

Capital Market Reform in China: The Role of Corporate Governance

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Evolution of Capital Market Development in China

- Capital Market has a short history in China: the Shanghai and Shenzhen Stock Exchanges were established in 1990, marked the beginning of the securities market of China
- The China Securities Regulatory Commission was established in 1992
- But the growth of our capital market in the last 12 years has been very impressive by any standard

A Dynamic and Growing Market

- The total market capitalization at the end of September 2002 was RMB4.4 trillion, accounting about half of GDP. China is now the third largest market in Asia after Tokyo and Hong Kong
- From only about a dozen listed companies in 1990, there are over 1,200 listed companies by the end of year 2002
- From 1991 to the end of September 2002, total funds raised by Chinese companies through public offering reached RMB 854 billion
- There are now 124 securities firms, with over 100,000 practitioners, and almost 68 million investor accounts.

Capital Market Development: the Role of Corporate Governance

- But despite these impressive statistics, one often hears that China's stock markets are fraught with problems
- While the US was plagued by corporate scandals of Enron and others last year, China had experienced its own version of "Enron" a year before. In July 2001, a blue-chip high-tech company called "Yin Guang Xia" was found to have forged customs receipts and made up profit figures in order to support its extremely high and rising stock price.

Corporate Scandals highlight the Importance of Corporate Governance Reform in China

- Since then, a few other blue chip companies were also found to have falsified accounts and disclosed misleading financial information.
- The exposure of these scandals, among other things, greatly damaged investor confidence and caused the market to take a nose-dive: our index lost almost 40% in the last 18 month (from the highest of 2,200 to about 1400 currently).
- Investors confidence relies on good corporate governance

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 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 14

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 follow and will be merged 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

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

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

Improving the quality of listed companies: listing and delisting

- Listing: moved toward merit-based system, no longer discriminate against non-state enterprises
- CSRC also has instituted delisting procedures for companies which have incurred losses in three consecutive years, as mandated by our Company Law
- So far 10 companies have been delisted from our main board and moved to an over-the-counter share transfer system commonly known as the Third Board
- It is anticipated in the future there will be orderly delisting of companies every year. This will further improve the overall quality of our market.

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 entrepreneurs 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: Great 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, 38% of GDP
- WTO provides more opportunities; joint venture funds and securities firms are allowed to established

Thank You!!