

Executive Summary

The private sector emerged gradually after China's reform and opening up to the world economy. The following twenty and more years witnessed its vigorous and strong growth and today it (excluding foreign investment) contributes to nearly half China's GDP. Some of the private enterprises were listed after restructuring and have become a new force in the securities market. These privately controlled listed companies (whose ultimate controllers are natural individuals) are the private (ownership) listed companies referred to in this report. In the Shanghai Stock Exchange market, 212 private ownership listed companies account for 1/4 of the number of all the listed companies, their capitalization accounts for 11.34% of total market capitalization, and their floating capitalization accounts for 16.82% of total floating capitalization.

Similar to other listed companies, a comprehensive set of corporate governance practice has been adopted by these private listed companies. However, on the one hand, controlling shareholders have strong interest in these companies so that agency problem is less severe compared to state controlled listed companies. On the other hand, because of a lack of effective protection of shareholder rights, these companies are more likely to misappropriate assets of other shareholders, i.e. the moral hazard become a bigger problem as controlling shareholders abuse their power. In summary, the prominent characteristics of corporate governance of these companies are listed below.

Firstly, differences between ownership and controlling interests are more severe in private ownership listed companies. The ultimate controller of these companies usually adopts a pyramid group structures to maintain control with lower investment. On average, the ultimate controller only needs to invest 22.42% of a company in order

to control 34.32% of its interest. Such differences between ownership and controlling interests bring negative impact on company's business performances.

Even more complicated are the ownership and controlling interest of private conglomerates. They have exacerbated differences between listed companies' ownership and controlling rights through the control of a few listed companies and thus have exerted negative influences on company's business performances. Some of these conglomerates disguise themselves in the process of industry integration and diversification, and take advantage of the regulation loopholes. They tunnel company assets and manipulate stocks through their complicated relationship within the conglomerate. These severely undermine the stability, health and development of securities markets.

Secondly, family control is wide spread in private ownership listed companies and is reflected in a lack of democratic decision making process as a key person determines everything. This leads to a lack of internal risk control mechanism and affects the rights of medium and small investors.

Thirdly, in the incentive aspect, private ownership listed companies tend to have lower equity based compensation, this may have something to do with management's preference of salary based compensation; the external directors mostly are paid by cash, and legal responsibility is therefore not commensurate with their compensation, undermining their effective roles in the company's board meeting decision process.

Fourthly, in terms of information disclosure, private ownership listed companies perform relatively unsatisfactory and the percentage of repeated violations is high. Their motivations in these violations mainly come from an intention to "hide

company bad deeds” and “protect company image”. However, because of untradable share issues, their incentive to conceal information or disclose false information will not be strong.

Fifthly, in terms of financial performance, listed non-private ownership companies perform better than of private ownership listed companies. For example in 2003 and 2004, the gross sales margin, the return on equity, the return on total asset, and the sales per employee of listed private companies are all below those of non-private listed companies.

The main reasons that domestic private listed companies perform less favorably in terms of corporate governance and business outcomes are directly related to the following two factors.

Firstly, due to different preferences of financing channels, the listing requirements, and listing costs, many private enterprises have not become listed in the domestic market. According to 2003 statistics by National Industry Association, the top 500 private enterprises averaged 14.1% in terms of return on equity, far exceeding the 3.1% of listed private enterprises. Many outstanding private enterprises have not been listed. Another statistic shows that in the top 50 private enterprises in 2002, 28 have not been listed and neither are the subsidiaries of their control.

Secondly, many good private companies choose to list overseas. Research has shown that average return on equity of private enterprises listed overseas is 2.4 times of that of domestically listed private enterprises.

The above analysis has shown that corporate governance and business

performance of listed private companies are not necessary better than that of other listed companies. Considering their status quo and problems in corporate governance, this report raises the following suggestions:

Firstly, the external environment for good corporate governance must be improved. This shall include setting up effective property and shareholder rights protection and improving a fostering regulatory environment to allow these companies the same status as state enterprises in industry entry and direct and indirect financing.

Secondly, natural person shareholding companies should be encouraged to list with all their assets to ease problems from the differences between ownership and control. This will help lower moral hazard risks associated with the power of the ultimate controller and will help reduce illegal activities associated with related-party transactions, fund misuse and guarantees that violate regulations.

Thirdly, the information disclosure on the ultimate controller of listed companies must be accurate and timely. For example, regulations need to clarify the test rule for the ultimate controller, and include other activities such as indirect control through trust agreement and other private agreements as information to be disclosed.

Fourthly, regulations on companies with strong separation in controlling rights and cash rights should be strengthened, especially with regard to refinancing, related party transaction, guarantees, information disclosure, minority shareholder rights protection, competition within the industry, and ownership changes so that a more transparent information disclosure system is in place.

Fifthly, regulations should be strengthened in the mergers and acquisitions related to private ownership companies during the decentralization process, for example, the funds used in M&A should be checked against its legitimacy and regulations should prevent private ownership companies from using controlling listed company's funds to buy out other listed companies.

Sixthly, both the civil liability measures and criminal punishment measures need to be strengthened for directors and executives of listed companies. As ownership and controlling separation is severe for listed companies of private ownership, there must be effective constrains to curb any activities that affect company's (small investors') interest. Legal measures are needed, such as detailing the civil responsibilities of securities market illegal activities through legislative means, and toughening of criminal punishment to deter directors and executives from misusing company assets and tunneling shareholder's wealth.

Seventhly, the listing rules should be revised along with the strengthening of regulation and legal environment to lower listing cost and attract good private enterprises to list on domestic market and to allow domestic investors to contribute to and share the fruit of the development of private sectors.

Lastly, the reform on the untradable share issues must speed up. The percentage of untradable shares should gradually decrease to zero so as to promote the healthy development of the market for corporate control and improve the efficiency of capital markets.