Corporate Governance for Listed Companies in China
– Recent Moves to Improve the Quality of Listed Companies –

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I. Introduction

The quality of capital markets cannot be improved without raising the quality of listed companies. Owing to the history of China's capital markets, the number of its listed companies of high quality is limited; even government officials have stated[1] that about 70% of the companies listed on China's domestic market do not meet international standards in terms of profits, returns and other indicators. In fact, with problems such as companies falsifying their earnings statements and parent companies misappropriating funds from their listed subsidiaries still a common occurrence, investors view China's capital markets as nontransparent and full of risks. The China Securities Regulatory Commission (CSRC) and other regulatory bodies have responded by working to improve the quality of listed companies, a process that began after the State Council's January 2004 release of its *Several Opinions on promoting the reform, opening up, and stable development of capital markets* (referred to as the "*Nine Opinions*"). These efforts include implementation of the new *Company Law* in January 2006, the writing of regulations governing M&A (which is expected to take off after non-tradable share reforms), and the introduction of new accounting standards in January 2007. Governmental authorities are using administrative guidance in an attempt to solve issues that have built up thus far, including the misappropriation of corporate funds by large shareholders.

II. Governance structure of listed companies

A key question to ask is whether listed companies are well-managed, i.e., whether they make efficient use of resources and generate profits, viewed both from the micro-perspective of the investor as well as from the macro perspective of resource allocation across China's overall economy. Among listed companies in China,

[1] Remarks by Cheng Si-Wei, Vice-Chairman of the Standing Committee of the National People's Congress, People's Republic of China, quoted in the 31 January 2007 edition of the *Financial Times*.

however, there are frequent examples of a parent company misappropriating funds from its listed subsidiary or manipulating accounting data that is critical to assessing the company's business.

To better consider why these problems occur we will take a look at institutional design, which is closely related to a listed company's corporate governance capabilities. As explained later, the fundamental institutional design of China's listed corporations is built around a shareholders' general meeting, under which there is a board of directors and a board of supervisors.

Although it is the rules governing joint stock limited companies (JSLC; also referred to as "companies limited by shares") that are applied to listed companies, under the Corporate Law the rules governing limited liability companies (LLC) are in some cases the same as for JSLC, so we discuss here both LLC and JSLC.[2] More detailed rules for listed companies are set out in the *Guidance for the Articles of Listed Company*, which was amended in 2006.

1. Shareholders' meetings and general shareholders' meetings

We start by looking at shareholders' meetings and general shareholders' meetings. The shareholders' meetings of LLC comprise all of the shareholders and are considered the company's power structure (Article 37 of the *Company Law*[3]). The LLC's shareholders' meeting has the power to decide the company's management policy and investment plan, to elect and reappoint members of the board of supervisors and the board of directors who do not work as employee representatives, to decide matters concerning the compensation of directors and supervisors, to examine and approve reports issued by the board of directors, and to examine and approve reports issued by supervisors or the board of supervisors (see Figure 1) (Article 38).

The composition and powers of a JSLC's general shareholders' meeting are similar (Articles 99 and 100), although it is also possible to use cumulative voting[4] to elect auditors and directors at the general shareholders' meeting, per the company's articles of association or resolution of the general shareholders' meeting (Article 106).

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[2] An LLC differs from a JSLC in several respects, including minimal initial capital, which is 30,000 yuan for an LLC and 5 million yuan for a JSLC, and the number of founders, which can be a single person for an LLC but must be between two and 200 persons for a JSLC.

[3] The English translation of these articles is based on the Japanese translation published on 14 November 2005 by the law office of Mori, Hamada, and Matsumoto.

[4] This system takes into account the needs of minority shareholders when there is an election. It gives to each shareholder the same number of votes for each share as the number of directors being selected. Shareholders can either give all of their votes to a single candidate or spread them out among multiple candidates.

Figure 1:The powers of the general shareholders' meeting

The general shareholders meeting is a company's highest authoritative body and exercises the following powers

1) Deciding the company's management policy and investment plan
2) Electing and replacing members of the board of supervisors and the board of directors who do not work as employee representatives, and deciding matters concerning the compensation of directors and supervisors
3) Examining and approving reports issued by the board of directors
4) Examining and approving reports issued by the board of supervisors
5) Examining and approving the company's proposed annual financial budgets and financial results
6) Examining and approving the company's plan for distributing profits and for recovering losses
7) Adopting resolutions regarding increases or decreases in the company's registered capital
8) Adopting resolutions regarding the issuance of corporate bonds
9) Adopting resolutions regarding the company's merger, division, dissolution, liquidation, or changes in the company's format
10) Revising the company's articles of association
11)* Make resolutions regarding the appointment or dismissal of an accounting firm
12)* Examining and approving matters pertaining to guarantees as prescribed in Article 41 of the *Guidance for the Articles of Listed Company*
13)* Examining and approving the purchase and sale of important assets when the amount of said purchase/sale during any one-year period exceeds 30% of the company's total appraised assets in the most recent fiscal year
14)* Examining and approving changes in the use of procured funds
15)* Examining and approving stock incentive plans
16)* Examining and approving other matters which laws, administrative regulations, departmental rules, or the company's articles of association prescribe that the general shareholders' meeting must decide

Note: Based on the *Company Law*. Items marked with * are prescribed in the *Guidance for the Articles of Listed Company*

Source: Nomura Institute of Capital Markets Research, based on the *Company Law* and the 2006 revision to the *Guidance for the Articles of Listed Company*. The English translation is based on the Japanese translation of the *Company Law* published on 14 November 2005 by the law office of Mori, Hamada, and Matsumoto. (The same holds for Figures 2 to 4).

2. Board of directors

An LLC must establish a board of directors, comprised of between three and 13 persons. This must include an employee representative for LLCs established with the investment of at least two state-owned enterprises (SOEs) or at least two other types of state-owned investment entities. Other limited companies may also have an employee representative on their board of directors (Article 45). The board of directors is responsible to the shareholders' meeting (Article 47) and exercises ownership rights when the shareholders' meeting is not in session.[5] Its powers include determining the company's operating and investment plans, establishing the

[5] Feng Wen-li, *Governance Practices and System Establishment of China's Listed Companies*, Beijing: Economy and Management Publishing House, 2005 (in Chinese).

company's internal management structure, and hiring and replacing general managers and deciding on matters related to their compensation (Article 47; see Figure 2).

JSLC also establish a board of directors, comprised of from five to 19 persons, and the board of directors' powers are the same as in the case of an LLC (Article 109). The board of directors is responsible to the general shareholder's meeting (Article 105 of the *Guidance for the Articles of Listed Company*). The board of directors of a JSLC must meet at least twice a year (Article 111 of the *Company Law*).

Figure 2: The powers of the board of directors

The board of directors is responsible to the general shareholder's meeting, and exercises the following powers

1) Convening the general shareholders' meeting and reporting to same
2) Executing resolutions adopted by the general shareholders' meeting
3) Deciding the company's business plan and proposed investment plan
4) Formulating plans for the company's annual financial budgets and financial results
5) Formulating plans for distributing profits and for recovering losses
6) Formulating plans for increases or decreases in the company's registered capital and for the issuance of corporate bonds
7)* Formulating plans for important acquisitions and share buybacks by the company, the merger, division, or dissolution of the company, and changes to the company's form
8)* Deciding within the scope authorized by the general shareholders' meeting external investments, the purchase or sale of assets, the pledging of assets, external guarantees, entrusting money management, and related-party transactions
9) Deciding on the establishment of internal governance bodies
10)* Appointing or dismissing managers and the board of directors' secretary; hiring or dismissing the deputy general manager, CFO, and other senior management appointed by the general manager; and deciding the compensation, punishments and rewards for same
11) Determining the basic management organization
12)* Formulating proposed revisions to the company's articles of association
13)* Managing corporate disclosures
14)* Proposing to the general shareholders' meeting the hiring or replacement of an auditing firm
15)* Receiving the general manager's work report and examining the general manager's work
16)* Other powers authorized by laws, administrative regulations, departmental rules, or the company's articles of association

Note: Based on the *Company Law*. Items marked with * are prescribed in the *Guidance for the Articles of Listed Company.*
Source: Nomura Institute of Capital Markets Research, based on the *Company Law* and the 2006 revision to the *Guidance for the Articles of Listed Company.*

3. General managers

An LLC may have a general manager who shall be hired or dismissed by the board of directors, as noted above. The general manager is responsible to the board of directors, and has powers that include leading the management of the company's production and business operations and implementing board of directors' resolutions (Article 50; see Figure 3). The board of directors determines the business policy, and

the general manager executes that policy.[6] A JSLC may also have a general manager, who has the same powers as above (Article 114). In addition, the board of directors of a JSLC may appoint one of its members to concurrently serve as general manager.

Figure 3: The powers of the general manager

The general manager is responsible to the board of directors, and exercises the following powers

1)* Leading management of the company's production and business operations, implementing board of directors resolutions, and reporting on work to the board of directors
2) Implementing the company's annual business plan and investment plan
3) Formulating plans for the establishment of internal governance bodies
4) Proposing the company's basic management organization
5) Determining the company's detailed rules
6) Proposing to the board of directors the appointment or dismissal of the deputy general manager and the CFO
7) Determining the appointment or dismissal of managers other than those who must have their appointment or dismissal determined by the board of directors
8) Other powers as assigned by the board of directors

General managers must attend board of directors meetings

Note: Based on the *Company Law*. Items marked with * are prescribed in the *Guidance for the Articles of Listed Company.*
Source: Nomura Institute of Capital Markets Research, based on the *Company Law* and the 2006 revision to the *Guidance for the Articles of Listed Company.*

4. Board of supervisors

An LLC must set up a board of supervisors (equivalent to the board of auditors in Japan), comprised of at least three persons. The board of supervisors must include representatives of shareholders and employee representatives, with the latter comprising a suitable percentage (at least 1/3) of the total number of board of supervisors members. No director or senior manager (general manager, deputy general manager, CFO, board of directors secretary, or other officer as stipulated in the articles of association) may concurrently serve on the board of supervisors (Article 52). The composition of a JSLC's board of supervisors is similar (Article 118).

The powers of the board of supervisors include review of company's finances, supervision of directors and senior management, and submission of proposals to dismiss directors and senior managers who violate the law (Article 54; see Figure 4). Supervisors may attend board of directors meetings (Article 55), and the company must bear the necessary costs incurred by the board of supervisors in executing its powers (Article 55). The authority of a JSLC's board of supervisors is similar (Article 119).

6 Ibid

Figure 4: The powers of the board of supervisors

The board of supervisors shall exercise the following powers

1)* Examining, and submitting written opinions on the periodic company reports prepared by the board of directors
2) Examining the company's finances
3) Supervising the performance of duties by directors and senior management, and making proposals on the dismissal of directors and senior management who have violated laws, administrative regulations, the company's articles of association, or resolutions of the general shareholders' meeting
4) Demanding that directors and senior management correct any conduct that harms the company's interests
5) Proposing the convening of extraordinary meetings of shareholders, and convening and presiding over the general shareholders' meeting when the board of directors does not convene or preside over the general shareholders' meeting, as prescribed in the *Company Law*
6) Submitting proposals at general shareholders' meetings
7) Bringing suit against directors and senior management based on Article 152 of the *Company Law*, which provides rules concerning shareholder class action
8)* May launch an investigation when irregularities in the company's management are found. When necessary, may employ the services of accounting firms and law firms to cooperate in the investigation, the expense of which shall be born by the company.

The articles of association may prescribe other powers of the board of supervisors

Note: Based on the *Company Law*. Items marked with * are prescribed in the *Guidance for the Articles of Listed Company.*

Source: Nomura Institute of Capital Markets Research, based on the *Company Law* and the 2006 revision to the *Guidance for the Articles of Listed Company.*

5. Special provisions for listed companies

In addition to the above, the *Company Law* includes special provisions for listed companies. Listed companies must have independent (outside) directors (Article 123). Another provision is that when the director of a listed company has a relationship with a company involved with a board of directors resolution, that director may not exercise voting rights for said resolution (Article 125, abbreviated), and for related transactions that director is limited in exercising voting rights.

6. Establishing a committee

Based on the *Listed Company Rules*, a listed company's board of directors may, with a general shareholders' meeting resolution, establish specialized committees to handle business strategy, auditing, appointments, and compensation & appraisals. All members of these specialized committees must be directors. Independent directors must comprise the majority of committees handling audits, appointments, and compensation & appraisals, and must be the heads of their respective committees. At least one of the independent directors on the audit committee must be an accounting specialist (Article 52 of the *Listed Company Rules*).

7. Special features of the institutional design of China's listed companies

As seen above, the institutional design of China's listed companies includes a board of directors and a board of supervisors under the general shareholders' meeting, which is similar in format to Japan's institutional design. Under the *Listed Company Rules*, however, the board of directors may establish an auditing committee, which means that a listed company in China can have both a board of supervisors and an auditing committee. In some cases, there is a division of duties between the two, such that the board of supervisors provides checks on the overall business situation and on the directors and senior management, while the auditing committee checks the accounting information. In some cases, the thinking is that the auditing committee must be under the control of the board of supervisors.[7]

III. Problems related to listed companies

Although the institutional design for the corporate governance of listed companies has been put in place, problems still occur that betray the trust of investors, including the misappropriation of funds associated with related-party transactions[8] and the manipulation of accounting.

We will look here at related-party transactions and the provision of guarantees between related companies.[9] Specifically, the interests of minority shareholders can be harmed when the listed company's funds are misappropriated or its profits manipulated through the use of related-party transactions among listed subsidiaries, the parent company, and sister companies.

There are a variety of ways that a parent company can misappropriate funds from a listed subsidiary. This is often done through the use of related-party transactions, although there are also more direct examples whereby the parent company arbitrarily uses funds procured from a capital increase at a listed subsidiary. A specific example of the former is when a parent company misappropriates funds from the listed company over an extended period in the form of accounts receivable or prepaid expenses, related to the purchase and sale of products or manufacturing inputs. Another common example is when a listed company is forced to provide guarantees. When the parent company receives bank financing, for example, and makes the listed subsidiary provide guarantees, the listed company is under obligation to repay the

7 Based on interviews with CPAs and securities firms.

8 Transactions with related parties. Article 217 of the *Company Law* defines a related-party relationship as follows. A relationship between any two companies in which one is controlled directly or indirectly by the other's controlling shareholder, person with effective control, director, supervisor, or senior management, or any other relationship with the potential to result in the shifting of profits between the two sides. Provided, however, that this does not include relationships between companies in which the sole connection is that the government owns a controlling stake in both.

9 For more on accounting manipulation, see Takeshi Jingu and Suiyo Ri, *Chugoku no Kigyou Kaikei, Kansa Seido* (Corporate Accounting and Auditing in China) *Capital Market Quarterly*, Winter 2007 issue (in Japanese).

loan if the parent company is unable to do so. Another example is a paid-in capital increase, where the parent company puts nothing up, leaving most of the payment to the minority shareholders, and then pays out a cash dividend, thereby bleeding the listed company of funds. Profits can be manipulated by manipulating either the price paid between affiliates in an internal purchase/sale of products or materials, or the price of assets.

To give an idea of the scale of the problem, the funds misappropriated by major shareholders in 2003 was about 110 billion yuan.[10] Illegal guarantees (those violating *Order #56* described below) on both the Shanghai and the Shenzhen Stock Exchanges totaled 27.284 billion at 145 companies at the end of 2003, and 23.883 billion yuan at 148 companies at the end of 2004.[11]

IV. Why these problems occur

1. Large shareholder control and the lack of separation from state government

Much of the blame for the poor functioning of corporate governance at listed companies can be attributed to the process for listing state-owned enterprises. Many of China's listed companies were originally state-owned enterprises that were reorganized as joint stock companies as part of the reform process. In the 1990s, listing quotas were allocated to regional governments, which were able to meet these quotas by creating seemingly strong joint stock corporations, transferring only the higher quality assets into the company to be listed ("*Baozhuang* (wrapper) listings.") In other words, the listing was not of the entire state-owned enterprise but only of a part of it, i.e., a partial listing. The original state-owned enterprise was turned into a holding company, under which is both the listed company and the corporations comprising the unlisted parts (see Figure 5).[12]

The majority of China's listed companies were established through this sort of restructuring of state-owned enterprises, with the state and the state-owned enterprise that was the parent company (the holding company in the example above) becoming the major shareholder. As of end-March 2005, prior to the reform of non-tradable shares, of the 1333 companies listed on both the Shanghai and Shenzhen Stock Exchanges, 1074 (about 80%) were state-owned enterprises with some of their shares owned by the state. The companies under state control, with the state owning at least a 30% stake, numbered 798 (60% of the total), with a simple average state ownership of 55%.[13] The state or state-owned enterprise we refer to here often signifies that either a

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[10] *Sohu Caijing*, 23 July 2004. This was a statement from the listing division of the CSRC.

[11] Shanghai Stock Exchange: *China Corporate Governance Report* (2006), Shanghai: Fudan University Press, 2006 (in Chinese)

[12] The decision as to whether the shares of the listed company are owned by the government (state shares) or by a holding company as in the example above (SOE shares) depends on the asset breakdown of the state-owned enterprise prior to its transformation into a listed company. Even in the case of state shares, the holding company acts on the state's behalf and effectively becomes the shareholder.

[13] Calculations based on data from Wind Information.

regional government (State-Owned Assets Supervision and Administration Commission (SASAC)) or a state-owned enterprise belonging to a regional government owns the company (enterprise). The general shareholders' meeting and board of directors are controlled by the major shareholders, and the chairman of the board in some cases is also the general manager, which lowers the effectiveness of the board of directors' supervision of management.

In fact, the chairman of the board and general manager are often appointed by the regional government as part of a system for promoting government officials. Consequently, listed companies owned and controlled by the state failed to achieve separation from the government, leaving the functions of the regional government and the company commingled.

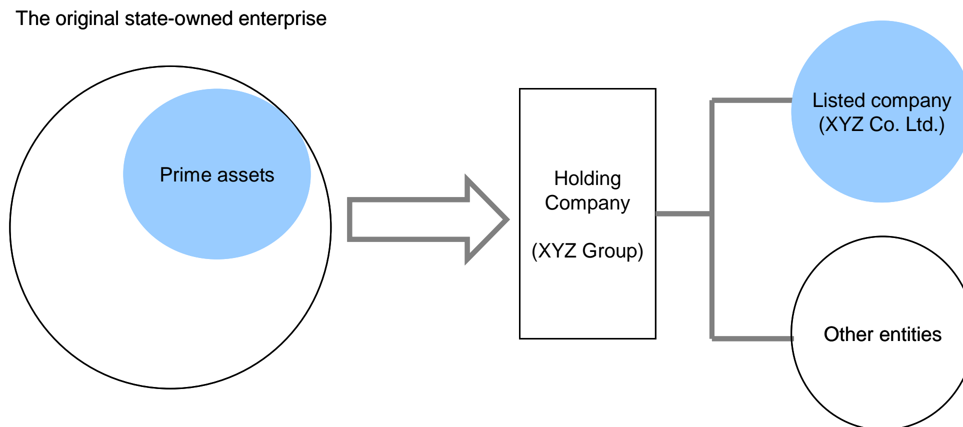
According to the *Provisional Rules on the Supervision and Administration of State-Owned Assets* (2003), the SASAC performs its duties primarily as an investor, without taking over the government's function of managing the social and public aspects, and also does not get directly involved in the company's production or other business activities. In other words, the SASAC's only role should be that of a shareholder, and it should not give any consideration to such issues as protecting jobs in the region. In reality, however, when there is a conflict of objectives between the investor and the government (such as regards the need to protect jobs), the government's objectives wind up taking precedence. Particularly amid the vicious competition for economic development between regional governments, which has been cited as one cause of the recent macroeconomic overheating, the listed companies of each region have played an extremely important role in promoting economic development and encouraging socioeconomic stability, from the perspective of each regional government.

This explains the use of manipulative accounting to help the listed company meet the requirements for raising capital and the market manipulations aimed at boosting the offering price. The funds thus obtained wind up being diverted to the parent company and other companies under its umbrella through the use of related-party transactions, and otherwise being misappropriated by the parent company. Meanwhile, because the listed company serves as a vehicle for regional governments and state-owned enterprises to raise funds, in some cases the regional government injects profits into the listed company in order to keep it from losing its listing.

This control by the major shareholders is also harmful in the case of private-sector corporations, given their poor corporate governance capabilities.[14]

[14] Shanghai Stock Exchange, op. cit.

Figure 5: Typical examples of state-owned enterprises that have been reorganized and listed as stock companies



2. Weak checking function

Under these conditions, neither the internal nor the external management checking function worked very well. We have already noted the weakness of checks between directors and management, but checks on the directors and management by the board of supervisors have also been weak.

As noted earlier, there are two types of supervisors, those who are shareholder representatives and those who are employee representatives. The majority of the former are sent by major shareholders, while the latter have jobs working under the general manager. In most listed companies, the chairman of the board of supervisors is also the head of the labor union, and the head of the labor union is effectively appointed by the in-house party chief (who is often concurrently the chairman of the board of directors). Either way, this arrangement makes it difficult for the board of supervisors to check on the conduct of the directors and management. Meanwhile, it appears that few listed companies have established an auditing committee.[15]

One could also argue that pressure on corporate management from the outside has been weak. The market for the right to control companies has been slow to develop. Prior to the reform of non-tradable shares, share prices did a poor job of indicating enterprise value, as was evident from the discrepancy between the price of tradable shares on the exchanges and the negotiated price for the transfer of non-tradable shares. Because major shareholders were unable to sell their non-tradable shareholdings on the exchanges, they were indifferent to the prices of tradable shares. A negotiated transfer of non-tradable shares was also the primary method used for M&A, thereby eliminating the pressure from hostile acquisitions.

Institutional investors have also had a fairly small presence and thus no impact on corporate management. In addition, there were problems with the disclosure of accounting information, and because these companies' general manager and other

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[15] About 20% of all listed companies in 2003. Yang Yang, Jiang Ya Peng: *Shangshi Gongsi Kuaiji Jianguan Wenti Yanju* (Research on Accounting and Auditing Problems in Listed Companies), Dongbei University Press, 2005 (in Chinese).

managers were effectively appointed by the responsible government divisions, an outside market for hiring talent has been slow to develop.

V. Recent efforts toward improvement

1. Improvement on the legislative and regulatory fronts

There have thus been problems in the ability to place checks on management, both internally and externally, but there have been some recent moves toward improvement that bear watching.

We look first at the progress made on the legislative and regulatory fronts. The new *Company Law* was implemented in January 2006, and new accounting and auditing standards have been applied to listed companies since January 2007. In the following paragraphs we look more closely at the new *Company Law*.[16]

One key element of the new *Company Law* relevant to corporate governance is the increase in powers given to the board of supervisors.[17] The board of supervisors has been given more powers, including the right to propose the dismissal of directors and senior management, and it is also now able to make proposals to the general shareholders meeting and bring lawsuits against directors and senior management (Articles 54 and 119). In addition, to solve the real problem of the chairman of the board not convening a general shareholders' meeting, procedures for convening a general shareholders' meeting have been established, and the board of supervisors as well as shareholders with at least a 10% stake are now able to convene and preside over the meeting (Articles 41 and 102). The board of supervisors can also now question and propose board of directors' resolution items as well as investigate when it discovers irregularities in how the company is being managed. It can hire an accounting firm to help with the investigation, and can make the company pay the fees involved (Articles 55 and 119).

Second, the directors, supervisors, and senior management have been given new duties of diligence and loyalty, including an obligation to comply with laws and a prohibition on bribery and embezzlement (Article 148). The controlling shareholder, person with effective control, director, supervisor, and senior management cannot use an affiliate relationship to harm the interests of the company, and directors with an affiliate relationship are unable to exercise their voting rights on resolution items relevant to that relationship (Articles 21 and 125). Transgressions such as the misappropriation of company funds or the offering of company assets as collateral without the consent of the general shareholders' meeting or board of directors are also prohibited, and any ill-gotten gains are returned to the company (Article 149).

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[16] For more on new accounting and auditing standards, see Takeshi Jingu and Suiyo Ri, *Chugoku no Kigyou Kaikei, Kansa Seido* (Corporate Accounting and Auditing in China) *Capital Market Quarterly*, Winter 2007 issue (in Japanese).

[17] The description in this portion is based on Takeshi Jingu and Suiyo Ri, *Chugoku no Kigyou Kaikei, Kansa Seido* (Corporate Accounting and Auditing in China) *Capital Market Quarterly*, Winter 2007 issue (in Japanese).

Third, there is now stronger protection of minority shareholders. It is also now possible to use cumulative voting at the general shareholders meeting when electing directors and supervisors (Article 106). Furthermore, the rights of shareholders to view financial statements have been strengthened (Article 34), and shareholder class action can now be brought (Article 152). Companies are now obligated to present truthful and complete accounting records to their accounting firm (Article 171).

Fourth, there are sections in the *Company Law* that refer specifically to listed companies. Chapter IV, Section 5 of the *Company Law* (Special Provisions on the Organizational Structure of a Listed Company) requires listed companies to have independent directors. This was added in response to the State Council's *Nine Opinions*, and is specifically aimed at improving the corporate governance of listed companies. The *Guidance for the Articles of Listed Company* states that internal directors (directors currently working as senior management or employee representative directors) may not comprise more than half of a company's directors (Article 96 of said *Guidance*).

All of these points have become critical to future operations, but taking the example of the system of independent directors implemented in 2001, although there are examples of financial scandals at large corporations where the independent directors were not made aware of information,[18] in other companies the system has been working, and we expect gradual improvements moving forward.

2. Reform of non-tradable shares

We look next at the impact from the reform of non-tradable shares. First, the process of reforming non-tradable shares resulted in a reduction in the percentage of shares held by major shareholders, because the non-tradable shares were transferred to the holders of tradable shares through a gratuitous conveyance (Figure 6). This increased the voice of minority shareholders in numerical terms. The state has been withdrawing from traditional industries and competitive industries and moving into industries critical to national economic stability in terms of managing state-owned assets, and we expect this reshuffling of ownership to continue.

Regarding the reform of non-tradable shares at individual corporations, it is important to note that at this point there has been no radical change in the general level of control exerted by major shareholders. This is because in some cases another form of paying compensation is being chosen when it appears that the gratuitous conveyance of non-tradable shares to minority shareholders may have an impact on control of the company.[19]

Second, the interests of major shareholders, management, and minority shareholders are starting to be aligned. The reform of non-tradable shares will

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[18] A financial scandal involving China Southern Airlines. *Caijing Magazine*, 2006, No. 10.

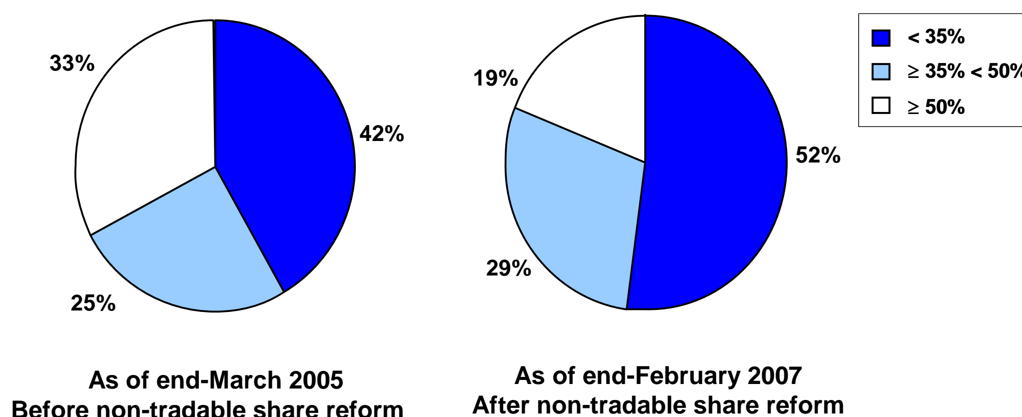
[19] The non-tradable share reforms required holders of non-tradable shares to pay compensation to tradable shareholders in return for the right to sell their shares on stock exchanges. This compensation could be in form of cash or the gratuitous transfer of stock (non-tradable shares), among others.

gradually make it possible in the future to trade state-owned shares, SOE shares, and other non-tradable shares on a securities exchange. Until now, the price of tradable shares and the negotiated price for the transfer of non-tradable shares has been different, but we expect the market price quoted on exchanges to start reflecting enterprise value and thus the performance of corporate management.

As non-tradable shares become tradable, shareholders will be able to sell their shareholdings on the market, and this should quickly make them shed their indifference to the market price. There is also now a tendency for the share price to be a factor in managers' performance evaluation. The *Measures for the Administration of Equity Incentive Plans of Listed Companies* (implemented January 2006) also attempts to provide directors, supervisors, and senior management with long-term incentives. Under both the new *Company Law* and the 2006 revision to the *Guidance for the Articles of Listed Company*, directors, supervisors, and senior management are allowed to sell up to 25% of their holdings in the company's stock each year during their stint (they could only purchase stock previously).

Fourth, once share prices begin to reflect enterprise values, conditions should become more conducive to M&A activity. Hostile takeovers will also become a possibility, providing a basis upon which capital markets can apply external pressure on company management, even though this may not function immediately. In this regard, China is working seriously toward establishing an environment conducive to M&A, including its implementation in September 2006 of the *Measures of Administration of Acquisition of Listed Companies*.

Figure 6: Large shareholders' ownership share of listed companies



Note: Shows the respective percentages of all listed companies in which the largest shareholder owns 1) less than a 35% stake, 2) at least a 35% but less than a 50% stake, and 3) a 50% stake or greater. There were 1,333 listed companies at end-March 2005 and 1,430 at end-February 2007.

Source: Nomura Institute of Capital Markets Research, based on data from Wind Information

3. Improvement through administrative measures

Measures implemented by regulators aimed at improving conditions include moves taken in 2005-06 to solve the problem of parent companies misappropriating listed company funds. In response to the *Nine Opinions* announced in 2004, the CSRC announced its *Opinions on Improving the Quality of Listed Companies* on 19 October 2005, with the specific aim of solving this problem. It required parent companies to pay back all misappropriated funds to their subsidiaries before the end of 2006.

As a result, the over 45.6 billion yuan in funds that had been misappropriated from 396 companies as of end-2005 dropped to 31.6 billion yuan from 147 companies by end-June 2006, and then to 9.2 billion yuan from 17 companies by end-2006.[20] The parent companies use the various methods to repay their debt to listed subsidiaries, including cash, offsets with their equity in subsidiaries or dividend payments from subsidiaries, and proceeds from the sale to third parties of their equity in subsidiaries.

The exchanges severely penalized those companies that had continued to conceal their misappropriation of funds over an extended period until it ultimately became too difficult to hide. Official decrees were handed down that publicly reprimanded those company's senior management and officially deemed them unsuitable to serve as senior management of a listed company. Negative inheritances that had accumulated over time were cleared through strict measures such as these.

The problem with guarantees is dealt with by Order #56 of 2003, *Notification of Some Problems Related to the Exchange of Funds Between Listed Companies and Related Parties, and to the Regularization of External Guarantees for Listed Companies*, which prohibits controlling shareholders or other related parties from forcing a listed company to provide guarantees. More recently, there have been reports of a reduction in illegal guarantees in 2006, just as with funds misappropriation. The number of companies whose management was penalized for guarantee-related violations dropped from about 25 in 2005 to around 10 in 2006.[21]

4. Listing of all affiliates

Although administrative measures are able to solve past problems, they are unable to fundamentally solve the problem of funds misappropriation. In this respect, the problem of transactions between listed companies and their affiliates can be definitively solved by ensuring that all, rather than just some, of a state-owned enterprise's affiliates are listed.

There have long been examples of such entire listings, but their number has increased since the reform of non-tradable shares because the CRSC has been promoting it.[22] This group listing has been one focus of capital markets in 2007.

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[20] From various news sources.
[21] *Shanghai Securities News*, dated 22 December 2006.
[22] Integrating and listing only the major businesses is also considered an entire listing.

The authorities have taken a supportive of view of group listings since the reform of non-tradable shares. In its *Guidance Opinions on the Split Share Structure Reform of Listed Companies* of 23 August 2005, China's government supported (1) after solving the non-tradable share problem, the listing of all affiliates of large firms with strong earnings through third-party capital increases at the listed companies they control. The government also promoted (2) the strengthening of listed companies and supported restructuring through M&A, financed with the stock of listed companies either in a direct purchase or an exchange of shares.

In opinion #14 of its *Opinions on Improving the Quality of Listed Companies*, it supported the use of capital markets to make China's best companies even stronger. This opinion specifically advocated the use of capital markets by state-owned enterprises to consolidate the prime resources in listed companies and to insure that all affiliates of the best large companies are listed.

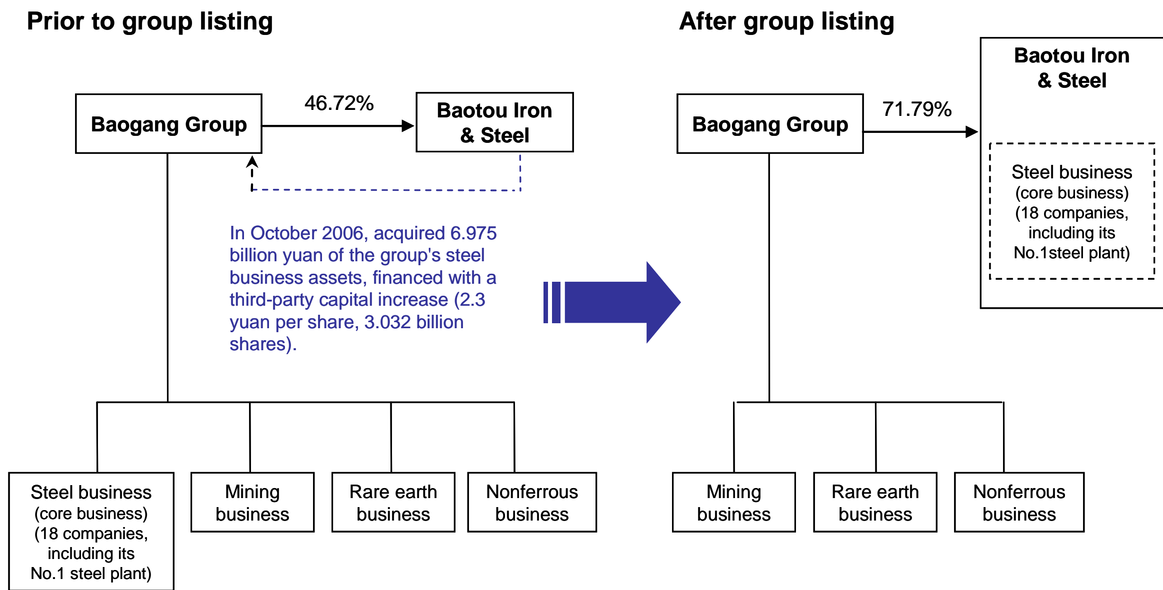
Methods for achieving a group listing can be broadly categorized into two different types: third-party capital increases and mergers through the exchange of shares. One example of a third-party capital increase is the one announced in November 2006 by Baotou Iron & Steel, a leading steel company based in Inner Mongolia. Baotou Iron & Steel conducted a 3 billion share third-party capital increase with its parent company, the Baogang Group, to finance the purchase of the group's assets and companies, primarily in the steel business (Figure 7). This has allowed Baotou Iron & Steel to become a company with refining and other upstream processes. Looking only at the impact from the capital increase, the Baogang Group's stake in Baotou Iron & Steel increased from roughly 47% to 72%.

An example of an exchange of shares was the group listing of Shanghai International Port (Group) (SIPG), mainland China's largest port operator. SIPG owned about a 70% stake in Shanghai Port Container (SPC), and it acquired the rest of the company with a share exchange of 4.5 of its shares for every share of SPC (Figure 8). SIPG then listed its shares. Because the new company became listed, the usual IPO procedures were followed.

A group listing is also advantageous to the major shareholders because it makes it possible to concentrate the prime assets. As could be surmised based on the examples cited above, the parent company is able to increase its stake in the listed company (or in the case of SIPG, the shares owned by SIPG's major shareholders, including Shanghai State Assets Supervision and Administration Commission, become listed company shares) and with the time approaching when nearly all shares will be tradable, in the future it will be able to sell shares in the listed company to raise cash if necessary.

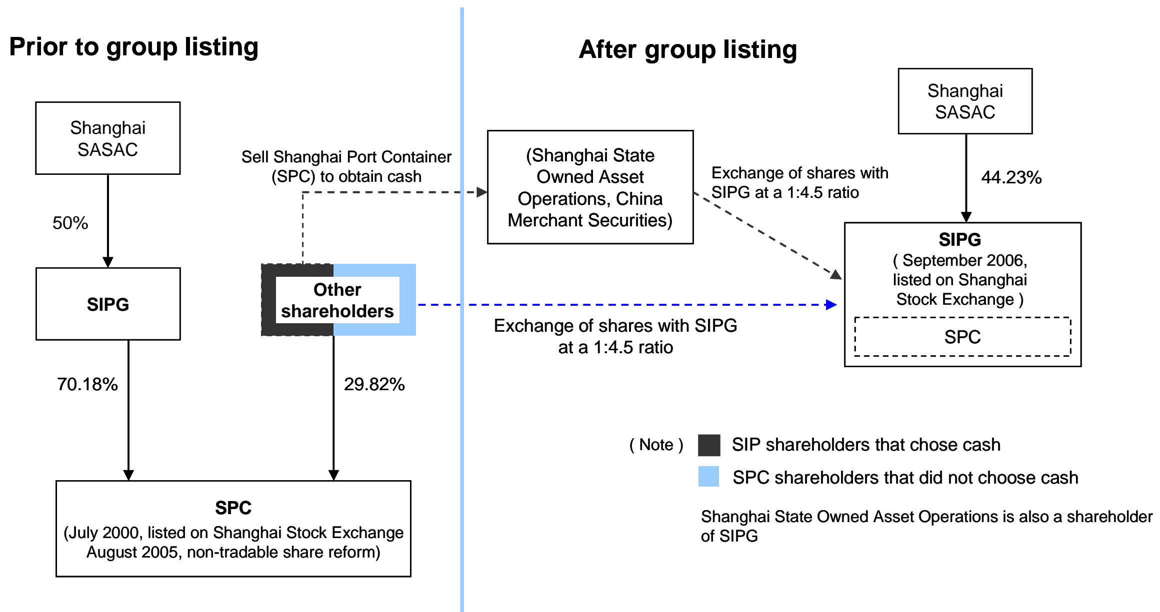
As of end-2006, roughly half of the companies that had been group listed were in the steel industry. The steel sector's large number of companies with partial listings and its heavy reliance on related-party transactions makes it a good candidate for group listings.

Figure 7: Group listing of the Baogang Group



Source: Nomura Institute of Capital Markets Research, based on various news reports

Figure 8: Group listing of Shanghai International Port (Group)



Source: Nomura Institute of Capital Markets Research, based on various news reports

5. External checking function

Focus has recently shifted to the growing presence of institutional investors, including through the emergence of large-scale investment funds, and the role this has played in placing outside pressure on listed companies to improve corporate governance. Despite improved corporate disclosures and access to the prices paid for related-party transactions, it is probably difficult for individual investors to accurately value companies, given their lack of specialized knowledge. Analysts working for institutional investors, meanwhile, have the ability to analyze such information, which should help insure that the information is reflected in the share price. Recently, a growing number of capable foreign institutional investors have begun participating in China's market through the Qualified Foreign Institutional Investor (QFII) program, and their presence should bring checks on corporate management up to international standards.

VI. Conclusion

With the stage set by the State Council's *Nine Opinions* in 2004, and then the *Opinions on Improving the Quality of Listed Companies* of October 2005, specific steps have been taken in China to improve the quality of listed companies, including, just over the past year, substantial reductions in the misappropriation of funds and efforts to promote group listings. The reform of non-tradable shares, which is coming to a close, was an initial step toward changing a shareholder structure that had been dominated by the state, and the implementation of the new *Company Law* and the new *Securities Law*, along with revisions to related rules, has strengthened the check function of corporate governance. One result of non-tradable share reform appears to be that market share prices are starting to reflect the enterprise value of listed companies. This should make it easier to provide incentives to management through M&A and the greater use of stock options.

In addition to efforts to raise the quality of individual companies already listed, it is clearly also raising the quality of the stock market overall to promote new listings of quality companies. In 2006, listing standards and procedures were revised in response to the new *Company Law* and new *Securities Law*. In addition, some large companies strong enough to be listed on overseas markets were listed in the domestic market.

These rapid moves, aimed at improving the quality of both individual companies as well as the overall market, bear watching. These moves are all in their initial stages, of course, and the direction this takes moving forward is of key importance.