The structure of corporate governance in Chinese Enterprises

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1、The system preconditions for the establishment of corporate governance in Chinese enterprises

1-1 Laws and Regulations

- "The Company Law of the People's Republic of China", which went into effect on 1st July,1994, and was revised on 25th December,1999 for the first time and in October 2005 for the second time
- "The Securities Law of the People's Republic of China", which was adopted on 29th December,1998 and was revised in October 2005.
- "The Code for Corporate Governance for Listed Companies in China", which was promulgated on 7th January,2002, by China Securities Regulatory Commission and The National Economy and Trade Commission.

1-2 Policies for improving corporate governance

- "Central CCP's Decision on Several Major Issues in the Reform and Development of State-Owned Enterprises", which was adopted by the Fourth Plenary Secession of the 15th Central Committee of the Party, put forward for the first time that corporate governance is the core of company operation mechanism
- The Sixteenth Congress of the Party stated that China would actively push the joint stock system and develop a mixed possession economy system. It will strive to realize the multiplication of investment main body. The state will control some critical enterprises, while other state-owned enterprises will continue their corporate reforms and improve corporate governance, in accordance with the requirements of modern enterprise system.

1-3、The reform of state-owned enterprises and multi ownership

（1）Few state-owned and state-run enterprises (those abiding to Law of the PRC on Industrial Enterprise Owned by the Whole People) are transformed into state-owned and state-run companies with limited liabilities (comply with the company law and belong to the second layer of the national capital system). In some critical enterprise and industries which are closely related to national security and the lifeline of the national economy, shares must be absolutely or relatively held by the state. These enterprises will set up corporate governance structure and belong to the second or third layer of the national capital system.

（2）The remaining state-owned enterprise (the third layer of the national capital system) will actively adopt the joint stock system, realize the multiplication of investment main body, and improve corporate governance.

By means of:

- State-owned enterprise coming to list in the capital market
- Selling shares to private enterprises
- Selling shares to foreign companies
- Selling shares to their own managers and employees

The last three means could also be combined together

2、The corporate governance and supervision of large state-owned enterprises

2-1、The measures adopted by the State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council to push reforms in large state-owned enterprises

（1) Continue pushing state-owned and state-run enterprises establish and improve the board of directors, and perfecting their corporate governance.17 enterprises have adopted the test by the end of 2006. And gradually bring the state-controlled central level enterprises (so far the number is 157) into this reform.

(2) State-Owned Assets Supervision and Administration Commission of the State Council hire and recommend senior managers to these enterprises.

2-2、Large state-owned and state-run enterprises should improve corporate governance

（1）It is the primary job to set up board of directors in large state-owned and state-run enterprises, and to make them shoulder the personal entrusted responsibility to state-owned assets institutes and the monitoring the business decisions to companies.

（2）State-owned and state-run enterprises must have outside directors and independent directors, so as to distinguish strategic decisions, monitoring and implementation, and to prevent the conflict of interests brought by the combination of management and decision-making.

The importance of designating outside directors

To improve the governance system of large state-owned enterprises

- The state-owned enterprises are becoming companies with board of directors
- To set up a reasonable governance structure

——to clear up the duties and responsibilities of various institutes (such as shareholders and shareholder meeting, directors and board of directors, CEO)

——the internal supervision and controlling system

- To set up a sound system

——the structure and combination of the organization, introducing in outside directors, solving the intersection of managers and directors

——the operation and aftermath of board of directors, director's responsibilities

——the system of board of directors and director's duties and responsibilities

At present, the chairmen of the experimental enterprises are still selected from "insiders"

- **Case One: The board of directors of Bao Steel Group**

The board of directors is made up of 9 people, which means more than a half are outside directors designated by the State-Owned Assets Supervision and Administration Commission of the State Council

One as the chairman and from the standing committee of the party committee; one as the vice chairman and as secretary of the party committee from the standing committee of the party committee; one as director, general manger and from the standing committee of the party committee; five outside directors, two of whom are from Hong Kong and Singapore and three of whom are retired senior managers; one employee director and as labor union president; one secretary for the board of directors and chief legal counselor

Under the board of directors: nomination committee, remuneration committee and audit committee

- **Case Two: China Chengtong Group**

9 directors, 3 of whom are outside directors; The general manager was recommended, hired and designated by the State-Owned Assets Supervision and Administration Commission of the State Council

There are four directorate committees, namely strategy committee, compensation and examination committee, governance and human resources committee, and audit committee.

2-3、Governmental supervision on large state-owned enterprises

China set up a supervisory board in State-Owned Assets Supervision and Administration Commission of the State Council. The supervisors sent by it and supervisors from the employees constitute a supervisory board in large enterprises. They attend the board meeting and keep the State-Owned Assets Supervision and Administration Commission of the State Council informed in time.

Foreign government's supervision on their enterprises is exterior supervision (afterward supervision)

- A complete frame of exterior supervision is: legislation organization+ treasury department+ industrial department+ audit office
- The French experience: APE, which is affiliated to Ministry of Economy, Finance and Industry, are separated from national supervision office.

2-4、National capital budget and its dividend policy

（1）China is accelerating its pace in setting up a budget system for national capital operation, which is related to the hard constraints on public finance budget and national capital budget, so as to strengthen the supervision and management of national capital.

（2）China is working on the budget of national capital operation in central level enterprises and editing files on budget of national capital operation in central level enterprises and its related systems.

（3）China is further improving the management performance assessment system and salary-incentive system.

The making of capital budget system, performance assessment system and incentive methods should be verified with different conditions in public filed, general competition filed and natural monopoly field.

3、The governance of listed companies

3-1 General introduction

- Shenzhen Stock Exchange and Shanghai Stock Exchange were founded in 1990 and 1991.
- The multiplication of investment main body is achieved. The competitiveness is increased by means of coming into market and bringing in strategic investors. The best method at present is: coming into domestic market (A share) and into overseas market (H share).
- Large state-owned enterprises had their initial public offerings in capital market. There are 1600 listed companies (1353 with A share); In 2004, 43 came into market in Hong Kong, 31 in Singapore. 17 mainland Chinese enterprises came into market in America in 2005.
- More than 200 listed companies are private ones or family-controlled.

Several characteristics in listed company's share right and governance structure

——a large proportion of nonnegotiable share with separate stock right

——a large proportion of state-owned shares

——the low independence level of board of directors

——the infringing on small shareholders through party transactions

——the insiders operation problem in stock market

Case Three:

SASAC of Shanghai

Shanghai Electric Group

- 20 people, 3 departments
- 9 directors, 2 of whom are senior directors
- 7 presidents and vice presidents,6 of whom also work in sub-companies
- 20 managers,3 managing departments

Pearl River,Guangdong、Simens and so on， 24.67%

Public shares 23.75%

100%

51.58%

Shanghai Electric Assets Operation Co.

- In charge of restructuring, downsizing and training
- Holding company of more than 1300 sub-companies
- Restructured 370 enterprises and 10.3 billion debt. Downsized some ten thousand people.

Shanghai Electric CO,. Ltd.

- Electricity power equipments, machinery equipments, transportation and environment protection
- An income of 28.8 billion RMB in the first six months of 2005
- More than 40 people in the managing departments and a central research institute.

3-2 The problems of governance in listed companies

（1）State-owned stocks and state-own legal person stocks dominate exclusively, which easily result in the transfer of interests, related transactions and infringing on small shareholders' interests.

（2）Insider's control. The board of directors and managing level have vague sphere of responsibilities. Most of the time, the chairman does what CEO should do, while CEO does what COO should do. Independent directors cannot fully play their role.

（3）The board of directors does not have complete duties and a standardized operation. The internal control system has not been established, while the internal audit system is not independent. The performance assessment system and incentive system are not effectively carried out.

（4）The insufficient information disclosure. Some listed companies intentionally delay and hold information, or even reveal false information, so as to manipulate share price, obtain share allotment right and get personal capital, etc.

（5）Some agencies, such as audit certified public accountants, lose their independence. Therefore, they become the "magicians" hiding financial problems for listed companies.

（6）The ineffectiveness of external administration mechanism. The capital market is unsound . A number of state-owned stocks and legal person stocks are not free to negotiate. The price-earning ratio is too high. Retail investors do not have enough shares, and are not motivated to supervise the company's activities. Stock speculation and "free ride" phenomenon are rampant, the supervision and judging system becomes useless.

3-3 How to solve these problems

- To learn more about corporate governance and establish a culture of corporate governance.
- To improve the board of directors system

——Clear up the essence and status of directorate, and draw a clear line between directors and managers

——Bring in independent directors and directors' committee

——Regulate the procedure and process of board of directors

——Strengthen supervision, performance assessment and incentive system

- To strengthen supervision and management, improve information disclosure, and public and media supervision

4、The governance of unlisted companies

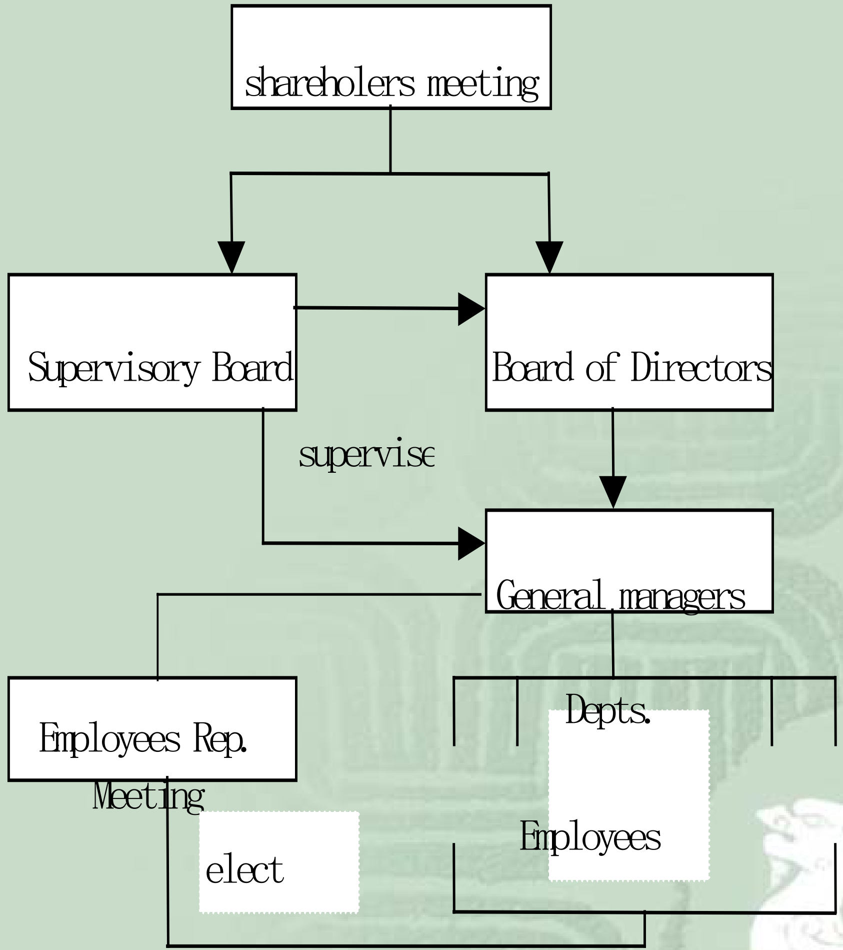
There are more than 3.6 million small and medium-sized enterprises and more than 280 million individual entrepreneurs, which is 99.6% of the total number of enterprises in China. They have various legal forms such as share cooperation system, partnership, state-owned. and collective ownership The problems are:

- **Family controlled, "one person's words count"**
- **Friends controlled (many people hold shares), untimely and blind decisions**
- **The role of professional mangers and their successors.**

5、The structural problems of corporate governance in Chinese enterprises

5-1、Dual boards system in Chinese enterprises

Dual boards system renders principal-agent relation asymmetrical: The shareholders meeting designates both directors and supervisors of the supervisory board. The board of directors makes strategic decisions and designates senor managers. The supervisory board poses soft constraint on directors and managers.



5-2、Historical origins and problems

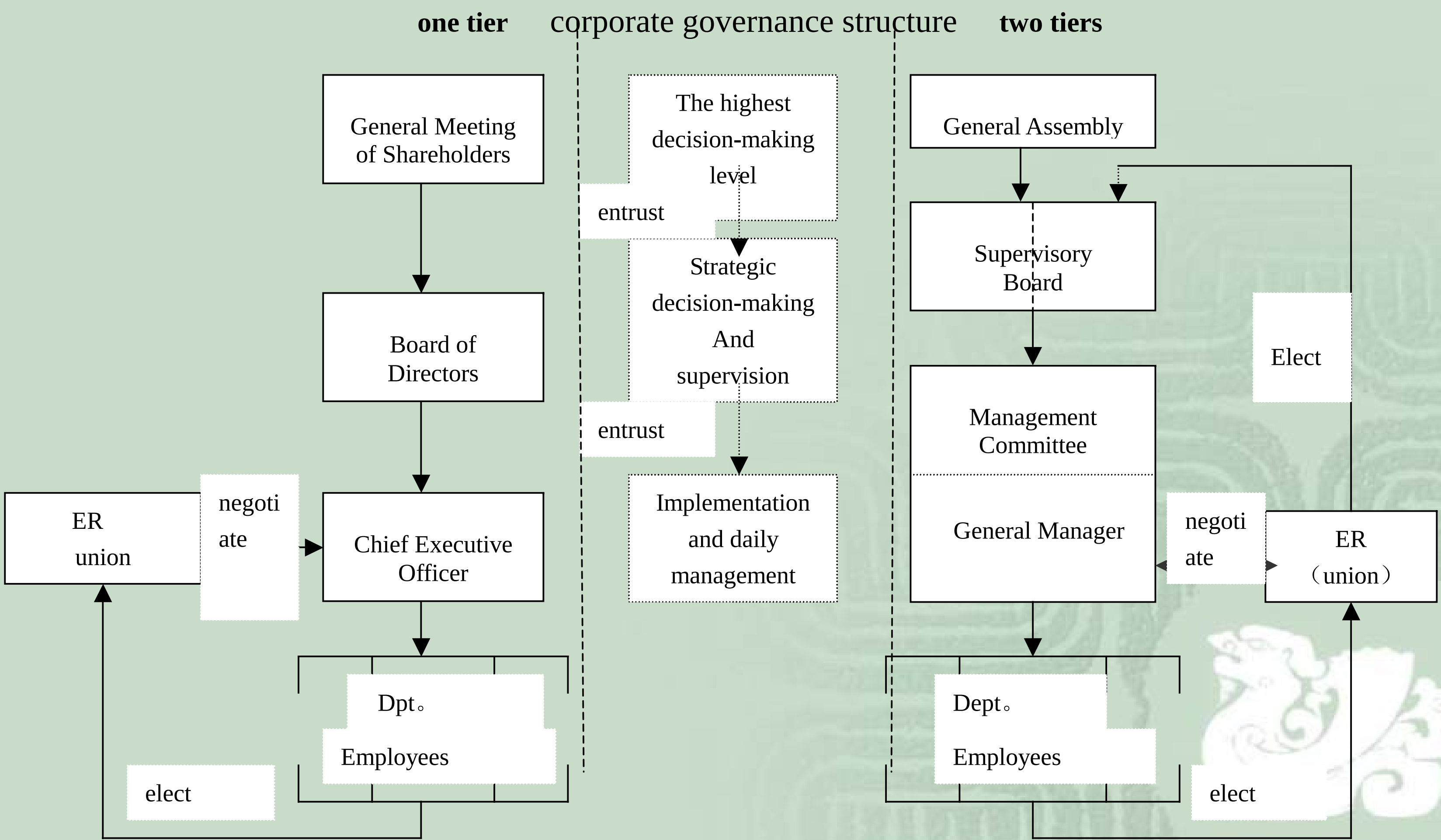
People used to translate “managing committee” in Germany’s two tiers system to “board of directors”, which reflects people’s misunderstanding of principal-agent relation among the shareholders meeting, supervisory board and managing committee. This mistranslation had a certain impact on China’s design of its own directorate structure.

- China’s current corporate governance structure is more like Japan’s binary system, rather than Germany’s two tiers system.

- Unlike Germany’s supervision committee, China’s supervisory board does not reflect the labor relation and shoulders no responsibility of investment return on the behalf of shareholders. The supervisors are interior supervisors and some are employees, who shoulder no responsibility in making critical decisions. The supervisory board does not directly order or designate the board of directors, which makes it difficult to conduct an effective supervision, but only a “soft” supervision.
- China’s board of directors is designated by the shareholders metering and is responsible to the shareholder, not to supervision committee in Germany’s case. Though it makes critical decisions and designates senior managers, it is separated from the supervisors. This dual board system renders it asymmetrical between the entrust of power on directorate and supervisory board and responsibility of capital return. This soft constraint and supervision have been reflected in the practice of listed companies and other companies.
- “Code for Corporate Governance for Listed Companies in China” in 2002 brings in audit committee, compensation committee, nomination committee into the directorate, which curtails the efficiency of supervision.

5-3、Compare with the board system in two legal syatem

（1）The one tier system on the U.K. and U.S.A, and the two tiers system in Germany



（2）**Japan's binary committee**

- The directorate in Japan's stock company combines administration and supervision together, it is a unified system. But at the same time, it has a special supervisory board, so in this way, it is a binary system (not two tiers system). The structure is rather complicated. （Chizu Nakajima，1997）。
- Japan's corporate governance forum issued a mid-term report named "The principles of corperate governance structure-some thoughts on the corporate governance structure of new Japanese enterprises", which pointed out that "A supervisory board constituted by all outside directors should be set up in side the board of directors. In this way, the supervision system can be abolished, and a unified structure can be established". The report states a long-term goal of corporate governance reform in Japan.

（3）**The international trend**

Board structure is heading for a one tier committee, while outside directors will play important supplement roles. The general trend is a corporate governance pattern dominated and controlled by capital market

6、The direction of China's corporate governance structure reform

- The main issue is one share dominates exclusively and the lost of control on "insiders".
- The dual board system not only damages the principal-agent relation in corporate governance, but also results in the low efficiency of supervision.
- In the long term, we should combine corporate governance and capital market supervision together. The supervisory board should be included into the audit committee in the board of directors. That should be taken into consideration by the next amendment of "The Company Law of the People's Republic of China".

Thank you all!

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