英文摘要

China Corporate Governance Report 2003

Executive Summary

The Transformation of Corporate Governance in China

A good corporate governance is of vital importance, and it can never be accomplished without our constant efforts.

The Chinese economy has undergone a long and arduous journey from a planned economy to a market one in the past fifty years. Coupled with this economic transition, great changes have taken place in the corporate governance of Chinese enterprises. The history of the changes can be divided into three phases: the administrative governance before 1978, the planned and market-based two-track governance during 1978 and 1992, and the evolving modern corporate governance after 1992.

The Chinese governance reform started among the shareholding companies in the early 1990's. Many state-owned enterprises were listed after being restructured into shareholding companies. The number of listed companies on the Shanghai and Shenzhen Stock Exchanges reached a total of 1223 at the end of 2002.

At the turn of the century, as the worldwide movement for better corporate governance is on the rise, China is putting extra emphasis on the significance of governance. Shanghai Stock Exchange (SSE) conducted comprehensive and in-depth research at the end of the 1990's, and put forward "Shanghai Stock Exchange Guidelines for Corporate Governance of Listed Companies" in October 2000. Aiming at practical issues, this pioneering guideline is a comprehensive, systematic, and implementable recipe for listed companies.

In the first half of 2001, the China Securities Regulatory Commission (CSRC) began to draft corporate governance guidelines for the Chinese listed companies. Shanghai Stock Exchange actively involved in the drafting process. In January 2002, CSRC and the State Economic and Trade Commission (SETC) jointly published "Code of Corporate Governance for Listed Companies in China". This comprehensive

code is the first binding regulation for listed companies' corporate governance practice. Based on this standard, the CSRC and SETC carried out a comprehensive inspection on corporate governance at more than 1,100 listed companies in 2002. For this reason, 2002 is called the "corporate governance year".

During the past ten years, China is accelerating its development process of listed companies' corporate governance. However, since most listed companies were transformed from state-owned enterprises, the Chinese securities market is still an emerging market of a transition economy, and the improvement in corporate governance is only at a very early stage. It is no surprise that China has many problems in this area. Below, we will discuss both the main progress and existing problems of corporate governance in China. We will also provide relevant reform measures and policy suggestions.

Ten Highlights of the Corporate Governance Reform

From the mid-1990's, the significance of corporate governance is increasingly recognized all over China. Legislative and regulatory bodies as well as self-regulatory organizations have enacted a series of regulations. The listed company's corporate governance has been gradually improving. In short, during the recent years, China has made progress in corporate governance mainly in the following ten areas:

1. Role of the Government redefined

As the immediate predecessor of China's market economy is a planned economy, the government inevitably becomes a key figure in corporate governance. On the one hand, the government enacts laws and regulations, sets up rules for the market, regulates the economic activities, and supervises the implementation of corporate governance institutions that it imposes on the companies. On the other hand, the government is a major shareholder of the company. The overlap and conflict of being both referee and player, combined with the inefficiency caused by pursuing political objective instead of taking responsibility as a shareholder, are the apparent negative influences on governance qualities. In order to minimize these influences and improve the efficiency of state-owned enterprises, China is constantly exploring new paths for

its state asset management system by trial and error.

Under the pre-requisite of state ownership and following the idea of reducing government direct control, the post-1987 state enterprise reform emphasized on transforming the enterprises into independent for profit businesses by introducing market incentives. In 1987, the government began to adpot various forms of “contract responsibility system” based on the “factory manager responsibility system”. At the same time, in order to expand equity financing, the state began shareholding reform for some enterprises. At the end of 1991, with the establishment of Shanghai and Shenzhen Stock Exchanges, some shareholding companies became listed and achieved ownership diversification.

In November 1993, the Third Plenum of the Fourteenth Central Committee of the Chinese Communist Party passed “the decisions on several issues about building socialist economic system”, put forward the concept of “modern corporate framework”, emphasized the separation of ownership and management, and encouraged the development of diverse ownership structures including “private, individual, and foreign enterprises”. Subsequently, the Corporate Law enacted in December 1993 provided legal support for the “modern corporate framework”. In 1995, the State Council selected 100 large enterprises for the corporate experiment and by the end of 1996, about 5800 state-owned enterprises had completed the corporate reform. In the listed companies, the government maintained the control by having majority shares and keeping state shares out of circulation. In September 1997, the Fifteen’s National Congress of the Chinese Communist Party put forward the reforming policy of “keep the big and privatize the small”, which encourages merger to form large corporate groups and promotes restructuring to vitalize small-sized state-owned enterprises.

On the Eighth of December 2002, the report of the Sixteenth National Congress of the Chinese Communist Party established the new direction for reforming the management of state assets. The report put forward principles such as “The state should set up laws and regulations, and establish a state asset management system

under which the central and local governments represent the state in performing their duty and acquiring owner's rights. Such a system unifies responsibility, obligation, and rights, and shall integrate the functions of administering asset, personnel, and other affairs", "The central government represents the state in performing its duty on large state enterprises, infrastructure, and crucial natural resources that have a vital bearing on the lifeline of state economy and national security. The local government represents the state in performing duty on the rest of the state assets.", "The central government, and the provincial or city (local) government should set up organizations for state asset management ". On March 10th, 2003, the first meeting of the Tenth National People's Congress passed the reform measures proposed by the State Council. On April 6th, the State-owned Asset Supervision and Administration Commission (SASAC) is established. China has made a crucial step in separating government roles in state asset management and in public regulation. Without question, this will provide a foundation for the government to take the right position in microeconomic activities and corporate governance.

2. Legal and regulatory environment improving constantly

The Corporate Law of the People's Republic of China, the basic law governing corporate governance, came into effect on July 1, 1994 and it is based on "Regulatory opinions on shareholding limited companies" and "Regulatory opinions on limited companies" issued by the Commission for Reconstructing the Economic System. The Securities Law of the People's Republic of China issued on December 29, 1998 further established the three principles of Transparency, Fairness, and Equity and the principle of protecting shareholder's rights. It provides another legal support for improvement in corporate governance in China. Nonetheless, the Corporate Law and the Securities Law are inadequate in many aspects due to outdated concept and limited practical experience at the time they were drafted. For example, there are lack of measures to stop controlling shareholders from abusing the limited liability principle; there are inadequate protection for minority sized shareholders; there are excess reliance on administrative measures to directly limit improper behaviors of market participants.

In order to meet the changing demands of corporate development and to cope with the inadequacy of existing laws before a formal modification, China issued many supplementary stipulations related to corporate governance. For example, the National Securities Commission and the Commission for Reconstructing the Economic System formulated "Compulsory clauses in the article of association for companies to be listed overseas" according to the "the State Council's Special rules for shareholding limited companies for overseas IPO and listing". The CSRC issued "Guidelines of listed companies' articles of association", "Regulatory opinions of listed companies' annual general shareholders' meetings", "Guiding opinions about establishing independent director system in listed companies", and many other regulations of information disclosure; the Ministry of Finance issued "Accounting principles for related party transaction and its disclosure" in 1999; the People's Bank of China issued "Corporate governance guidelines for commercial shareholding banks" and "Guidelines for commercial shareholding banks on the independent director and external supervisor system", etc.

2002 is China's "Corporate Governance Year". China has made great progress in the legal and regulatory environment as part of the overall scheme in promoting corporate governance. The supreme court issued "Notice on issues related to civil actions against securities market misrepresentation" and "Several provisions on hearing civil cases related to securities market misrepresentation", making China's first move in establishing securities civil compensation schemes. The supreme court also issued "Provisions on several issues related to hearing bankruptcy cases", providing external incentives for strengthening corporate governance through bankruptcy and liquidation. In 2002, the CSRC and the State Economic and Trade Commission jointly issued "Code of Corporate Governance for Listed Companies in China", a guiding document for promoting the practice of corporate governance in China.

3. Large shareholders' violation of listed companies' interest under control

In the recent years, CSRC and other government organizations formulated regulations to prevent controlling shareholders from violating listed companies' interests.

In terms of related party transaction, two regulations, "the Accounting principles

for related party transaction and its disclosure" by the Ministry of Finance in 1999 and "Code of Corporate Governance for Listed Companies in China" by CSRC and SETC in 2002, both compel companies to disclose related party transaction, ensure fair transaction price, and obtain independent opinions from the independent directors.

"Notice on issues related to listed companies providing guarantee to others" issued by CSRC in June 2000 stipulates that the listed companies are not allowed to provide guarantee to its shareholders, to companies that its shareholders have a controlling interest, to companies that its shareholders have an affiliation, or to any individuals. CSRC also requires listed companies to achieve the "separation of the five"[1] and disclose in details related information in their annual report from 2000. Based on this notice, some listed companies demand that large shareholders return the illegally obtained companies' assets. Some have even resorted to legal procedures.

In addition, the development of proxy voting also helps to prevent controlling shareholders and management from infringing company's interest.

4. Rising independency boosting board's role

As regulatory bodies and self-regulatory organizations are attaching greater importance to board independence, great improvements have been made during the recent years.

First, people have gradually realized that the independence and effectiveness of board is crucial to a company's corporate governance. Some companies have begun to improve the structure and function of their boards and have increasingly emphasized the key role of the board in corporate governance.

Secondly, board independence is improving significantly. Regulations require that in the event of a conflict of interest, directors should not participate in voting, and independent directors should intervene. After CSRC issued the "Guiding opinions about establishing independent director system in listed companies" in August 2001, listed companies began to engage independent directors. According to the guiding opinions, by June 30, 2003, 1/3 of the listed companies' board members should be independent directors. Although it is not rare that independent directors are not independent "enough", their increasing role in ensuring independence is without question. In addition, some listed companies' boards also set up special committees,

[1] "Separation of the five" means that listed companies, their controlling shareholders, and other related parties should not share employees, assets, accounting, business, and divisions.

such as Investment Committee, Audit Committee, Financial Management Committee, and Strategy Committee, to perform some special functions of the board.

5. New incentive mechanisms under test

The Chinese enterprises have extensively explored incentive mechanisms under existing laws. During the mid-1990's, some of them experimented the annual salary system for the managers. Later, some listed companies explored using equity-based compensation as an incentive. At present, listed companies adopt one of the four representative stock incentive programs: 1) paying stocks as bonus; 2) paying bonus based on stock price, for example, management's bonus is paid based on the product of the number of phantom shares rewarded and the share's market price; 3) paying bonus based on net profits, for example, the company can set up a rewarding fund for directors, senior management, and other people with significant contributions. The source of the fund comes from the companies' net profit. It can only be used to buy shares for those to be rewarded and the shares may not be accessed until a later time; 4) requiring the buy-and -hold of a certain number of shares, for example the senior management may be required to hold a certain number of the company's public shares.

The equity-based compensation programs can unify the interests of managers and owners, enhance the effort of senior management as well as employees, and increase shareholder's value.

6. M&A market on the upswing

Progress in the M&A market is remarkable during recent years. Volume of M&A has been increasing at an annual rate of seventy percent in the past five years. China has become the third largest M&A market in Asia. Ever since the first M&A case, Shenzhen Baoan acquiring Yanzhong in September 1993, the number of changes of listed company's controlling owner increases every year. According to the survey conducted by CSRC and SETC in 2002, 30% of all the listed companies (a total of 338 companies) had a change of controlling owners through transfer of non-tradable shares.

In October 2002, the CSRC issued "Regulatory Measures for Listed Companies' Mergers and Acquisitions", providing a favorable framework for the further development of M&A market. The measures establish equal status of all market

participants and provide two forms of acquisitions, through negotiation and through offering, to take control of listed companies. The transfer of non-tradable state shares and state legal person shares expands further the base of M&A market. With a series of CSRC policy measures in place, the objectives of acquisition are gradually becoming long-term and strategic.

In November 2002, the CSRC, the Ministry of Finance, and the SETC jointly issued "the Notice of several issues related to transferring state shares and legal person shares to foreign investors", allowing transfer of listed companies' state and legal person shares to foreign investors. By the end of May 2003, the number of listed companies that have non-tradable foreign legal person shares reached 84, of which 52 are listed in Shanghai and 32 are listed in Shenzhen. The participation of foreign investors will help promote the development of the M&A market in China.

7. Institutional investors growing rapidly

Institutional investors grow rapidly from 1998 under the support of a series of policies. The mutual fund has achieved unprecedented development in particular. According to the current market classification, there are five types of institutional investors, the mutual fund, the pension fund, the insurance company, the security company, and the investment company. These institutional investors are gradually becoming the pillar of the securities market, and they are beginning to play an active role in corporate governance.

In November 2002, the CSRC and the People's Bank of China jointly promulgated the "Qualifying Foreign Institutional Investors (QFII) Investing in Domestic Securities Markets Tentative Procedures". This policy allows qualified foreign institutional investors (QFII) to invest in China's A share[2] market. Currently, a number of domestic and foreign banks have been approved to be custodian banks for QFII and several international investors are granted the QFII licenses. QFII is believed to attach great importance to corporate governance and sustainability of

[2] Access to the "A" share (RMB denominated shares issued by PRC companies listed on one of the two domestic Stock Exchanges in Shanghai and Shenzhen) market was previously reserved only for domestic PRC individuals and institutions and consequently off-limits to offshore foreign investors.

listed companies' profit. Their entry will increase the overall efficiency of the equity market and have an active impact on the corporate governance in China.

8. Creditor's role in corporate governance attracting attention

Recently, the state banks have made noticeable progress in the transition toward for profit banks of a market economy. According to international standards, the domestic commercial banks have carried out the "five category" quality system for loan classification, improved the method of evaluating bank assets, and continuously upgraded the internal control and risk management of their lending business. Through introducing specialized asset management companies to enliven assets, the state commercial banks aim to reduce the percentage of non-performing loans. They are striving for better asset qualities by optimizing on the newly increased loans. With the change of state banks from traditional passive loan providers to modern banks, the borrower companies are facing stronger external pressures for better performance.

From 1999, three shareholding banks, Pudong Development Bank, China Minsheng Banking Group, and the China Merchant Bank have become listed after a series of restructuring and reform. Through this process, these banks successfully increase their equity, introduce new investors and external supervision, strengthen information disclosure, and give management more incentive in improving performance. Currently, the four state commercial banks are also under active reform in their equity assets, organizational structure and development strategies. They are following the corporate governance model of modern financial companies. After meeting certain requirements, these banks may also become listed.

In June 2002, the People's Bank of China issued "Corporate governance guidelines for commercial shareholding banks" and "Guidelines for commercial shareholding banks on the independent director and outside supervisor system". The former defines the right and responsibility of shareholders, directors, supervisors and the general manager, and lay down the incentive scheme in corporate governance. Through setting up this basic structure, it distinguishes right and responsibility, and enhances governance in the commercial shareholding banks. The latter provides comprehensive and concrete rules for the number, election, qualification, rights and liabilities of the independent directors and external supervisors so that those selected will have a high level of independency and provide supervising functions to promote

the safe operations of the banks. The good corporate governance in banks will no doubt create a better chance for borrower companies to improve their governance.

9. Self-regulatory organizations and intermediaries playing greater roles.

With the growth of the market economy, the accounting profession experienced tremendous development. In 1999, in order to ensure independence, professionalism, and fairness, the Ministry of Finance required that the accounting firms should separate its employee, accounting, business, and name from their original parent companies. From then, the accounting profession began to change from effectual affiliates of state-owned enterprises into social intermediaries that are responsible for their own business, risk, and development. In the end of 2002, there were about 4300 accounting firms, of which 71 firms have securities and futures related business licenses. In 2002, the Ministry of Finance, which is in charge of setting accounting standards, made a series of major adjustments to harmonize domestic accounting standards to the International Accounting Standards. By March 2002, China had made five batches of regulations, a total of 46 independent accounting standards, including independent audit foreword, basic principles of independent auditing and three related principles, 27 concrete clauses, 10 practical announcements and 4 professional guidances. This preliminary structure of independent auditing rules has already begun to have an effect. From 1993, the number of unreserved audit opinions gradually falls, and correspondingly the number of qualified opinions rises. At the same time that the accounting profession is gaining maturity, it will play a greater role in the securities market.

In addition, some self-regulatory organizations and professional associations are taking part in the process of improving listed company's corporate governance. After two years of extensive investigation and research, Shanghai Stock Exchange issued "Shanghai Stock Exchange Guidelines for Corporate Governance of Listed Companies" in October 2000. Aiming at practical issues, this pioneering guideline is a comprehensive, systematic, and implementable recipe for listed companies. The Shanghai Association of the Secretaries to the Board of Listed Companies has also published "Guidelines for implementing the strategic committee of the board", "Guidelines for the nomination committee of the board", "Guidelines for the renumeration and evaluation committee of the board", etc.

10. Improving disclosure

On the path toward a mature securities market, the Chinese regulators are attaching greater importance to the role of disclosure in promoting the healthy development of market. Their endeavor during the past several years has produced remarkable improvement in the institution for information disclosure. As a result, the quality of disclosure is experiencing significant progress.

In terms of the law and regulations, China has established a multi-dimensional and multi-layer disclosure regulatory system formed by the Securities Law and related administrative regulations or provisions. Great improvements have been made in the content and means of disclosure, and detailed provisions are also in place. Especially after the "examination, verification, and approval system" for IPOs came into effect, regulators made a large number of amendments to existing rules and issued many new regulations concerning disclosure. The resulting disclosure regulations are compulsory in nature and emphasize on authenticity, accuracy, completeness, timeliness, and effectiveness. They fully reflect the regulators' advocate of quality disclosure.

In terms of disclosure standards, on the one hand, China is speeding up in making accounting standards; on the other hand, it is integrating the traditional sector-specific accounting methods. The difference between the Chinese accounting standards and the International Accounting Standards is becoming smaller.

It has been well recognized in China that disclosure is crucial for good governance. On the one hand, the regulators require that listed companies establish internal functional mechanisms for disclosure and have a balancing mechanism to ensure the authenticity, accuracy, completeness and timeliness of such disclosures. One the other hand, the regulator requires that listed companies improve transparency through separate disclosure of governance related matters.

Eight Basic Problems in Corporate Governance of Listed Companies

As the securities market is growing and expanding, listed companies are on a journey toward good corporate governance. It is worth noting that most listed

companies are transformed from state-owned enterprises, the securities market is still an emerging market, and the improvement in corporate governance is only at a very early stage. Therefore there is no surprise that we can find many problems in their corporate governance. In sum, eight basic problems exist in the corporate governance of listed companies.

1. Improper shareholding structure

Chinese listed companies have three types of shares, the state shares, the legal person shares, and the public shares. The state and legal person shares can not be traded in the secondary market, and are called non-tradable shares. The tradable public shares include A shares (shares that are denominated in RMB and listed on mainland exchanges.), B shares (shares that are denominated in US Dollar or Hong Kong Dollar and listed on mainland exchanges), or foreign shares listed overseas (shares that are denominated in foreign currencies and listed on overseas exchanges).

A prominent characteristic of Chinese listed companies is an overwhelmingly large percentage of non-tradable shares, which represents about 2/3 of all the listed companies' combined equity. The tradable shares represent the remaining 1/3. A majority of listed companies' non-tradable shares are 60%-80% of their total number of shares. A few companies even have more than 90% shares not tradable. About 6% of all the listed companies have more than 40% of their total equity in tradable shares. Only 0.4% of all listed companies have only tradable shares. On average, the larger the size of the company, the higher the percentage of state shares, which demonstrates that large listed companies are essentially state-owned.

The second characteristic of the shareholding structure is an excessive concentration of non-tradable shares. In the end of 2001, the average largest shareholder of an A share company owns 44.26% of all the company's shares; above 40% of the largest shareholders owns more than 50% of their companies' shares; in 74.4% of all the A share companies, the top five shareholders own more than 50% of their company's shares. According to statistics based on the 2002 annual report of 734 companies listed on the Shanghai Stock Exchange as of June 20, 2003, in the end of 2002, in 40.9% of all the companies (a total of 300 companies) the largest shareholder owns more than 50% of the company's shares; in 32.8% of all the companies (a total of 241 companies) the largest shareholder owns between 30% to 50% of the

companies' shares; the average largest shareholder owns 44.3% of its company's shares.

The third characteristic of the shareholding structure is an overly dispersed ownership of tradable shares and a tiny percentage of institutional investors. In the end of 2002, the number of accounts opened at Shanghai Stock Exchange stands at 35 million, of which 99.5% belongs to individual investor and only 0.5% belongs to institutional accounts.

The fourth characteristic of the shareholding structure is that usually the largest shareholder is a shareholding company instead of a natural person. The majority of Chinese listed companies are transformed from state-owned, collective, and private enterprises through restructuring. In the restructuring process, the state and legal person essentially transforms part of their assets into the non-tradable shares of the listed companies. The original enterprise becomes a shareholding company, and coexists with the listed company under a parallel or pyramid structure.

The above mentioned shareholding structure of Chinese listed companies is problematic. First, the institution for implementing state shareholder's rights is unsatisfactory. Either the government exerts too much influence on listed companies and the company's objective is affected by political considerations, or there is a lack of monitoring on the shareholders, resulting in insider control in the form of misuse of company assets and pursue of private objectives. Therefore, the company's objective deviates from maximizing shareholder's value. Secondly, the parallel or pyramid shareholding structure induces and facilitates related party transactions that impair the interest of listed companies. It also induces and facilitates controlling shareholders to tunnel the listed companies through its shareholding companies. Thirdly, under excessive concentration of ownership, the management is less likely to be subject to monitoring from a diverse set of owners. Minority investor's interest and the independence of board are at risk. Fourthly, excessive dispersion of the ownership of tradable shares is the reason for lack of direct control of public shareholders on the listed companies. Public shareholders have no direct role in corporate governance. Fifthly, because of the low percentage of tradable shares and a severe segregation of the equity market, hostile takeover is nearly impossible. As the room for operation in the M&A market is severely limited, the efficiency and quality of this market can't be achieved. Sixthly, because a majority of the shares are not tradable, the stock prices in

the secondary market are distorted. This prevents competition and the efficient allocation of resources, and leads to abnormal pecking order.

2. Misplaced government roles

Up till today, the development of market economy in China is mainly a result of reform measures initiated by the government. The development starts under the planned economy and is inevitably led by the government. Therefore, the government's economic policies and measures have a strong administrative-order nature. In making economic decisions, the state still has not broken out of the traditional path of administrative control. The role of the government in corporate governance is often misplaced. Frequently, the government acts as both regulator and owner.

First, from the perspective of the principal-agent relationship, the state-owned enterprise differs from the private enterprise in that the principal of state-owned enterprises is the "country" or the government. Without a clear definition of the controlling ownership, the state-owned enterprise is nominally owned by all the citizens but controlled by the government organizations and officials. As government organizations and officials are not the final shareholders, they are not responsible for the performance of the company. Their behaviors are governed by political incentives and individual utility maximization instead of shareholders' value. The problem is essentially a "lack" of ownership and a misplacement of government regulator in the position of the agent.

Secondly, unlike shareholders of private enterprises, the state as owner of the state-owned enterprises influences business decisions through several departments of the government. Inevitably the government will use administrative measures to directly affect business decisions and burden these enterprises with public functions. The objectives of these enterprises are diversified. In addition, the appointment of managers is determined not by the market force and business performance, but by the relationship with government officials. The performance is evaluated by the Party's department of organization and the government's personnel division. The government officials are not shareholders and are not responsible for business performance, therefore the system can't ensure that a real talent for management can become the manager. The administrative means of appointment also prompt managers to

emphasize on personal political futures and relationships with government officials rather than focus on business performance and expertise related to company's development. The misplacement of government roles has resulted in a disallocation of companies' resources and a distortion of business operations.

Thirdly, for a long time state-owned enterprises are run by multiple divisions of the government. This system of multiple owners has many drawbacks in the management of state asset. First, from the firm's perspective, multiple owners mean a long process of approval for every major decision. The decision cost is too high and the decision process is too slow. The road to enterprise development is full of obstacles. Secondly, the division of functions is not clear, each government department has a say in the business operations, and the enterprise is often faced with conflicting orders. Thirdly, a negative vote by any department of the government constitutes an overrule. Every department can easily overrule a proposal and none will take the responsibility of the company's final business results. This kind of power with no responsibility easily leads to abuse of power. Fourthly, during a transition period, this kind of multiple department responsibility system can lead to the other extreme, insider control. That is none of the departments will perform its ownership function and insiders can use their controlling power to maximize private benefit.

In 2003, China began to carry out the new state asset management system. This reform aims to completely separate government's role of regulator from its role of owner, but many detailed problems concerning the implementation of this reform remain to be solved. First, how to distinguish between the ownership of central government and that of local governments? Secondly, the size of state assets is huge, for example, total asset of the 196 core enterprises under the regulation of the SASAC amounts to RMB 6.9 trillion. How does the SASAC keep an efficient organization to manage assets of such a large magnitude? Thirdly, how do the future organizations for state asset management deal with the relation with other government organizations such as the State Development and Reform Commission, the Ministry of Finance, the Ministry of Commerce, the CRSC and the state's social security fund? Fourthly, how do the state asset management organizations appropriately perform its right in the state enterprises? Fifthly, how do the state asset management organizations administer the personnel? Sixthly, how do the state asset management organization select personnel and design incentive mechanisms for itself? Seventhly, the state asset

management organization is effectively both player and referee, setting the rules for asset management and participating in the management process. How to avoid and eliminate the conflict of these two roles? How to effectively regulate the "regulator"? Eighthly, as the local government is in charge of exercising the ownership rights, if the interest of local government and state asset are in conflict, how to avoid segregation of resources and equity markets caused by local protection? If the above eight problems can't be solve properly, it will be difficult to achieve good corporate governance of state-owned enterprises.

3. Legal self-enforcement is inadequate, and investors face obstacles in seeking legal protection.

The legal and regulatory structure is far from mature, although there is noticeable improvement in the legal and regulatory environment for corporate governance. In practice, the punishment on the illegal behaviors of insiders as well as violations in the securities market reflects an emphasis on administrative and criminal responsibility instead of civil liability, an over-reliance on government regulation and intervention, an unsatisfactory implementation of laws concerning investors' civil actions, and the difficulty of investors in the search of legal protection.

(1) Recently, the state amended the Criminal Law as well as enacted the Corporate Law and the Securities Law. The State Council's relevant division also issued "Tentative rules on securities issuance and trade" and "Tentative measures on prohibiting securities fraud". However, all these laws and regulations stress the use of administrative and criminal punishment on violators in securities market. They relatively neglect the civil liability and compensation, and have not provided a procedure and specific clauses for enforceable civil actions. This causes victims of securities market violations great difficulty in protecting their interest through civil actions.

(2) The judicial interpretation "the supreme court's several provisions about hearing civil compensation cases related to misrepresentation in the securities market" was issued on Jan. 9th, 2003. However, the market is lack of clear, concrete and implementable laws for victims of securities market violation such as insider trading, market manipulation, and insider's infringement on listed company's interest. Even if cases like these are raised, the court will not hear them. This incompleteness in investors' suing rights is the basic reason for lack of effective protection of investor's

interest. The punishment doesn't constitute effective deterrence on violators. The order of the securities market can't be improved if violators are not paying fully for their violations.

(3) In the punishment of securities market violation, administrative orders often replace legal discipline, or as in the above supreme court interpretation, the pre-requisite of an acceptance in hearing civil case is order from an administrative department and decision of a criminal case. All these greatly hinder investors from defending themselves by using lawful means. Many victim investors can not obtain effective legal protection.

(4) Lack of legal channels for civil action and protection for investors. The country's legal system has not adopted the highly effective class action widely used in the US and the derivative suits in the hearing of civil compensation cases related to securities market violations. These arrangements significantly increase suing cost and decrease efficiency and benefit of legal action, discouraging investors from fighting for their rights and in some sense encouraging violators through lowering their violation cost.

4. Insider control in corporate affairs and the key person model

Insider control, or the key shareholder control, is one of the main characteristics of China's corporate governance. Because of the lack of effective monitoring mechanism, insiders including the controlling shareholder and the management usually exert excess control on the company. This facilitates immoral and opportunist behaviors aimed at pursuing private gains rather than the best interest of the company. Typical "behaviors" include: 1) transferring and appropriating company's profit and assets through unfair related party transactions, for example, the controlling shareholders may seize a large amount of listed company's fund; the large shareholders may sell commodities, "services", and assets with "water content" at unfavorable prices to the listed companies. 2) neglecting conflict of interest and engaging in self-dealing in pursuit of private gains, for example, insiders may use company's resources for personal consumption; they may approve their own extravagant compensation packages despite severe losses of the company. "Poor company and rich insider" is not a rare combination in China. 3) cheating on profit level to meet public offering requirements, manipulating IPO and secondary market prices, and trading on insider information, engaging in deceiving public investors for

private gains through outright misrepresentation. 4) developing connections by using companies resources, for example, insiders may favor nepotism and appoint only those with certain “background”.

With a high concentration of ownership, if the controlling shareholders are individuals or other enterprises, the insider control problem is frequently associated with the phenomenon of family-type enterprises; if the controlling shareholder is the state, the problem is associated with conflicting political and enterprise objectives. A large number of direct interventions and political controls are inconsistent with maximizing company’s value.

In the corporate affairs, insider controller is a synonym for the key person. The key person has a large discretionary power and is frequently endowed with the power of control, execution, and supervision. The key person usually is the most senior executive manager and the de facto controller of the controlling shareholder.

The insider or the key person is the center for decision making on corporate affairs. He or she easily controls and manipulates the company’s general shareholder’s meeting, board meeting, and the supervisory board meeting, making them essentially “rubber stamps”.

5. Immaturities of the external governance structure

China’s reform and opening-up from the end of 1970’s is transforming the traditional planned economy into a modern market economy. However, the complexity and delicacy of modern economic system means that such a process may be a long one. The immaturities of the current market mechanism in China is the fundamental reason for the underdevelopment of market-based external governance, and for the ineffectiveness of corporate control market in ensuring “the survival of the fittest”.

First, the market for corporate control is still lagging behind.

Most important reasons for the underdevelopment include the high concentration of ownership, the insider or the key person problem, the conflicting objectives in managing state shares, the untradability of 2/3 of listed companies’ shares, the distortion of secondary market price, and the deviation from maximizing shareholder value because of government organization acting as agent for the state shares and because of controlling shareholders’ improper behavior. The main problems in the market for corporate control include lack of professional management, obstacles in

regulations, the inefficiency for the lack of competition, and high cost in obtaining information because of lack of transparency and prevalence of under-the-table deals, The lack of competition causes the prevalence of M&A deals that emphasize on short-term result from combining financial statements. Strategic deals that emphasize on long-term result are extremely limited. The dominance of un-tradable shares causes negotiation to be the main means of change in corporate control. This aggravates the difference in the rights between the owners of un-tradable shares and those of tradable shares. The buyer frequently seeks private gains through corporate control change. In the secondary market, we can even find manipulation in stock price and insider trading based on undisclosed information related to corporate take-overs.

Secondly, the governance of creditors is far from perfect.

In the credit and corporate bond market, creditor's rights are not well protected, and the corporate governance of borrower company is shadowed by the soft budget constrain of creditors. The reasons include 1) The dominant state commercial banks in the credit market are to some extent government subsidiaries. They are not founded on good corporate governance and are not operating as a for profit business. There is lack of independency in lending decisions, and the internal and external credit risk control is not up to the standard. 2) the bankruptcy and liquidation is usually arranged by the largest shareholder, i.e. the government, instead of the creditors. This usually results in apparent unfair arrangements to the creditors. 3) the practice of repudiating debts is prevalent and close to causing a social disaster, for example, there exists vicious bankruptcy to escape debt after company assets are transferred away.

Thirdly, institutional investors are still playing an insignificant role.

The Chinese stock market is still dominated by individual investors, with high volatility, high price earning ratio, high turnover, and high systematic risk. Investors prefer momentum trading styles and exhibit herding behaviors. The market is highly dependent on government policy. Declining and unstable post-listing performance adds to the high risk of long term investment. Investors are paying more attention to short term supply and demand in the secondary market and technical analysis than the fundamentals of listed companies' financial performances. Both individual and institutional investors are not willing to follow the buy and long-term holding strategy.

The key shareholder problem and the majority of non-tradable shares make it difficult for minority public shareholders to take control of the listed company and to

exert influence on the corporate affairs. The existing law stipulates that a mutual fund is not allowed to invest more than 10% of its net asset value in a single company, and that it is also not allowed to hold more than 10% of a listed company's shares. These provisions limit the voting shares of institutional investors and discourage them from actively participating in uplifting the corporate governance of listed companies. They prefer voting by their feet rather than voting by their hands. Moreover, the mutual fund is by itself lagging in the corporate governance. Shareholder activism is not in place yet. Some institutional investors even collude with listed companies to manipulate stock price through insider information and false financial information, only to generate adverse impact on the corporate governance of these listed companies.

In state controlled listed companies, the appointment of managers are constrained by the administrative system. The key person is frequently selected directly or indirectly by the government or the party organizations in advance. The board then follows the formality of appointment. The listed companies even exists the administrative (political) rank similar to that of a government organization, and the appointment is based on political relationship rather than entreprenurship. In private listed companies, the appointment of senior management is usually based on relationship to the family members of the controlling shareholders. Overall, market based management selection is not in place, resulting in inefficient allocation of management resources in the companies.

In addition, the compensation structures for the management in listed companies are quite uniform. Long-term equity-based incentive program is very limited, and performance based compensation is not generally adopted. The lack of market force in determining the compensation and incentive mechanism also prevents efficient allocation of management resources.

6. The quality of information disclosure not guaranteed

From the perspective of majority public shareholders, the information disclosed by Chinese listed companies is not reliable. For the listed companies, the form of disclosure is far more important than the substance. New regulations concerning disclosures are drafted and enacted with impressive speed, but the practice of disclosure lags far behind. A significant number of listed companies only comply with disclosure standard in form but not in substance. Some even don't bother to comply

with the form, for example they may create false financial statement with huge discrepancy between the actual and the reported numbers. The main reasons for low quality disclosures are:

First, lack of effective legal punishment for disclosers.

The false information discloser should be subject to penal, administrative, and civil liabilities. However in practice, many false information disclosers have only received administrative punishment. Such practice doesn't constitute effective deterrence.

Secondly, improper administrative intervention and lack of competition in the capital market.

A majority of listed companies are state enterprises or state shareholding enterprises. For some, the restructuring for listing is led by the government organization under the then listing quotas. The larger the number of listed companies, the larger the sum of financing, the more the resources in control, and therefore the greater the potential for GDP growth. When GDP growth formally or informally becomes a performance indicator of local government officials, the larger the number of listed companies, the more "significant" the political achievements.

Therefore, the process of listing becomes a political game, rather than a process based on market competition. As political and business objectives are overlapping in China, after getting IPO quotas, some government organizations directly or indirectly support enterprises to make false statement and help "package" unqualified companies to obtain chances for public offering. In addition, because of lack of investor protection, the equity financing is regarded by issuers as both "free lunch" financing with no obligation to repay principal and interest, and means to bring in substantial private gains. Even without the quota system, "hunger" for such financing exists still. Under such environment, some short-sighted intermediaries and their employees connive with listed companies to cheat investors either under pressure or out of profit motivations.

Thirdly, lack of proper internal control system for disclosure within the companies.

Chinese listed companies still have not established an effective system of internal control and accountability. Many have not installed independent and effective audit committee. Even if an audit committee is set up, its member composition and functions fall short of generating effective monitoring and control over the executives.

Board of supervisors and the internal audit organization are frequently dominated by the insider, and therefore are ineffective or even useless in monitoring the management.

7. lack of fiduciary duties and the supporting culture environment

Fiduciary duty means the responsibility of the agent to act in the best interest of the principal. In operation of a shareholding company, fiduciary duty requires that directors and management act in the best interest of all the shareholders, and act in due diligence. From the perspective of stakeholders and minority shareholders' interest, fiduciary duty require economic agents act in good will, work in due diligence, and maintain an integrity that is consistent with honesty, uprightness, reliability, and unselfishness.

The lack of due diligence of the director and the management in performing their fiduciary duty leads to the sacrifice of the principal's interest. For example, members of the board may abuse their voting rights, act in negligence, avoid responsibility, or even feel contented with existing only in name. They may be lack of integrity and neglect their responsibility to monitor insiders such as the management and controlling shareholders.

There are mainly two causes:

First, there is a lack of supporting institutions for good performance of fiduciary duty.

For example, in the underdeveloped legal system, the insider's private gain from violation far exceeds his private cost. There is a lack of deterring punishment on violators in certain laws and regulations. In particular, there is a lack of institutional arrangements based on the law and legal procedures for civil compensations in securities market and for investors' protection.

China is in need of not only a corporate governance legal structure, but also a mature self-regulatory system that provides practical solutions for best practices of corporate governance,

Secondly, there is a lack of supporting social norm for good fiduciary duties.

In the political, economic and legal aspects of society, the current China has still not all around formed a social and culture environment that cherishes uprightness, honesty and keeping one's words. These are to a large extent only in people's good wills, rather than voluntary behaviors based on maximizing individual interests that is

consistent with a social norm.

8. Stronger roles of the media and the public needed

Researches from comparing different countries has shown that the freedom in the media is positively related to the efficiency of government, the uprightness of society, and the development of securities market.

Supervision by the media and the public based on a free press can mitigate information asymmetry on the securities market, and can increase the transparency of listed companies and the market. It can also help investors bring down searching costs, understand the truth of related events, and obtain timely and accurately complete objective information of vital importance. Thus it improves decision quality, avoids irrational investment, and provides quicker control over investment risk. Supervision by the media and the public may also help listed companies operate in line with laws and regulations, prompt them to properly utilize investor's capital, and build up and cherish their good social reputation and image. With the right supervision, the efficiency of pricing and resource allocation in the securities market can be improved. A free, objective, professional and independent modern medium system is vital towards the healthy development of the securities market.

However, in the current Chinese securities market, the supervision from the media and the public is obviously insufficient.

Problems related to this issue include 1) Under the excessive control and external intervention in press and media's report of the securities and the listed companies, the independence of a free press and the freedom of media is limited. 2) The institutional arrangement for public opinion is not in place. Legal and systematic protection of free public opinion is insufficient. 3) There is a lack of self-governance and self-regulatory system for the press and media themselves. There is a lack of effectiveness, accuracy, professionalism and objectivity in the news and public opinions. Market based competition is greatly needed in this profession.

Fifteen Policy Recommendations for Improving Corporate Governance

Both research and practice have showed that a good corporate governance is essential to the healthy operation and development of enterprises. All problems

mentioned in the previous section are severely threatening the functioning and development of listed companies. Therefore, China has to make greater effort to further improve corporate governance to meet its current specific situation. The proposal suggested by this report is a comprehensive and coherent plan. We believe that only by starting from the most fundamental problem and by working on all aspects in coordination, can we effectively enhance corporate governance in the listed companies, and provide fundamental solutions to various difficulties.

1. Pushing forward in substance the reform in state asset management

In a transition economy, the government's dual role of being both a regulator and a shareholder of state enterprises is inevitable. The misplaced government position in corporate governance is having an adverse impact on its development. The new state asset management system provides a good beginning for concentrating government's role of state asset owner and for replacing administrative measures with market mechanism. However, the following steps in reform are tremendous tasks.

First, the scale of state assets should be downsized. The role of government in corporate governance is associated with its proportion of shares in companies. If the government is a controlling shareholder, the board meeting is likely dominated by a single shareholder. A large share in the company provides economic means for the government to exert administrative intervention, and administration may easily dominate market principles. A fundamental solution is to weaken the government's status in the company. The government therefore needs to decrease the percentage of shareholding in competitive sectors or even withdraw completely. China has about 180,000 state enterprises, most of them medium and small sized companies. From a management perspective, no organization or system can manage such a large number of companies. Therefore, in improving management of state assets, the reform needs to accomplish the "strategic withdraw" of government. The key of state asset management is to ensure that the right owner owns, and the key of the "withdraw" is to prevent unfair transactions and to ensure that the right buyer is in place.

Secondly, regulator and shareholder must be separate entities. Otherwise, the role of shareholder will inevitably be scattered among many government organizations. Everyone can intervene in the business operations and none is willing to take responsibilities. The state enterprises with no unified objectives and profit motivations must satisfy various requirements and preferences and therefore cannot become a true

competitor in the market.

Thirdly, the market mechanism should be fully utilized and the administrative intervention should be minimized. Only under a competitive market environment, can a good corporate governance play an active role. Therefore, the government is facing an important task of providing proper institutional environment for listed companies. The proper roles of the government are in setting fair, efficient, and transparent rules for the market and in ensuring their enforcement. When the government stops being both player and referee, the market mechanism will begin to take a role in corporate governance at a larger scale and with profound impact.

Fourthly, the new asset management organization should confine its role to ownership. As representatives of state asset, it must exercise shareholder rights according to corporate law and not by direct intervention in the business.

Fifthly, the objective of state enterprise should be unified, for profit, and return-oriented. The practice of emphasizing output and scale rather than cost and return must be changed. Other than a few sectors such as defense, most state enterprises should make maximizing capital return their single objective.

Sixthly, the board should ensure good governance of state-owned enterprises. Experience from other countries shows that a well managed state enterprise usually adopts the organizational structure that depends on the board. Having a strong board will push forward healthy operations of the company and reduce the necessity of government control.

2. Gradually floating the un-tradable shares

The mobility of factors of production including capital is the pre-requisite for efficient allocation of resources and improvement of corporate governance. The dominance of un-tradable shares in listed companies results in segregation of the equity market and price distortion. It constrains the competition in the capital market and restrains the normal development of market for corporate control. It also leads to differences in the rights of the two types of owners in the transferring of ownership, in the means of maximizing shareholder value, and in the selection of financing structure. This induces controlling owners of un-tradable shares to adopt strategies in favor of themselves and unfavorable for owners of tradable shares.

Realizing full floating of all listed companies' shares is the major task of the securities market. It concerns the balance of interest groups and its key is in pricing

and determining the object of transfer. It also concerns how to compensate for "hidden" losses of owners of tradable shares and how to realize stable development of the stock market. A feasible proposal is to sell off the un-tradable shares to existing owners of tradable shares at proper prices. After the plan for freeing state shares is in place, newly listed companies should adopt international standard to allow all shares to be tradable and may consider introduce a certain frozen-period.

3. Strengthening legal liabilities and enforcement

In order to strengthen the legal liabilities of directors, the management, and controlling shareholders, to protect investors, and to promote companies to operate according to the best interest of investors, the practice of class action and derivative suits need to be introduced as soon as possible. At the same time that civil compensation related to securities action is being perfected, other systems for protecting investors should also be improved so that the two sides of a dispute can reach an agreement through out of the court settlements. Thus the cost of solving a dispute will decrease, the efficiency of solving a dispute will increase, and a solution will ease the conflict and its impact. To further protect creditor's interest, legal bankruptcy and liquidation procedures should be in place to prevent companies from willingly going bankruptcy to escape debt liabilities. After "piercing the corporate veil" and identifying the liabilities of a company in civil actions, individual bankruptcy arrangements should also be set up, so that the wrongdoers will be responsible to pay for the damage.

In order to strengthen the enforcement of laws, efforts should be made in the following areas. (1) In the drafting and amending of current laws and regulations to protect investors, emphasis should be put on setting up self-enforcing mechanisms and perfecting market functions rather than heavily relying on government regulation and administrative measures. (2) Efforts are needed to provide, by focusing on efficiency, economic feasibility, and implementability, a good legal environment for investors' necessary judicial remedy in terms of procedures and fee arrangements, so that victims may easily and cost-effectively find their protection. (3) Efforts are also needed to allow for economic suing rights in the substantial law, so that victims can find judicial remedy to protect themselves. (4) Efforts are needed to allow both direct victims and their independent third party representatives to pursue legal compensation. (5) To fundamentally change the abnormal arrangement that listed companies are

paying for insider violations, managers and large shareholders who play decisive roles in the management should guarantee their private assets for any violation. Rules of individual bankruptcy should also been set up. (6) In order to protect the weak investors, under asymmetry of information, the burden of proof should be born by the defendant.

4. Strengthening shareholder rights and increasing controlling shareholder's legal obligation

To improve corporate governance, efforts are needed to strengthen the mechanism for shareholders to enforce their rights, especially through the shareholders' meeting. Efforts are also needed to increase controlling shareholders' legal liabilities. Measures urgently needed include:

(1) Enhancing shareholders' voting mechanism. For example, we need to stipulate the minimum number of attendees for a lawful voting, perfect the cumulative voting rules, allow online voting, improve proxy voting, facilitate attendance by selecting good timing and location of the general shareholders' meeting, ensure fairness to all types of shareholders in voting procedures and rules, and to prevent unreasonable expenses for shareholders and the company.

(2) Improving the right of the shareholders to know, to enquire and to propose. For example, the board of directors should communicate with shareholders through the general shareholders' meeting. Shareholders are entitled to seek answers from the board, the board committees, the supervisory board, and the senior management. Shareholders are also entitled to demand answers from directors, supervisors and senior managers with regard to issues arising from the meeting's agenda. The board should facilitate the process by which the shareholders can enforce these rights. The companies should lower the threshold for shareholders to raise proposals by lowering the minimum required number of shares, especially when the proposals is in conflict with controlling shareholder's interests.

(3) Increasing the legal obligation of controlling shareholders. Controlling shareholder should act in good will and up to good ethics toward the listed companies

and other shareholders. The exercising of controlling shareholder's rights should be in strict accordance with the law. The controlling shareholder should comply with established rules and procedures in nominating directors and supervisors. The controlling shareholder should not violate the legal rights of the listed company and other shareholders, should not take advantage of its special position to seek extra interest, and should not intervene the business decisions and legal operations of the company. The controlling shareholder and listed company should not share employees, assets, accounting, business, and divisions. They should be independent in finance, responsibility and risk. The listed companies are not allowed to provide loan guarantees to related parties. All the above should be reflected in the substantial laws and procedural laws, and any violations could be attacked under an established legal framework.

5. Accelerating the reform of the board of directors

First and foremost, the independence of the board should be strengthened. (1) Most board members should be independent and outside directors, and independent directors should take control of the board and key board committees. Some board committees, such as those in charge of auditing, nomination, evaluation and renumeration, should comprise solely of independent directors. (2) Independent directors should arrange regular meetings without the presence of the management and other non-independent directors. (3) Chairman of board should avoid becoming CEO of the company. In case such arrangement becomes inevitable, the board should designate a leading independent director to coordinate with other independent directors. (4) The compensation of directors should compose of both cash and equity-based incentives, and the latter should take up a large proportion of the total. (5) The board should keep in record information regarding firm performance, and data of customer and employee satisfaction. (6) The independent directors should formulate plans and standards for CEO compensation and evaluate on a regular basis CEO performance accordingly. (7) The senior management should regularly report to the

board and the board should regularly examine the plan of the personnel development of senior management.

Secondly, the board should establish a self-evaluation system. (1) The board should keep a set of written regulations for evaluation, and regularly re-evaluate its performance. (2) The board should set qualifications for becoming directors and select from nominees directors based on experience and skill background. Follow-up evaluations of directors should be regular. (3) The board should set and follow transparent standard for self-evaluation. (4) Salaries of board members should be set in accordance with the long-term performance and sustainable growth of the company. Other comparable company's compensation can serve as a reference.

Thirdly, efforts are needed to strengthen the efficiency of board operations, improve the board function of strategic management, increase board responsibility, advocate group leadership to prevent manipulation by large shareholders, and promote best practices of the board. In order to prevent formalism, implementable rules should be adopted.

Fourthly, efforts are also needed to keep up with the education and training of board members. National independent self- regulatory organizations should be set up timely. The organizations should draft detailed and complete guidelines for directors in order to make themselves platforms for professional communication and education.

Fifthly, efforts are needed to increase the civil liabilities of directors, promote D&O insurance, and encourage directors to act in accordance with the value of shareholders and society.

6. Clearly defining the functions of supervisory board

The board of supervisors was set up to monitor insiders and the management by the designer of corporate framework in China with an intention to follow the German model. However, "strong management and week supervisory board" becomes the reality. In addition, recently many listed companies have engaged independent directors, and many have also established board committees comprised mainly of

independent directors. The rise in the role of independent directors prompts debate on whether independent directors and supervisors have overlapping functions.

With the global development of corporate governance and the opening of the Chinese capital market, the independent directors will play more important roles in corporate governance in the long run. However, there is still room for the board of supervisors to contribute to the improving of corporate governance. Clearly defined supervisor functions and increased supervisor independence will help in this regard. In the end, the efficient use of resources will require that the monitoring and supervising roles be performed by a single entity. By then whether to elect the board of supervisors should be a choice of the listed companies.

7. Developing the market for corporate control

The competition in the market for corporate control helps efficient allocation of capital and provides an external pressures for better performance on directors and managers. Possible measures that we can take include:

First, further introducing foreign and private capital to acquire state shares through merger and acquisition. An important channel for state assets to exit is through selling off to investors, therefore for efficient allocation of resources and adjustment in industry structures, efforts are needed to develop the market for corporate control. Given that state shares are not tradable, the percentage of state shares should gradually decrease. In addition, greater efforts are needed to prevent insider control or "the key person problem" through ownership diversification in order to extend both in depth and width the market for corporate control.

Secondly, greater efforts are needed to improve the legal environment for M&A, establish a set of rules and laws for the market of corporate control, ease government over-regulation, and decrease the cost of operating in the market. Thus there may be enough rooms for financial innovation that is based on market force and natural demand rather than excessive reliance on government's direct intervention.

Thirdly, market mechanism and monitoring schemes aimed at creating values should be created. These mechanisms should prevent market manipulation, insider trading, and related party transactions that harm listed companies and their minority shareholders. These mechanisms should also help M&A activities break out of the

predicament of “protecting the shell”(keep being listed and stay entitled to refinance in the equity market) and transferring accounting values in and out of the listed companies. They should enhance mechanisms for both pricing and financing, improve transparency in M&A deals, ensure market fairness, transparency and efficiency, generate external pressure for good corporate governance through the market of corporate control, promote survival of the fittest in the market, and provide the listed companies means to grow in both size and strength.

8. Active roles of institutional investors in corporate governance needed

In contrast to those on the mature securities markets, institutional investors in China have still yet to play an active external monitoring role in corporate governance. In order to improve in this direction,

First, efforts are needed to gradually eliminate the drawbacks of current system and provide a good policy environment for institutional investors.

For example, the key shareholder problem and the 2/3 non-tradable shares prevent institutional investors from exerting a real impact on corporate decisions. Their indifference is understandable. This problem also makes ineffective of any proxy voting rights and shareholder proposing rights.

Secondly, the governance, monitoring and incentive mechanisms for the institutional investors themselves should be improved. They should act in accordance with investor interest, in line with the current laws, and in due diligence rather than abuse their power of attorney in voting and using other resources.

Thirdly, efforts are needed to strengthen and improve the regulation of the securities market and institutional investors, to prevent market manipulation, insider trading, and illegal profiting, to improve the regulation of listed companies in order to prevent adverse selection that favors wrongdoers, and to eliminate market distortion as much as possible.

Fourthly, efforts are needed to foster institutional investors that have long-term investment demand including all kinds of pension funds, insurance companies and QFIIs. Efforts are also needed to cultivate the notion of long-term investment and related investment culture, help institutional investors look at long term factors that

are related to corporate governance, and make them vote with “their hands” rather than with “their feet”.

Fifthly, in practice, efforts are needed to provide support for institutional investors in improving corporate governance themselves, to eliminate obstacles in existing systems, and to help them understand how to participate in improving listed companies’ corporate governance, how to decrease cost in participation, and how to increase effectiveness and improve the results of participation. Efforts are also needed to promote international exchanges, to organize training and consulting to provide better education, and to realize global sharing of related experience and resources.

9. Improving the role of creditors

Creditors need to play a positive role in corporate governance of the lending companies, and to give the management of listed companies enough pressure so that the debt will be properly used.

(1) In the governance of listed companies, the creditors should be given a concrete, comprehensive and legitimate set of rules on the means, the extent, and the form of participation. For example, the external directors should include representatives of creditors; in terms of approval procedures, the M&A proposals must be approved by creditors if they may affect substantially creditors’ interest; once the company is in financial distress, the creditor and an impartial third party formed by the accounting firms and the law firms should take over.

(2) Efforts are needed to promote the establishment of laws and regulations to protect creditor rights, enhance the judicial remedy for creditors by clarifying the responsibility of borrower companies, and set up a set of healthy bankruptcy and M&A acts in order to prevent self-dealing, embezzlement, on the job personal high consumption, bankruptcy for escaping debt liabilities, and unfair related party transaction aimed at transferring away company assets.

(3) Efforts are needed to speed up the reform in the banking sector, and restructure the state banks by introducing modern corporate framework and diversification of ownership. Efforts are also needed to improve the risk management,

self-governance, transparency in the bank operations to prevent government intervention and ensure operations in line with commercial principles. Efforts are also needed to ensure that all parties should pursue efficient allocation and utilization of debt assets, and that the banking sector can develop healthily.

10. Promoting the market for managers

The emphasis should be on removing the administrative ranks in government controlled listed enterprises, abandoning the political appointment of corporate executive managers, and establishing a market and entrepreneurship-based, transparent procedure to select managers. In addition, efforts are needed to push forward the development of intermediaries in the managers' market and establish databases of entrepreneurs.

11. Establishing a long term and dynamic compensation scheme for directors and executives

Corresponding to the development of the market for executives, efforts are needed to promote directors and top executives to act in the best interest of shareholders and stakeholders through a dynamic, performance-oriented, market based, and long-term compensating scheme. (1) A comprehensive compensation mechanism needs to be set up, for example, efforts are needed to enhance the operation of the compensation committee, establish transparent standards for evaluating performance, and closely link compensation with performance in order to prevent conflict of interest such as self-determined executive salaries and ensure a fair, transparent, and effective process for setting salary. (2) A proper compensation structure needs to be established, namely through decreasing the portion of fixed compensation, and increasing variable compensation based on equity and the firm performance, so that directors and managers will share the outcome of firm development. (3) Fair rules of game in determining director and management compensation especially those related to equity-based incentives should be established by the government and securities market regulators in order to promote

activism and creativity of listed companies. Therefore, efforts are needed to abandon direct government intervention in the operation of individual cases and provide a free environment for efficiency and creativity in designing compensation mechanisms for directors and executive managers.

12. Furthering the role of intermediaries and self-regulatory organizations

External incentives created by intermediaries and SROs are needed to improve corporate governance. First, efforts are needed to greatly improve the external policy environment for intermediaries and SROs in order to eliminate the obstacles to creating a fair, objective, integral, up-to-standard, and professional first defense. In addition, efforts are needed to strengthen the civil responsibility of intermediaries and their employees, set an appropriate entry threshold, and introduce competition in order to prevent the distortion in incentive setup. Secondly, strict and implementable rules should be introduced to provide a procedural backup for intermediaries to perform their due diligence. Thirdly, good internal control and corporate governance within the intermediaries need to be established in order to prevent conflict of interest and impairment of company interest for private gains. Fourthly, the power of audit committees in determining the change of accountings firms needs to be strengthened in order to provide further backup for the independence of external auditing. Fifthly, efforts are needed to fully develop SROs, and to enhance their functions in setting rules, educating professionals, setting standards of practice, maintaining public confidence, and withholding the order of the market for fair competition. For example, they may directly participate in listed companies' improvement of corporate governance and formulate best practices for corporate governance.

13. Perfecting the institutional environment and implementation for information disclosure

In order for quality disclosures, China is in urgent need of a favorable information disclosure environment and an effective mechanism for disclosure.

Firstly, efforts are needed to set up an implementable disclosure liabilities system

and increase the liabilities of top executives in the accuracy, completeness and timeliness of corporate information disclosure. For example, such liabilities should include adequate administrative, criminal and civil liabilities to effectively deter cheating in financial disclosures.

Secondly, efforts are needed to increase the independence of the board, set up disclosure procedures within the company, and strengthen the function of independent director dominated audit committees in terms of internal auditing and selection of external audit organizations.

In addition, efforts are needed to further improve the accounting standard, improve its quality, and limit the room for profit management. At the same time, efforts are needed to promote the establishment of relevant policies so that medium and small sized investors, accounting firms, and others will play effective roles in monitoring disclosures.

14. Strengthening the vangard role played by the public and mass media

"The sun is the best disinfectant". In order to prevent listed companies from improper behaviors, efforts are needed to bring such activities under public scrutiny and bring the public into full play in monitoring.

Therefore, on the one hand, the public and mass media should clearly position themselves, and increase independence and fairness. China should provide a favorable environment to ensure freedom in speech and expression of opinions, and prevent arbitrary intervention in the press without lawful reasons. The press and media should a) provide accurate and objective accounts to all market participants to promote efficiency of the capital market, b) identify and disclose violations of laws and regulations to promote the fair and transparent operations of the securities market and listed companies, and c) identify, disclose, analyze and discuss new problems of the securities market and the listed companies.

On the other hand, efforts are needed to improve the quality of professionals in the public and mass media, to enhance their governance and self-regulatory mechanisms, to introduce the separation of news and advertisement, and to prevent

the entanglement of objective news and subjective comments. Greater efforts is needed to improve the quality, accuracy, professionalism, objectivity and responsibility of the public and mass media, and to introduce market competition based on ”the survival of the fittest”.

15. Establishing favorable corporate governance cultures

In order to ensure the healthy operation of listed companies, we need to create institutional environment for market participants so that

Firstly, a proper corporate operation mechanism should be in place to eliminate as much as possible any opportunities for violations.

Secondly, a proper legal framework should have effective deterrence on violators and encourage people to get rich by lawful means.

Thirdly, a culture of good corporate governance and good social ethical standard should make people unwilling to act against laws and prevailing ethics, thus realizing the harmony of personal interest and social moral standard.

In order to achieve this, efforts are need to build a set of rules to increase violation cost and to deter violators. In designing policies, efforts are needed to accommodate different interests, prevent the distortion in the incentive setup, and eventually develop people’s reluctance to violate laws and regulations.

Secondly, in developing legal framework and private contract system, we need to build up as complements a social culture and a behavioral ethics that cherish fairness, honesty, integrity, freedom, equality, responsibility, and in terms of the principal agent relationship, due diligence for the best interest of the principal. This is consistent with our goal for setting up a systematic and integral social adjustment framework, and with our aim for establishing a civilization based on legal, contractual, and high moral standard necessary for the healthy development of a market economy.