

Executive Summary

The progress toward a market-based modern corporate China started after the Third Plenary Session of the Eleventh Central Committee of the Communist Party of China. The Corporate Law for Joint Ventures enacted in 1979 requires joint-ventures to set up the board, setting a leading example for board based operations of the modern Chinese corporate system. The 1993 Company Law made pathbreaking requirements that limited liability companies should set up the board of shareholders, the board of directors, and the board of supervisors; that wholly state-owned enterprises should set up the board of directors instead of the board of shareholders; that limited shareholding companies should set up general shareholder's meeting, board of directors and the board of supervisors; The law has also delineated specific descriptions as to the power of each of these boards.

Since then and more so recently, the board system of listed companies has made substantial progresses. Firstly, the systems of independent directors and the board's sub-committees have basically been established. Nearly half the listed companies have set up sub-committees, which provide a foundation for the independent and effective board operation. Secondly, the rights of shareholders, especially small investors, have been strengthened. More than half of the listed companies have adopted cumulative voting in electing board members and therefore broadened the representation from the shareholders. Thirdly, decision-making rules and procedures for the board are also improving gradually. Above 90% of the listed companies formulated detailed rules on how to decide on company issues. Corporate China has gradually formed some generally accepted outlines on rules of the board in deciding company issues according to the Corporate Law and the practice of good corporate governance. Fourthly, board member liabilities including civil liabilities have been basically defined, for example, in January 2003, the Supreme People's Court enacted "Several Provisions on the Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market", under which both the Securities Law and the Company Law become more implementable.

With the deepening of China's economic reform, corporate governance including the running of board is becoming more up to the standard. However, because of the long term impact of the traditional plan economy, problems at a deeper level still remains. This in turn has severely limited the independence and effectiveness of the board operations.

Firstly, there is a serious problem of insider control and formalism in board operations. As most listed companies are transformed from state-owned enterprises through the corporatization reform, they have a large percentage of non-tradable state-owned shares and legal-person-owned shares, the largest shareholder and state shareholder basically controls the board, and the representation of tradable share shareholders are very limited. The operation of such a company is therefore controlled by a few keymen and the operation of the board is more of a formalism.

From March to May 2004, the research center at Shanghai Stock Exchange surveyed 208 Shanghai listed companies and paid visit to some of these companies. The survey shows that more than half the board directors are nominated by the largest shareholder, and more than 40% of the board members are nominated by state shareholder. Excluding independent directors, the number of directors from state shareholder constitutes more than 60% of the board members. About 40% of the surveyed companies have yet to establish more detailed voting procedures and rules, and the processes are currently controlled by chairman of board and the largest shareholder. In addition, although most surveyed companies have set up cumulative voting rules, a substantial number of them still use simple majority voting rules in practice. Perhaps more importantly, whether the cumulative voting system is set up or not, the representation of tradable share shareholders is still very limited.

Secondly, the independence of the decision-making of the board should be strengthened. On one hand, the chairman usually holds excessive power, and almost all decision-making rules and procedures are determined by representatives from the board and the large shareholders. On the other hand, attendance on board meeting is low, the participation of independent directors is limited and direct intervention by large shareholders on board meeting is quite frequent.

Thirdly, the lack of independence of independent directors reflects that the system has still many problems and obstacles to be overcome. Firstly, the election process of independent director is not up to the standard, and generally cannot ensure independence of the selected directors. In fact, 90% of the independent directors are nominated by the largest shareholder. Secondly, independent directors are mostly reputable individuals of whom nearly half come from universities and research institutes. They usually are lack of the time, energy and practical experience to perform their duties. Lastly, the incentive mechanism for independent directors is quite uniform and there is a lack of dynamic and long term performance based compensation scheme.

Fourthly, the sub-committees of the board have yet to play an important role. The independence of sub-committees depends on the independence of independent directors. The committee's independence cannot be ensured without the directors being independent. At present, an independent director can hold different positions in more than several sub-committees, making such committees less effective in their operations. In addition, the operation of the sub-committee depends on the right to find out the company issues and the right to investigate, but currently such rights are quite limited. Lastly, the sub-committees have overlapping functions relative to other organizations such as the board of supervisors.

Fifthly, there is a lack of sound evaluation and compensation system of the board, especially the mechanism to motivate board members in the longer term. Our survey shows that on average an executive director owns about RMB150,000 each year, but generally there is no long term incentive based compensations. In addition, the outside non-independent directors usually hold relevant positions at the parent company and are not paid by the listed company. This is what we call "zero salary directors". In fact among the 208 listed company surveyed, only 7 of them are paying the outside

non-independent directors.

Sixthly, the legal system is yet to be improved. The civil rights and obligations of directors are not clearly defined and are not comparable to each other. The lack of a sound financial responsibility system in China often leads to the over-reliance on criminal and administrative punishment and the neglect of (in some cases forgo of) civil compensations. The provision of the current Chinese law on civil liabilities is not detailed enough for any effective implementation and therefore there is a lack of legal basis on putting a case on file except for those cases involving misrepresentation. In both legislation and practice, director's violation of the rights of shareholders and other related parties can't be effectively punished and investor's means for seeking judicial remedy is very limited.

The reform of China's corporate governance is an ongoing process. From the set up of the basic objectives to their realization, it will require long time efforts. All the problems mentioned above can only be solved with the development of corporate governance. The effectiveness and independence of the board are interweaved with the improvement of overall corporate governance in China. The improvement on one can provide opportunities for the improvement on the other. Therefore, the following reform measures we propose are not only ways to improve the board operations but also necessary for the improvement of overall corporate governance in China.

Firstly, the system for electing directors should be improved. Large shareholders and keymen's control of board should be prevented to promote boarder representation of all shareholders. We should (1) introduce and enforce cumulative voting, and take active measures to prevent large shareholders from interfering with cumulative voting through such methods as reducing the number of directors on the board. (2) require that there be representatives of tradable share shareholders on the board. (3) lower the barriers on minority shareholders to exercise their rights, for example we could stipulate that shareholders with more than 1% of the shares should have the right of nominating the directors and the right to propose the discharge of a director. (4) introduce remote voting system such as online voting system, and (5) improve relevant mechanisms for the proxy voting rights.

Secondly, decision-making procedures on company issues need to be improved. (1) the regulations should provide higher standard on such procedures and ensure the establishment and implementation of feasible and reasonable board decision-making rules and processes. (2) The rights of the board chairman should be restricted in areas of the composition of board members, the selection of topics of discussion, the voting on proposals, etc. (3) The stock exchanges and the regulators could set up mechanisms to examine the directors' attendance rate of board meetings. (4) The board should abolish anonymous voting. (5) The board should ensure the independence of the decision-making process and effectively prevent related parties in board meetings concerning their transactions. (6) Secretary of the board should play more important roles, and have enough resources to carry out their work.

Thirdly, listed companies need to strengthen the role of independent directors, and establish the incentive based compensation scheme for them. (1) They need to clearly define the qualification of independent directors. In addition to being

independent and having relevant expertise, the independent directors should have enough time and energy to put into the operation of the board. The independent directors should perform duties in no more than two listed companies. (2) The listed companies should improve the process of selecting independent directors, and prevent the control of controlling shareholders on such a process. (3) The listed companies should increase the percentage of independent directors and so that eventually the number of independent directors should exceed 50% of the number of board members. (4) The listed companies should strengthen the communication between the independent directors and the senior management, improve the participation of independent directors in the company's activity and establish special rules to ensure that independent directors can implement their plans. (5) The listed companies should establish a combination of fixed and equity based compensation scheme. (6) The listed companies should establish effective controlling mechanisms for independent directors and make their rights comparable to their responsibilities. (7) The listed companies should coordinate the relationship between independent directors, supervisors and the supervisory board. The independent directors should be more involved in recruiting, remunerations, auditing, and other important business decisions, while the supervisors should be more involved in the monitoring of internal financial affairs and the activities of the directors and managers.

Fourthly, efforts are needed to gradually improve the role of sub-committees under the board. At present, the right to be informed and the right to investigate should be the emphasis. The role of the auditing committee and remuneration committee should also be strengthened and they should be provided with good external environment and supplementary measures. In the medium to long term, with the establishment of relevant measures, listed companies should increase the percentage of independent directors, and provide foundations for furthering the role of sub-committees.

Fifthly, efforts are also needed to soundly manage the relationship between the board and the senior management. Whether one person should assume both the role of the chairman and that of the CEO should be left to the choice of the company, but the independence of the board needs to be protected. On one hand, the board should provide sound evaluating and monitoring mechanism to ensure that the board should provide strategic guidance and provide effective monitoring of the management. On the other hand, the board should give the management full authorization on daily business decisions.

Sixthly, the listed companies should improve the compensation system for external directors and establish proper shareholding plans for directors. Fixed compensation such as bonus, annual payment and fringe benefits should decrease in percentage and efforts should be focused on strengthening the role of remuneration committee under the board.

Seventhly, the listed companies should strengthen both the responsibility and the rights of directors. (1) The responsibility of the directors should be legally defined, and the provision on their civil liability to the third party should be included. The directors should be responsible together with the company for damages done to the

third party when there is a violation of civil rights. (2) The civil responsibility of the director should be strengthened. A more scientific and proper provision should be established to provide the legal basis and procedural support for ascertaining director's civil liabilities. (3) more severe criminal punishment should also be enforced on cases such as abuse of company assets and tunneling.