Reforms of Non-tradable Shares Opening the Way for the Privatization of Major State-owned Enterprises

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The privatization process in China began with small and medium-size enterprises and extended to large state-owned enterprises after the policy of "strategic realignment of state-owned sectors of the economy" was adopted at the 15th National Congress of the Communist Party of China in 1997. Many small and medium-size state-owned companies have been privatized through such means as management buyouts, but privatization has been delayed in the case of large state-owned enterprises because even if they are listed, state-owned shares and corporate shares – which together comprise two-thirds of all their outstanding shares – cannot be floated on the market. Great progress in resolving this problem is expected thanks to ongoing stock market reforms, and this in turn will most likely accelerate the privatization of large state-owned enterprises.

When proceeding with privatization in a capitalist country, the method generally adopted is one in which the state-owned firm is turned into a corporation, after which its shares are listed and the state's shareholdings are gradually reduced. Typical examples of this in Japan are the listings of the Nippon Telegraph and Telephone Corp. (NTT) and the companies of the Japan Railways (JR) group. In China, it has been more than 10 years since stock markets were set up in Shanghai (1990) and Shenzhen (1991). However, the fact that most of the state-held shares of listed firms cannot be traded has proven to have many negative effects on the markets' development, such as the violation of the rights of the minority shareholders – those holding tradable shares – by the majority shareholders with state-owned shares and the ensuing stock market sluggishness. If left uncorrected, China's stock markets will not be able to sufficiently fulfill the role expected of them as the instrument through which privatization should proceed.

Against such a backdrop, Chinese authorities attempted on two occasions – in 1999 and in 2001 – to sell off state-owned shares. This prompted fears that the supply-demand relationship would deteriorate, however, and stock prices plunged, forcing the authorities to postpone the sales. Based on such lessons, "The Opinions of the State Council Concerning Promotion of the Reform and Opening and Stable Development of Capital Markets" were announced in February 2004. These opinions serve as the blueprint for future reforms of China's capital markets, stressing the importance of turning non-tradable shares into tradable ones while noting that holders of such shares should be obliged to pay a consideration to holders of negotiable shares.

In line with this policy, the government on April 29, 2005 released its "Notice Regarding the Issue of Experimenting with Reforms to the Split-share Structure of Listed Companies" and launched a new pilot project to sell state-owned shares. Unlike the previous two occasions, the experiment simultaneously takes into consideration the interests of both types of shareholders -- owners of negotiable shares and owners of non-negotiable shares -- by including such provisions as "the companies selected to take part in the experiment decide for themselves how they will sell their non-tradable shares" and "the proposed sale method must not only be approved by an extraordinary shareholders' meeting but also be supported by at least two-thirds of the voting rights held by holders of tradable shares that take part in the voting." In addition, out of consideration for the supply-demand relationship in the stock market, even if state-owned and corporate shares are converted into tradable shares, their actual floating on the market is banned for the first year and limited to no more than 5% of all outstanding shares for the second year.

The first round of the experiment began with four companies whose names were publicly announced on May 9, and 42 additional firms were included in the second round on June 19. On Aug. 19, the reform proposals of the last of these firms were approved at its extraordinary shareholders' meeting, and since overall stock prices remained stable, the experiment could be called a success. Based on this, guidelines for reforming non-tradable shares at all listed firms and a series of measures to realize this were successively announced between late August and early September. In line with these moves, another 40 companies unveiled proposals to reform their non-negotiable shares on Sept. 12, and since then on average about 20 firms have done so each week. This suggests that reforms of non-tradable shares have moved from the experimental to the full-scale stage, and are expected to be completed by spreading to all listed firms in the relatively short time of one to two years.

The authorities explain that the sole aim of these reforms is to improve corporate governance at listed firms and the intermediary function of the stock market by giving equal rights to non-tradable and tradable shares, and that they do not intend to float state-owned shares on the market. The reason for such a cautious stance is probably a desire to dispel concerns about a possible deterioration of the supply-demand relationship on the stock market. However, if non-negotiable shares remain in the hands of the state even after they are turned into negotiable shares, there cannot possibly be any improvement in corporate governance or the intermediary function of the stock market. In order to achieve the desired effects, privatization of state-owned enterprises must be carried out through the floating of state-owned shares. This is also a path that China cannot avoid as it strives to shift to a market economy.