transparency, fairness, and justice“. Legislation is supplemented by other regulations, administrative rules, listing requirements, departmental rules, guidelines, and codes. The framework includes the CSRC and SETC Code of Corporate Governance for Listed Companies, CRSC Guidelines for the Introduction of Independent Directors to the Board of Directors of Listed Companies, CSRC Guide to Articles of Association of Listed Companies, and the CSRC Standardisation of Shareholders Meetings. For an extensive summary of the legal framework describing the different types of shares and their respective characteristics we refer to the 2002 OECD publication "China in the World Economy, the Domestic Policy Challenges" (pages 431-453).

26. Since its implementation in 1993, the Company Law has not been amended substantially. Reflecting concerns at the time, the Law was written with the specific circumstances of the state sector in mind.
mind rather than as an enabling framework for the private sector. An update is clearly necessary including serious reconsideration of the role of the supervisory board which has proved generally superfluous, apart from allowing employee representation. The authorities are now considering necessary amendments to the Company Law in order to, amongst others, introduce a more appropriate framework for proper corporate governance (see Box 3).

**Box 3. Corporate governance topics being considered in the pending Company Law reform**

- Improving corporate governance by clearly describing the duties of the different corporate bodies and stakeholders
- Securing self-determination rights for companies, amongst other things in drafting their constituent documents (articles of association and shareholders agreement)
- Strengthening shareholder rights with respect to information, dividends and derivative suits and/or class actions
- Clearly defining the role of independent and non-executive directors
- Strengthening the position of the external auditor and adjusting company accounting
- Strengthening exit possibilities, e.g. liquidation liability in case of dissolution or bankruptcy
- Defining the role of public servants in their capacity as board directors or supervisory board members of listed companies in representing the state

27. With respect to the regulatory framework, the CSRC has recently published draft rules on transferring more power to minority shareholders. In particular, the draft rules propose that listed companies will need prior approval from a majority of independent directors for any related-party transactions. In addition it is proposed that only investors owning traded shares\(^\text{15}\) will have voting rights on both (i) new share issues, and (ii) major strategic decisions. This would result in an expropriation of state shareholder rights, but at the end of the day may strengthen weak market incentives favouring improved corporate governance.

28. The abovementioned proposals for legislation and regulation have at least one thing in common: they all focus on the internal governance of the listed companies: the interaction between the different corporate bodies such as the shareholders meeting, the board of directors, the supervisory board and the employees. However, in order to make the proposed measures work, they need to be properly implemented, and enforced.

29. Experience in other transition economies indicates that the method of privatisation and the associated regulatory environment is crucial if corporate governance is to be improved. One method being

\(^{15}\) SOEs which have been “corporatized” issued three types of shares: one third are legal persons shares (faren gu) owned by other SOEs having contributed to the capital before the IPO, typically the parent companies. These can not be traded on the exchange but can be exchanged among legal persons. Another third are state shares (guojia gu), non listed and non tradable, their transfer being subjected to multiple approvals. Thus, only one third (geren gu) is publicly issued and freely tradable by individual and institutions. These are in turn divided into three types, A, B, and H/N shares. A and B shares are respectively hold by mainland private individual and institutions, or by foreign individual and institutions and domestic individual in China. H and N shares are listed abroad, in Hong-Kong and New-York.
pursued in China is negotiated sales, which are being pursued slowly but surely. Not all these sales result in a change in control to the benefit of private owners, but an increasing number do so. By the end of 2003, 250 listed firms were controlled by private shareholders. Many of these sales may be motivated by the strengthening of regulation and enforcement by the CSRC. Controlling legal person shareholders (i.e. SOE) are increasingly limited in their ability to strip assets from the listed firms, and consequently may prefer exit and raise cash. Since private firms are still largely excluded from the IPO market, such purchases of listed firms gives them access to financing on the secondary market.

30. There is, however, a downside to such developments. A number of these deals may also be aimed at manipulating market prices, as has been evidenced in a few cases in 2003. Indeed, most transactions are one-to-one deals, without a transparent or competitive bidding process. However, here again the CSRC has reinforced its oversight of takeovers but a new global framework or regulation should be developed and make mandatory that sales of non-tradable shares are done in open and transparent auctions. The first necessary step towards a constructive role for private shareholders is indeed to enable control to be held in the market by legal rules and/or private ordering mechanisms that protect shareholders from stealth acquisitions of control (Coffee 2000).

31. A recently announced strategy aims at allowing listed blue-chip companies to begin selling their state shares on the basis of negotiated agreements with existing shareholders. A variety of methods are being developed or tested including selling, writing-off or giving away state shares. As any transfers of state shares would have a large impact on share prices and on the ownership structure of listed enterprises, this program will most probably take time to evolve and is likely to be implemented only progressively.

32. Institutional investors are becoming apparent and closed and open-ended funds are rapidly expanding, and are expected to double their investment in the stock market in 2004, to reach 15 to 20% of market capitalization. The CSRC is actively encouraging this trend, both by licensing new funds, and by working with other relevant regulators to encourage insurance companies and pension funds to invest in stocks. The recently introduced Qualified Foreign Institutional Investor (QFII) scheme is a “partial and measured opening of the market”, allowing foreign institutional investors who meet certain criteria to apply for approval to the CSRC in order to invest directly in a wider range of securities. A number of challenges and complex legal and regulatory issues are ahead, but this scheme is expected to contribute to improving the situation with regard to ownership diversification (Yeo, 2003).

**The key issue of enforcement**

33. Although the basic legal framework has been established over the past decade, it does not by itself secure proper enforcement. In general, enforcement in corporate governance matters can be pursued in three ways: administrative, civil or criminal enforcement. For administrative enforcement to function well, responsibilities should be distributed functionally and transparently among the relevant players, including in any event the stock exchanges and the regulator (i.e. the CSRC). Given the predominance of the state in each of these institutions, a number of difficulties will need to be resolved.

34. For civil and criminal enforcement a solid and independent judiciary is needed. The challenge will be to diminish and even prevent or abolish state (or local) government interference. In addition, training of the judiciary on corporate governance issues should be considered. Specialised company courts

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16 For example by limiting the number of times large blocs of legal persons shares may be traded, or by fixing a minimum price floor at the Net Asset Value. However, this latter measure may have negative consequences, by blocking the sale of non-performing assets and by making it easier for local officials to strike deals just above the minimum, but still well below the real market value.
have been used in other jurisdictions to tackle the lack of in-depth knowledge of corporate governance matters by attributing company law disputes to the competence of specialised judges and prosecutors.

35. For civil enforcement, shareholder activism is the obvious tool to be used by investors to improve corporate governance practices. However, in China this seems to be not yet the most appropriate and effective path for corporate governance improvement given that the state still owns more than two thirds of the shares of all listed companies. Some empirical research on securities markets laws suggest that the impact of private sector led mechanisms to enforce minority shareholders rights and disclosure is greater than the use of public (i.e. administrative and criminal) enforcement mechanisms (Berglof and Claessens, 2004). Having said that, at this stage of development of its capital markets it appears that China cannot afford to rely solely on private sector led enforcement mechanisms for corporate governance. Public enforcement of corporate governance remains for the time being crucial and will need the further development of administrative enforcement via regulatory bodies such as the CSRC.

**Clearly defining the role of the regulatory bodies**

36. As a starting point for effective enforcement, the national and local authorities need to commit themselves to adhering to the rule of law, including the regulations set by the regulatory agencies. Regulatory and judicial capacity will also need to be expanded (Berglof and Claessens, 2004). However, perhaps of even greater importance, the accountability of regulatory agencies and the division of responsibilities between them needs to be clearly identified.

37. The division of responsibilities between the SASAC and the CSRC is of particular importance. For example, if one of the 186 SOEs currently under the control of the SASAC will apply for an IPO on one of China’s stock exchanges, it will have to comply with the CSRC’s rulings. In such cases both state agencies might have strong incentives to defend their respective positions which might not be necessarily aligned. It might be the case, for example, that the SOE concerned would tend to overstate disclosed revenues to attract more investors. In the end both the SASAC and the CSRC report to the same ultimate beneficiary, the state, but this does not make them necessarily accountable. The accountability of the CSRC, rather than just their reporting lines, needs to be clearly defined. The mere fact of being publicly accountable increases transparency and improves the incentives for rational decision making and policy development.

38. In addition, enhancing the enforcement functions of the CSRC should also be addressed including broadening the range of incentives and sanctions currently available to meet policy objectives. For example, the Securities Commission in Malaysia has established a system including incentives such as protection for whistle blowing, a green lane scheme (which means faster approval for corporate proposals and less stringent conditions of approvals for companies with good records of corporate governance), and recognition of good corporate governance through annual awards. Sanctions include enforcement actions against those who breach securities laws and listing requirements as well as a “merit / demerit” scheme, which means that the Securities Commission will investigate listed companies with poor governance practices. Such investigations may result in slower approvals for corporate proposals. In some jurisdictions, a black list is published listing the worst performers and has proved very effective.

39. Finally, a transparent division of responsibilities between the CSRC, the stock exchanges and other self-regulating organisations needs to be implemented. Such clear delineation of responsibilities may benefit both the efficiency and the effectiveness of administrative enforcement. In other jurisdictions the securities market regulator (i.e. CSRC equivalent) is often positioned as the enforcement agency with powers to investigate and take administrative actions. The role of the stock exchange is to enforce compliance with the listing rules and any corporate governance code. The enforcement power is embedded in its right to suspend, or even de-list companies, to issue formal warnings and to impose fines. The role of
Policy options: legislation, regulation or self regulation?

40. What to include in legislation and what to include in other regulation or even in market-based corporate governance codes is an important decision for policy makers in their efforts to ensure good corporate governance (Hopt 2004). Chinese policy makers are confronted with similar difficulties as in other jurisdictions, although the initial conditions they face are quite different.

41. China may need to consider several ways of addressing corporate governance challenges relating to the internal functioning of listed companies. Currently, a two way approach is being pursued with substantial amendments of the Company Law on the political agenda for 2005, while the CSRC just issued last September its proposal to grant minority shareholders more substantive rights. However, it may add even more substance to the debate on corporate governance in China if policy makers would communicate explicitly what approach will be followed as well as the rationale behind it. This would enhance the transparency of the legislative and / or regulatory drafting process. This in turn may be beneficial to the investors, who can then more clearly assess the policy approach and include that in their respective investment decisions.

42. Although it has been argued that sound self-regulation by securities exchanges and professional associations in transitional economies can close much of the gap between “advanced” Western markets and those of transitional economies (Coffee, 2000), it seems that there remains an important role to be played for the legislator in this context. In particular, regarding the need for a transparent division of responsibilities among the CSRC, the stock exchanges and other self regulating organisations, effective legislation, rather than self (or market) regulation, seems to be the natural option at this particular stage of the transition.

Concluding remarks

43. China has introduced laws, regulations and codes for better corporate governance that are comparable with those in some developed countries. It has also implemented major steps in reforming the management of its state-owned enterprises with the creation of a central agency, the SASAC. Furthermore, there have been initiatives by the regulators to enhance the enforcement of those laws and regulations, for example, through special comprehensive inspections in 2002. But the fact remains that the state is the dominant player and thereby has to undertake several functions at once, each associated with strains, tensions and the possibility for conflicting decisions.

44. Several major challenges need to be addressed in a timely manner. First, regarding the management of state-owned assets, China should further reduce state ownership while at the same time clearing the way for informed and effective private owners. The newly-created SASAC needs to clarify its role and function, and to implement significant measures to “fulfil the functional responsibilities of the capital investor” in an effective way, without interfering in the day-to-day management of SOEs. To this end, the SASAC might give priority to creating and enhancing the role of SOE boards and encourage them to improve the recruitment and evaluation of managers. It should also strive to control the behaviour of the state as a controlling shareholder and reduce the abuse of minority shareholders. Finally, the legal and regulatory framework for state asset supervision requires further improvement regarding its scope, completeness and consistency.

45. Second, as far as the corporate governance of listed companies is concerned, the key challenge for China lies in implementation and enforcement, as is often the case with many emerging market
economies and developed countries. Good corporate governance requires not only proper laws and regulations but even more their effective enforcement. Company law is in need of reform but more effective sanctions and incentive mechanisms also need to be developed. A clear and transparent division of tasks among state regulatory bodies, stock exchange and SROs is needed. Their independence and capacity should also be strengthened, and they should be granted sufficient financial and human resources as well as legal authority. However, while strengthening the enforcement capacities of regulators, it is also important to enhance in parallel their accountability.

46. Another challenge for implementing effective corporate governance will be to prevent box ticking exercises and “form over substance” behaviour. Although both specific and detailed legislation on corporate governance and more flexible, principle based, codes might well lead to same outcome in the end, this may not be the case for China. This is due to its unique shareholding basis in listed companies, its relatively short history in dealing with corporate governance matters, and above all the encompassing role of the state as (often) the ultimate decision maker and also beneficiary in all relevant aspects involved in the corporate governance debate.

47. China is at a critical point in transforming its economy, with old methods of corporate control showing signs of stress while new systems are not yet effective. In such a situation, the potential for distortions is great. It is thus extremely important to move quickly and resolutely to establish a new system, something which the authorities understand well and which needs support from the international community.
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