

China Corporate Governance Survey

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CHINA CORPORATE GOVERNANCE SURVEY

April 2007

1. INTRODUCTION

The Chinese economy is experiencing a period of unparalleled wealth and growth opportunities. The mandate to improve the corporate governance (CG) of Chinese companies as part of the government's efforts to develop the financial market has become a top priority for the Chinese national agenda. As a result, over the past few years, China has made significant strides on the CG front. Related government agencies have issued various laws, rules, regulations, and standards aimed at laying the foundation for a sound CG framework.

To understand CG in China, one has to take into consideration that China has been undergoing a transition from a planned economy to a market-oriented economy. The pace of this transition varies by sector. The challenge with CG reforms is that China started its CG reform efforts in an environment where most of the elements of a well-functioning financial market (e.g., well-defined legal system, efficient regulatory agencies, rigorous law enforcement) were not in place.

Although there is a perception that private entrepreneurs in China operate under ineffectual checks and balances and lack transparent financial reporting, such weak CG practices are at odds with the fact that Chinese businessmen are not just seeking domestic leadership for their businesses but also setting their sights higher. They seek to become influential multinational companies. The International Financial Corporation (IFC) noted that a growing number of Chinese managers and entrepreneurs show willingness and desire to improve their CG practices. They are becoming aware that a commitment to good CG (i.e., well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, an empowered board of directors, etc.) makes a company more attractive to both investors and lenders and ultimately more profitable.

Development of a sound CG framework will work to build trust in China's nascent capital markets and remove some of the constraints in its growth. CG is a prerequisite of any modern financial market where the base is credibility and confidence; without such a base, it would be difficult for China's market to attract and gain the trust of both domestic and international investors.

In order to gain a better understanding of CG issues in China, in August/September 2006 the CFA Institute Centre for Financial Market Integrity (the Centre) conducted a study of CG practices in China. As part of the study, a survey—described below in detail—of members investing in or having interest(s) in Chinese companies was carried out to obtain members' opinions and views on the following:

- CG issues among Chinese companies;
- effectiveness of recent reforms made by China to improve CG practices; and
- suggestions on how to further improve CG practices in China.

2. SURVEY METHODOLOGY AND REPORT STRUCTURE

2.1 Survey Methodology

In August 2006, an e-mail invitation containing a link to a web-based survey was distributed to 3,780 CFA charterholders and CFA Institute members in Hong Kong and China. The survey closed in September 2006.

At the start of the survey, participants were asked whether they or their companies, within the past three years, had either invested in or considered investing in Chinese companies. This question served as an initial filter/requirement for participation in the survey. Participants who replied in the negative were not counted in the survey results. The analysis of the survey findings was based on the responses of 475 charterholders and members who completed the survey.

Profile of respondents

A summary of the profile of the respondents is as follows:

| | | |
|---|--------------------------------|------------------|
| Primary base of work | China | 56% |
| | Hong Kong | 42% |
| | Other ¹ | 2% |
| Professional responsibilities (respondents were allowed to select multiple responsibilities) ² | Investment managers | 59% |
| | Analysts | 45% |
| | Service providers ³ | 29% |
| | Officers of Chinese companies | 30% |
| Average size of assets under management by the companies of respondents who manage funds | China | HK\$38.4 billion |
| | Hong Kong | HK\$17.6 billion |
| Type of investment or interest in Chinese companies | A-share companies ⁴ | 64% |
| | H-share companies ⁵ | 55% |
| | Privately owned companies | 49% |
| | State-owned enterprises | 49% |
| | B-share companies ⁶ | 31% |
| | Other interests | 8% |

In addition, only 29 of the 475 respondents said they have served on the board or board committees of the Chinese companies in which they invested. Of those, 25 have served on the board, whereas 13 also served on the audit committee and 5 on other board committees.

2.2 Survey Discussion Group Meetings

Discussion group meetings were also held in Shanghai, Beijing, and Hong Kong to develop the questionnaire and also to review the responses obtained from the survey. These discussion group meetings provided feedback on the findings from the survey as well as the discussion group members' experiences with regard to CG issues of Chinese companies.

2.3 Structure of the Questionnaire

The respondents were presented with 16 CG-related issues, which were categorised under:

- (i) board composition, structure, and mechanisms;
- (ii) relationship with stakeholders and shareholders; and
- (iii) disclosure and transparency.

For each issue presented, respondents were required to rate on a scale of 1 to 5 how important each issue was to initial investment decision making⁷ and how each issue has changed over the past three years.⁸

The respondents were also asked to give their views (also on a scale of 1 to 5)⁹ on the effectiveness of the following CG reforms:

- Split share structure reform of listed companies by the China Securities Regulatory Commission (CSRC) to convert nontradable shares into regular class A common shares by the end of 2006.
- China's release of a new accounting standards system based closely on the International Financial Reporting Standards (IFRS) in February 2006.
- Directive on quarterly reporting in March 2003.
- Introduction of the Qualified Foreign Institutional Investors (QFII) programme in December 2002 to allow foreign investors to invest in Chinese securities.

The respondents were also asked for comments on how China can improve its CG practices.¹⁰

2.4 Structure of the report

The remaining sections in this report will discuss the following CG-related topics:

- CG reforms by the Chinese government;
- financial disclosures and transparency;
- board composition and structure;
- executive compensation; and
- relationship with shareholders.

Each section starts with some background information on a particular CG issue, followed by an analysis of the results from the survey on this issue. Where relevant, the analysis will include comments given by the survey respondents or discussion group members.

3. CORPORATE GOVERNANCE REFORMS BY THE CHINESE GOVERNMENT

A key component of China's CG reform is the privatisation of state-owned enterprises (SOEs). The restructuring of SOEs, which started in the 1980s, has seen more than 80 percent of the SOEs being transformed into corporate entities under the Company Law¹¹ to facilitate listing on the stock exchanges. More than 1,200 enterprises have raised funds through initial public offerings (IPOs) and sought subsequent listing on one of China's two stock exchanges—the Shanghai Stock Exchange and the Shenzhen Stock Exchange.¹² The state, however, still holds a majority of the shares in the listed companies (data show that in 2001, the shareholding held by the state was estimated at 60 percent).¹³

It has been observed that the SOEs in the process of becoming private enterprises face a number of governance challenges. Many still carry on the practices of the state-dominated decision-making regime. They tend to have complex and opaque corporate ownership structures, overlapping bodies of corporate control, management teams with continuing links to the Chinese government, and reporting practices that are more often focused on meeting the needs of the major shareholder (i.e., the state) rather than the needs of investors.

Conversely, companies that seek a listing on a stock exchange are required to adopt good CG practices, such as the inclusion of independent directors on the board. It has been viewed that the process of getting listed, particularly on the Hong Kong Exchange or other foreign stock exchange, has the potential of enhancing the quality of CG in Chinese companies. As such, this initiative has been proclaimed as one of the more successful vehicles for China's SOE reform.

According to a study by Professor Lin¹⁴ from the University of Southern California, since the establishment of China's security regulator, the CSRC, in 1992, more than 300 guidelines concerning the securities and futures markets have been issued. The issuance of these regulations and the adoption of the key legal framework for CG, including the passing of the Company Law in 1993, the Securities Law in 1998, and the issuance of the Code of Corporate Governance for Listed Companies¹⁵ in 2002, have led the way for board directors and corporate managers to adopt sound CG practices that are on par with global capital markets.

The following discussion highlights some recent CG reforms undertaken by the Chinese government.

3.1 Conversion of Nontradable Shares into Freely Tradable Shares

In 2005, the CSRC announced the initiative to convert nontradable shares¹⁶ into tradable shares. The new initiative (called "Administrative Measures on the Split Share Structure Reform of Listed Companies") provides the ground rules to allow for the conversion of the shares. SOEs constitute close to 90 percent of the 1,400 listed companies in China. As of 19 June 2006, 1,006 A-share companies have completed the transformation, with 343 companies yet to do so.¹⁷ Completing the transformation requires the approval of the CSRC and a two-thirds majority of the outstanding shareholders with tradable shares. The deadline for all companies to comply was year-end December 2006.

The key to the transformation lies in the compensation in the form of cash, warrants, or bonus shares to the holders of outstanding tradable A-shares to make up for the expected diminution in the value of their shares by a large increase in the free-float. Furthermore, in order to limit immediate divestment and speculation in the converted shares and to prevent disruption in the marketplace, there is a one-year moratorium on the disposal of the newly converted tradable shares. In the second year after conversion, the shareholder is not allowed to sell more than 5 percent of the total shares of the listed company. In the second and third year together, the shareholder is not allowed to sell more than 10 percent of the total shares of the listed company.

Many investors view this, coupled with another government regulation eliminating nontradable shares in all future IPOs, as a significant reform that would continue to shift the balance of share ownership from government ownership to public ownership by minority shareholders, especially among institutional investors.

3.2 New Accounting Standards

In February 2006, the Ministry of Finance released the Basic Accounting Standards for Business Enterprises (ASBE), consisting of 38 standards to be applied to all listed Chinese companies. The aim of this initiative is to facilitate further development of a market-like economy in China, raise the quality of financial information, and boost investor confidence. The new ASBE standards are intended to bring Chinese accounting practices largely in line with the IFRS. Although there are concerns that these new Chinese standards do not completely replicate the IFRS as intended by the international accounting standard setters, they have incorporated many of its key principles.¹⁸

The Ministry of Finance also released a new set of 48 auditing standards for certified public accountants, which will bring China's auditing rules more closely in line with the International Standards on Auditing. The new accounting and auditing standards in China both took effect on 1 January 2007.

3.3 Quarterly Reporting

In March 2003, the CSRC released an amended directive on quarterly reporting (replacing its original directive of April 2001). This new directive focuses on the form and content of such reports and requires listed companies to deliver them within one month after the end of the first and third quarters. These quarterly reports must include, among other things, a profit and loss statement and data on total assets and net cash flow from operations.

3.4 Qualified Foreign Institutional Investor Programme

The QFII programme, introduced in 2002, was aimed at opening the doors for foreign capital into China's financial market. Foreign investors are now allowed to invest in A-shares, Treasuries, convertible bonds and corporate bonds listed on China's stock exchanges, and any other financial instruments approved by the CSRC. QFII entities must meet the following criteria:

- fund management companies—five years of operational experience and assets under management of at least US\$10 billion in the last accounting year;
- insurance and securities firms—30 years of operational experience, paid-up capital of at least US\$1 billion, and management of securities assets of at least US\$10 billion in the last accounting year; and
- commercial banks—securities assets not less than US\$10 billion in the last accounting year and total assets ranked among the world's top 100 banks.

Investors should note that the QFII programme does not allow for unrestricted repatriation of funds with a lock-in period of at least one year. For closed-end funds, the minimum period is three years. During the lock-in periods, the funds remitted into China by the QFIIs must be held by custodians in a special-purpose Renminbi account.

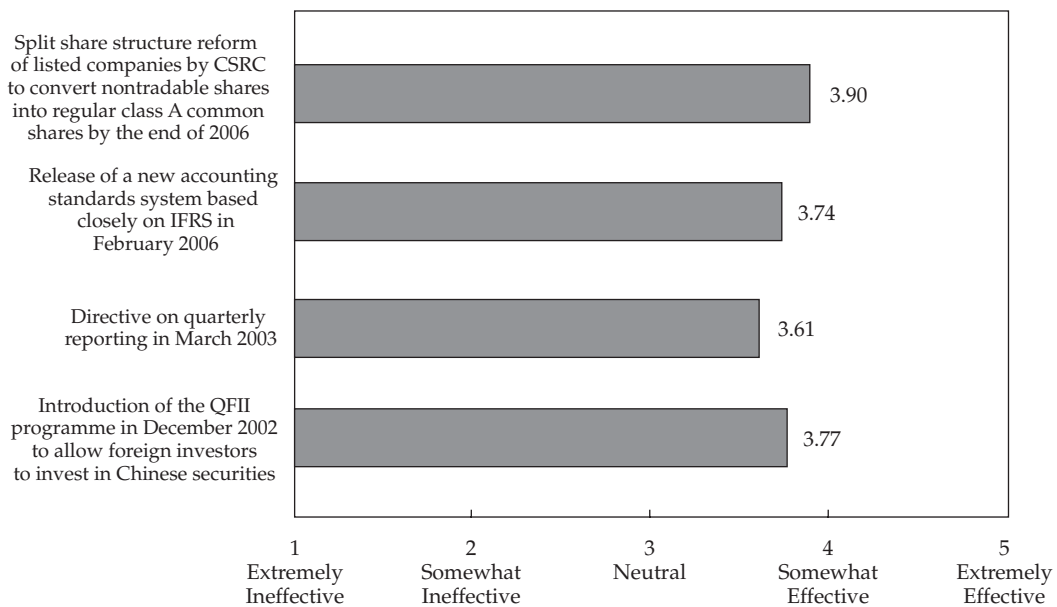
There are also investment limits on the amount a single QFII, and all QFIIs in the aggregate can invest in a single listed company. The list of approved QFIIs and their combined and individual investment quotas are frequently updated by the CSRC and the State Administration of Foreign Exchange (SAFE), the regulators of the securities investment activities conducted by QFIIs. The specific distribution of QFII quotas is up to SAFE, whereas the CSRC has the right to decide which foreign investors qualify for the programme. Currently, the amount of available shares falls short of demand, and a QFII is never assured of getting an allocation in any event.

Although participation by China's retail investors continues to grow on the two major stock exchanges, such investors have not, as a group, demonstrated a strong interest in CG matters. Over time, however, it is anticipated that the QFII scheme will lead to more market-driven improvements in CG practices.

3.5 Survey Findings

Overall, survey respondents felt that implementation of the four CG reforms identified in **Figure 1** have been "somewhat effective." Of the four reform measures, the conversion of nontradable shares to freely tradable shares was viewed as being more positive to the development of China's capital market compared with the directive on quarterly reporting. The full conversion of nontradable shares would add liquidity to the stock markets along with increased transparency of ownership. In addition, one of our discussion group members remarked that previously with two sets of shares, two different shareholder meetings would need to be held. In theory, with one class of shares, all shareholders would be receiving consistent information and the value of all share types would converge.

Another suggestion of survey participants to improve CG practices was to increase institutional investor participation. For instance, increasing the QFII quota would attract more foreign institutional investors. It has been acknowledged by most market participants that mutual funds and other institutions have contributed positively to the Chinese securities markets by agitating for improved governance practices. Hence, promoting greater institutional participation could result in better self-regulation of the marketplace.

Figure 1: Effectiveness of CG Reforms

4. FINANCIAL DISCLOSURES AND TRANSPARENCY

A significant concern of both foreign and domestic investors in Chinese companies relates to the adequacy and transparency of disclosures. In view of this, the government has moved recently to strengthen disclosure rules. Moving forward, investors will have more information available in quarterly and annual reports.

4.1 Related-Party Transactions

Because of the complex nature of the ownership structure of SOEs, a listed company will continue to have significant ongoing business relationships with the parent (holding company) and other related companies within the state-owned group, post listing. A low level of transparency and inadequate disclosure of related-party transactions create additional concerns for investors because they do not have a clear picture of where or how the listed company resources are channelled or valued.

To date, regulations governing related-party transactions have been strengthened.¹⁹ Amendments to the Company Law have established procedures for entering into related-party transactions and where shareholders' approval is required before a company can provide security to a major shareholder or to the actual controlling party/entity.

4.2 Adequate and Timely Information Disclosures

The CSRC Code, issued in 2002, clearly states that information disclosure is an ongoing responsibility of listed companies. In addition to disclosing mandatory information, companies are encouraged to disclose in a timely basis all other information that may have a material effect on the decision of shareholders and stakeholders. This includes information on the composition of the board of directors and supervisory board; attendance records, performance assessments, and compensation of directors; establishment of functional subcommittees and their operating details; independent directors' opinions on related-party transactions; controlling shareholders' interests; and executive appointments/removals. Companies seeking a listing must have financial statements prepared in accordance with local rules for the three years prior to an IPO.

Furthermore, the “comply or explain” rule in the CSRC Code requires all listed companies in China to disclose the gap between their existing practices and the recommendations in the Code, reasons for any gap, and whether/how they plan to close such a gap. Meanwhile, it should be noted that there is no penalty for failing to close the gap or requirement that the company must do so.

Quality of disclosure

In 2001 and 2002, the CSRC released a series of disclosure standards and requirements to ensure quality of disclosures. The new Ordinance on Disclosure requires the heads of the company, the accounting department, and the external accounting firm to make a public announcement attesting to the true and complete disclosure of the reports. The Ordinance also requires disclosure of any cross-shareholdings among the 10 largest shareholders.

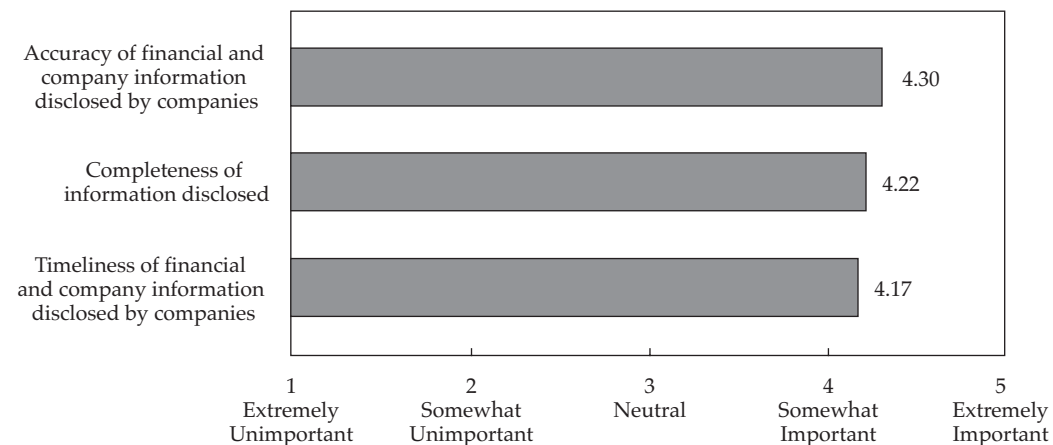
Timing of financial reporting

All publicly listed companies have to file and disclose financial results on a quarterly basis. Although continuous disclosure is not required, any significant event that may impact stock prices has to be publicly announced immediately. Because Chinese regulations are generally principles based, no specific definition of what constitutes a significant event exists.

4.3 Survey Findings

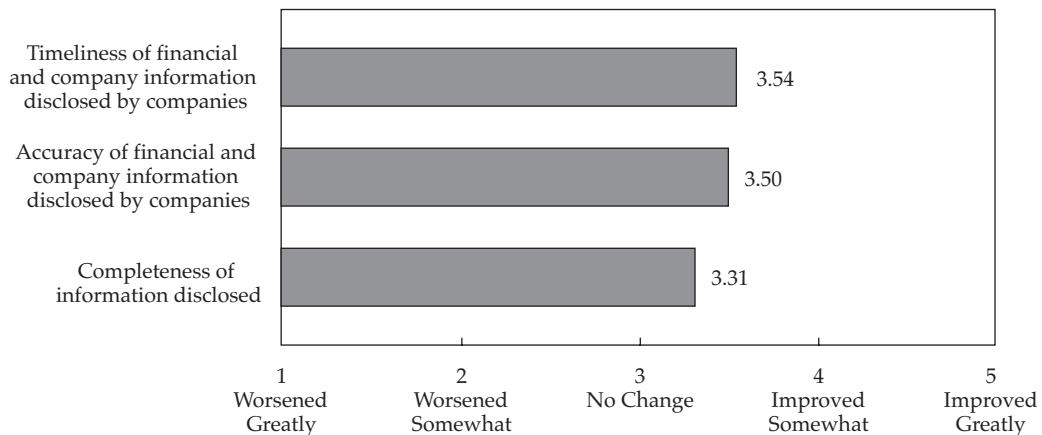
The survey findings show that of the three categories of CG issues presented in the questionnaire, disclosure and transparency were viewed as the most important to investment decision making. The average rating of 4.23 for all three of the disclosure and transparency issues lies between “somewhat important” and “extremely important,” as shown in **Figure 2**.

Figure 2: Disclosure and Transparency: Importance to Decision Making



In addition, the respondents generally thought that the level of disclosure and transparency had “improved somewhat” over the past three years, particularly in respect to the timeliness and accuracy of financial and company information disclosed by companies, shown in **Figure 3**. Completeness of information disclosed, however, received a lower average rating than timeliness and accuracy. All three of the scores relating to the pace of change in disclosure and transparency suggest that there is still opportunity for improvement, even though rules and regulations are in place and have been added over the past several years.

We received a number of comments that supported this overall view. Survey respondents urged that annual and interim reports should include increased information relating to business segments, intercompany and related-party transactions, and more detailed cash flow disclosures. As the China reporting system evolves, there will continue to be significant disparities in both the quality and quantity of information from one company to another.

Figure 3: Disclosure and Transparency: Change over the Last Three Years

Some respondents further suggested that if the investment community were to reward listed companies that provide high-quality financial disclosure with higher valuations, it would be an incentive for both those companies and others to improve disclosure quality. Respondents also noted that most of the disclosures are currently in Chinese and urged that timely disclosures and updates on the companies' websites should be in both Chinese and English.

5. BOARD COMPOSITION AND STRUCTURE

The SOE structure has resulted in complex governance issues with respect to board structure and independence of the board directors from the management team. Some of these issues are highlighted as follows.

5.1 Two-Tier Board Structure

China adopts a quasi two-tier structure of board governance, designed very loosely on the German governance system, with a board of directors and a supervisory board. The board of directors is the main decision-making authority, in which members work closely with management on the day-to-day operations of the company. Conversely, the supervisory board is an independent board that provides independent views and monitors the executive management and the board directors.

A survey conducted in 1999 found that the supervisory board in some companies faced difficulties in performing its duties.²⁰ The supervisors were found to possess neither the knowledge nor the professional experience to actually supervise the board directors and management team. This is accentuated by the fact that supervisory directors are not involved in the selection of the directors and managers and, therefore, lack the authority to supervise them effectively.

Recent revisions to the Company Law have clarified the structure and the roles of the board of directors and the supervisory board, as follows:

- The board of directors is styled after the “board of directors” in the Anglo-Saxon model of CG, where the board oversees and aids management decision making. Similar to practices followed in the United Kingdom and the United States, guidelines issued by the CSRC require that at least one third of the directors on the board be independent.
- The board of directors is the main decision-making authority, with the supervisory board designated with legal powers to overturn decisions made by the board of directors.

It has been observed that the blending of the Anglo-Saxon model and the German model, with a duplication and overlap of functions, can create redundancy and confusion in the governance structure. It dilutes the authority of both boards and at the same time increases administrative costs for the company.

5.2 Board Committees

Some board committees do not exist in Chinese companies. For example, nominating and compensation/remuneration committees are largely absent in many Chinese companies. The process of nomination and compensation review is primarily handled by the management team or directed by the state.

5.3 Independent Directors

In August 2001, the CSRC issued specific guidelines on the qualifications of independent directors of listed companies, namely, the “Guideline on Establishment of Independent Director System in Listed Companies.”²¹ The guideline, which covers all companies listed on the Chinese stock exchanges but not Chinese companies listed overseas, includes specific rules on the definition of independence as well as gives independent directors more power in the functioning of the board.

5.4 Role of Chairman and Chief Executive Officer

In many cases, the chairman of the board is also the chief executive officer (CEO) of the company. This is consistent with other major markets but is a structure that is often criticised as creating the potential for conflicts of interest. Chinese officials and companies cite difficulty in recruiting talent in the market as a reason for not separating the two roles. Currently, there is no requirement for the separation of the roles by either the CSRC or the Hong Kong Exchanges and Clearing Ltd (HKEx). It is only a recommended best practice by HKEx. Companies that are not in compliance simply have to explain and suggest a time period for compliance. Again, there is no penalty for noncompliance.

It has been observed that several of the large China companies have separated the roles of the chairman and CEO (e.g., Petro China, China Construction Bank, China Shenhua Energy, Air China, and China Southern Airlines).

5.5 Survey Findings

Of all the issues presented under the board composition, structure, and mechanisms section of the questionnaire, skills and experience of management emerged as the most important factors in investment decision making (shown in **Figure 4**) and were viewed as having improved the most over the past three years compared with the other issues raised (shown in **Figure 5**).

Most respondents did not place as much importance on the issue of qualifications and the effectiveness of independent directors and the separation of the roles of chairman and CEO as they did on manager competence. The state and majority shareholders still play an important role in the nomination and appointment of independent directors, chairman, CEO, and senior management. Correspondingly, these issues also received the lowest average ratings for change over the past three years.

There were a number of respondent suggestions relating to independent directors. First, there should be a mechanism to allow appointment of independent directors by minority shareholders. Second, there should be more independent directors that can communicate with foreign shareholders given the increasing foreign interest to invest directly in China. And third, the appointment of non-Chinese nationals with international experience in running Western-style boards may help in CG reforms; this is already happening.

The concept of the supervisory board was introduced before the advent of independent directors. Respondents felt that because independent directors are a requirement and committees formed by independent directors are increasing, the role of the supervisory board has become even more unclear. It has been observed that the duplicated functions between independent directors and the board of supervisors are costly and inefficient.

Figure 4: Board Composition, Structure, and Mechanisms: Importance to Decision Making

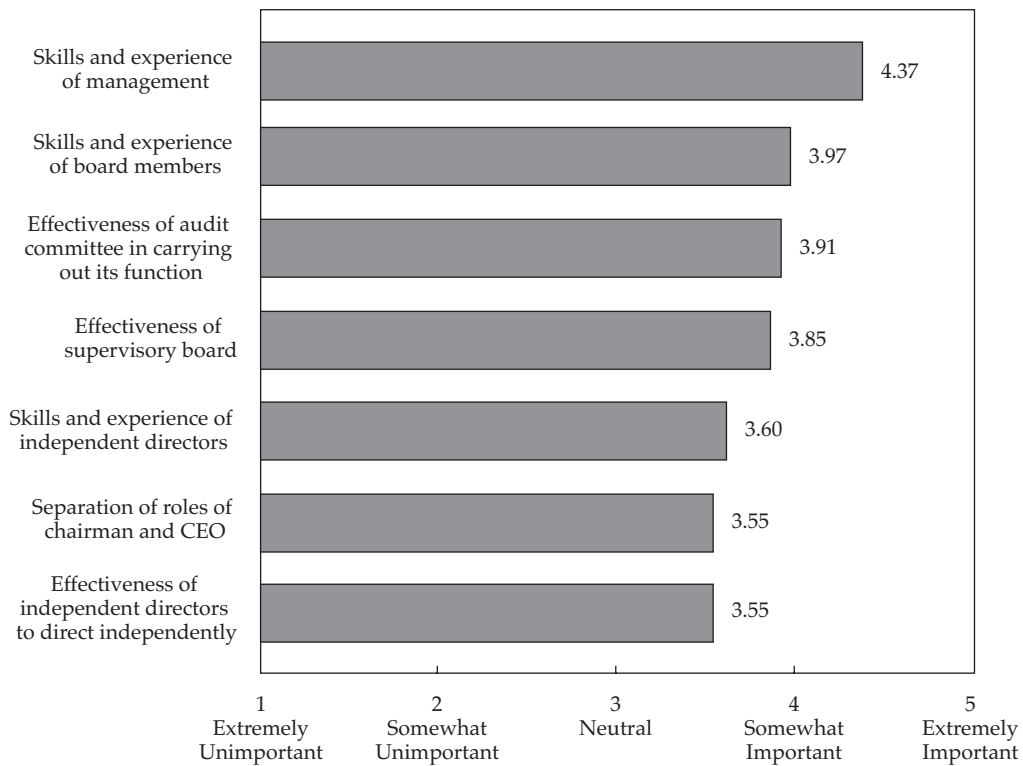
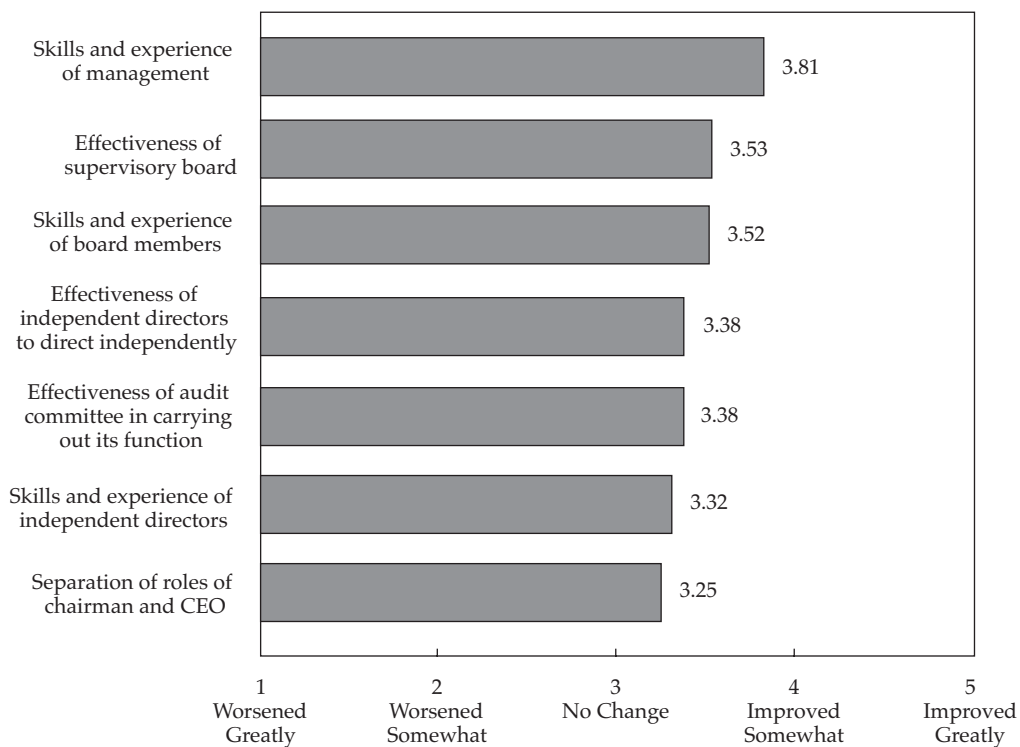


Figure 5: Board Composition, Structure, and Mechanisms: Change over the Last Three Years



Suggestions to improve the structure of the board include increasing the number of independent directors and fully independent audit committees. Preference should be given to independent directors who have professional and managerial experience and who possess some level of financial skill. Examples mentioned include lawyers, professional analysts, and accountants. Respondents also suggested a requirement that the board of directors be held more fully accountable for the running and performance of the company.

It is unlikely that a separation of the role of the chairman and CEO will happen soon in China. Even if a separation were mandated and enforced, it is questionable whether enforcement would be effective. Under the Chinese model, the board chairman is viewed as the *de facto* head and everyone defers, including the CEO, who often takes a back seat. Furthermore, most Chinese companies have a single dominant shareholder—for example, the state—that generally appoints both the chairman and CEO positions. Having a separate chairman and CEO under these circumstances may be of little value.

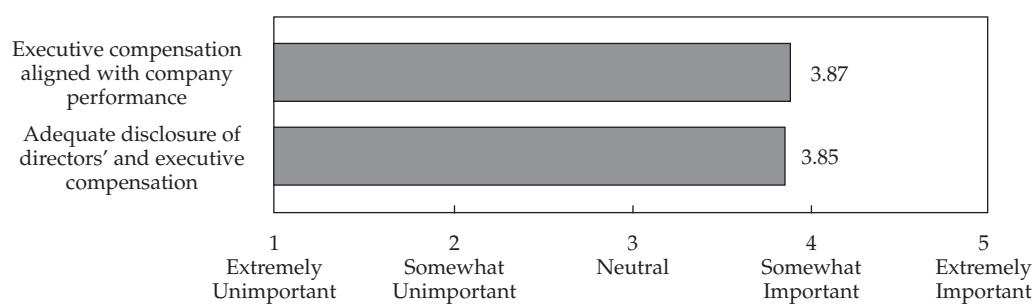
6. EXECUTIVE COMPENSATION

Within the public sector and SOEs, executive compensation generally consists of a fixed salary plus a cash bonus. It has been suggested that the provision of efficient managerial incentives may be a crucial ingredient in the transformation of SOEs into more profitable modern companies. A recent revision to the Securities Law paves the way for the issuance of stock options for managers and directors, an important tool for aligning manager and shareholder interests.²² The Chinese government is promoting equity-based pay as one component of compensation because it sees it as a way to encourage growth in the capital market. We expect to see a growing number of Chinese companies adding stock-based incentives to the compensation mix.

6.1 Survey Findings

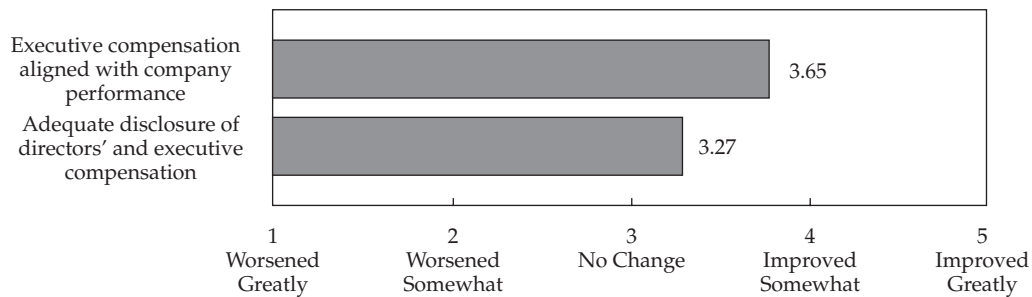
The survey findings showed that executive compensation issues were “somewhat important” in the investment decision-making process (see **Figure 6**). As for change over the past three years, the respondents were of the view that more had been done to align compensation with company performance than to provide adequate disclosure of directors’ and executive compensation (see **Figure 7**).

Figure 6: Executive Compensation: Importance to Decision Making



There were a number of respondents who encouraged the increased use of options or restricted shares as a form of compensation.

It was also noted by several respondents that a potential issue with SOEs is a change toward having senior management employed on a contractual basis. Such term contracts together with revised pay packages linking to share performance will lead to a shift toward shorter-term performance of the company.

Figure 7: Executive Compensation: Change over the Last Three Years

7. RELATIONSHIP WITH SHAREHOLDERS

In China, minority shareholders are a highly fragmented group of individuals. The presence of institutional investors (e.g., pension funds, mutual funds, asset managers) is still not sizable. Retail investors in China, as with many markets around the world, often lack investment knowledge and awareness of shareholders' rights. This has traditionally made it difficult to organise opinion and investment actions to encourage shareholder activism and improved CG.

In China, it is difficult for the individual investor to enforce any legal rights against a listed company for negligence or fraud. Lacking financial resources and understanding of the investment landscape, these small investors are seldom able to take any action when their rights are infringed by the company or major shareholders.

The CSRC Code is an attempt by the authorities to draw attention to the importance of minority shareholders' rights. Coupled with revisions in the Company Law and Securities Law, which came into effect on 1 January 2006, minority shareholder protections have improved, including the following allowances and developments:

- Proxy voting is permitted.
- Cumulative voting is encouraged, thereby empowering minority shareholders to appoint directors and/or supervisors.
- A stricter duty of care has been imposed on directors, supervisors, and senior management.
- Shareholders are granted the right to bring a derivative suit or direct suit against directors, supervisors, and senior management.
- The concept of "piercing the corporate veil" has been introduced, enabling courts to look beyond the principle of limited liability.
- Shareholders are granted the right to check and copy the company's account books and meeting minutes, allowing share buybacks and granting shareholders the right to petition for liquidation of a company.

Looking forward, as China's capital markets open up more to international investors and the general public's awareness of CG increases, shareholders should eventually become more actively focused on protecting their own interests and ownership rights.

7.1 Survey Findings

In this section of the questionnaire, the protection of shareholders' rights emerged as the most important issue in the investment decision-making process, as shown in **Figure 8**. When asked about the change over the past three years, the average rating from the respondents for all four identified issues was closer to "no change" than "improved somewhat," shown in **Figure 9**.

Figure 8: Relationship with Stakeholders and Shareholders: Importance to Decision Making

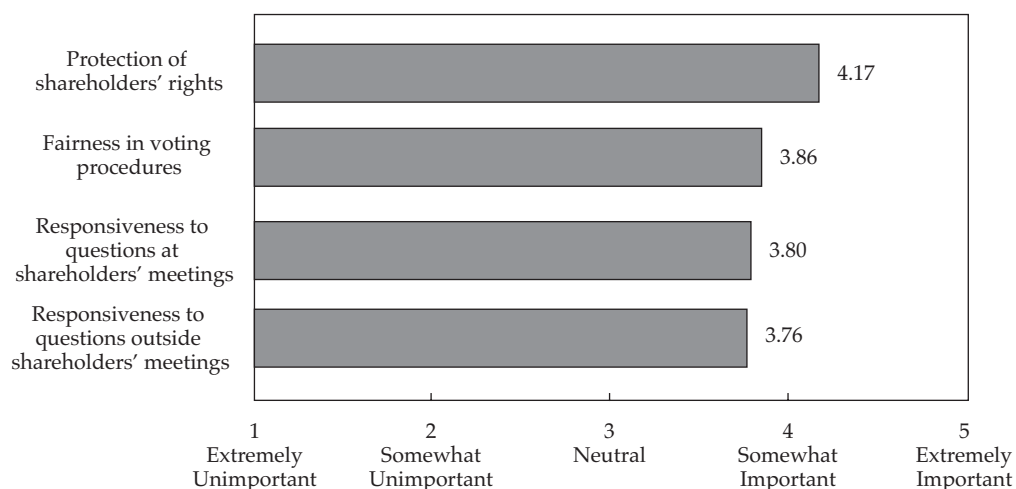
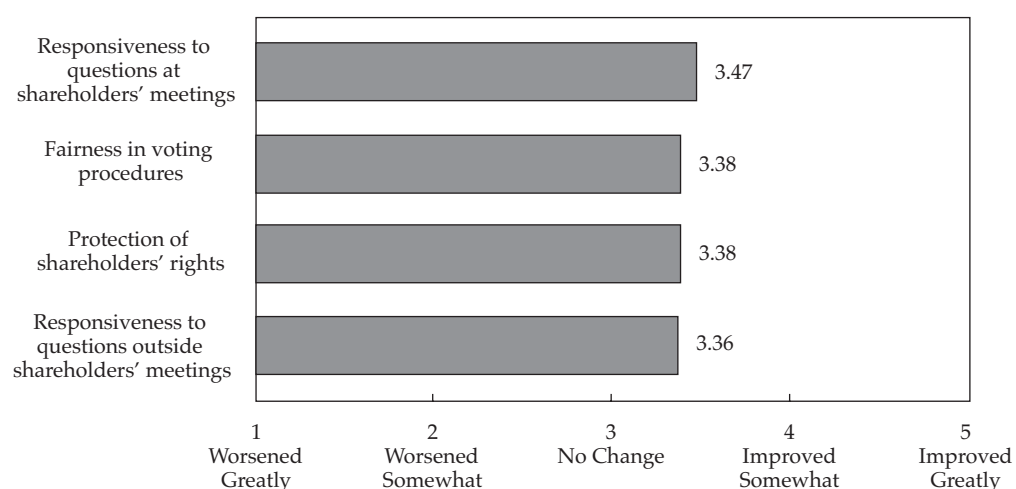


Figure 9: Relationship with Stakeholders and Shareholders: Change over the Last Three Years



Respondents remained concerned that despite the efforts taken so far by the authorities to emphasise minority shareholders' rights, significant or observable changes have yet to take effect in the listed Chinese companies.

Respondents believed that important improvements to CG practices in China would include the introduction of class action lawsuits to enable easier enforcement of shareholder rights, improved voting/proxy procedures, and, in cases of related-party transactions, limits on the ability of the major "affiliated" shareholders to vote to prevent actions that are often detrimental to minority shareholders.

8. CONCLUDING REMARKS

The cultural and market differences that exist in the major Asia-Pacific markets create challenges with respect to developing and implementing appropriate CG systems. China is particularly challenging given the recent and rapid emergence of its markets and attendant infrastructure. Given the large number of CG "best practice" templates that have

evolved over the past several years, there are numerous models and strong guidance on effective systems. In the case of China, survey respondents encourage a continued evolution of the existing system, with particular attention to improving shareholder rights and transparency of financial reporting. As the institutional investor market becomes more fully developed, many of the issues, such as separation of the roles of CEO and chairman and executive compensation, will become more important. Other activities that will receive institutional scrutiny as they develop in China include disclosure requirements regarding related-party transactions and procedures for mergers and takeovers.

Finally, under the existing SOE system, China will face the ongoing challenge of balancing between maximising shareholder wealth and social responsibility toward the larger population. This is not an issue unique to China but presents a significant test issue given the larger scale in China. The sheer size of competing social, health, and well-being issues and the desire for global competitiveness and top standing among global securities markets will create sizeable challenges for the nation. Improving CG is one aspect of this.

China has become the world's third largest economic power, after the United States and Japan. Its financial and capital markets play an important role in its reforms to a market economy. Much progress has been made in respect to the rights of shareholders; the duties, responsibilities and independence of board directors; greater information disclosure and transparency; and strengthening the role of the auditor. It is important to the China market and to Chinese companies generally to continue along the path of improving CG structures in consultation with the investor community and in concert with global best practices for CG. Such improvements will further secure China's place as a global competitor and major global marketplace.

BACKGROUND READINGS

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ENDNOTES

1. Other includes Asia Pacific and Singapore.
2. The percentages imply that some of the respondents could be assuming the role of investment managers or analysts in Chinese companies or companies that are service providers.
3. Service providers include brokers, custodians/administrators, rating agencies, and information/data service providers.
4. A-shares are issued by domestic companies and are held and traded in RMB by domestic investors only. Since December 2002, qualified foreign institutional investors are also allowed to trade A-shares.
5. H-shares are issued and listed by domestic companies in Hong Kong (China).
6. B-shares are stocks issued by domestic companies registered on the mainland but traded in foreign currency by foreign investors, including overseas Chinese and individuals and institutions from foreign countries as well as from Hong Kong, Macao, and Taiwan. Individual domestic investors have been allowed to trade B-shares since February 2001.
7. (1) extremely unimportant, (2) fairly unimportant, (3) somewhat important, (4) fairly important, and (5) extremely important.
8. (1) worsened greatly, (2) worsened somewhat, (3) no change, (4) improved somewhat, and (5) improved greatly.
9. (1) extremely ineffective, (2) fairly ineffective, (3) somewhat effective, (4) fairly effective, and (5) extremely effective.
10. Comments sought were in relation to:
 - quality of financial disclosures,
 - quality and independence of external auditors,
 - structure of ownership of state-owned enterprises,
 - protection of rights of minority shareholders (e.g., proxy voting, voting procedures, class action lawsuits),
 - participation of institutional investors in domestic Chinese securities markets,
 - alignment of executive compensation with long-term company performance goals,
 - separation of role of chairman and chief executive officer, and
 - structure of board of directors, committees, and supervisory boards.
11. This is the primary piece of legislation governing Chinese companies.
12. As of year-end 2006, 842 companies were listed on the Shanghai Stock Exchange with a total market capitalisation of US\$915 billion, and 579 companies were listed on the Shenzhen Stock Exchange with a total market capitalisation of US\$228 billion.
13. Data source: *Taiwan Economic Journal*, 2003.
14. Lin, T.W. 2004. "Corporate Governance in China: Recent Developments, Key Problems, and Solutions." *Journal of Accounting and Corporate Governance*, vol. 1:1–23.
15. The Code emphasises the importance of credibility and integrity and identifies the relationships between shareholders and board directors, executives and management, and trustors and the trustees. The Code requires that all annual general meeting details comply with the Company Law. Requirements for board directors and board supervisors as well as shareholder rights and related issues are articulated. The Code also sets additional disclosure requirements for listed companies.
16. State and legal person shares are not tradable. State shares are held by central and local governments, which are represented by local financial bureaus, state asset management companies, or investment companies. State shares can also be held by the parent of the

listed company, typically an SOE. Legal person shares are held by domestic institutions, such as industrial enterprises, securities companies, trust and investment companies, foundations and funds, banks, construction and real estate development companies, transportation and power companies, and technology and research institutes.

State and legal person shares can be transferred to domestic institutions upon approval of the CSRC.

17. *Thompson Financial News*, 20 June 2006.
18. Company Law calls for companies to establish internal accounting systems in accordance with these standards. Company Law also requires listed companies to prepare and publish their financial and accounting reports at the end of each fiscal year. These reports should include the company's balance sheet, income statement, cash flow statement, and profit and loss statement. Furthermore, the CSRC has issued rules requiring companies issuing B-shares to explain any departure from the IFRS in the appendix of their annual reports. The accounting reports of listed companies should be available for shareholder inspection at the companies' premises.
19. The CSRC Code is fairly detailed in its description of rules pertaining to related-party transactions. First, such matters as the nature, type, and other pertinent information of related-party transactions among a listed company and its connected parties should be disclosed in accordance with relevant regulations ("Disclosure of Related-Party Relationship and Transactions," published by the Ministry of Finance in 1997, and rules as amended by the CSRC from time to time regarding the contents and standard format for information disclosure). Second, listed companies should take efficient measures to prevent related parties from damaging company interests. Third, related-party transactions should observe commercial principles.
The CSRC "Guideline on Establishment of Independent Director System in Listed Companies" accords a special role to independent directors to oversee related-party transactions in a proper manner. Specifically, related-party transactions whose total value exceeds RMB3 million or 5 percent of the company's net assets should be approved by the board's independent directors before being submitted for board discussion.
20. Lu T. 2005. *Developing Effective Boards of Directors of SOEs*. Chinese Centre for Corporate Governance/Chinese Academy of Social Sciences.
21. An independent director is defined as a director "who holds no posts in the company and who maintains no relationship with the company and its major shareholders that might prevent them from making objective judgements independently." A person who holds more than 1 percent of the outstanding shares of a company directly or indirectly, who is among the top 10 largest shareholders of a company, and/or who was an employee of the company in the past year cannot be an independent director. Independent directors have to make a public statement as to their independence. The CSRC Guideline also states that independent directors can concurrently hold the post of independent directors at a maximum of five listed companies.
22. The "Administrative Measures on Stock Incentives in Listed Companies" provides detailed implementation rules for listed companies to adopt stock options and other stock incentive plans. It requires that the remuneration/appraisal committee under the board of directors draft a stock option plan. When it deems necessary, the remuneration committee may retain an independent financial consultant to provide opinions on the draft plan. Independent directors' opinions and a legal opinion are required for the draft plan. Upon the approval of the board of directors, the plan has to be filed with the CSRC, which has 20 working days to raise any objection to the terms in the plan. The listed company may submit the plan for deliberation and approval at the shareholders' general meeting only if there is no objection by the CSRC. These provisions are aimed at preventing listed companies from abusing stock options.