

## RECENT OWNERSHIP REFORM AND CONTROL OF CENTRAL STATE-OWNED ENTERPRISES IN CHINA: TAKING ONE STEP AT A TIME

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### I INTRODUCTION

Competition between State-Owned Enterprises ('SOEs') and foreign companies has intensified as China liberalised market access in order to fulfil its commitments for entry to the World Trade Organization ('WTO'). To help SOEs meet the challenge of increasing international competition, the Chinese Government has adopted a variety of reform measures to increase the productivity and efficiency of SOEs. Reforming the ownership structure of SOEs and instituting standardised corporate governance are two important measures. This article examines recent ownership reform and control of central SOEs as well as issues to be tackled as part of ongoing reform. Part II provides a short review of the corporatisation of SOEs, Part III examines the powers and functions of the State-owned Assets Supervision and Administration Commission ('SASAC') as a representative body of State ownership, while Part IV reflects on the recent ownership reform and argues for further reform in ownership diversification and ownership regulation.

### II CORPORATISATION OF SOEs

Since 1979, SOEs have undergone four major strategic steps towards better governance: (1) greater autonomy for managers; (2) management contracting; (3) restructuring; and (4) ownership diversification.<sup>1</sup> The most important shift was the restructuring of SOEs as corporations.<sup>2</sup>

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1 For a detailed account of governance of State-owned Enterprises in China, see Chenxia Shi, 'International Corporate Governance Developments: The Path for China' (2005) 7(1) *Australian Journal of Asian Law* 60.

2 See Fang Liufang, 'China's Corporatization Experiment' (1995) 5 *Duke Journal of Comparative and International Law* 149.

Ownership change has been closely guarded by the Government due to ideological and social stability concerns.<sup>3</sup> The privatisation of large SOEs has never been promoted as a policy goal.<sup>4</sup> The reform of SOEs in China has attracted great interest from international law and economic scholars alike. Contrary to the mass privatisation approach adopted by Russia<sup>5</sup> and other transforming economies, China's gradual approach to SOE reform with minimal

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3 'In late June [2002], more than a year after authorities unveiled a plan to raise much-needed money for the country's social-security fund by selling some of the shares they control, the State Council admitted failure and scrapped the sales. Only a tiny portion of the sales had actually happened, but the threat that more might come had sent Shanghai's A-share market, which consists of renminbi-denominated shares restricted to domestic investors, into a 35 per cent tailspin between May and October [in 2001]': Ben Dolven, 'Capital Drought' (2002) 165(27) *Far Eastern Economic Review* 30.

4 This is largely due to an ideological barrier: predominant public ownership in the Chinese economy. The Chinese socialist economy has been characterised by public ownership since the founding of the People's Republic of China. The ongoing transformation from planned economy to market economy has not fundamentally changed this character, although other forms of ownership including private ownership have recently been enshrined in the Constitution and encouraged. Ownership reform has focused on diversification of ownership, although some small and medium-sized SOEs were allowed to merge with or be acquired by other parties. The Government encourages development of diversified economic elements whilst retaining the dominance of the public sector. For example, the amended 2004 Constitution states: '[t]he basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people': Constitution of the People's Republic of China art 6(1). Further, '[t]he state-owned economy, that is, the socialist economy under ownership by the whole people, is the leading force in the national economy. The State ensures the consolidation and growth of the State-owned economy': Constitution of the People's Republic of China art 7. Premier Wen Jiabao also mentioned this in his 2007 Government Report: '[w]e will encourage, support and guide the development of individual-proprietorship businesses, private companies and other components of the non-public sector of the economy': Wen Jiabao, *Report on the Work of Government* (2007) The Central People's Government of the People's Republic of China <[http://english.gov.cn/official/2007-03/16/content\\_552995.htm](http://english.gov.cn/official/2007-03/16/content_552995.htm)> at 14 October 2007.

5 Rapid mass privatisation of SOEs in Russia (previously a centrally planned economy) from 1992 to 1994 failed, very badly, to revive its economy. According to Black, Kraakman and Tarassova, 'mass privatization was part of the shock therapists' effort to destroy the existing structure of state control, quickly and irrevocably': Bernard Black, Reinier Kraakman and Anna Tarassova, 'Russian Privatization and Corporate Governance: What Went Wrong?' (2000) 52 *Stanford Law Review* 1731, 1803. They observed three main failures in the Russian privatisation effort: first, mass privatisation of large enterprises is likely to lead to massive insider self-dealing. The development of an effective legal and enforcement infrastructure for controlling inside dealing must precede or go alongside with privatisation of large enterprises. If privatisation goes ahead first, massive theft is likely to occur before the infrastructure to control it can develop; second, the profit incentives to restructure privatised enterprises (instead of looting them) can be swamped by an unfriendly business environment created by such things as a tax system and official corruption; and third, corrupt privatisation of large enterprises can compromise future reforms: at 1731.

privatisation appears to be more successful in transforming corporate governance and spurring economic development.<sup>6</sup>

During the initial reform period, the Government supported SOEs through heavily subsidised bank loans to keep them operating and solvent. This approach was unsustainable, as State banks were nearly paralysed by the astronomical amount of bad debts and non-performing loans<sup>7</sup>. It was therefore imperative to explore new workable ways to reform SOEs. The corporatisation of SOEs was initiated to build up the effective internal governance mechanisms of SOEs, as well as to increase profitability and efficiency through the pressure exerted by market forces.

The Company Law 1993 ('Company Law')<sup>8</sup> was passed by the National People's Congress to facilitate the corporatisation of SOEs. Under the Company Law, SOEs can be restructured, or 'corporatised', into three types of companies: wholly State-owned companies, limited liability companies and joint stock limited companies.<sup>9</sup>

Corporatised SOEs can be listed on a stock exchange if listing requirements are met. To date, the majority of listed companies in China are transformed

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6 China's SOE reform began with granting managers autonomy and introducing a shareholding system, then to corporatisation and ownership diversification on a trial and error basis. Such a gradual approach has helped with maintaining social stability, which is vital for the progression of the reform. Although SOE reform still faces many challenges, achievements have been made in transforming organisational structures and enhancing the efficiency of SOEs; see Harry G Broadman, *Lessons from Corporatization and Corporate Governance Reform in Russia and China* (2001) Social Science Research Network <<http://ssrn.com/abstract=292599>> at 14 October 2007; Varouj A Aivazian, Ying Ge and Jiaping Qiu, 'Can Corporatization Improve the Performance of State-owned Enterprises Even Without Privatization?' (2005) 11(5) *Journal of Corporate Finance* 791.

7 According to Li Rongrong, the Minister in charge of SASAC, from 1994 to 2002, 3,080 SOEs were closed down or bankrupt in China, with RMB 199.54 billion (US\$24.1 billion) of non-performing loans written off and 5.3 million laid-off workers relocated. In 2003, China still had some 2,500 large and medium-sized SOEs that were bankrupt but had yet to be closed down. These SOEs employed 5.1 million workers and involved liabilities of RMB 240 billion (US\$29.0 billion). See 'Over 2,500 Chinese SOEs yet to be closed: official', *People's Daily Online*, 19 November 2003, <[http://english.peopledaily.com.cn/200311/19/eng20031119\\_128566.shtml](http://english.peopledaily.com.cn/200311/19/eng20031119_128566.shtml)> at 27 October 2007.

8 Company Law of the People's Republic of China, adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on 29 December 1993; amended at the Thirteenth Session of the Standing Committee of the Ninth National People's Congress on 25 December 1999, at the Eleventh Session of the Standing Committee of the Tenth National People's Congress on 28 August, 2003, and at the Eighteenth Session of the Tenth National People's Congress on 27 October 2005, effective 1 January 2006.

9 Company Law 1993, ch V, art 159. In a limited liability company, shareholders assume liability towards the company to the extent of their respective capital contributions, with the company liable for its debts to the extent of all its assets: Company Law 1993, ch I, art 3. A wholly State-owned company is a limited liability company invested in and established solely by a State-authorized investment institution or a department authorised by the State: Company Law 1993, ch II, art 63. A joint stock limited company has its total capital divided into shares of equal value, with shareholders being liable to the proportion of their holdings and the company being liable for its debt to the extent of all its assets: Company Law 1993, ch I, art 3. A joint stock limited company may be organised as a public share offer, with a maximum of 65 per cent of shares going to the public: Company Law 1993, ch III, art 83. With such public involvement, incorporation is subject to the approval of either a department authorised by the State Council or a government department at the provincial level: Company Law 1993, ch III, art 77.

SOEs.<sup>10</sup> Initially only subsidiaries of large SOEs<sup>11</sup> were listed on the market with the wholly State-owned parent company retaining a controlling ownership. Such practices created governance problems for both listed subsidiaries<sup>12</sup> and parent companies. Hence, full listings (comprehensive listing of both subsidiaries and parent SOEs) are currently on the reform agenda.<sup>13</sup>

Organisational restructuring through corporatisation has brought about more effective information and incentive constraints on managers<sup>14</sup>. Chinese companies have generally upgraded their internal governance mechanisms by setting up board committees, appointing independent directors<sup>15</sup> and enhancing information disclosure, all of which are mandated by law and enforced by the China Securities Regulatory Commission ('CSRC'), which acts as the corporate regulator.<sup>16</sup>

However, the restructured companies also inherited the traditional operating and management culture of the old SOEs.<sup>17</sup> Previously, the State always played a significant role in enterprise operation and management. SOEs operated according to State production plans and governance was then mainly about setting up linkages between State policy and factory production. SOEs were used as sites of general welfare production, not as sites of narrow private wealth

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- 10 Cindy A Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now' [2002] *Columbia Business Law Review* 1.
  - 11 China's corporatisation program relied partly on the stock market to provide capital for financing restructuring of converted SOEs, so listing of large SOEs was a priority. However, SOEs must comply with listing standards provided by the Company Law. It was impossible for largely debt-ridden and underperforming SOEs in the 1990s to meet all requirements; hence, there was a flurry of asset reorganisation activities within SOEs whereby quality assets were separated from bad assets, and then a subsidiary took over the best assets of the SOEs, which met listing requirements and was launched onto the stock exchange. For other issues concerning the listing, see Liufang, above n 2.
  - 12 For detailed account, see Shi, above n 1. See also Liu Junhai, 'Legal Reform in China' in Jean-Jacques Dethier (ed), *Governance, Decentralization and Reform in China, India and Russia* (2006) 373; Yaohui Zhao, 'The Nature of Chinese State-owned Enterprises and Its Implications' in James G Wen and Danqing Xu (eds), *The Reformability of China's State Sector* (1997) 302; Peter Lee, *Industrial Management and Economic Reform in China: 1949–1984* (1987).
  - 13 See, eg, 'SASAC Encourages Whole Listing of Central SOEs', *Xinhua News Agency*, 13 August 2007 <[http://news.xinhuanet.com/english/2007-08/13/content\\_6521859.htm](http://news.xinhuanet.com/english/2007-08/13/content_6521859.htm)> at 27 October 2007.
  - 14 See Gao Xiqing, 'The Perceived Unreasonable Man – A Response to Fang Liufang' (1995) 5 *Duke Journal of Comparative and International Law* 271. See also Shanghai Stock Exchange, *China Corporate Governance Report 2003* (2003) 8.
  - 15 Baoshan Steel Company, regarded as one of China's best-run state companies, recently appointed two independent directors to its board, one from Hong Kong and the other from Singapore: 'Outside Directors Installed at BaoSteel', *Xinhua News Agency*, 28 January 2006 <<http://english.sina.com/business/1/2006/0128/63778.html>> at 9 October 2007.
  - 16 These laws include: the Company Law; the Securities Law of the People's Republic of China, adopted on 29 December 1998 and amended in 2005; the Criminal Law, which was originally promulgated by the National People's Congress on 1 July 1979 and amended in 2006 to provide criminal penalties for corporate misconduct; and, the Code of Corporate Governance for Listed Companies and the Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies, issued by the State Economic and Trade Commission ('SETC') in 2001.
  - 17 Traditionally, State enterprises were not independent economic entities because the government managed and operated them. See Shi Jianhui et al, '*Gong si zhi li: zhong guo de jing yan*' [Corporate Governance: China's Experience] (2001) 103. See also Lixin Colin Xu, Tian Zhu and Yi-min Lin, 'Politician Control, Agency Problems and Ownership Reform: Evidence from China' (2005) 13(1) *Economics of Transition* 1.

production. They did not concern themselves with markets or particular shareholders and operated under State protection.

Therefore, corporatised SOEs face problems inherent in the transition from a planned socialist economy characterised by public ownership and State control to a market economy.<sup>18</sup> Many of the problems relate to State ownership and control of the SOEs, which SOEs themselves are incapable of handling without the initiative of the Government.

The State plays multiple roles in regulating SOEs. The State is a key figure both as a drafter and an enforcer of regulations and rules and as the sole or controlling shareholder in corporatised SOEs.<sup>19</sup>

The overlap and conflict of being referee and player, combined with the inefficiency caused by pursuing political objectives instead of taking responsibility as a shareholder, are the apparent negative influences on governance qualities. In order to minimise these influences and improve efficiency of state-owned enterprises, China is constantly exploring new paths of its state asset management by trial and error.<sup>20</sup>

### III REPRESENTATIVE BODIES OF STATE OWNERSHIP: MANAGEMENT AND CONTROL OF STATE ASSETS BY SASAC

As a result of the concentration of State ownership in corporatised SOEs, the State, as a controlling shareholder, has unmatched power to dominate shareholders' meetings, the board and management in general. However, the State is an abstract form: it must perform its role as a controlling shareholder through agents. The directors and managers of listed companies are largely political appointees whose job it is to safeguard State assets, but without adequate supervision State assets have been misappropriated and siphoned off by the managers.<sup>21</sup>

To address this problem, the Government set up an Asset Management Agency, subordinate to the Ministry of Finance ('MOF') to exercise the ownership rights of the State and supervise the management of State assets by SOEs.<sup>22</sup> However, this arrangement failed to achieve its goal. The establishment of SASAC<sup>23</sup> in 2003 demonstrated the Government's renewed efforts to tackle long-standing problems concerning SOE ownership. SASAC is mandated to

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18 Such as the separation of the State's role as the owner of the SOEs from its role as the regulator.

19 Shanghai Stock Exchange, above n 14, 4.

20 Ibid.

21 In 2001, about 50 listed companies received an inspection, warning, criticism or fine as a result of investigation by the CSRC, most cases involving embezzlement and misappropriation of State assets. See 'Wave of Corporate Governance Measures Taking on Companies Breaching Rules, Regulation of Securities Market Enters the Final Stage', *Financial Times* (Shanghai) 25 October 2002. See also Shanghai Stock Exchange, *China Corporate Governance Report 2003* (2003) 7.

22 Shanghai Stock Exchange, *China Corporate Governance Report 2003* (2003) 6.

23 Originally called the 'State Asset Regulatory Commission', SASAC is defined as a ministerial-level 'special organisation' reporting directly to the State Council. See State Council, *Interim Regulations on the Management of Enterprise State-owned Assets* (2003) <[http://news.xinhuanet.com/fortune/2003-06/04/content\\_905211.htm](http://news.xinhuanet.com/fortune/2003-06/04/content_905211.htm)> at 13 October 2007. The 2006 Company Law provisions on wholly State-owned companies refer to SASAC as the agency that wields ultimate power in matters related to these enterprises.

consolidate functions previously scattered over various government agencies, which include representing State ownership, as well as regulating and supervising central SOEs.<sup>24</sup> SASAC at the central level supervises central SOEs which are those owned and controlled by the Central Government, whereas SASAC at the local level supervises local SOEs which are owned and controlled by the provincial governments.<sup>25</sup> The central SASAC drafts laws, administrative regulations and rules on the management of State-owned assets, and directs and supervises the work of local State-owned asset managers.<sup>26</sup> This discussion focuses on central SASAC.

The number of central SOEs is down from 196 in 2003 to 159 in 2006 as a result of continuous restructuring<sup>27</sup> and the Government's aspirations to foster larger and global Chinese companies.<sup>28</sup> The revenue of central SOEs surged 82 per cent from RMB 4470 billion in 2003 to RMB 8140 billion in 2006, while profits more than doubled from RMB 301 billion to RMB 755 billion, witnessing an annual growth rate of 35.9 per cent.<sup>29</sup> Central SOEs own 194 listed mainland companies and 57 Hong Kong companies, and 33 of 159 central SOEs have listed on stock exchanges at home and abroad.<sup>30</sup>

Central SASAC supervises 159 companies which are considered vital to national security and strategically important enough to warrant the maintenance of State control.<sup>31</sup> The State still retains significant ownership control over key SOEs and plays an active role in the restructuring of SOEs through SASAC.<sup>32</sup> SASAC has endeavoured to play a large part in the strategic management and restructuring of large SOEs with a stated goal of ultimately reducing their number to 30 to 50 globally competitive companies, either through mergers or injecting State resources to strengthen their global competitiveness.<sup>33</sup>

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24 The main functions of SASAC include: assuming rights and responsibilities as the owner and safeguarding the interests of the owner; conducting reform and reorganisation of SOEs; appointing Boards of Supervisors to monitor SOEs; appointing and dismissing enterprise managers; auditing State assets; and performing other functions allocated to them by respective governments: Interim Regulations on the Management of Enterprise State-owned Assets 2003, art 13.

25 See the Interim Regulations on the Management of Enterprise State-owned Assets 2003.

26 See, eg, 'SASAC's Responsibilities & Targets', *People's Daily Online*, 22 May 2003 <[http://english.peopledaily.com.cn/200305/22/eng20030522\\_117060.shtml](http://english.peopledaily.com.cn/200305/22/eng20030522_117060.shtml)> at 27 October 2007.

27 See Xinhua News Agency, *China to Open Up More Centrally Administered SOEs* (2007) <[http://news.xinhuanet.com/english/2007-04/04/content\\_5935403.htm](http://news.xinhuanet.com/english/2007-04/04/content_5935403.htm)> at 14 October 2007.

28 See Wen Jiabao, *Government Work Report 2007* (2007) The Central People's Government of the People's Republic of China <[http://english.gov.cn/official/2007-03/16/content\\_552995.htm](http://english.gov.cn/official/2007-03/16/content_552995.htm)> at 14 October 2007.

29 See Xinhua News Agency, above n 27.

30 Ibid.

31 The seven industries on top of the Government's priorities are defence, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping. See, eg, Edward Tse, *Context and Complexity* (2007) Strategy + Business <<http://www.strategy-business.com/press/article/07304?gko=9b267-1876-26315905&tid=230&pg=all>> at 19 October 2007.

32 SASAC will compile a 'state assets management budget' for the central enterprises consolidating their investment funds and require them to hand over a portion of their post-tax profits to the State. This will shift certain authority on allocating profits and directing investments from individual enterprises to the Central Government.

33 See Xinhua News Agency, *Four Trends in the Reform of SOEs discussed in the meeting of the Standing Committee of the State Council* (2006) <<http://finance.sina.com.cn>> at 14 October 2007.

While one of the main objectives of SOE reform has been to separate the State's ownership role from its regulatory role,<sup>34</sup> central SASAC does not seem to be a good example of a functional division as its mandate combines both functions.

Central SASAC exercises ownership rights on behalf of the Central Government. It guides the reform and restructuring of central SOEs and supervises the maintenance and appreciation of the value of State assets. It also dispatches the supervisory board to some large enterprises on behalf of the State and takes charge of daily management of the supervisory board.<sup>35</sup>

In addition, SASAC plays an important role in mergers and acquisitions ('M&A') involving SOEs. Mergers involving SOEs are aimed at improving their international competitiveness by increasing scale and consolidating operations. There were 818 acquisitions of Chinese companies by foreign companies in 2006.<sup>36</sup> Although only a small proportion of foreign acquisitions were blocked by the Chinese Government, no single foreign company acquired a controlling stake in the Chinese SOEs.<sup>37</sup>

Regulations on foreign M&A were issued in August 2006, which specifically state that restrictions on foreign investment cannot be violated as a result of a merger or acquisition.<sup>38</sup> The Ministry of Commerce ('MOFCOM') decides whether the acquisition will endanger national security or lead to a monopoly, and approves the establishment of foreign-invested enterprises following the foreign acquisition of a Chinese company. SASAC supervises procedural regularity and ensures that State assets are not divested at an undervalued price.<sup>39</sup> The CSRC also has a regulatory role when M&A activity involves a listed company. The roles of these regulatory bodies are yet to be well coordinated enough to achieve the optimum results of regulation.

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34 See Stoyan Tenev, Chunlin Zhang and Loup Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (2002) 76.

35 See, eg, 'SASAC's Responsibilities & Targets', *People's Daily Online*, 22 May 2003 <[http://english.peopledaily.com.cn/200305/22/eng20030522\\_117060.shtml](http://english.peopledaily.com.cn/200305/22/eng20030522_117060.shtml)> at 27 October 2007.

36 Fang Yan and Andrew Torchia, 'China Stalls Major Foreign Buyouts', *International Herald Tribune* (Paris), 15 February 2007.

37 In industries requiring Chinese controlling ownership, foreign investors cannot hold majority ownership through acquisition. In industries requiring a Chinese partner, foreign investors cannot adopt a wholly owned company through acquisition. In industries prohibiting foreign investment, no merger or acquisition activities can be allowed. See Ministry of Commerce, the CSRC et al, Administrative Measures on Strategic Investment of Foreign Investors in Listed Companies, issued on 31 December, 2005, effective 30 January 2006.

38 Ministry of Commerce, the CSRC et al, Administrative Measures on Strategic Investment of Foreign Investors in Listed Companies, issued on 31 December, 2005, effective 30 January 2006.

39 In a recent circular, SASAC requires that state assets sold to foreigners be transferred through official asset exchanges, not through direct contractual transfers. See Ministry of Commerce, the CSRC et al, Administrative Measures on Strategic Investment of Foreign Investors in Listed Companies, issued on 31 December 2005, effective 30 January 2006.

#### IV STATE OWNERSHIP OF CORPORATISED SOEs AND RECENT CHANGES

The shareholding structure of domestically listed companies is comprised of State shares, legal person shares, and individual shares.<sup>40</sup> Central and local governments generally hold State shares and are represented by corresponding financial institutions.<sup>41</sup> State Asset Management Companies ('AMCs') or investment companies may also hold State shares.<sup>42</sup> Legal person shares are held by domestic institutions such as industrial enterprises, securities companies, trust and investment companies, various foundations and funds, banks, construction companies, transportation and power companies, and research institutes.<sup>43</sup> Individual shares are held by individual investors.

State shares and legal person shares were non-tradable shares. The non-transferability of these shares constrained the fair liquidity of the stock markets,<sup>44</sup> which also affected effectiveness of monitoring mechanisms for corporate control – as accurate pricing and good liquidity are essential features of an efficient market.<sup>45</sup> Accurate pricing is not only important for initial public offerings and subsequent offerings but also for monitoring corporate control and management performance.<sup>46</sup> Market liquidity reduces transaction costs and risks associated with investments.<sup>47</sup>

By the end of 2004, 'the non-tradable shares accounted for 64 per cent of the total shares in the Chinese capital market (among which the State owned 74 per cent)'.<sup>48</sup> The non-tradability of these shares had such a negative impact on the markets<sup>49</sup> that in October 2005, the CSRC and SASAC took a bold move to reform non-tradable shares.<sup>50</sup> According to the reform measures, the State still owns around two-thirds of shares of China's listed companies, but those shares were converted into tradeable form during 2006 under a plan which compensated minority shareholders for the dilution in their holdings.<sup>51</sup> Some 97 per cent of

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40 Tenev, Zhang and Brefort, above n 34, 76.

41 Ibid.

42 Ibid.

43 Ibid.

44 Liu Xinhui, *Liquidity on China's Securities Market After the Full Circulation Reform* (2006) King & Wood

<[http://www.kingandwood.com/Bulletin/China%20Bulletin/Issue%20July%202006/bulletin\\_2006\\_7\\_en\\_liuxinhui.htm](http://www.kingandwood.com/Bulletin/China%20Bulletin/Issue%20July%202006/bulletin_2006_7_en_liuxinhui.htm)> at 14 October 2007.

45 See Ronald Gilson and Reinier R Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70(4) *Virginia Law Review* 549.

46 See Marcel Kahan, 'Securities Laws and the Social Costs of "Inaccurate" Stock Prices' (1992) 41(5) *Duke Law Journal* 977, 1006.

47 Ibid 1020.

48 China Securities Regulatory Commission, *China's Securities and Futures Markets* (2006) 5

<<http://211.154.210.238/en/jsp/detail.jsp?inford=1153810173100&type=CMS.STD>> at 14 October 2007.

49 Ibid.

50 The Administrative Measures on the Separation of Equity Ownership and Trading Rights of Listed Companies was issued on October 14 2005.

51 The reform process involves four steps:



listed companies have now completed the reform program.<sup>52</sup> Those companies that fail to undertake the reform have been placed in a new category: 'S' shares. They will be penalised by having their daily trading limits halved.<sup>53</sup>

The reform program has successfully removed split share structures (tradable versus non-tradable shares), which was initially designed to maintain stability in the early stage of the stock market's development but in recent years has been seen as the key culprit for China's stagnant stock market.<sup>54</sup> The split share structure reform achieved multiple goals: raising funds,<sup>55</sup> as well as increasing market liquidity while maintaining State control.<sup>56</sup> The implementation of the reform has already boosted investor confidence and market performance.<sup>57</sup>

However, ownership reform does not directly enable the owner to effectively exercise ownership rights. The two most important attributes of ownership under Chinese law are use rights and income rights. The normal use rights enable the owner to appoint management, but SASAC's ability to do so is limited despite the powers granted under the Regulations.<sup>58</sup> The Communist Party makes the key appointments to central SOEs. Moreover, the right to income is also difficult to exercise, with central SASAC still not receiving any after-tax profits from SOEs.

The top management and chairman of the board of the 53 largest enterprises are appointed by the Communist Central Committee Organisation Bureau. The position of Deputy Chief Executive Officer and above is appointed by the central

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First, a reform proposal must be raised by the holders of at least two-thirds of the non-tradable shares of the company, with the help of professional advisors such as sponsors and lawyers. The sponsor must, on behalf of the board, seek the opinion of the relevant stock exchange on the technical feasibility of the reform proposal. Second, the holders of non-tradable shares and the listed company will hold various meetings with the holders of tradable shares to discuss the reform proposal. Third, the holders of the non-tradable shares entrust the board of directors of the company to convene a shareholders' meeting. The reform proposal must be approved by at least two-thirds of the voting rights of all shareholders present at the meeting and at least two-thirds of the voting rights of the holders of tradable shares who participated in the vote (either by attending the shareholders' meeting or via the Internet voting system). Finally, if the reform proposal is approved at the shareholders' meeting, the board makes a public announcement on its implementation. If the reform proposal is not adopted at the shareholders' meeting, the holders of non-tradable shares may, after three months, entrust the board to convene another shareholders' meeting on the reform proposal.

See Emma Davies, 'China's Share Conversion Reform: Impact on Foreign Companies Investing in Chinese Listed Companies' (March 2006) 12 *World Security Law Report*.

52 See, eg, '97% Listed Companies Complete Non-Tradable Share Reform', *China Radio International*, 23 January 2007 <<http://english.cri.cn/3130/2007/01/23/262@188060.htm>> at 27 October 2007.

53 The share price of these companies cannot rise or fall by more than five per cent in one day from the previous session's close, compared to 10 per cent for other shares: Shenzhen Stock Exchange, *Listed Companies Not Implementing the Share Reform to be Differentiated* (2007) <<http://www.szse.cn/main/aboutus/bsyw/200612259669.shtml>> at 14 October 2007.

54 See Sohu, *Challenges and Opportunities for Post-WTO China's Securities Market* (2007) <<http://business.sohu.com/20060708/n244690661.shtml>> at 14 October 2007.

55 This was achieved through selling non-core assets and minority shares in core assets of SOEs. Share reform will create a huge pool of equity by allowing previously non-tradable shares to be sold.

56 Apart from the shares that have been given away as compensation, the State has not sold any of its shares on the market.

57 See Colleen Ryan, 'Reforms Lift Shanghai Market Skyward', *Australian Financial Review* (Melbourne), 5 January 2007.

58 Article 13 of the Interim Regulations on the Management of Enterprise State-owned Assets provides that SASAC controls personnel appointments 'in accordance with appropriate legal procedures'.

SASAC Communist Party Committee through the First Personnel Bureau of SASAC. Managerial positions in other SOEs are controlled by the Second Personnel Bureau of central SASAC.<sup>59</sup> Any other SOEs not in central SASAC's supervision list are under local government authority. Central SASAC has issued guidance to local SASACs, indicating that the 'principle that the Party manages cadres shall be upheld and the local party committee shall strengthen its control of important personnel in key local SOEs'.<sup>60</sup>

There are three tiers in the management system of SOEs, with SASAC in the top tier, the holding companies of SOEs in the middle tier and listed SOEs in the lowest tier. This structure has created ample opportunities for SOEs at lower tiers to engage in related-party transactions which would effectively transfer State assets,<sup>61</sup> posing difficulties for SASAC in safeguarding its ownership interests.

The layer of intermediate holding companies and group companies represents the relatively unreformed part of the Chinese State-owned economy.<sup>62</sup> The dividends and after-tax profit of SOEs are generally remitted upwards into this intermediate layer.<sup>63</sup>

SASAC and MOF have agreed to adopt a State capital management budget system<sup>64</sup> to improve the situation, with budget revenues from central SOEs profits and asset sales, and expenditures set aside for investment and restructuring.<sup>65</sup> SASAC receives a portion of revenues for State enterprise restructuring and investment while the MOF will also receive a portion for social security and other public finance needs.<sup>66</sup> The successful operation of this capital management budget system will enable the State to exercise the right to income from its assets, which is a good practical step forward. However, while the protection of State ownership is important, it should not be overstated. Greater diversification of ownership of SOEs will be instrumental in further optimising

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59 See Communist Party of China, 'Central Party Circular on Matters Concerning the Establishment of State Council SASAC' (24 March 2003) in *Zhongguo Guoyou Zichan Jiandu Guanli Nianjian* [State-owned Assets Supervision and Management Yearbook of China] (2004) 99.

60 See SASAC, *Guiding Opinions on the establishment of the State Asset Supervision and Management Agencies at Municipal (Prefectural) Government Levels* (2004) The Central People's Government of the People's Republic of China <[http://www.gov.cn/zw/gk/2005-08/15/content\\_23237.htm](http://www.gov.cn/zw/gk/2005-08/15/content_23237.htm)> at 14 October 2007.

61 See Mikael Mattlin, *The Chinese Government's New Approach to Ownership and Financial Control of Strategic State-Owned Enterprises* (2007) Social Science Research Network <<http://ssrn.com/abstract=1001617>> at 14 October 2007.

62 Ibid.

63 Ibid.

64 Zhou Xiaochuan, *Capital Return of State-Owned Enterprises* (2005) The People's Bank of China, <<http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=102>> at 14 October 2007. Premier Wen Jiabao also referred to the system of capital management budgets in his 2006 Government Work Report: Wen Jiabao, *Government Work Report* (2006) Xinhua News Agency 19 <[http://news.xinhuanet.com/misc/2006-03/15/content\\_4305660.htm](http://news.xinhuanet.com/misc/2006-03/15/content_4305660.htm)> at 14 October 2007.

65 Under the state capital management budget, a certain portion of after-tax profits of SOEs shall be remitted to the SASAC. See Duan Xiaoyan, *SASAC Will Compile State Capital Budget Requiring Central Enterprises to Remit Dividends* (2005) 21<sup>st</sup> Century Economic Herald <<http://www.southcn.com/finance/nfcm/21sjjbd/200512310055.htm>> at 14 October 2007.

66 See Liu Xiaowu, *The Payment of Dividends by State Firms is Nearing Resolution; SASAC and MOF have Reached Agreement* (2006) *China Management* <[http://news.hexun.com/1693\\_1661127A.shtml](http://news.hexun.com/1693_1661127A.shtml)> at 14 October 2007.

ownership structures and assisting the integration of China's markets into the global economy.

In recent years, China has gradually diversified the ownership of central SOEs whose operations do not affect national security and in which private and foreign investment is not forbidden in order to standardise the management and transferability of State-owned shareholdings of listed companies.<sup>67</sup> Diversification of the ownership of non-essential SOEs aims to optimise the shareholding structure and place SOEs in a position where they no longer depend entirely on State capital. The main vehicles of ownership diversification of listed companies include stock market listing, split-share reform, and the setting up of joint ventures with foreign investors.<sup>68</sup> For instance, the four State Central Banks – the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank and the Agricultural Bank of China – were successfully listed on domestic and overseas stock exchanges<sup>69</sup> and ranked in the 2007 Fortune Global 500.<sup>70</sup> However, the State will continue to hold a controlling stake in strategic enterprises that concern the national economy and national security.<sup>71</sup>

## V CONCLUSION

The removal of the legal distinction between tradable and non-tradable shares enables companies to adopt share incentive schemes that align the interests of management with shareholders. As a result, the share ownership structure of listed companies has been improved while simultaneously facilitating governance reform of corporatised SOEs.

Nevertheless, it is clear that further reform is required, as the scope of State ownership will continue to determine the effectiveness of the corporate governance of SOEs. For this reason, the diversification of State-held shares through share listing and M&A activity should continue.

Whilst previous reforms enhanced managerial control over enterprise management, recent initiatives by the Government seem to intensify State authority over large SOEs through SASAC. SASAC currently combines the regulatory, strategic planning, and ownership functions of the State, creating difficulties in resolving corporate governance issues of SOEs resulting from this overlap of enterprise management and State control as both owner and regulator.

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67 See 'China to Open up More Centrally Administered SOEs', *Xinhua News Agency*, 4 April 2007 <[http://news.xinhuanet.com/english/2007-04/04/content\\_5935403.htm](http://news.xinhuanet.com/english/2007-04/04/content_5935403.htm)> at 14 October 2007.

68 Ibid.

69 See 'Bank of China listed in HK', *Xinhua News Agency*, 1 June 2006 <[http://news.xinhuanet.com/english/2006-06/01/content\\_4632335.htm](http://news.xinhuanet.com/english/2006-06/01/content_4632335.htm)> at 14 October 2007; 'No. 1 China Bank Gets IPO Clearance' *International Herald Tribune*, 19 July 2006 <<http://www.iht.com/articles/2006/07/19/business/icbc.php>> at 14 October 2007; 'China Regulator OKs Construction Bank's IPO', *Reuters*, 7 September 2007 <<http://www.reuters.com/article/newIssuesNews/idUSPEK36245620070907>> at 14 October 2007.

70 See CNN Money, *Fortune Global 500* (2007) <<http://money.cnn.com/magazines/fortune/global500/2007/countries/China.html>> at 14 October 2007.

71 Premier Zhu Rongji, 'Report on the Outline of the Tenth Five-Year Plan for National Economic and Social Development' (Speech delivered at the Fourth Session of the Ninth National People's Congress, Beijing, 5 March 2001).

Moreover, the tight control of SASAC over SOEs may unravel the achievements of nearly three decades of reforms: expanding enterprise autonomy and creating independent management. Therefore, excessive State control should be curbed while State ownership is adequately protected. Given the importance of SOEs in China's economy and continuing State ownership in SOEs, a specific law governing the ownership and management of the State assets should be promulgated to further reform the State sector in the markets opened up as a result of China's accession to the WTO.