Comparative Corporate Governance: The Case of Chinese Publicly Listed Companies

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Outline

- Comparative analysis of corporate governance models of the US, Europe, East Asia, and transitional economies
- Chinese model of corporate governance
- Corporate governance reform in the publicly listed companies in China
- Assessment and agenda

What is Corporate Governance

- Corporate Governance is a system of ownership and control in a corporation. It governs the relationship between the shareholders, the directors, and the management in a corporation
- Corporate governance becomes an issue when there is a separation between ownership and control, the divergence of interests between the shareholders and those of the management. The core of corporate governance is the so-called "principal-agent" problem the "agency" costs associated with it

Models of Corporate Governance

- Different models of corporate governance evolved from different legal system and cultural environment
- Anglo-Saxon Model: Common law system
- Continental European model: Continental law system
- Japanese model
- East Asian Model
- Corporate Governance of Transitional Economies

The US Model

- Based on common law system
- Priority is to maximize shareholder value and and protect shareholder rights and interests
- Core issue of corporate governance under the US model: dispersed shareholding structure, "free-rider" problem leading to weak monitoring of the management by shareholders and "insider-control". 70% of US corporations are publicly-owned
- Reply on "outsider" supervision and monitoring

Core elements of the US model

- Independent board: majority of independent directors on board; independent directors chairs the nomination, remuneration, and audit committees under the board
- Strong role of institutional investors
- Important role of intermediaries, such as external auditing and accounting institution
- Strong securities regulation and severe punishment for wrong-doing, leading to high costs for violations of securities laws and regulations

Core of elements of the US model (Cont'd)

- Legal institution aiming at protecting shareholders, such as class-action and derivative suits
- Active market for corporate control, strong pressure on management from the market for good performance and increase in shareholder value
- Incentive and compensation system linking long term company performance with the performance of the management, extensive use of stock options and other stock-based compensation scheme

German (Continental Europe) Model

- Concentrated shareholding structure, 54% of European companies have controlling shareholders, most of them are families. 2/3 of family-controlled companies appointed their relatives to the management (Lang, 2002)
- Dual board system, a supervisory board and board of directors; "Insider-control" model, both boards are controlled by the employees, the banks, and the management
- Stake-holder oriented model: strong role of employees and banks, with representative of workers consisting 1/3 to ½ of the supervisory board, and bank representatives accounting for another 1/5,who often chair the supervisory board

Japanese Model

- A unitary board system, but it is also a “insider-control” model: the management plays a leading role
- Cross-shareholding among corporations, and strong bank role on corporate governance: “main bank” system, close relationship between the banks and the corporations
- Stable employer-employee relationship, loyalty of employees to the corporation

East Asian Model

- A main characteristic of corporate governance in this region is the family-controlled, concentrated shareholding structure and a close link between the banks and corporations
- A survey of 2980 corporations in the 9 countries in this region shows that 2/3 of firms are controlled by a controlling shareholder, and majority of them are families. 60% of these family-controlled firms whose top executives are from the families. In Indonesia and Philippines, one single family controls about 1/6 of total market capitalization (Lang, 2002)

East Asian Model (Cont'd))

- Pyramid corporate structure: family holding companies on the top, while the family-controlled listed companies on the bottom of the pyramid. In between are the subsidiaries of the family-holding companies
- Unfair related-party transactions between the family holding companies or their subsidiaries and the listed companies that they controlled. Good assets are often taken away from the listed companies to their mother companies, in exchange for bad assets or even liabilities

Corporate Governance in Transitional Economies

- Mass-privatization:still facing issues of corporate governance post-privatization and how to establish a modern governance system
- Gradual privatization: through ownership diversification and public offering to dilute state-ownership; increase management autonomy while making management accountable to the state as the owner of the assets
- SOE reforms have resulted in significant degree of insider-control as SOE managers have acquired considerable discretion over the use of state assets; "vacancy" of the state as a owner in SOEs

Global Convergence on Corporate Governance?

- In 1980s, the Japanese model of corporate governance was considered one of the best in the world due to a strong Japanese economy and exports
- However, the banking crisis and stagnation of the Japanese economy since early 1990s posed important challenges to the Japanese model
- In the 1990s, the booming of the US economy, especially the high-tech sector and venture capital, demonstrated the advantages of the US model
- The Enron and other corporate scandal, however, showed that US model has its own problems

Lessons from US Corporate Scandals: the Corporate Governance Failure

- Corporate Scandals: Enron, Global Crossing, WorldCom, Xerox…
- Largely due to corporate governance failure:
  - Dispersed shareholding structure, leading to weak control on the management by shareholders and insider-control by management
  - Lack of independent of the board and the directors; “independent directors” are not truly independent

Lessons from US Corporate Scandals: the Corporate Governance Failure

- Lack of independence of the audit committee under the board
- Lack of independence of the external audit; external audit firm often also provide consulting services to the same firm
- Related-party transactions to inflate profit figures
- Executives overpaid; extensive use of stock options without proper supervision; provide strong incentive for the management to inflate profit figures in order to raise the stock price

US Corporate Governance Reform Post-Enron

- Radical reform in corporate governance of listed companies: revising listing standards
  - Increasing the role and authority of independent directors; must comprise the majority of the board
  - Tighten the definition of "independent" director, must have no material relationship with the listed company
  - Must have audit, compensation, and nomination committees comprised of solely independent directors
  - Must adopt good corporate governance guidelines and code of business conducts
  - Shareholders given the opportunities to vote on equity-based compensation plans
  - Stock Exchanges be empowered to publicly reprimanding of listed companies

Corporate Governance Reform: Sarbanes-Oxley Act

- Require certification for the truthfulness and accuracy of financial reports by CEOs and CFOs
- Strengthen disclosure requirements, real-time current disclosure
- Audit committee becomes a legal requirement
- Severe criminal and civil penalties for securities crimes
- Strengthen supervision and regulation of accounting and auditing firms, establishing PCAOB

What is the best model of corporate governance

- Corporate governance models were formed from different legal and cultural environment
- Each model has its own characteristics, and might be the best model in a specific historical period and for a particular country/region
- The best model of corporate governance is the one that can quickly adopt to the changing environment; must "advance with time"
- China will need to to learn experiences and lessons in other countries, and at the same time pay attention to the Chinese peculiarities.

Evolution of Corporate Culture in China

- China has a relatively short history of corporate culture.

- 1978-84:

  -- reform of SOE's by giving enterprises more autonomy in management,

  -- more decision-making power, and

  -- ability to retain some profits;

Evolution of Corporate Culture in China (cont'd)

- 1984-87:
  -- SOE's started paying income tax rather than turning over profits to the State,
  -- there was still little distinction between the functions of government and those of the enterprises;

Evolution of Corporate Culture in China (cont'd)

- 1987-92:

  -- gradual separation of ownership and management in SOE's when contract system was used (where SOE's were contracted by the State to manufacture or provide services in return for fees),

  -- SOE's were required to assume own responsibility for profits and losses;

Evolution of Corporate Culture in China (cont'd)

- 1993 – present:
  -- company Law provides a legal framework for the structure of modern enterprises;
  -- creation of capital markets allowed SOE's to become listed companies;
  --rapid growth of the non-state sector, including private enterprises and foreign invested enterprises

Chinese model of corporate governance

- Chinese legal system: a Continental Law tradition
- Dual boards: Supervisory board (consists of employees and representatives of shareholders) and board of directors; similar to that of Germany
- High level of ownership concentration the largest shareholder, which is usually the state, holds about 53% total shares in average in a listed company. The second largest shareholder holds about another 10%.
- The state owns about 59% all the shares in the stock market. 75% of listed companies whose controlling shareholders are with the state or state controlled companies

Major Issues on Corporate Governance in Chinese Listed Companies

- With characteristics of a transitional economy as well as an emerging market economy
- State ownership has been fragmented and exercised by several Party and government ministries, such as Ministry of Finance, Party's Central Enterprise Working Committee, State Economic and Trade Commission, resulting in "vacancy" of the state as an owner in publicly listed SOEs;
- Management or the parent company have acquired considerable discretion over the use of state assets; interests of state as a owner are usually not well represented and protected in listed SOEs

Major Issues on Corporate Governance in Chinese Listed Companies (Cont'd)

- Inability or reluctance to have separation of personnel, finance and assets between the listed companies and their controlling shareholders
- Lack of fiduciary duty of the controlling shareholders, which are usually the parent companies. Conflict of interests between controlling shareholders and listed companies often leads to unfair related party transactions between parent company and the listed company, which is detrimental to minority shareholders

Major Issues on Corporate Governance in Chinese Listed Companies (Cont'd)

- Insider-controlled board. Before 2001, the boards of directors consisted of mainly representatives of controlling shareholders and the management, few independent directors
- Lack of market for professional managers. The chairman of the board of directors and top executives of state-controlled listed companies are still mostly chosen by the local and central governments
- Lack of proper long-term incentives for managers. Only 5% of listed companies have established some sort of stock-based compensation scheme for the management

Corporate Scandals highlight the Importance of Corporate Governance Reform in China

- In the year 2001, the exposure of several major Enron-type corporate scandals highlights the emergency of corporate governance reform in China
- Companies involved were “blue-chips” and their stock prices performed extremely well before they collapsed. It turns out that profit figures were highly inflated or even made up by the directors and management to support the high stock prices

Corporate Governance Reform in Chinese Listed Companies

- Independent directors on board
- Code of Corporate Governance
- Fiduciary duties of the controlling shareholder and independence of listed companies from their parent company
- Fiduciary duties of directors
- Information disclosure
- Role of institutional investors, including qualified foreign institutional investors scheme (QFII)
- Take-over Code and market for corporate control
- Legal reform protecting shareholder rights through lawsuits
- Accounting reform and supervision of auditors

Independent Directors

- Overhaul the insider-controlled board structure by promulgating a regulation requiring each listed company to have at least **one-third of the board to be independent** directors by June 2003. The regulation was issued in August 2001
- By June 30, 2002, 2,414 independent directors had been elected and appointed by shareholder meetings of the 1,187 listed companies in China. 70% of companies have at least one accounting professional to be independent director

Independent Directors (Cont'd)

- Half of independent directors are from academic and research institutions; another 30% from intermediaries such as accounting and legal firms, and investment banks; the remaining are from other sources including the executives of other firms; professional of foreign nationals are allowed and encouraged to become independent directors of listed companies
- Independent directors now account for about 20% of all the directors in listed companies; outside directors account for about 60% of all the directors of the boards of directors

Independent Directors (Cont'd)

- CSRC's regulations require that independent directors must spend enough time on the companies they hold directorship; one person can not hold more than 5 directorship positions concurrently; they must perform the duty of due diligence and can not just act as "flower bottles"
- Recent survey shows independent directors on average spend about 20 days in a company they hold directorship

Definition of “Independence”

- We define “independence” as independent from
  - Controlling shareholder
  - Management
  - Major business relations
- The independence qualifications of the candidates for independent directors need to be checked and approved by CSRC first before they can be voted in shareholder meetings
- Candidates for independent directors have to make a public declaration on their independence qualifications and their information need to be publicized on newspapers
- Can not work for more than 6 years in a company

The Roles and Responsibilities of Independent Directors

- Protect shareholder rights and the interests of the company, paying particular attention to minority shareholders
- Major related party transactions have to be approved by independent directors
- Serve as chairs of the auditing, compensation, and nomination committees. Independent directors must consist of a majority of these committees

Code of Corporate Governance for Listed Companies in China

- Developed and enforced the first Code of Corporate Governance for Chinese Listed Companies in January 2002. The Code is mandatory for all listed companies to follows and will be melt into listing rules of the two stock exchanges
- The Code stipulates the rights and responsibilities of shareholders, directors, the management, stakeholders, and information disclosure. Available in English at our website: *http://www.csrc.gov.cn*

Fiduciary duties of controlling shareholder

- Chapter II of the Code of Corporate Governance deals with the duties of the controlling shareholders and their relationship with the listed companies
- The Code also specifies that the controlling shareholders have to perform fiduciary duties to the company and other shareholders
- Listed companies must be totally spin-off from their parent companies, and must be independent in management, personnel, assets, production, and sales

Fiduciary duties of directors

- The Code specifies for the first time as a legal documents that directors of listed companies must perform fiduciary duty and duty of care
- Public reprimanding of director and severe punishment for directors violating laws and regulations, and those not performing their fiduciary duties
- The chairmen of listed companies in about 10 out of 30 provinces signed various kinds Treaties of Honesty and Fiduciary Duties and sworn in public to guarantee the truthfulness of their disclosure

Cumulative and Electronic Voting

- Use of cumulative voting method is encouraged in election of directors; the Code of Corporate Governance specifies that a company with a controlling shareholder who holds more than 30% of all shares must use cumulative voting methods in elections of directors
- Long distance voting methods such as electronic voting, is encouraged in the Code, to facilitate more investors to participate in voting

Information Disclosure

- Information disclosure is a ongoing and continuing responsibility of all the listed companies
- All the shareholders have the equal right to receive the correct, timely, and complete information; disclosure through the internet
- Regular disclosure through audited annual report, mid-year report and unaudited quarterly report
- Require disclosure of corporate governance practices in the annual report
- Disclosure of information about the controlling shareholder or the actual controller of the company

Role of Institutional Investors

- Expanding the institutional investors base: developing close-end and open-end funds. The securities fund industry started in 1998. There are currently 17 fund management firms, managing over RMB108 billion of client funds.
- Opening stock market for insurance funds and social security funds. Insurance companies are now allowed to invest up to 15% of their total investment in the stock market
- Proxy voting is encouraged in the Code of Corporate Governance

QFII Scheme

- Opening stock market for foreign institutional investors: qualified foreign institutional investors (QFII) scheme
- Qualified foreign institutional investors with good record and certain size, including fund management firms, insurance companies, securities houses, and commercial banks are allowed to enter into Chinese stock market and buy and sell A shares

Market for Corporate Control

- Take-Over Code for Chinese listed companies was promulgated and became effective on December 1, 2002
- Opening up stock market listed SOEs for foreign M&A, and taken-over by private sector
- One-third of listed companies have had changes in the controlling shareholder after IPO, most of them end up with change of management
- Active market for corporate control should foster better corporate governance

Legal and Accounting Reform

- Lawsuit against directors and management: the Supreme Court issued an Ordinance last year on the the procedures for shareholders suing directors and management in case of losses due to false disclosure by the company. The Courts have started to accepted cases
- Vigorous revised Chinese accounting standards according to IAS
- Strengthened supervision on auditors. Revoked the license for securities business of the largest auditing firm in China because of its involvement in the scandal. The firm was dismantled in the end

Stronger Enforcement

- Regular on-site inspection on the listed companies on the issues of accounting, disclosure, related party transactions, etc. Last year about 300 firms went through regular inspection
- This year special inspection on the compliance of the Code of Corporate Governance; the first stage, self-assessment by all the firms, have been successfully completed; the second stage, on-site inspection of about 200 firms, is about to completed.
- Stronger sanctions against violations on laws and regulations, including public criticism. Stock exchanges were empowered for public reprimands of listed companies for violations of their listing rules
- Joint Bureau of Investigation for Securities Crime between CSRC and Ministry of Public Security

Training of Directors and Investors Education

- Monthly training classes for independent directors candidates in Shanghai and Beijing. Trained about 5,000 candidates during the last 10 months
- Monthly training courses for directors already on board by the two stock exchanges, to train all the directors in three years
- Investors's education session on major cities and through the media, including the internet

Assessment

- CSRC attached great importance on corporate governance reform of listed companies even before the Enron case was discovered
- New policies and regulations have been promulgated; regulatory rules and disclosure standards are in many respects in line with international standards and practices
- But enforcement of these rules and standards need to be further strengthened. It requires the cooperation of other law enforcement agencies besides CSRC, and the participation of civil society including the media and NGOs, NPOs, etc

Looking Ahead

- Messages from the 16th Party Congress:
  - Recognize the private sector as an important part of the Chinese economy; private enterpreneurs will be respected
  - Protection of private property rights first appear in Party's document, is supposed to be written into the Constitution
  - A single agency, the State Asset Management Commission will be established to represent the state as the owner of state assets

Implications

- More private and other non-state firms will be listed in the stock market
- More mergers, acquisitions, and takeovers of state-controlled listed companies by the private and foreign sector
- The state as a owner whose rights and interests will be better protected under the single state asset management agency

Capital Market: Potential to grow

- GDP grew at 8% in the year 2002. GDP exceeded 10 trillion Yuan
- Market Cap accounts for 50% of GDP, still much room to grow
- Only 5% of the population owns stocks
- High savings rate, 40%
- WTO provides more opportunities; joint venture funds and securities firms are allowed to established

Things to think about

- Is China moving toward a shareholder-oriented model corporate governance, or stake-holder oriented one, or a combination of both
- Continuing with the dual board structure, or moving toward the unitary board
- What to do with the labor, and the banks

The changing role of labor

- Pre-corporatisation: employees are considered the "masters" of SOEs
- Change of concept after corporatization: firms are owned by shareholders, and employees are only employees, no longer "masters"
- Significant lay-off in the corporatized SOEs: Listed companies have laid off about 9% of their labor force since IPO. Still have about 7% of redundant employees
- Protection of labor rights for the sake of social stability?

Thank You!!