Corporate Governance and Capital Structure Decisions of the Chinese Listed Firms

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This paper studies the relationship between some characteristics of the corporate board and the firm's capital structure in Chinese listed firms. The findings provide some preliminary empirical evidence and seem to suggest that managers tend to pursue lower financial leverage when they face stronger corporate governance from the board. However, the empirical results of the relationships are statistically significant only in the case of the board composition and the CEO tenure. The results are statistically insignificant in the case of the board size and fixed CEO compensation. This may in general suggest that, up to the time period of our investigation, the corporate board structures and processes in Chinese listed firms might not as yet be fully working in the manner, or as well, as might have been so far assumed on the basis of Western theoretical finance literature.

Keywords: Corporate governance, capital structure, governance, boards, Chinese firms

Introduction

S everal capital structure studies focus on testing the hypothesis of association between capital structure and the main characteristics of corporate governance, which include board size, board composition, management compensation, the tenure of directors and managers, managerial equity proportion etc. (Friend and Lang, 1988; Berger *et al.*, 1997).

Pfeffer and Salancik (1978) find that there is a significant relationship between leverage and both board size and composition, whereas Jensen (1986) states that firms with higher leverage have larger boards and relatively more outsiders, which possibly reflects one way in which debt can act as a monitoring device. On the contrary, in Berger *et al.*'s (1997) paper, leverage is lower when the board of directors is larger. But lower leverage is related to a low fraction of outside directors in their empirical result, which is similar to the evidence of Jensen (1986).

Berger et al. (1997) also indicate that leverage is lower when the CEO has a long tenure in office. John and John (1993) studied the interrelationship between top-management compensation and design and the mix of external claims issued by a firm and found a negative relationship between pay-performance sensitivity and leverage. Some empirical results show both positive (Jensen and Meckling, 1976; Leland and Pyle, 1977; Myers and Majluf, 1984; Agrawal and Mandelker, 1987; Amihud et al., 1990; Berger et al., 1997) and negative (Friend and Hasbrouck, 1988; Friend and Lang, 1988) associations between the managerial equity proportion and capital structure.

As the Chinese economy is increasingly integrating into the global economy and the Chinese capital market is gradually developing with more foreign investment flowing into the economy, more and more researchers have begun to focus on studies of corporate governance of Chinese firms (Tam, 1995, 2000; Xu and Wang, 1997). However, up to now,

* Address for correspondence: Maastricht School of Management (MSM), Endepolsdomein 150, P.O. Box 1203, 6201 BE Maastricht, The Netherlands. Tel: +31-43-3870808; Fax: +31-43-3870800; E-mail: Wen_yu@ uusa.net there have not been many empirical analyses of the characteristics of corporate boards and the capital structure of Chinese firms. In this study, we intend to investigate empirically whether any relationships exist between some selected characteristics of the corporate board and the firm's capital structure in Chinese listed firms. We also evaluate whether, and how closely, our findings support the Western finance theories and empirical evidence advanced above about how corporate governance might possibly be interacting with the firm's capital structure.

This study examines the relationships between the levels of various corporate governance variables and firms' debt to total asset ratios based on 60 Chinese listed firms studied between 1996 and 1998. The empirical results tentatively suggest a lower leverage in firms when the board of directors is small, or when there is a high proportion of outside directors on the board of directors, or when the tenure of the chief executive officer (CEO) is longer and the salaries and bonuses of the CEO are higher. We recognize that in as much as these interesting results are still consistent with the theories of corporate governance and capital structure, nevertheless they need to be analysed and re-interpreted more carefully in the context of the corporate governance of Chinese firms. The empirical results of relationships between financial leverage on the one hand, and the board composition or tenure of the CEO on the other, are statistically significant. But the relationships are not statistically significant in the case of variables related to board size and CEO fixed compensation. This may suggest that the corporate board structures and decision-making process in Chinese listed firms might not as yet be working as well as might have been so far assumed.

In the following sections of the paper, we will be presenting the variables and hypotheses used, the sample, as well as the empirical results of the multiple regression model, and the interpretation.

Variables and hypotheses

Several variables were used for analysis of leverage levels and corporate board characteristics and derivation of the relevant hypotheses.

The key dependent and explanatory variables for our analysis of leverage appear in Table 1. Leverage is the dependent variable in our regression model. We measure the level of leverage at the end of each fiscal year as: leverage (book value) = total debt (book value)/total assets (book value). Leverage was calculated by dividing total debt and total assets using the data obtained from the financial statements database of Sengyin Wangui Security Company.

We used a variety of regression models to investigate the possible influence of corporate governance upon capital structure decision. The variables of corporate governance used in our model appear widely in corporate governance studies (Pfeffer and Salancik, 1978; Jensen, 1986; Berger *et al.*, 1997).

Board size

The first variable in our analysis is the size of the board, which is measured in a log specification. The board size has been identified as the important determinant of corporate governance effectiveness in theoretical articles (Lipton and Lorsch, 1992; Jensen, 1993). The empirical evidence show a different relationship between the leverage and board size. Jensen (1986) finds that firms with higher leverage have a larger board size. On the contrary, in Berger et al. (1997), leverage is lower when the board of directors is larger. If it can be assumed that larger board size translates into strong pressure from the corporate board to make managers pursue lower leverage to get good performance results, we propose that:

Hypothesis 1: *Leverage is negatively related to the board size.*

There is a supervisory board in Chinese listed firms. The supervisory committee assumes the function of monitoring the board of directors and senior management. There are scant theories and empirical evidence about the association between the capital structure and size of supervisory board in a two-tier board system like the Chinese system. For that reason, the analysis of its influence and relationship with the financial leverage is left out in this paper.

Board composition

Our analysis also includes a variable related to the composition of the board. This variable measures the percentage of outside directors in the board. The top managers generally face more rigorous monitoring when the board of directors is controlled by independent or outside directors. The outside directors monitor managers more actively, causing these managers to adopt lower leverage to avoid the performance pressures associated with commitments to disgorge large amounts of cash (Jensen, 1986). Therefore, we also propose that:

Hypothesis 2: Leverage is negatively related to the percentage of outside directors on the board.

Tenure

The models used include the variable measuring the CEO's years in that position. The variable measuring the tenure of CEO is in a log specification. This variable reflects the likelihood that the CEO's control over internal monitoring mechanisms increases as the tenure lengthens. Berger *et al.* (1997) have identified that tenure of CEOs is negatively related to the leverage. The entrenched CEOs and directors prefer low leverage to reduce the performance pressures accompanying high debt. Therefore, we propose that:

Hypothesis 3: Leverage is negatively related to the tenure of CEO.

CEO fixed compensation

The other related characteristic of corporate governance is fixed compensation of CEOs. In our models, we use salary and bonus payments, which are measured in a log specification, as a proxy fixed compensation of CEOs. Because managers with good fixed compensations might pursue lower leverage to reduce the financial risk and keep their job for its good salary and bonus (Harris and Raviv, 1988; Stulz, 1988), we propose that:

Hypothesis 4: Leverage is negatively related to the CEOs' fixed compensation.

In the literature, there is empirical evidence that shows two opposing relationships between the managerial equity proportion and capital structure. A positive relationship is claimed by the papers of Jensen and Meckling (1976); Leland and Pyle (1977) and Berger et al. (1997) and a negative relationship is shown by Friend and Hasbrouk (1988) and Friend and Lang (1988). Because managers with a higher percentage of ownership may prefer a higher debt level to keep their control on firms, one might propose that leverage is positively related to the managers' stock ownership. However, because of the likely insignificant impact of such small holdings in the former state-owned and now privatised Chinese firms, no further analysis of this variable is included in the paper.

Control variables

In addition to the above dependent and explanatory variables, our models include

control variables for the firms' attributes expected to influence leverage. We use a return on asset (ROA) variable, defined as earning before depreciation, interest and taxes, divided by total asset at the end of the year to control for firm profitability. The other control variable is the company *size*, which is measured by using the book value of assets in place (the log of total assets). We measure the collateral value of assets as the ratio of net property, plant and equipment plus inventory over total assets. Our model includes two variables measuring the uniqueness of assets: research and development (R&D) expense over sales and selling, general and administrative expenses over sales.

Sample selection

Our analysis uses a sample of 180 observations for 60 Chinese listed firms between 1996 and 1998. All data of the sample were collected by sending questionnaires in July–November 1998, and details obtained from the database of Shengying Wangui Security Company. The original operational population included all 865 non-finance Chinese listed firms. But the actual operational populations in our survey only include 628 Chinese listed firms because we could not find detailed addresses or names for the Chairman of the other 237 Chinese listed firms.

The effective response rate was 9.5 per cent, which some may consider rather low by Western standards. But in China, the 9.5 per cent effective response rate should be satisfactory, particularly in light of the fact that this study was being conducted by a nongovernment research agency from outside China. The main reason for the lower response rate is that some listed firms in China still want to keep their business secret. Some state-dominated listed firms received orders from government that they could not partake in any investigation by a non-government research agency. Some CEOs or Chairmen of listed firms did not want to publicise their compensation and tenure, which were subjects included in the questionnaire. There was no proxy statement in Chinese listed firms until 1998. In 1998, the Chinese security regulatory commission required that listed firms also publicise the information of proxy statement, as with Western countries. These may provide more information and data for further research of corporate governance of Chinese listed firms.

Before starting our analysis, we first tested for the representativeness of the responses because of the low effective response rate. The representativeness of the research population was established with respect to the size of firm, which is done by means of the goodness-of-fit variant of the χ^2 test for independence. The results of the χ^2 tests suggest that research populations are considered representative of the operational populations with respect to the size of the firm. Also as our operational populations represent a larger fraction of market capitalisation of the original operational population, the empirical result should illustrate the association between capital structure decisions and characteristics of corporate governance of Chinese listed firms.

Our analyses only apply to Chinese listed firms because of our sample selection criteria limitation. The conclusions of our analyses therefore may not necessarily apply to other types of ownership structure of Chinese firms, such as wholly state-owned Chinese firms, foreign firms and private Chinese firms.

Table 1 lists the definition of all the dependent and explanatory variables for our analysis of company leverage levels. Table 1 also presents sample-wide means and standard deviations, sample correlation between the explanatory variables and leverage measure.

Multiple regression analysis results and interpretation

Table 2 presents the OLS regression results of models of leverage levels. The results show that there are significant associations in the case of board composition and CEO tenure. The results are statistically significant in the case of the board size and CEO's tenure.

According to Chinese securities rules, the board of directors is responsible for the management of the firm and its operations. The board of directors also develops the firm's strategy. Our results show a positive though statistically insignificant relationship between board size and financial leverage in 180 observations for 60 firms during 1996-1998. If this empirical result were statistically significant, it would be inconsistent with our hypothesis. Such a finding would seem to suggest that large boards, which are more entrenched due to superior monitoring by these bodies, pursue higher leverage to raise company value. However, there is a possibility that the assumption of large board meaning strong corporate governance may not be suitable in the case of the Chinese listed firms. It is possible that Chinese culture produces more conflicts among directors when the

Table 1: Descrip	otive statistics	of c	lependent	and	independent	variables
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Dependent variables	Definition	Mean 0.4457		SD	
Leverage (book values) Total debt (book value) ÷ total assets			0.1897	
Explanatory variables	Definition	Mean	SD	Correlation with leverage (book value)	
Board size	Log (number of directors of board) % outside directors of board	1.0071	0.124	0.109***	
Tenure of CEO	Log (year in CEO position)	0.7016	0.2823	-0.167***	
Asset uniqueness (1) Asset uniqueness (2) Asset collateral value Return on asset Company size	Research & development ÷ sales Selling, general & development ÷ sales (Net property, plant & equipment + inventory) ÷ total asset Earning before interest, taxes and depreciation ÷ total asset Log (total asset)	0.0166 0.0962 0.3031 0.0728 5.9328	0.2742 0.0539 0.1364 0.2661 0.0682 0.4712	0.00 0.081 -0.035 0.038 -0.476^{***} 0.403^{***}	

Correlation significant at the 10% (*), 5% (**), and 1% (***) levels.

Note: Definitions and descriptive statistics for variables used in analysis of capital structure levels. The sample generally consists of 180 observations for 60 firms at the end of 1996 to the end of 1998 (there are some missing cases in some explanatory variables because some questionnaires were not completed). Financial statement variables were obtained from database of Shenyin Wangui Security Company, defined as of the end of each fiscal year. Corporate governance variables were obtained from the answers of the questionnaires, also defined as of the end of each fiscal year.

Table 2: Regression coefficient estimates

	Leverage (book value)	<i>t</i> -statistics
Constant	-0.183	-0.795
Board size (board of directors)	0.129	1.148
Board composition (outside directors of board)	-0.0935^{***}	-1.723
Tenure of the CEO in the office	-0.0766^{***}	-1.783
Fixed compensation per month by CEO	-0.0119	-0.259
Asset uniqueness 1 (R&D expenses/sales)	0.003532	1.449
Asset uniqueness 2 (Sales and admin expenses/sales)	-0.00117	-1.221
Asset collateral value [(net PPE + inventory)/total assets]	0.0003449	0.756
ROA (EBDIT/total asset)	-0.0115^{***}	-6.324
Company size (total asset)	0.119***	4.232
R-squared	0.385	
F-statistic	10.774	

Significant at 1% (***), 5% (**) and 10% (*) levels.

Note: OLS regression coefficients for models of capital structure levels. The sample generally consists of 180 observations for 60 firms in the 1996–1998 period. The *t*-statistics appears as the absolute value.

number of board members increases, thus making it harder to arrive at consensus decision making. These conflicts arising from bigger board size may result in weaker corporate governance. However, the specific explanation of this empirical result still needs deeper investigation and research. The coefficient estimate of 0.129 (Table 2) would imply modest changes in leverage in response to significant changes in the board size.

Among the legal and listing requirements imposed on the Chinese firms as indicated by the standard operational guide of Chinese listed firms published by Shenzen Stock Exchange (see Appendix A), there are to date no requirements to distinguish executive and outsider (non-executive) directors from the Chinese Stock Exchange. The appointment of outside directors depends on the specific situation of each listed firm. The empirical evidence in Table 2 suggests that the number of outside directors on the board has a negative estimated association with leverage in our OLS model and it is significant. This result is consistent with our hypothesis that outside directors tend to monitor managers more actively, causing these managers to adopt lower leverage for getting good performance results. These findings also might be caused by the possibility that with a higher proportion of outside directors, the board tends to pursue lower financial leverage with a high market value of equity. However, one has to be cautious about these interpretations because the two sets of variables are endogenous to some extent. The economic significance of this variable is a little lower, at -0.0935 (Table 2).

The day-to-day management of a Chinese listed firm is the responsibility of the CEO and other senior management. These managers are accountable to the board of directors for the company's performance. As an important incentive factor, the tenure of CEO should have an effect on the decision of firm performance. The empirical evidence shows that the CEO's tenure in office has a negative estimated association with the level of financial leverage and is significant in 180 observations for 60 Chinese listed firms. The result is consistent with our hypothesis that entrenched CEOs prefer low leverage to reduce the performance pressures accompanied by high debt. The economic significance of this variable is modest (-0.0766, Table 2).

According to many research findings in the literature (Coughlin and Schmidt, 1985; Murphy, 1985; Barro and Barro, 1990), there are relationships between managerial compensation and firm performance. How about the possible influence of CEOs' fixed compensation on the capital structure decision in Chinese listed firms? Our study results suggest that the CEOs' fixed compensation may be negatively associated with leverage, but this result is statistically insignificant. One possible reason for this negative relationship may be that managers pursue the lower leverage to reduce the financial risk and keep their jobs for their good salary and bonus (Harris and Raviv, 1988; Stulz, 1988). This result, if it were statistically significant, would be consistent with our hypothesis.

For comparative purposes, we also ran the multiple regression based on the raw data without any transformations. Table 3 lists the definitions of the entire list of dependent and explanatory variables for our analysis of company leverage levels. Table 3 also presents sample-wide means and standard deviations, as well as sample correlations between the explanatory variables and leverage.

Table 4 presents OLS regression results of the models of leverage levels. The results show that there are significant associations only in the case of board composition. The results are statistically insignificant in the case of board size, CEO's tenure and CEO's fixed compensation. The control variables in our models have signs in line with accepted theories of capital structure. But in as much as board composition turns out be a significant variable, it may still not be easy to draw a conclusion that it is the board composition that causes management to assume low or high debt levels, because this set of variables (leverage and board composition) is probably endogenously determined. Besides, some variables in our models of leverage levels are determined simultaneously, thus making it difficult to draw outright cause-and-effect relationships only on the basis of estimated regression coefficients.

The empirical evidence in Table 4 reconfirms the significance of the presence of outside directors on the board. The number of these outside directors on the board is negatively associated with leverage. This result is consistent with the results obtained earlier with the previous data set and is consistent with our hypothesis drawn from the literature. The explanation may be that it is because the standard measure of this variable is the same in both data sets. Some inconsistencies observed on comparing the results obtained from the two data set inputs demonstrate that the form in which data is input may have some influence on the empirical results. While taking note of this, we are reporting the results on the basis of the first data set largely because these are the results based on the measures of variables and data input according to most of the related previous studies quoted in this paper and this ensures ease of comparability of results.

Table 3: Descriptive statistics of dependent and independent variables (using raw data)

Dependent variables	Definition	Mean 0.4457		SD 0.1897	
Leverage (book values	s) Total debt (book value) ÷ total assets				
Explanatory variables	Definition	Mean	SD	Correlation with leverage (book value)	
Board size Board composition Tenure of CEO CEO compensation Asset uniqueness (1) Asset uniqueness (2) Asset collateral value Return on asset	Number of directors of board % outside directors of board Year in CEO position Salary and bonus of CEO per month Research & development ÷ sales Selling, general & development ÷ sales (Net property, plant & equipment + inventory) ÷ total asset Earning before interest, taxes and depreciation ÷ total asset	9.82 0.3116 8.9 RMB 4418 0.01551 0.1058 0.8752 0.2323 1.000.744	4.02 0.2552 44.83 3229 0.0521 0.1421 5.63 1.2722 4.227 (80)	$\begin{array}{r} -0.034 \\ -0.251^{***} \\ -0.027 \\ -0.001 \\ 0.068 \\ -0.058 \\ -0.09 \\ -0.1^{***} \\ 0.224^{***} \end{array}$	

Correlation significant at the 10% (*), 5% (**) and 1% (***) levels.

Note: Definitions and descriptive statistics for variables used in the analysis of capital structure levels. The sample generally consists of 180 observations for 60 firms at the end of 1996 to the end of 1998 (there are some missing cases in some explanatory variables because some questionnaires were not completed). Financial statement variables were obtained from the database of Shenyin Wangui Security Company, defined as of the end of each fiscal year. Corporate governance variables were obtained from the answers of the questionnaires, also defined as of the end of each fiscal year.

Table 4: Regression coefficient estimates (using raw data)

	Leverage (book value)
Constant	0.476***
	(10.931)
Board size 1 (board of directors)	0.0236
	(0.889)
Board composition 1 (outside directors of board)	-0.181^{***}
•	(-2.843)
Tenure of the CEO in the office	0.00007639
	(-0.249)
Fixed compensation per month by CEO	0.000005353
1 1 5	(-0.124)
Asset uniqueness 1 (R&D expenses/sales)	0.152
	(0.531)
Asset uniqueness 2 (Sales and admin expenses/sales)	-0.126
	(-1.21)
Asset collateral value [(net PPE + inventory)/total assets]	-0.0022
	(-0.89)
ROA (EBDIT/total asset)	-0.01318
	(-1.202)
Company size (total asset)	0.00000008265***
	(2.513)
<i>R</i> -squared	0.126
F-statistic	2.678

Significant at 1% (***), 5% (**) and 10% (*) levels.

Note: OLS regression coefficients for models of capital structure levels. The sample generally consists of 180 observations for 60 firms in the 1996–1998 period. The absolute value of *t*-statistics appears in parentheses below each coefficient estimate.

Summary and conclusions

In this paper, we study the association between the capital structure and some characteristics of corporate governance in Chinese listed firms.

The testing of associations between capital structure and some characteristics of corporate governance is based on the 60 Chinese listed firms from 1996 to 1998. The empirical results show there are lower leverage levels in Chinese listed firms when the percentage of outside directors on the board is higher, or tenure of the CEO is longer. These empirical results are consistent with a number of previous research findings (Tam, 1995; Xu and Wang, 1997).

In general, our empirical results about the relationships between capital structure and some characteristics of corporate governance suggest that managers seek lower leverage when they face stronger corporate governance. These results illustrate that managers who face stronger corporate governance might pursue lower debt levels to avoid extra risk associated with higher leverage. However, our findings indicate that relationships between the capital structure and board characteristics are statistically significant only in case of the board composition and the CEO tenure. The results are statistically insignificant in the case of the board size and fixed compensations of CEOs. This may in general suggest that the corporate governance processes in Chinese listed firms might only partly be working in the manner that might have been so far assumed on the basis of Western theoretical literature during the time period of our investigations.

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Appendix A

Legal and listing requirements imposed on Chinese firms*

A. Requirements for firms applying to be listed.

- (1) The firms must hold the shares, which are publicly issued to society. The issuance of shares must be approved by the security management department of the State Council.
- (2) The capital stock of listed firms cannot be less than 50,000,000 RMB.
- (3) The period of establishment of the firm must be more than three years. The firms must have continuous profits for the last three years.
- (4) The numbers of shareholders holding more than 1000 RMB shares cannot be less than 1000; the percentage of publicissued shares must account for 25 per cent of total shares. If the total value of capital stock is above 4000,000,000 RMB, the percentage of public-issued shares must account for up to 15 per cent of total shares.
- (5) The firms cannot have false records on their financial reports or have taken part in illegal activities during the last three years.
- (6) The firms must abide by other regulations of the State Council.

B. The firms applying to be listed must submit relevant documents to the security management department of the State Council for approval. The security management department of the State Council will approve the firms that are in compliance with the listed requirements. After the firms are approved to be listed by the security management department of the State Council, the listed firms must publish their shares and related reports. The application documents of the firms must be put in the assigned place for access by the public.

C. The shares of firms can be traded on the exchange after approval.

D. The shares of firms can be traded on the exchanges abroad. The detailed operation

methods must be according to the special regulations of the State Council.

E. The listed firms must publish the financial status and operations results according to the laws and regulations. The listed firms must publish the financial reports semi-annually.

F. One of the following situations will result in the listed firms being barred from trading by the security management department of the State Council.

(1) The total value of capital stock and percentage of public shares failing to

satisfy the essential requirements of listed firms.

- (2) The firms failing to publish the financial condition and operations results according to the regulations, or the financial reports of firms containing false records.
- (3) The firms having significant illegal activities.
- (4) The firms having continuous loss for the last three years.
- (5) The firms making a decision or being forced to go bankrupt.

* Source Shenzen Stock Exchange Standard Operational Guide of Chinese Listed Firms (June 1998).

"Can fund managers be any good at intervention? Fund managers are not natural activists. Their culture is based on relatively short term financial gain creating internal cultural conflicts: if a stock 'underperforms', most prefer to sell rather than seeking change from within. Most have virtually no expertise, experience or track-record of engagement upon which to build. On balance many managers are poorly placed to do the job of shareholder engagement. That means it's down to pension fund trustees or third-party intermediaries like PIRC."

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