4
Ownership and Control of Listed Companies

Today's ownership and governance characteristics of listed companies in China are largely shaped by the past incentives structure of the listing process. The government introduced stock markets partly as a means of reforming the state sector, and under the quota system, local governments were responsible for selecting which companies were to be listed. Local governments tended to give preference to companies that were under their control, urgently needed capital infusion, or were otherwise socially or economically important. Such criteria would not necessarily result in the selection of the most dynamic, successful, and high-growth companies. They also created a bias against private sector companies.

While the Company Law stipulated various criteria for listing modeled after regulations in successful developed markets, the criteria were insufficient to play a screening role. For example, the law allowed issuers who were divested from SOEs or large and medium SOEs to use pro-forma profit records. This provided incentives to establish SOEs for the specific purpose of listing, a trend that came to be known as "packaging for listing." The packaged shell companies often did not have a meaningful track record, and their business models were at times ad hoc. Thus the companies that are listed on China's stock exchanges are mostly SOEs. They have strong links with the government, especially local governments, and their boundaries with their parent groups are relatively new and often artificial.

This chapter examines the ownership and control structure of Chinese listed companies and the main corporate governance issues associated with it. It focuses on the board of directors as the main corporate governance mechanism. The discussion is based on a survey of 257 companies listed on the Shanghai stock exchange (see Xu and Wang 1997 for a similar survey).

Ownership Concentration and Types of Investors

Chinese company shares are classified as A shares, B shares, and H shares.[1] In our sample, 252 companies issued A shares, 21 companies issued A and B shares, 5 companies issued only B shares, and 4 companies issued A and H shares. Shares of listed companies are further classified into state shares, legal person shares, and tradable shares. Each type accounts for about one-third of all shares. Shares of the same kind carry the same rights.

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. They are not tradable. By 1999, 42 percent of the largest shareholders in the sample held state shares, as did 5.1 percent of the second largest shareholders. The state therefore tends to be the controlling shareholder, and is relatively rarely the second or third largest shareholder.

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 hold legal person shares. These institutions are further classified according to their ownership structure as SOEs, state-owned nonprofit organizations, collectively owned enterprises, private enterprises, joint stock companies, and foreign-funded companies. Legal person shares are not tradable. In 1999, in 57 percent of the companies in the sample, the largest shareholder was holding legal person shares. Almost all the largest legal person shareholders are industrial SOEs (table 4.1). Thus in more than 95 percent of the cases, the state is directly or indirectly (through industrial SOEs) in control of listed companies.

State and legal person shares can be transferred to domestic institutions upon approval of the China Securities Regulatory Commis-

[1] A shares are issued by domestic companies and are held and traded in RMB by domestic investors only. B shares are stocks issued by domestic companies registered on the mainland, but traded in hard currency by foreign investors, including overseas Chinese and individuals and institutions from foreign countries as well as from Hong Kong (China), Macao, and Taiwan (China). Individual domestic investors have been allowed to trade B shares since February 2001. H shares are issued and listed by domestic companies in Hong Kong (China).

TABLE 4.1
NATURE OF THE THREE LARGEST SHAREHOLDERS, AT IPO AND 1999
(percentage of all firms)

	First largest		*Second largest*		*Third largest*	
Shareholder	*At IPO*	*1999*	*At IPO*	*1999*	*At IPO*	*1999*
Industrial SOE	55	57	32	27	26	22
State asset management company	9	7	0	0	0	0
Natural person	0	0	12	8	17	15
Diversified agribusiness	7	8	5	6	5	6
Transportation and telecommunications co.	6	5	3	3	0	0
Commerce entity	5	6	10	8	10	9
Construction and real estate company	4	7	5	3	4	4
Trust and investment company	2	1	12	11	11	11
Securities firm	0	0	4	16	5	11
Bank	0	0	0	0	4	3
Foundation or fund	0	0	8	11	8	9
Other	12	9	9	7	10	10

SOURCE: Survey.

sion (CSRC). In about 47 percent of the sample companies, nontradable shares accounted for 70 to 90 percent of total shares, and in 41 percent of the sample, nontradable shares accounted for 50 to 69 percent of the total. In only 8 percent of sample firms did tradable shares represent more than 50 percent of all shares. Domestic individuals and institutions hold tradable A shares. About 30 percent of all shares are tradable.[2] At the end of 1999, of the 30 percent of tradable shares, individuals held 25 percent and institutions held 5 percent.[3]

In addition to state, legal person, and tradable shares, there are the so-called employee shares. The company sells employee shares to

[2] According to the Company Law, the shares issued to the general public will amount to 25 percent or more of total shares issued.

[3] Article 46 of the Provisional Regulations for Issuance and Trading of Securities specifies that an individual cannot hold more than 5 percent of the shares issued by a single listed company. However, some natural persons indirectly control listed companies through the legal persons shares of parent companies.

management and employees, typically at a significant discount, at the time of going public. These shares have to be held for 6 to 12 months after an IPO, and can then be sold on the stock exchanges following approval by the securities regulatory authorities. In 1998 the regulatory authorities issued a circular in relation to discontinuing the issuance of employee shares. As a result, the number of employee shares is gradually falling.

Some features of the ownership structure are correlated with enterprise size, the nature of the largest shareholders, and the sectoral affiliation of the listed company. As table 4.2 shows, the percentage of state shares tends to increase with company size and that of individual shareholders tends to decrease. The proportion of tradable shares seems to be higher in companies in which the first largest shareholder holds state shares. For example, among the listed companies with more than 50 percent tradable shares, in only 6 percent is a legal person (industrial SOE) the largest shareholder. In terms of sectors, the state has higher shareholdings in manufacturing and in energy and power. Legal persons have controlling positions across all sectors, but their control is especially pronounced in chemicals and conglomerates. Individual investors are relatively better represented in retail and chemicals, while institutional investors are conspicuously avoiding retail and chemicals and pharmaceuticals.

Ownership in China's listed companies is relatively highly concentrated. Data from 1999 indicate that the three largest shareholders held, on average, about 58 percent of total shares, of which the average shareholding of the largest shareholders is about 47 percent, of the second largest is 8 percent, and of the third largest is 3 percent. In

TABLE 4.2
OWNERSHIP STRUCTURE OF COMPANIES AND SIZE, 1999

Company size (RMB)	*State*	*Legal persons*	*Employees*	*Individual (tradable)*	*Institutional (tradable)*
< 500 million	13	50	3	29	5
500 million – 1 billion	24	40	2	28	5
> 1 billion – 1.5 billion	26	44	3	20	6
> 1.5 billion	31	40	2	22	4

SOURCE: Survey.

almost 49 percent of sample firms, the three largest shareholders accounted for 60 to 80 percent of all shares. This high concentration of ownership, combined with the relatively small portion of tradable shares, implies that few, if any, of China's listed companies have contestable control.

Overall, the ownership structure is relatively stable. The concentration, although quite high, has shown a slight tendency to decrease: the share of the three largest shareholders declined from 61 percent at IPO to 58 percent in 1999. However, the share of companies with highly concentrated ownership has shown a tendency to increase in recent years, although companies with the state as controlling shareholder have tended to decrease over time. For example, in 47 percent of the listed companies the largest shareholder was holding state shares at IPO, and in 49 percent of the listed companies the largest shareholder was holding legal person shares (table 4.3). By 1999 the percentage of companies with the state as largest shareholder had dropped to 42 percent and the percentage of companies with legal persons (industrial SOEs) as the largest shareholder had increased to 54 percent.

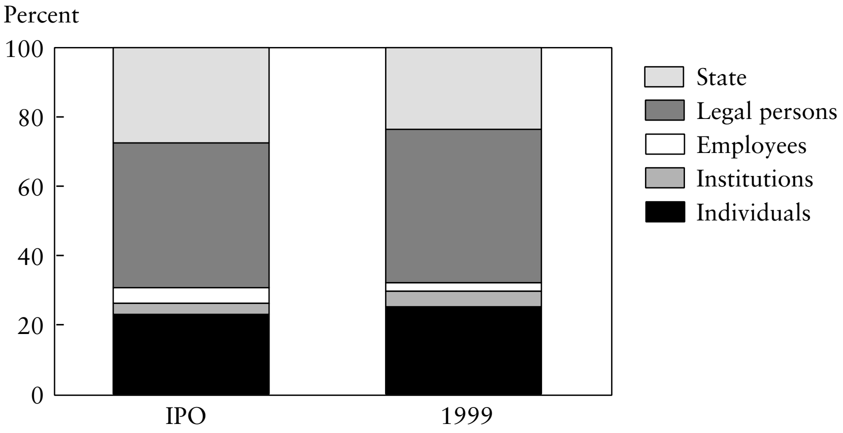
The total shares of listed companies are about equally divided between state shares, legal person shares, and tradable shares. Between the time of the IPO and 1999, the percentage of state shares has

TABLE 4.3
DISTRIBUTION OF SURVEYED COMPANIES
BY TYPES OF LARGEST SHAREHOLDERS, AT IPO AND 1999
(percent)

	First largest		*Second largest*		*Third largest*	
Share type	*At IPO*	*1999*	*At IPO*	*1999*	*At IPO*	*1999*
State shares	47	42	6	5	1	4
Legal person shares	49	54	64	58	17	53
Employee shares	0	0	4	1	4	1
A shares	3	2	22	26	28	31
B shares	0	0	3	5	3	6
H shares	0	0	0	1	1	1
Foreign legal persons	0	1	0	0	1	0
Other	0	0	0	4	0	4

SOURCE: Survey.

FIGURE 4.1
TRENDS IN COMPANY OWNERSHIP STRUCTURE, AT IPO AND 1999



SOURCE: Survey.

fallen while the percentage of legal person shares and tradable shares has increased (figure 4.1).

In 28 percent of the companies surveyed, the largest shareholder had changed since the IPO, with most of the changes taking place between 1998 and 1999. In almost 82 percent of these companies, the change was associated with the replacement of the chair of the board of directors, and in 44 percent with the replacement of the general manager.

In addition to the transfer of control, new share issues are another channel through which the ownership structure evolves. For example, one possible reason for the decline in state shareholding is that most listed companies pay dividends not in cash but in rights issues. In general, legal persons are financially able to accept rights issues, while the government or its agencies prefer cash payouts.

Ownership and Corporate Governance Issues

The information in tables 4.4 and 4.5 allows us to compare the ownership structure of Chinese listed companies with that in some West European and East Asian countries and the United States. In terms of

TABLE 4.4
CONCENTRATION OF COMPANY OWNERSHIP, SELECTED COUNTRIES, 1998
(percentage of shareholding)

Country	*Largest*	*2nd largest*	*3rd largest*	*4th–10th largest*
Austria	82.2	9.5	1.9	6.5
China	47.0	8.0	3.0	—
France	56.0	16.0	6.0	5.0
Italy	52.3	7.7	3.5	5.1
Netherlands	28.2	9.2	4.3	7.1
Spain	38.3	11.5	7.7	10.3
United Kingdom	14.0	8.3	6.1	9.2

Country	*Largest*	*2nd and 3rd largest*	*4th and 5th largest*	*6th–10th largest*
Belgium	55.8	6.9	0.6	0.2
Germany	59.7	8.6	2.6	0.3
United States	22.8	9.5	7.5	3.8

Country	*Largest*	*1st–5th largest*
Indonesia	48.2	67.5
Korea, Rep. of	20.4	38.5
Malaysia	30.3	58.8
Philippines	33.5	60.2
Thailand	28.5	56.6

— Not available.
SOURCES: ADB (1999); Tricker (1999).

concentration, China is somewhere in the middle. The ownership structure is concentrated, but at levels similar to those in most West European countries. What differentiates China's ownership structure is the identity of the controlling shareholders (table 4.5).

A similarity with ownership structures in some West European and East Asian countries is the dominant position of other corporate entities as shareholders. In terms of types of largest shareholders, China is differentiated by the absence of significant ownership by individuals and families, the negligible role of financial institutions and institutional investors, and the large state role. These features have a direct bearing on the types of corporate governance issues that China faces.

TABLE 4.5
TYPES OF LARGEST SHAREHOLDERS, SELECTED COUNTRIES, 1997
(percentage of shareholders)

Country	*Individuals and families*	*Banks*	*Insurance companies*	*Investment funds*	*Holding and industrial companies*	*State*	*Company directors*
Austria	38.6	5.6	0	0	33.9	11.7	0
Belgium	15.6	0.4	1.0	3.8	37.5	0.3	0
China	0	0	0	1.0	57.0	42.0	0
France	15.5	16.0	3.5	0	34.5	1.0	0
Germany	7.4	1.2	0.2	0	21.0	0.7	0
Italy	68.6	7.2	0	0	24.2	0	0
Korea, Rep. of	60	8.5	2.0	6.1	—	1.5	—
Malaysia	4.8	—	—	—	45.6	17.2	—
Netherlands	10.8	7.2	2.4	16.1	10.9	1.3	0
Philippines	5.5	2.1	0.2	13.5	4.9	2.6	—
Spain	21.8	6.6	8.8	0	32.6	0	0
Thailand	35.2	2.2	—	—	—	2.5	—
United Kingdom	2.4	1.1	4.7	11.0	5.9	0	11.3

— Not available.
SOURCE: ADB (1999); Tricker (1999); survey.

Perhaps the most important implication of the dominant role of state ownership in China's listed companies is the control the government can exert over management appointments and incentives, and thereby over companies' behavior. Most corporate managers still aspire to a civil service rank and are concerned about how their superiors in the political and administrative hierarchy assess their performance. This assessment may be quite arbitrary or subjective and be based on such indicators as profits, political correctness, and the discharge of social obligations. Furthermore, local governments may have incentives that are not aligned with the plans of companies that operate on a national or international scale.

As noted, the dominant position of corporate entities as controlling shareholders is not unique to China. However, in China, the nature of the listing process in the past compounds the risks of conflicts between controlling and minority shareholders. Listing and parent companies are often in the same business sector and may compete with each other, have business transactions with each other, or share resources and functions. In some cases, the listed company may depend on the rest of the group for distributing products or supplying raw materials. Senior managers often work for both the listed and unlisted parts of the group. This type of interdependence between listed companies and their parent firms creates fertile ground for agency problems.

Corporate control mechanisms and shareholder activism can do little to alleviate such agency problems under the existing ownership structure. The high degree of ownership concentration and the nontradability of more than two-thirds of the shares imply a low contestability of control. In addition, tradable shares are held largely by individuals, who have few incentives and resources to perform monitoring functions.

Board of Directors

The board of directors is the critical link between ownership and corporate governance. This is the setting where governance takes place and where some of the solutions to corporate governance problems can be sought.

Ownership and Control. According to the survey, shareholders appoint 76 percent of the directors of listed companies (table 4.6). Holders of state-owned legal person shares are the most influential, selecting 48 percent of all directors, followed by owners of state shares at 21 percent. Thus directly or indirectly, the state is in absolute control, selecting almost 70 percent of all directors.

State enterprises appoint 45 percent of all the directors appointed by shareholders (table 4.7). In line with their insignificance as shareholders, financial institutions play a relatively minor role in the selection of directors. Trust and investment companies, securities companies, and banks together account for the selection of 1.3 percent of executive directors and 9.3 percent of nonexecutive directors. Private enterprises appoint 1.5 percent of all directors appointed by shareholders. Those holding state shares and tradable shares tend to appoint a larger proportion of executive than nonexecutive directors.[4] As table 4.7

[4] Public servants from government departments are not permitted to become directors of listed companies and banks are not allowed to be shareholders. However, directors from these institutions do exist. To some extent this reflects the lack of effectiveness of the regulations. It also reflects some banks' recent practice (in the past two years) of engaging in debt-equity swaps.

TABLE 4.6
COMPANY OWNERSHIP AND CONTROL
(percent)

Shareholder type	*Ownership*	*Control (board seats)*
State	24	21
Legal persons	44	48
Employees	2	3
Tradable shares	30	4
Total	100	76

SOURCE: Survey.

shows, the owners of state shares select a higher portion of executive directors, while the owners of state-owned legal persons shares, who typically represent the interests of the parent SOE, select the majority of nonexecutive directors.

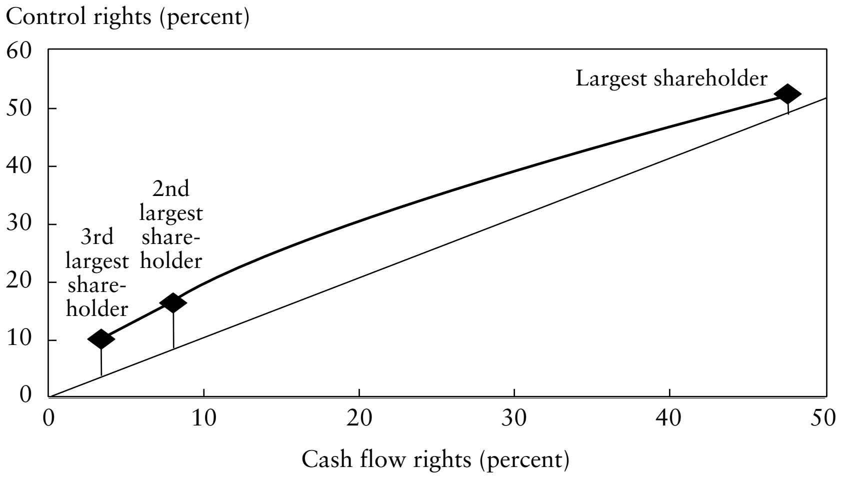
Like ownership, control is highly concentrated. The largest shareholder accounts for slightly less than 50 percent of all shares but controls more than 50 percent of board seats. The average share of the three largest shareholders is 59 percent, but they appoint 79 percent of the directors. Furthermore, considerable disparity is apparent

TABLE 4.7
SELECTION OF DIRECTORS AND SUPERVISORS OF LISTED COMPANIES
(percent)

	Directors			
	Total	*Executive*	*Non-executive*	*Super-visors*
Owners	76	—	—	50
State shares	28	36	16	25
State-owned legal person shares	45	44	54	44
Public legal person shares	18	13	27	12
Internal employee shares	3	3	1	11
Publicly circulating shares	6	5	2	7

— Not available.
SOURCE: Survey.

FIGURE 4.2
DISCREPANCY BETWEEN CASH FLOW AND CONTROL RIGHTS IN LISTED COMPANIES



SOURCE: Survey.

between the shares of board seats and the ownership of different shareholders, that is, between control and cash flow rights. A comparison of the control and cash flow rights of the largest three shareholders shows that the discrepancy is higher for the second and third largest shareholders than for the largest shareholder, conditional on the latter's having obtained majority control (figure 4.2). The marginal value of control diminishes after majority control has been obtained. This can be seen in table 4.8, which compares the distribution of the single largest shareholder with board control. The share of board seats controlled by the largest shareholder is higher than that shareholder's ownership share, but this situation is reversed after the shareholder obtains a majority stake (more than 50 percent).

Thus to a significant extent, parent companies control the boards of listed companies. Few board seats are available for nonshareholders, and the notion of independent directors is new to most listed companies. The directors appointed by nonshareholders account for 24 percent of total directors. The executive directors appointed by nonshareholders are mainly recommended by company staff, but are

TABLE 4.8
DISCREPANCY BETWEEN SIZE OF THE LARGEST SHAREHOLDING AND CONTROL RIGHTS

Largest share (percent)	*Number of companies in sample*	*Average size of the largest share (percent)*	*Percentage of directors appointed by largest shareholder*
> 80	5	87	66
50–80	77	63	62
20–49	78	34	46
< 20	11	16	31
Total	171	48	53

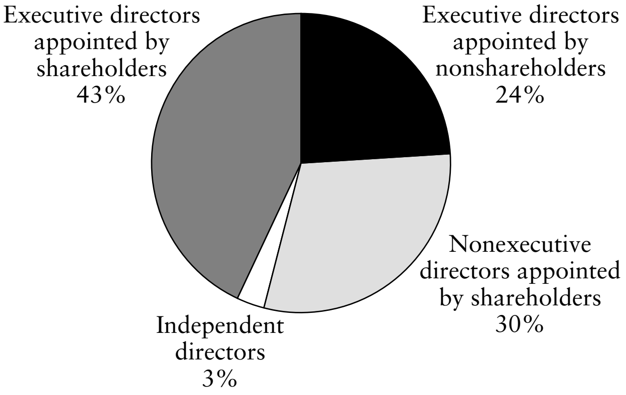
SOURCE: Survey.

sometimes appointed by the government. The independent directors are mainly recruited by the companies. They tend to be former advisors to the companies and are usually elected because of their reputations and professional expertise.

Board Composition and Trends. According to the Company Law, a board of directors should consist of 5 to 19 directors. The average size of boards in 1999 was 9.9, compared with 10.1 in 1996 (table 4.9). Two-thirds of all directors are executive directors. Only 54 directors, or 3.1 percent of all directors, have some degree of independence (figure 4.3).[5] About half of the executive directors take senior manage-

[5] The U.S. National Association of Corporate Directors (1996, pp. 9–10) defines an independent director is one who (a) has not been employed by the company in an executive capacity within the last five years, (b) is not affiliated with a company that is an adviser or consultant to the company, (c) is not affiliated with a significant customer of or supplier to the company, (d) has no personal services contracts with the company or with a member of the company's senior management, (e) is not affiliated with a not-for-profit entity that receives significant contributions from the company, (f) has not had any business relationships with the company other than service as a director within the last five years, (g) is not employed by a public company for which an executive officer of the company serves as a director, (h) has not had any of the relationships described above with any affiliate of the company, and (i) is not a member of the immediate family of any person described above.

FIGURE 4.3
Distribution of Company Directors by Type of Appointment, 1999



Source: Survey.

ment positions. Comparatively fewer directors hold professional positions such as chief engineers, advisers, and economists.

In about 22 percent of the companies surveyed, the board chair is also the general manager. In some 33 percent of the sample companies the chair is not a company employee. In the majority of listed companies, about 45 percent, the board chair and general manager are two different people, but the chair does hold a position in the company.

Table 4.9 shows trends in board size and composition. The average share of executive directors decreased from 56 percent in 1996 to 49 percent in 1999, and the average share of directors appointed by shareholders increased from 65 percent in 1996 to 70 percent in 1999 (table 4.9). A significant number of directors come from connected companies, and their percentage representation appears to be increasing. This is also true for associated companies that either hold shares of the listed company or provide credit to or have business transactions with the listed companies.

While the average number of executive directors on boards has been on the decline since 1996, as figure 4.4 shows, the concentration of control, as measured by the percentage of seats controlled by the three largest shareholders, has increased over time (see figure 4.5). The increase has been especially pronounced for small boards.

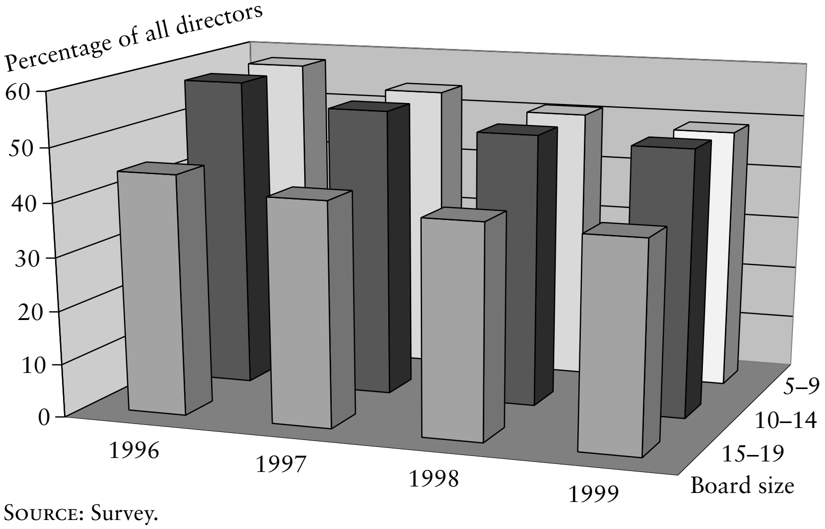
TABLE 4.9
TRENDS IN COMPANY BOARD SIZE AND COMPOSITION, 1996–99

Category	*1996*	*1997*	*1998*	*1999*
Board size (average number)	10.1	9.9	9.9	9.9
Director affiliation (average number)				
Holding management position	5.6	5.3	5.0	4.9
Appointed by shareholders	6.6	6.5	6.8	6.9
Representing nonbank financial institution (shareholder)	1.4	1.5	1.4	1.3
Connected companies (shareholder)	3.8	4.3	4.9	4.9
Connected companies via business transactions	2.5	2.9	3.5	3.2

SOURCE: Survey.

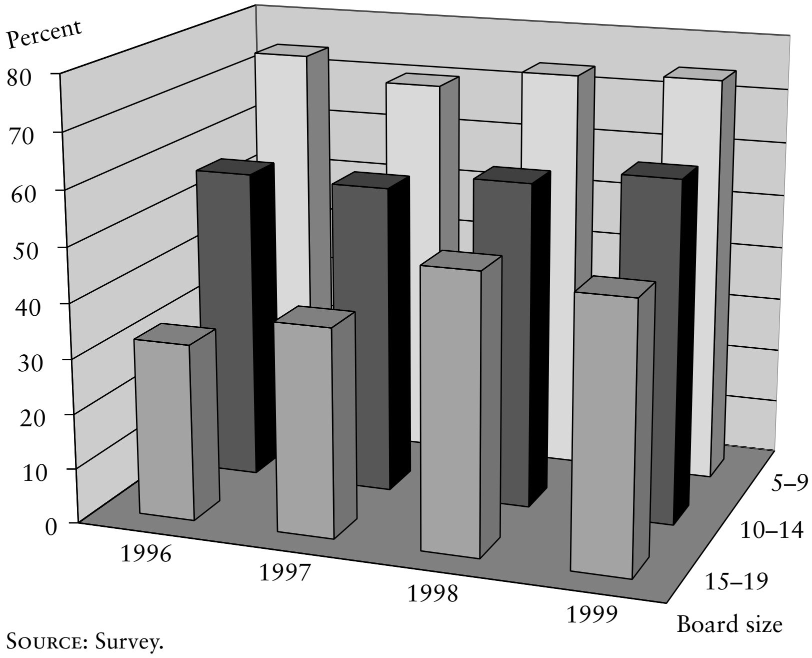
Directors' Qualifications and Careers. Almost 60 percent of the directors of listed companies have a graduate or higher degree (table 4.10). Nonexecutive and independent directors tend to be more highly educated than executive directors appointed by shareholders. About half of all executive directors, two-thirds of nonexecutive directors, and

FIGURE 4.4
CHANGES IN SHARE OF EXECUTIVE DIRECTORS AND BOARD SIZE, 1996–99



SOURCE: Survey.

FIGURE 4.5
PERCENTAGE OF BOARD SEATS CONTROLLED BY THE THREE LARGEST SHAREHOLDERS AND BOARD SIZE, 1996–99



SOURCE: Survey.

TABLE 4.10
EDUCATION OF COMPANY DIRECTORS
(percentage of directors)

Highest level of education	*Executive directors appointed by share-holders*	*Other executive directors*	*Non-executive directors*	*Inde-pendent directors*	*Total*
Postgraduate or higher	14	10	20	43	16
Graduate	43	37	47	33	42
College degree	35	42	28	22	34
High school graduate	7	10	6	2	7
Middle school and lower	0	1	0	0	1

SOURCE: Survey.

almost all independent directors hold degrees in management-related subjects or finance and accounting. An insignificant number of directors have studied law.

In terms of background, most directors have worked in the fields of engineering, marketing, and sales. Independent directors have more experience in technological research, education, and Chinese Communist Party and Chinese Communist Youth organizational work. Most executive and nonexecutive directors are former SOE employees, while independent directors are drawn mostly from government departments, research institutions, and universities (table 4.11). This accounts for the description of listed companies as "old wine in new bottles," that is, on the surface a new corporate governance framework appears to be in place, while in reality companies still operate more or less like the old SOEs.

Most executive directors were with the listed companies at the time of the IPO, and most of them had previously worked in the firm's parent company (table 4.12). Regarding nonexecutive directors, 32

TABLE 4.11
COMPANY DIRECTORS' FORMER EMPLOYERS
(percentage of directors)

Employer	*Executive directors appointed by shareholders*	*Other executive directors*	*Non-executive directors*	*Independent directors*
Macroeconomic government department	9.0	5	16	24
Government ministry	15.0	12	24	32
Research institute or university	15.0	9	15	33
Financial institution	3.0	1	13	24
SOE	76.0	73	73	43
Collectively owned enterprise	9.0	8	7	6
Private enterprise	6.0	5	8	4
Joint venture	11.0	6	10	4
Other listed company	2.0	1	6	2
Foreign company	0.4	1	4	2

NOTE: Numbers exceed 100% because individuals can have different employers over the course of their career.
SOURCE: Survey.

percent were with the company at the time of the IPO and 16 percent had worked in the parent company. More than one-third of all directors also sit on other boards. This percentage is higher for nonexecutive and independent directors (56 and 43 percent, respectively), and lower for executive directors not appointed by shareholders (25 percent).

Director Selection. Chinese corporations still lack nominating committees for directors and corporate governance committees. Listed companies do not disclose their procedures for nominating directors or their corporate governance principles. Most directors believe that their companies have internal criteria for selecting directors. When surveyed they cited management experience followed by professional expertise and reputation as the main criteria. Other criteria cited include share ownership and personal connections.

The Company Law stipulates that the shareholders' general meeting is responsible for selecting and removing directors, but it does not stipulate who is responsible for nominating directors. International practices typically include a nominating committee under the board—

TABLE 4.12
CAREER ROUTES OF COMPANY DIRECTORS
(percentage of directors)

Category	*Executive directors appointed by shareholders*	*Other executive directors*	*Non-executive directors*
With the company at IPO	78	87	32
With the predecessor company	59	69	16
Used to be manager of the predecessor company	32	27	9
Used to be an official in the relevant government department	8	6	10
Was employed at the shareholding company	48	26	53
Used to be a manager in another company in the same industry	18	14	19
Used to be a manager in another industry	18	14	32

NOTE: Numbers exceed 100% because individuals can have different employers over the course of their career.
SOURCE: Survey.

that is composed mainly of outside or independent directors who do not hold a position in the company other than as board directors—that formulates selection criteria and nominates new directors. In China, large shareholders nominate new directors in 57 percent of listed companies, the board of directors does so in 34 percent of companies, the chair of the board in 6 percent of companies, and existing directors in 3 percent of companies.

The May 2001 CSRC rules on independent directors stipulate that the board of directors, the board of supervisors, or any shareholders who separately or jointly hold 5 percent of the shares in the listed company can nominate candidates for independent directorships. In all cases the nominees must consent to being nominated. The final decision is made by a vote at the shareholders' meeting.

Compensation and Other Incentives. Most directors are paid less than RMB 50,000 per year (table 4.13). None of the independent directors receive more than RMB 50,000 per year. Listed companies provide most executive directors with such benefits as a company car and a house and independent directors with allowances. Few nonexecutive directors receive benefits from the company. Bonuses average 24 percent of directors' annual incomes, more for executive directors and less for independent and nonexecutive directors. Simple tests of the survey data failed to identify any statistically significant correlations between directors' compensation and various measures of company performance.

TABLE 4.13
COMPANY DIRECTORS' ANNUAL INCOME, 1999
(percentage of directors)

Salary	*Executive directors appointed by shareholders*	*Other executive directors*	*Nonexecutive directors*	*Independent directors*	*Total*
< RMB 25,000	40	47	70	89	46
RMB 25,000– RMB 50,000	36	38	22	11	35
> RMB 50,000– RMB 80,000	14	7	5	0	11
> RMB 80,000	9	8	3	0	8

SOURCE: Survey.

TABLE 4.14
COMPANY DIRECTORS' SHAREHOLDINGS, AT IPO AND 1999

		Executive directors			
Time	*Shareholding*	*Appointed by shareholders*	*Not appointed by shareholders*	*Nonexecutive directors*	*Independent directors*
At IPO	RMB value of shares	48,410	40,976	2,153,316	15,711
	Percentage of shares	0.004	0.006	0.180	0.002
1999	RMB value of shares	116,569	180,638	2,401,174	33,371
	Percentage of shares	0.006	0.008	0.140	0.001
	Shares/annual income	2.9	4.9	77	1.3

SOURCE: Survey.

Nonexecutive directors hold more shares than the other three types of directors, both at IPO and subsequently (table 4.14), while independent directors hold the smallest amount of shares. Directors' shareholdings are increasing rapidly, with the highest increase for executive directors and a moderate increase for nonexecutive directors. However, this largely reflects the internal distribution of shares prior to an IPO, a practice that has recently been restricted.

Functioning of Boards of Directors. Listed companies average 4.2 board meetings per year, significantly less than their counterparts in industrial countries.[6] In developed market economies, listed companies generally establish special committees under the board of directors to ensure that the board functions properly.[7] The survey revealed

[6] Based on a sample of 1,700 public U.S. companies, Bhagat, Carey, and Elson (1999) found that U.S. firms averaged 7.2 meetings per year, with smaller firms having fewer meetings than larger firms.

[7] Typically these committees are (a) a nominating committee responsible for recommending candidates for election as directors; (b) a compensation committee that reviews and approves compensation arrangements for management; (c) an audit committee responsible for reviewing the audited financial statements produced by independent auditors and overseeing the company's financial reporting process; (d) a finance committee that reviews the company's investments, capital requirements, and resource allocations; and (e) an executive committee responsible for approving major decisions taken between board meetings. Many companies also have public policy, public responsibility, and environmental protection committees.

that only 5.4 percent of the companies have established such committees and only 14 percent plan to set up such committees. In those companies that do have committees, these are usually an investment or finance committee, an audit committee, a financial management committee, and/or a strategy committee.

Among the committees established, investment committees and financial management committees are composed predominantly of executive directors, while strategy committees have a higher percentage of nonexecutive and independent directors. The main functions of the committees focus on decisions concerning major investment projects. Their supervisory and auditing functions are at an early stage of development.

Most listed companies do not have a system in place for establishing board committees. The main reasons for this are (a) the boards of directors' relative lack of independence, (b) the prevalence of insider control, and (c) the lack of independent directors who are familiar with the legal aspects of business operations. Some special committees cannot function meaningfully in the absence of independent directors. Table 4.15 compares board structures and directors' characteristics' in selected economies, including China. China differentiates itself by the relatively low percentage of nonexecutive directors and the extremely low percentage of companies with board committees.

Recent measures to strengthen the independence of boards of directors focus on increasing the number of external and independent directors, on upgrading directors' professional qualifications, and on standardizing the functioning of boards. For instance, as of May 30, 2001, CSRC rules on establishing an independent board of directors in listed companies require that at least one-third of the board consist of independent directors, including at least one accounting professional. The CSRC also requires the independent directors to work for the listed company for no less than 15 hours a year. The board of directors, the board of supervisors, or any shareholders who separately or jointly hold 5 percent of the shares of the listed company can nominate independent director candidates. Furthermore, two or more independent directors can now convene extraordinary general meetings, and in the case of companies listed overseas, they can report directly to the shareholders' meetings, the CSRC, and other relevant government department regarding the affairs of the listed company. Independent directors are now explicitly instructed to safeguard the

TABLE 4.15
Company Board Structure and Director Characteristics, Selected Economies

Economy	*Chairman/ CEO separate people*	*Average board size*	*Non-executive directors (%)*	*Worker representation*	*Average age of directors (years)*	*Percentage of companies with board committees*	*Audit committee*	*Nomination committee*	*Remuneration committee*	*Management and executive committees*
Board of directors										
Australia	Very high	8	75	No	55	85	Yes	Yes	Yes	No
Belgium	High	15	78	—	56	65	Yes	No	Yes	No
Brazil	Low	6	60	No	57	Low	Yes	No	Yes	Yes
Canada	66%	13	80	No	—	100	Yes	Yes	Yes	Yes
China	79%	10	50	Yes	47	5	Yes	No	No	Yes
France	Nil	13	82	Yes	59	77	Yes	Yes	Yes	No
Hong Kong, China	Very low	8	15	No	—	Low	Yes	No	No	No
Italy	100%	11	73	No	57	40	No	No	No	Yes
Singapore	Low	—	—	No	—	Low	Yes	No	No	—
South Africa	50%	13	60	—	53	100	Yes	No	Yes	No
Spain	37%	12	71	No	54	57	Yes	No	No	Yes
Sweden	High	9	85	Yes	56	Low	No	Yes	No	No
Switzerland	63%	5	89	No	60	67	No	No	No	Yes
Taiwan, China	Low	—	—	No	—	—	—	—	—	—
United Kingdom	90%	12	50	No	56	100	Yes	Yes	Yes	No
United States	15%	13	77	—	61	100	Yes	Yes	Yes	No
Supervisory board										
France	100%	12	92	Yes	59	Low	Yes	No	No	No
Germany	100%	15	100	Yes	59	None	No	No	No	Yes
Netherlands	100%	7	100	Yes	61	54	Yes	No	Yes	Yes

— Not available.
Source: Tricker (1999); Survey.

company's overall interests, especially the rights and interests of small and medium shareholders. According to a recent report (*Shanghai Securities News*, July 24, 2001), 204 listed companies have already hired 314 independent directors.

Compared with practices in other markets, Chinese boards have relatively little decisionmaking power within the existing legislative framework, while government ministries and commissions and securities regulatory authorities enjoy substantial decisionmaking power. As table 4.16 shows, for about 20 percent of China's listed companies, the board has full powers in matters regarding finance and investment, while in about half the companies the board has decisive influence over these matters. Some boards, typically those dominated by insiders, are trying to increase their autonomy from shareholders in relation to financial matters (box 4.1)

One of the major functions of a board of directors is to design and enforce management contracts. Table 4.17 shows average annual incomes and shareholdings of senior management in listed companies. Salary is still the main form of management compensation, and most corporate managers still aspire to a civil service rank. Thus their remuneration is explicitly or implicitly benchmarked against civil service wages and they aspire to being promoted to higher civil service positions (although this attitude does appear to be changing, espe-

TABLE 4.16
THE ROLE OF COMPANY BOARDS IN FINANCIAL AND INVESTMENT DECISIONS
(percentage of listed companies)

Company action	*Full powers*	*Decisive influence*	*Substantial influence*	*Some influence*	*No power*
Adjustment of equity structure	10.5	52.9	12.8	3.9	1.6
Dividend distribution	10.9	59.1	13.6	1.9	0.5
New capital investment	21.8	49.8	9.7	2.7	0.7
Sale of assets	20.6	48.6	10.9	1.6	0.8
Borrowing for fixed asset investments	25.7	38.1	14.8	3.9	0.8
Mergers and acquisitions	10.9	56.4	12.1	1.2	0.9
Company's strategic planning	35.4	44.4	6.6	1.2	0.4

SOURCE: Survey.

BOX 4.1
Expanded Role for Boards

Recent reports from listed companies suggest that more boards are asking shareholders for greater autonomy in finance and investment matters. The rationale is typically found in the dynamic nature of markets, which require quick responses to business opportunities. For other companies that are reorganized from SOEs, the main reason is to simplify procedures. In turn, some boards have authorized general managers to handle asset disposal, investments, and guarantees if individual deals are below some prespecified amount, typically RMB 10 million. As boards become more empowered, more comprehensive supervision of boards by the relevant regulators and the market community is called for to prevent board members from abusing their positions and harming the interests of medium and small shareholders.

Source: *Shanghai Securities News* (January 14, 1999).

cially in Guangdong). As a result, salaries of different categories of managers are generally low and undifferentiated between, as well as within, companies. Not surprisingly, tests on the survey data for possible correspondence between management compensation and company performance as measured by net assets per share, return on assets, and Tobin's Q failed to identify any relationship.[8]

Senior management hold mostly employee shares issued at the time of the IPO. With the authorities discouraging the issuance of employee shares, bonuses have become practically the only incentive component in the compensation contract. While some listed companies and shareholders have conducted some experiments (see box 4.2), the lack of legislative support has meant that stock-based incentives, including stock options, are not being developed.

Given the lack of strong incentives linked to share performance, corporate managers are particularly sensitive to their performance

[8] Tobin's Q is defined as the ratio between a company's market value and the replacement value of its physical assets.

TABLE 4.17
MANAGERIAL COMPENSATION AND
SHAREHOLDING AT SURVEYED COMPANIES

Category	*General manager*	*Executive deputy general manager*	*Deputy general manager*	*Assistant general manager*
Compensation				
(percentage of managers)				
< RMB 25,000	28	41	39	53
RMB 25,000 – < RMB 50,000	36	39	37	29
RMB 50,000 – RMB 80,000	16	8	15	9
> RMB 80,000	20	12	9	9
Shareholding				
RMB value of shares at IPO	40,859	53,474	52,583	26,127
RMB value of shares in 1999	136,860	112,155	87,471	21,686

SOURCE: Survey.

assessments by their superiors in the political and administrative hierarchy. In many cases the government still evaluates companies based on their total profits and taxes paid. Thus managers' incentives are not linked to their companies' return on equity or earnings per share growth. As a result, Chinese companies want to issue new shares as often as possible to increase investment, and correspondingly, total profits and taxes. Listed companies also tend to overstate their earnings as they aim to fulfill political expectations, for example, the profit and tax targets set by city governments. This behavior is quite different from the behavior of private companies, which typically try to understate profits so they can evade tax payments.

The board exerts full powers in the appointment of general managers in about 70 percent of the companies surveyed. Board secretaries' perceptions that the board of directors does not appoint all the general managers is probably because the secretaries consider that large shareholders or government agencies as large shareholders intervene. While the Company Law spells out the relationship between shareholders' meeting, boards of directors, and management relatively well, in reality, large shareholders often overstep their boundaries and exercise effective control. Board chairs usually have good government connections and exert genuine control over shareholders' meetings as

BOX 4.2
Stock Award Experiment, Wuhan

In July 2000, the Wuhan State Asset Management Company gave shares to the chairs of three listed companies as part of their annual compensation. For example, the income of the chair of Wuhan Zhong Shang was RMB 167,000, with RMB 70,000 in 8,000 company shares.

According to the internal regulations of Wuhan State Asset Management Company, a company chair is compensated in the form of an annual salary that consists of the following four components:

- Basic salary, which is based on the company's previous year's results and typically amounts to RMB 18,000 to RMB 42,000 for a company with a profitable track record.
- Seniority income, which usually ranges from RMB 2,400 to RMB 19,200 and depends on the length of service.
- Special annual bonus, which is a reward for consistently good company performance, that is, a 20 percent increase in net profits for three consecutive years.
- Risk income, which is also a reward for the company's performance based on reaching predetermined targets. About 30 percent of the risk income is in cash, and the rest is retained for conversion to company shares. This 70 percent of the risk income will be converted to company shares based on the average share price the month after the release of the annual report. For an agreed period the shares are not tradable and the State Asset Management Company exercises the voting rights. However, the recipient is entitled to dividends and rights issues, if any.

representatives of the largest shareholder. The state's dual role as owner and regulator implies that political intervention is likely. Managers and boards of directors tend not to resist arbitrary government intrusion into all areas of business operations.

Board of Supervisors

As conceived of in China, the board of supervisors is unique: a mixture of the German-style supervisory committee and China's traditional concept of employees as masters of enterprises. The Company

Law does not specify the proportion of shareholders' representatives and employees' representatives on supervisory committees, but just requires that corporate charters properly stipulate the proportion. Theoretically, shareholders could specify a low proportion of employee representatives on the supervisory committee. However, in reality, because of the SOEs' traditional business practices, shareholders appoint only about half of the supervisors, but especially in the case of holders of legal person shares (SOEs), appoint significantly more chairs and vice chairs. Leaders of party committees tend to assume the positions of chair and vice chair in almost all listed companies. Unions are not represented on supervisory boards to any significant extent.

The majority of supervisors hold political science degrees, with few holding degrees in economic management or engineering. Like directors, most supervisors took office at the time of the IPO, and many used to have positions in the parent companies. The proportion of supervisors coming from government authorities that supervised the parent companies is higher than in the case of directors. Overall, supervisors have less business and outside company experience than directors. Like directors, most supervisors come from SOEs.

Supervisors' average salaries are slightly lower than those of directors, and supervisors typically hold shares. The shareholdings of supervisory board chairs and vice chairs have tended to increase, while those of other supervisory board members decreased slightly in 1999 compared with their holdings at the time of the IPO.

Supervisors generally meet less often than boards of directors and their meetings are less well attended. Supervisory boards are more "decorative" than functional. Their published announcements indicate that they rarely contest decisions made by boards of directors and company executives. The lower-quality and less professional experience of supervisors compared with directors and managers has led to supervisors' inability to actually supervise directors and managers. Supervisors' main sources of information are attendance at board meetings as nonvoting participants and the working reports of the chair of the board of directors and the general manager. In addition, boards of supervisors lack the finance and audit committees that are usual in industrial countries. The Company Law does not stipulate that boards of directors and management have to report regularly to the supervisory board. In addition, supervisors are not involved in the selection of directors and managers and have no means of disciplining them.

Agency Problem of the Controlling Shareholder

As noted earlier, two main corporate governance problems arise from the current ownership structure of listed companies in China. One, the agency costs of the controlling shareholder, is related to the concentration of ownership. The other, the government's poor capacity to maximize shareholder value, is related to the identity of owners. Most recent initiatives have focused on attempts to control the first problem. Relatively few, if any, measures have directly addressed the second issue. However, as the two issues overlap because the government is directly or indirectly the controlling owner in most listed companies, measures aimed at the controlling shareholder problem have indirectly affected the ability of government agencies to exercise discretionary powers in their capacity as owners.[9]

Documented abuses by controlling shareholders include soft loans from listed companies on a long-term basis; the use of listed companies as guarantors to borrow money from banks; and the sale of assets to listed companies at unfair prices, usually without an appraisal by an independent evaluator. Given the historical relationship between listed companies and unlisted parent companies, the latter implicitly assume that listed companies will and should help a parent company if the need arises. Similarly, if the listed company comes under pressure—for example, if it has to satisfy an earnings requirement for a share placement—it may call on the parent company for help, for instance, by buying assets from the listed company to create exceptional gains for the latter. Interference by the parent company may also include transferring and appointing listing company personnel at will. This type of interference has often resulted in major difficulties for listed companies.

As some listed companies have tens of thousands of individual investors, abuses of this sort can have a major impact on social stability and on market confidence. The CSRC has been the most active in tackling the problem from the side of listed companies. Recent CSRC measures have focused on segregating the management of listed companies from the management of their controlling institutional shareholders, on prohibiting or restricting certain connected transactions,

[9] Note, however, that government agencies have a wide arsenal of instruments to affect a company's behavior.

and on strengthening managements' independence from their controlling shareholders and the boards of directors' independence from company management and main shareholders.

CSRC regulations now require that the management of listed companies (including boards of directors, senior management, and financial and marketing departments) be segregated from the management of their institutional controlling shareholders. They include provisions stipulating that listed companies cannot have more than two senior officers from the management of the controlling shareholder acting as the chair, vice chair, or executive director of the listed company at any time. They also prohibit the appointment of any officer from the management of the parent company to a senior management position in the listed company. Since March 1999, separation from the parent company and the absence of connected transactions are conditions for new rights issues by all listed companies.

Several CSRC stipulations, including informing the CSRC and the public, aim at making the procedures for transferring and removing listed company senior management more cumbersome. The stipulations explicitly state that for listed companies to perform well, the positions of directors and managers should be stable.

Other measures are aimed at making transactions between listed companies and controlling shareholders more costly. For instance, a June 2000 CSRC notice restricts listed companies from using their assets to provide guarantees for their shareholders or for connected companies. Many of these requirements are even stricter than in Hong Kong (China) and other developed markets. They underscore both the severity of the problem and the authorities' determination to protect minority shareholders.

A March 1999 CSRC measure (Further Standardizing the Operations and Reform of Companies Listed Outside China Opinion) emphasized directors' use of professional consultants, advisors, and experts and the formation of specialist committees. Some CSRC opinions have also included provisions in relation to supervisory boards, for instance, recommending an increase in the number of independent supervisors and suggesting that supervisory boards should have the power to request information and to be kept fully informed about listed companies' operations and financial status.

While these measures indicate significant progress in strengthening boards of directors' independence, without other supporting measures their effectiveness may be limited. Such supporting measures could emphasize directors' awareness and education and clarify the exact rights and responsibilities of directors. Such clarity would need to be supplemented by a proper system of rewards and penalties, with protection under the business judgment rule being an integral part of the system of rights and responsibilities.

Some of the current measures have the effect of creating different classes of directors with different rights and responsibilities. This contravenes the principle that all directors should have the same types of fiduciary responsibility toward all shareholders.

China's approach to strengthening the independence of boards of directors implicitly assumes a system of unitary boards; however, one could argue that the concept of independent directors is irrelevant in a dual board system such as China's. Under current circumstances, strengthening the supervisory board is an alternative to establishing a system of independent directors. However, applying a symmetric approach to the two types of boards can produce too much of a good thing. Recent measures reinforce the relative strength of the board of directors versus the supervisory board.

These measures rely exclusively on regulatory control for enforcement. They do not emphasize giving powers to minority shareholders directly and lowering the costs to minority shareholders of exercising their ownership rights. For example, the new independent director system gives every shareholder with more than a 5 percent stake the right to nominate independent directors. Under the current ownership structure, in practice this means that only the first and second largest shareholders have the right to nominate independent directors, yet these shareholders already have greater control rights relative to their cash flow rights. One could argue that nomination by these shareholders takes away independent directors' independence, and that they are therefore unlikely to look out for the interests of small and minority shareholders.

Conclusion

The ownership structure of listed companies in China is characterized by the absence of families and individuals as significant shareholders, the negligible role of financial institutions and institutional investors, and the large role of the state. In more than 95 percent of listed companies the state is directly or indirectly (through industrial SOEs) in control. Ownership is highly concentrated. In almost 50 percent of sample firms the three largest shareholders account for 60 to 80 percent of all shares. The high concentration of ownership combined with the relatively small portion of tradable shares implies that control is contestable in few, if any, listed companies.

These ownership features have a direct bearing on the type of corporate governance issues that China currently confronts. Perhaps the most important implication of the dominant role of state ownership in listed companies is the government's control over management appointments and incentives, and thereby over companies' behavior. While the dominant position of corporate entities as controlling shareholders is not unique, in China large shareholders often overrule shareholders' meetings and boards of directors and exercise direct control.

Recent measures to improve the functioning of boards of directors have increased the costs of actions by controlling shareholders that may hurt minority investors. They also limit the capacity of government agencies as controlling shareholders to exploit minority interests. However, such measures, are insufficient to control the government's distorting impact on managers' incentives and career concerns.