



International Corporate Governance Network
2006 YEARBOOK

Recent Corporate Governance Policy Reform in China – An Update

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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 State-Owned Assets Supervision and Administration Commission of the State Council (SASAC), and more recently with the reform of the share structure. Furthermore, there have been initiatives by the regulators to enhance the enforcement of those laws and regulations. But the fact remains that, in spite of the on-going share structure reform, 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. 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. To further improve implementation and enforcement, a clear and transparent division of tasks among state regulatory bodies, stock exchanges and self-regulating organisations is needed. Another challenge for implementing effective corporate governance will be to prevent box-ticking exercises and “form over substance” behaviour.

The fact remains that, in spite of the on-going share structure reform, the state is the dominant player.

Reforming the Share Structure

It should be noted that a fundamental reform was initiated by the Chinese policymakers in 2005, the reform of the share structure. The predominance of non-tradable shares had become a serious institutional barrier for further developing capital markets. Therefore, the China Securities Regulatory Commission (CSRC) issued a Circular on the Pilot Reform of Share Tradability of Listed Companies on 29 April 2005, which allows converting former non-tradable state shares, making them fungible with the existing A shares and allowing their floating on domestic exchanges, based on a negotiated agreement between management and existing shareholders. The conversion plan needs approval of both the general shareholder meeting and the floating shareholders. Companies are also supposed to compensate

existing shareholders for any loss and the regulation sets the limits for the proportion of shares that can be floated in the following three years. This structural reform process is advancing, with about 400 companies having already announced share conversion plans.

Effective Implementation and Enforcement of Corporate Governance Laws and Regulations

Major steps have been made on the legal and regulatory side with in-depth amendments of the Company and Securities Laws finally approved in October 2005 and effective since January 2006. These changes have addressed a series of corporate governance challenges and reinforced significantly the rights of minority shareholders (see Boxes 1 and 2).

However, the extent to which these new rights will be enforced remains to be seen. The key challenge for China lies in implementation and enforcement, as is often the case with many emerging market economies and developed countries. Recent measures have been taken to strengthen enforcement, including the establishment, by the Chinese Ministry of Public Security, of a Bureau for Investigation of Securities Crime on the premises of CSRC in order to facilitate the handling of criminal cases in securities crime. In 2004, CSRC also started to reform its supervisory regime of listed companies. A geographically-based listed company supervision responsibility system was established, clearly defining the division of labor and responsibilities among the CSRC, its regional offices and the stock exchanges. While consolidating regulatory resources, it aims to increase regulatory efficiency and power. Furthermore, the new Securities Law and Company Law each provide for civil and administrative enforcement tools. The CSRC has also the power to freeze corporate or individual capital, securities and bank accounts in cases of suspected illegal activity.

Another ongoing development in Chinese corporate governance is the increasing role of institutional investors in enforcement. With the establishment of SASAC in 2003 the state has embarked on a programme to strengthen its shareholder function and actively pursue its institutional investor's role in some of the largest listed companies. Moreover, the CSRC issued the *Statement on Institutional Shareholder Responsibilities* in February 2004; this will have particular implications for SASAC in its position of institutional shareholder in listed SOEs. The CSRC also

recently introduced the Qualified Foreign Institutional Investor scheme, which provides for opening the market for foreign direct institutional investments in a wider range of securities, and will soon increase the cap on quotas allocated under this scheme from \$4 billion to \$10 billion. Foreign investment in A shares thus continues to increase significantly, which should contribute to induce more market discipline. However, this scheme is still very restrictive, and only around 40% of the quotas are invested in A shares. This explains why foreign investors still play a modest role in mainland capital markets. Finally, combined with the increased role of Chinese large companies in the global economy, both through trade and investment, the move to listing overseas may also contribute to increase the pressure by foreign investors and regulators on Chinese largest companies to improve their corporate governance.

The Role of the Boards of Directors

Regulators, and in particular the CSRC, have been active trying to upgrade the board structure of Chinese companies. The CSRC *Guidelines on Independent Directors* (August 2001) require that at least one-third of the board of each

listed company be independent by June 2003. Most companies comply with that requirement. Furthermore, the CSRC December 2004 *Provisions on Strengthening the Protection of Rights and Interests of Public Shareholders* propose to set up track records of all corporate directors, supervisory directors and senior officers of listed companies, and those who have failed to perform their duties of good faith may be recorded and even banned from serving as directors and/or officers of public companies. In addition, the Shanghai Stock Exchange issued a draft *Code of Conduct for Board Chairmen* in 2005 which aims, inter alia, to reinforce disclosure requirements and to strengthen the board's responsibilities. SASAC has also been active in enhancing supervision and control over SOEs' management and boards. It started establishing boards in large state owned enterprises and also started recruiting CEOs and senior management from abroad for these companies. Finally, the new Company Law and Securities Law reinforce boards' duties, increase their responsibilities and prevent board members from voting on resolutions if they have a conflict of interest (please refer to Box 1 and 2).

Box 1 | Summary of Corporate Governance-Related Changes in the 2006 Company Law

Protection of Non-controlling Shareholders' Rights

- Shareholders holding at least 3% of the company's shares may put forward proposals to the board of directors.
- Shareholders collectively holding 10% of the voting rights may request a general meeting.
- Under certain circumstances, shareholders may require the company to repurchase their shareholding when they oppose.
- Shareholders are strengthened, giving them the right to bring actions against directors, supervisors and/or senior managers for violation of any law or the company's articles of association.
- Also, shareholders holding at least 10% of the company's shares have the right to petition the People's Court to liquidate the company when the company's managerial problems threaten to damage shareholders' interests.
- Minority shareholders of limited liability companies now also have an exit right imposing a share buy back by the company under certain circumstances.

Introduction of Fiduciary Duties for Management

- Directors, supervisors and senior officers are now legally bound by (fiduciary) duties of loyalty and diligence to their companies.

Flexible Voting Mechanisms

- The articles of association of any limited liability company may now allocate voting rights between shareholders in proportions different from their respective contributions.
- In addition, shareholders may receive dividends and/or enjoy priority subscription for new equity in proportions different from their capital contribution ratios.
- Cumulative voting system at shareholders meetings for the appointment of directors is now permitted.
- Moreover, the appointment mechanism of the chairman and vice-chairman of the board of directors shall now be specified in the articles of association.

Tools for Shareholders to Exercise Supervision over the Company

- Shareholders now have the right to view and copy (i) the company's articles of association, (ii) financial reports and (iii) board meeting minutes.
- Shareholders of limited liability companies are also entitled to consult the company's accounting books.
- Within 60 days after a shareholders' or board of directors' resolution is made, a shareholder may petition the People's Court to revoke the resolution if it breaches the company's articles of association.

However, if the role of independent directors is increasing, they are often not really independent or competent. In addition, there is still some confusion and overlap between the role of independent directors within the boards, particularly within audit committees, and the specific functions of the Chinese boards of supervisors. These have not been abolished and even seem to have been strengthened by the new laws. The Chinese policymakers should clarify and rationalise the role of the board of supervisors. Moreover, another obstacle to good governance which has not been removed is the informal, but still significant, role of the Communist Party Committees in enterprises, particularly with regard to the appointment of boards and senior management. The relationship between the Party Committee and the boards has not been clarified. So, Chinese boards in general might need some more time to become really active and independent.

Moreover, although the introduction (or widening, since there was already some reference to the concept in the old legislation) of the concept of fiduciary duties for directors, board members and senior management in itself is a good development, it may create a challenge to Chinese courts on how to apply the concept. There will be a need for further guidance on this issue in order to make it predictable and workable. The concept of fiduciary duties has evolved organically in OECD countries, both in common law and civil law jurisdictions, in particular due to the role of the judiciary. The introduction of fiduciary duties in the Chinese context brings the implementation risks of legal transplant, i.e., how should it be applied in corporate governance related disputes.

Protecting Non-controlling Shareholders from Exploitation by Insiders and Controlling Shareholders

With the amended Company Law and Securities Law, minority shareholders' rights are strengthened. Moreover, to better protect the rights and interests of public investors, the CSRC in December 2004 also issued the *Provisions on Strengthening the Protection of Rights & Interests of Public Shareholders*, pursuant to which listed companies' major business decisions, such as rights issues and issuing additional new shares, and equity-for-debt plans, now need a majority vote from holders of tradable-shares present in the general shareholders meeting. Because of China's geographical location, it is often difficult for investors to attend shareholders' meetings in person therefore the Provisions require listed companies to provide online voting platforms for shareholders' meeting. Since the promulgation of the Provisions in December 2004, more than 20 listed companies have provided online voting platforms for their shareholders during their shareholders' meetings and the results so far are satisfactory. Furthermore, in 2003, the Chinese People's Supreme Court released an ordinance that

Box 2 | Summary of Corporate Governance-Related Changes in the 2006 Securities Law

Investor Protection

- An investor protection fund is to be set up; details are yet to be published.
- A civil compensation system is introduced which prescribes that a party found to be guilty of activities such as insider trading, market manipulation, fraud against a client and failure to execute orders in accordance with clients' instructions, will have to bear the loss suffered by an investor or a client.

Disclosure of Information

- Issuers, controlling shareholders, directors, officers and senior managers will be liable for misleading information and omissions in prospectuses, financial statements and periodic reports.
- Similarly sponsors and securities intermediaries will also be held jointly liable, unless they can prove their innocence.
- Directors, supervisors and senior managers of listed companies are to guarantee in writing the authenticity, accuracy and completeness of the information (periodically) disclosed by the company.

Enforcement Power

- The CSRC now has the power to freeze or seal corporate or individual capital, securities and bank accounts in cases of suspected illegal activity.
- The CSRC may further suspend the trading activity of persons suspected of stock manipulation or insider trading.

enables shareholders, who have suffered from investment losses as a result of false information disclosed by listed companies, to take legal actions against the directors and senior officers of the company and claim for civil compensation.

Finally, another major step in protecting minority shareholders will be the reform of the IPO system. The government could soon "reopen the IPO pipeline," frozen since August 2004 following many instances of malpractices and abuses. The new IPO system will include a more market oriented pricing mechanism, requiring consultation with potential institutional investors (at least 20 or 50 for large IPOs). ♦