

The trends of transparency, laws and regulations on Chinese corporate governance

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Abstract: In this paper, the author analyzes the situation about market transparency, information disclosure of listed companies and Chinese corporate governance in china. It is found that faked presentation, black-boxes exchange and manipulating market led to unbalance of Chinese market order. Therefore, corporate governance must be regulated. Marker rules which are fitful for modern economical activities should be set down. Furthermore, effective regulation system should be built to improve law system, Chinese market transparency and the level of corporate governance.

Keywords: market transparency; information disclosure; laws and regulations; corporate governance; enterprise reform

1 The general situation and development trend about transparency of the Chinese market

Market transparency reflects the information disclosure of listed companies. It is one of the most important appraisal standards of quality and information efficiency in capital market. It is also the main political objective of regulation authorities. Information disclosure is the legal obligation of listed companies, but listed companies usually has options in terms of disclosure content, pattern, time, object and so on. Generally, listed companies can benefit from voluntary and abundant information disclosure by the following aspects: enhancing the reliability of financial report, improving the investors' relationship, increasing the liquidity of stocks, improving decision-making ability of investors, reducing the litigation risk and so on.

Since the 1990s', with constant development of the capital market in china, the information disclosure issue has been attracting more and more attention from society. Still at its initial stage and lack of criterion, the level of information disclosure of the Chinese capital market falls far behind its oversea counterparts. As the transparency of listed companies is still unsatisfactory, the Chinese information disclosure system is priority to compulsory disclosure, with voluntary disclosure as assistant.¹

1.1 Compulsory information disclosure of listed company in China

Compulsory disclosure stems from policy environment. For listed companies, information disclosure is not only a voluntary behavior, but also a legal obligation, which is regulated by the compulsory information disclosure system.

During the past decade, China has developed a comprehensive information disclosure system, which is composed of the *Securities Law*, as well as related administrative regulations and institutional rules. The information disclosure system contains four layers: basic laws, administrative regulations, institutional rules and market criteria.²

(1) Basic laws

It contains the basic laws passed by National People's Congress or its Standing Committee such as "*Securities Law*" and "*Company Law*", as well as other regulations the Penal Law.

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(2) Administrative Regulations

They mainly include some regulations enacted by State Council in April 1993, such as “Provisional Regulations on the Administration of Share Issuance and Trading”, “Regulations of the State Council on Foreign Capital Stocks Listed in China by Joint-stock Companies”, “Interim Measures for the Administration of Convertible Corporate Bonds” and so on.

(3) Institutional rules and Canonical documents

It contains the rules and regulations which are applicable to the information disclosure made by China Securities Regulatory Commission. Such as “Contents and Format of Information Disclosure regarding Companies Issuing Securities to the Public”, “Editing and Reporting Rules of Information Disclosure for Companies Publicly Issuing Securities” , “Questions & Answers on Information Disclosure of Publicly Listed Companies”, “Performing Rules of Information Disclosure for Companies Publicly Issuing stocks”, “ Managing methods of Stock Exchanges ” and so on.

(4) Market criteria

They mainly refer to the rules “Rules Governing the Listing of Securities” and “orientation program for Listed Company regulation” constituted by Shanghai and Shenzhen exchanges ³.

According to different periods of information disclosure, compulsory information disclosure about Chinese listed company can be divided into initial information disclosure and continued information disclosure. In the Chinese securities market, initial information disclosure includes offering brochures and books listed Notice. Continued disclosure of information includes periodic report and the interim report. Periodic report includes annual and medium-term reports (half, quarterly and monthly). Interim report includes events notice and takeovers notice.

1.2 The effectiveness of Chinese information disclosure system

Following the development of the stock market, Chinese information disclosure system has established a basic framework. However, with deceptive and lagged information, current information disclosure of Chinese public corporations is ineffective, thus rendering the whole system lack of effectiveness. ⁴

The lack of public corporation’s information disclosure it’s demonstrated in the following four aspects:

(1) Inaccurate or fabricated financial statements

Many public corporations often manipulate net profits by adjusting financial statements. By such means, they are able to satisfy requirements such as: the average net profitability in three years exceeds 10% (any of a year not below 6%). For example, in the stock right dispute of “Tibet Holy Place”(SH600749) in 1998, investors found that the non-arrived capital of Sichuan Province Economic Technology Collaborate Exploit Corporation, the primary stockholder, was 16.26 million RMB, 32.75% of all shares. Lacking the required amount of capital, “Tibet Holy Place” didn’t Reach the minimum requirement of public listing. However, it has been deliberately concealing rather than revealing the information.

(2) Discretionary information disclosure

The Chinese securities regulation authority emphasizes that listed corporations must publish information on the appointed newspapers. However, some public corporations still reveal information at will, disregarding time, required, place, and occasion. Common tricks include: reveal information on provincial newspapers rather than appointed newspapers, adjust revealed information at will disregarding consistency and without legal procedures, leak related

information before big events such as going public or Merger & Acquisition, announcing convertible issuing without the permission of regulatory authorities, and so on. For example, “Zhu Jiang Business” first reported that its profit was 200 thousand in 2000, and then supplemented later that there was 50 million loss. From the case above, we can see that the information revelation regulation is not strictly complied with.

(3) Untimely information disclosure

“The temporary enactment of stock issuing and transaction management” states that: in time of important events, which may have an important impact on the market price, but haven’t been known by investor, listed companies should submit report to the security exchange and security regulatory commission, inform the society and explain the essence of these events. This regulation aims to prevent insider trading. However, cases of untimely information disclosure still abound. Take the case of Chinese Changhong in 1996 as an example: the Shanghai Stock Exchange and Changhong Company did not issued any relevant information about Changhong corporate shares transferred to bonus shares. Changhong Company did not report this information to the Securities Regulatory Commission, and the information bulletin of the Shanghai Stock Exchange’s computer system didn’t publish any information of this on June 21. Obviously, they violated the three principles of revealing information of listed companies.⁵

(4) Price manipulation with inside information

There supposed to be serious price manipulation with inside information in the Chinese stock market. Those with inside information buy large amounts of stocks before the disclosure of information, and sell out their stocks or continue to boost price after the disclosure of information. The case of Qiong Minyuan in 1996 is a typical case in point. The corporate representative of Qiong Minyuan Hainan Corporation learnt about the content of corporation’s interim period report and annual report and the dividend policy in advance. Qiong Minyuan Hainan Corporation and Shenzhen Metal Finance Corporation purchased a large number of stocks before Qiong Minyuan reported its favorable interim profit in 1996. As a result, the stock price rose continuously, and they achieved the goal of manipulating the market.

1.3 The trend of Chinese market transparency

The construction of Chinese market transparency is going along orderly, and the market transparency is steadily improving. To meet the requirement of WTO, China Securities Regulatory Commission made a series of policies and rules to regulate the information disclosure of listed companies. In time of globalization, improving the market transparency is helpful for Chinese listed companies to adapt to the increasingly fierce market competition. The Chinese capital market is a typical new and transitional market. There are many nonstandard problems with the size and quality of listed companies, the controlling level and the development of rules and laws. These factors lead to a low-level of transparency, but Chinese market transparency is marching towards transparency step by step.

2 The construction of laws and regulations of corporate governance in China

2.1 Re-positioned the government role

The Chinese Market economy is transforming from the traditional central planned economy. On October 8th, 2002, the report of 16th National Congress of Communist Party of China confirmed a new reform direction for the management mechanism on state-owned assets. And on April 6th, 2003, State-owned Assets Supervision Commission was established.

2.2 The improving law and supervision environment

The Supreme people's court has issued "Notice about related problems to the accept of civil dispute torts cases in security market caused by misrepresentation" and "Supreme people's court's several policies on civil compensation cases in security market caused by misrepresentation" in succession. Also the "Rules of governance of the listed companies" published by China Securities Regulatory and State Economics and Trade Commission in combination in 2002 has become a guiding principle document for Chinese enterprises to improve the governance practice.⁶

2.3 Preventing the big shareholder from encroaching the profits of listed companies

To prevent the big shareholder from seizing the benefits of the listed company, the companies are asked to reveal the related party transaction and ensure fair trading price. Such regulations can be found in the "*enterprise accounting standard-the disclosure of related party relationship and transaction*" promulgated by the Ministry of Finance in 1997 and the "*the management standard of the listed company*" promulgated in 2002 by the China Securities Regulatory and the State Economic and Trade Committee. The independent board directors are also required to give independent opinions.

2.4 The enhancing independence and importance of the board of directors

Firstly, some companies have begun to improve the board structure and functions, and emphasized its core position in corporate governance. Secondly, according to "*the leading opinion on building up the institutional of independent board director in the listed company*" released in August in 2001 by the China Securities Regulatory, the listed company appoints the relevant people to act as the independent board director, which improved the independence of the board. In addition, the boards of directors in some listed company have established the subordinate professional committee, such as the investment committee, the auditing committee, and strategic committee etc, to exercise some professional functions of the board independently.

2.5 The exploration of stimulation mechanism

- (1) The model of purchasing the circulation stock in the second market with parts of bonus;
- (2) The model of virtual stock. According to performance appraisal results and bonus rules, offering virtual stocks at market price;
- (3) The model of performance reward: companies use part of the annual net profit to stimulate the small shareholders who purchase the circulation stock of its company;
- (4) Compulsory purchase of shares and lock mode: the managers of the companies must hold a certain number of public shares of the company.

2.6 The control right market of corporation significantly improved

In October 2002, CSRC issued "regulatory rules of listed company takeover", which provides a good frame for the operation and further development of corporate control power market. In November, 2002, Circular of the China Securities Regulatory Commission (CSRC), the Ministry of Finance (MOF), and the State Economy and Trade Commission (SETC), jointly issued "On Issues Related to Transferring State-owned Shares and Institutional Shares of Listed Corporations to Foreign Investors", which allowed the transfer of State-owned Shares and Institutional Shares to Foreign Investors. Along with a series of the reorganization policy measures, listed corporations reorganization tends to have the long-term effect strategic reorganization.⁷

2.7 institution investors are increasing

In November 2002, CRSC and the People's Bank of China together enacted the policy that

qualified foreign institution investors (QFII) are allowed to invest A stock of China. QFII pay more attention to the factors of corporate governance and sustainable management ability of invested companies. After coming into Chinese security market, QFII exerts positive influence to increase Stock market efficiency and improve the standard of corporate governance.

2.8 The role of the state-owned commercial banks in corporate governance catches attention

In recent years, the state-owned commercial banks in china have achieved significant progress in marketization. According to international norms and standards, State-owned commercial banks perfect the quality of assets of credit evaluation, assessment system and methods, and continuously improve the internal control mechanism of credit and credit risk management business; Through introducing of professional asset management, companies invigorate the stock assets and reduce the proportion of non-performing loans, optimize new credit orientation, and improve the quality of their credit assets. State-owned commercial banks ' long-term negative financial provider role had changed greatly, Credit market's external constrains debtor companies increasingly strengthened.

2.9 The rising role of the Self-regulation organizations and Intermediaries

Until the end of 2002, China has developed 46 independent audit guidelines in five waves, and thus initially established a system of independent audit guidelines. In October 2000 , Shanghai Stock Exchange developed and promulgated the "Shanghai Stock Exchange listed company governance guidelines" based on the last two years' extensive investigation and research. This is the first comprehensive, systematic, and highly targeted and applicable norms of the guidance document for listed company governance mechanisms.

3 The trends of the Chinese corporate governance

3.1 The motivations for changes in China-based corporate governance

In China, corporate governance is structured for solving the inherent two basic problems within the firm. The first is the incentive problem, namely, how to motivate all participants of the firm to contribute to the firm's output, given that output is a collective outcome and individual contribution is hard to measure. The second is the management selection problem; which means, what kind of mechanism can ensure that only the most entrepreneurial people are employed to fill in the management position.

Based on the benefit mechanism, what the reform of corporate governance has to reply is that, which type of enterprise system is most advantageous in guaranteeing investors to obtain the reasonable investment repayment” and protect their property in the listed companies. Or specifically, how to guarantee the exterior investor's legitimate rights and interests not to be infringed by the insider (Managers and the big stockholders who control the stockholder's rights).

3.2 The effects of China state-owned enterprise reform

Chinese state enterprise reform has been relatively successful in solving the short-term managerial incentive problem through both its formal, explicit incentive system and its informal, implicit incentive system. However, it still failed to solve the long-term managerial incentive problem and the management selection problem. An incumbent manager may have incentives to make short term profits, but at present there is no mechanism to ensure that only qualified people can be selected for management. The fundamental reason is that managers of SOEs are still selected by bureaucrats rather than capitalists. Since the bureaucrats have the authority to select managers but do not need bear the consequences for their selection, they do not have proper

incentives to find and appoint high ability people. Since good performance does not guarantee that the incumbent manager will stay long, and the manager does not have long-term incentive. To ensure that only high ability people will be professional managers, authority of selecting management should be transferred from bureaucrats to capitalists. This calls for privatization of the state-owned enterprises.

The state-owned enterprise (SOE)'s reform has been quite successful in terms of improvement in total factor productivity (TFP). According to many studies, the annual increase of TFP has been 2-4% since 1979, much higher than in the pre-reform period. However, the reform has not been successful, at least in terms of profitability of SOEs. It is widely reported (and most people believe) that one third of SOEs make explicit losses, another one third make implicit losses, while only one third are slightly profitable.

3.3 Main problems of corporate governance in China

(1) **Stock structure is not reasonable**, non-circulative stockholders take the holding position. The majority of these listed companies in China evolved from State-owned/ State-controlled enterprises. Due to restrictions in market capacity when offering shares to the public, the portion of shares available to the open market is relatively low. After the offering, more than half of the available shares are held by the promoters. This has enabled "control" of the company to remain with the promoters who are State-owned shareholders or State-controlled shareholders. Now, among all the Chinese listed companies, about 65% hold the state as their No.1 stockholder, which take over 40% stock share of each company, once the subsidiary successfully lists IPO, the parent company would take the listed company as money drawing machine. It will harm the assets of the listed company. This should kill listed companies, and violate the rights and interests of the middle and small stockholders.

(2) **The percent of negotiable securities is relatively low**. As discussed above, the promoters hold the majority stake. Based on existing regulations, State-owned shares and legal entity shares held by the promoters are not traded in the open market. As such, more than half of the shares are non-negotiable securities. In addition, for listed companies that went public in the earlier days, shares held by the public cannot be traded in the open market until three years after the company has been listed. This reduced the amount of negotiable securities.

(3) **The Number of individual shareholders is relatively high**. The Chinese securities market is primarily made up of individual investors and institutional investors. These individual investors are segmented, segregated and the shareholding ratios are relatively low. In addition, other factors including geography, time-zone, etc., will further restrict individual investors' participation in the management and significant-decision-making process in listed companies.

(4) **The difference of Company stock structure**. Between the parent corporation and the subsidiary corporations, black-box transactions happen frequently. These hurt both listed corporations and the public investors. And the directors and managers of the corporations mainly come from the controlling shareholders' companies or units. There is no effective managers' market among Chinese listed corporations. Company manager capacity and experience is not their main employment factors.

(5) **Regulation system is invalid**. The board of directors and the general managers of the state proprietary stock companies are appointed by the State Department. Chairman of the board of director is often general manager at the same time. The function of decision making of the

board of director could not separate from the executing function of the management. This directly results in the invalidation of the control system.^{8,9}

4Conclusion

In summary, Chinese market is still not mature. From the view of the quality of listed companies, controlling level, development of rules and laws etc, the market still lacks criteria. Chinese government and Regulation authorities are making much effort to improve the transparency of Chinese market and corporate governance's level.

NOTES

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