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A Primer On Corporate Governance

China

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Jean Jinghan Chen

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A Primer On Corporate Governance: China

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Abstract

Since its opening up and economic reforms in 1979, China has undergone tremendous economic growth and social development, with a 10 percent real gross domestic product growth per year on average through 2013. In spite of such an accomplishment, the current economic growth model in China, which is mainly triggered by the export-led policy and the huge government investment, has been challenged by potential external and internal risks, which do not support sustainable economic growth in the long run. In this book, we comprehensively review the corporate governance practices in China, based on which we try to identify the major problems within such practices. We contend that these problems have been seen as the major challenges facing the Chinese economy, and we further argue that the current weakness of corporate governance practices in China can be ascribed, to a great extent, to the incompleteness and weakness of law enforcement.

Keywords

China, corporate governance, external governance mechanisms, internal governance mechanisms, law enforcement

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CHAPTER 1

Introduction

Since the economic reform in 1979, the remarkable growth rate of China has been described by commentators as one of the greatest economic success stories in recent years. During the last three decades, the annual real gross domestic product growth of China was 10 percent on average. On one hand, the current economic growth model that triggered the previous economic achievement is mainly driven by the export-led policy and the large-scale government investment, and it could be argued that such a growth model cannot be maintained in the long run. On the other hand, the rapid economic growth in the last several decades has given rise to various social and economic problems that have impeded the country's future growth, one of which is the weakness of corporate governance practices in China.

To pursue sustainable economic growth in the long run, the Chinese government is attempting to conduct the structural transformation of its economy, by way of a process of shifting the economy from one mainly driven by large government investment to an economy which is mainly driven by high technology, services, and consumption. However, whether such a transformation can be accomplished hinges heavily on whether the government could offer a high quality of corporate governance practices in China. For example, small- and medium-sized enterprises (SMEs) have long been regarded as a key source of innovation and job creation, which can serve as the main engine of sustainable economic growth into the future. However, one of the major challenges facing SMEs is the ineffective enforcement and protection of intellectual property rights, which is highly associated with one of the external governance mechanisms, that is, the legal system. Thus, one of the key solutions to the maintenance of economic growth is to ensure a high quality of Chinese corporate governance practices offered by the government.

In this book, we comprehensively review the corporate governance practices in China since its economic reform in 1979, based on which we attempt to identify the current problems within both internal and external governance mechanisms and suggest that these problems have become the current and future challenges facing the Chinese economy. We argue that the current weakness of corporate governance practices in China can be entirely attributed to the incompleteness and weakness of the law enforcement system. Thus, the overriding action that should be taken by the government is to introduce a robust legal and regulatory system with strong enforcement mechanisms in the corporate sector.

The chapters in this book are organized as follows. Chapter 2 reviews the Chinese economy from a global perspective and the evolution of governance mechanisms in China's state sector. Chapter 3 examines the current legal and regulatory systems and major corporate governance-related legislation that has been in use since 1980, in the context of external governance mechanisms. Chapter 4 reviews boards of directors, ownership and control of listed firms, statutory audit, and various issues on managers of listed firms in the context of internal governance mechanisms. Chapter 5 concludes the book.

CHAPTER 2

Overview of Chinese Economy

Current Chinese Economy from Global Perspective

GDP Size and Wealth Per Capita—Developed Versus Developing Economies

Over the last three decades, China's economic performance has experienced a remarkable growth, which has succeeded in shifting it from a rural and agricultural economy to a modern and industrial one. As a result, the GDP size of the Chinese economy has increased dramatically since its huge economic reform began in the early 1980s and, since then, the *actual* size of China's economy has been a subject of extensive debate among economists and policy makers. Figure 2.1 illustrates the comparison of GDP sizes among the current three largest economies in the world, namely, the United States, China, and Japan during the period from 1980 to 2013.

According to this figure, the GDP size of the Chinese economy was at a very low level in 1980, which was US$309.06 billion, or approximately 10 percent of the size of the U.S. economy. However, since the economic reform that began in the 1980s, particularly after China's accession to the World Trade Organization in 2001, the GDP size of China has increased significantly. As a result, measured on a nominal U.S. dollar basis, China's GDP at the end of 2013 had reached 9.4 trillion, approximately 55 percent the size of the U.S. economy. According to Figure 2.1, in 2010, China overtook Japan to become the second largest economy in the world. Not only has the economy soared, the quality of life of the whole society has also improved dramatically.

It is known, however, that China has the largest population in the world (1.357 billion as of 2013). Thus, the per capita GDP, which is a

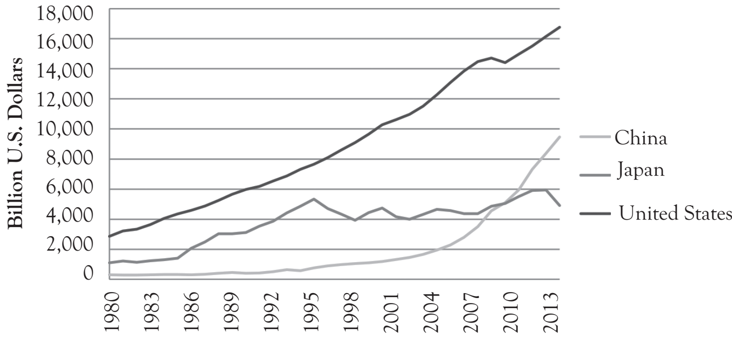

Figure 2.1 GDP sizes of the United States, China, and Japan

Source: IMF.org (2014).

Table 2.1 Comparisons of Chinese, Japanese, and U.S. GDP and per capita

	China	Japan	United States
Nominal GDP ($ billions)	9,323	4,901	16,800
GDP in PPP ($ billions)	16,119	4,611	16,800
Nominal per capita GDP ($)	6,900	38,550	53,104
Per capita GDP in PP ($)	11,940	36,260	53,104

Source: See Table 1 in Morrison (2014).

common measurement of a country's living standards, is not very high in China. Table 2.1 describes comparisons of Chinese, Japanese, and U.S. GDP figures and their per capita GDP for 2013 using both nominal U.S. dollars and a purchasing power parity (PPP) basis.

In terms of Table 2.1, on a nominal U.S. dollar basis, the per capita GDP of China is US$6,900 at the end of 2013, which was 18 percent the size of Japan's level and 13 percent that of the U.S. level. However, on a PPP basis, as of 2013, China's per capita GDP is US$11,940, which accounted for 32 percent of that of Japan and 22 percent of that of the United States. Although China is currently the second biggest economy in the world, there still remains a huge gap between China's living standards and those of developed countries. Thus, it still has a huge potential to develop its economy further and therefore improve the level of per capita GDP.

GDP Growth Trends

Economists generally consider that there are two major factors determining much of China's rapid economic growth (Morrison 2014). The first factor is large-scale capital investment, which is mainly financed by large domestic savings and foreign investment; and the second factor is rapid productivity growth. However, the current Chinese economic model that uses large-scale capital investment seems unsustainable in the long run.

Indeed, the Chinese government has expressed its desire to seek sustainable economic growth, by means of moving away from its current economic model of fast growth to a more *smart* economic growth (Morrison 2014). The government has also suggested that it would like to achieve a more balanced economic growth by decreasing reliance on energy-intensive and high-polluting industries using large-scale investment and relying more on high technology, green energy, and services.

Figure 2.2 shows Chinese real GDP growth from 2000 to 2019 according to the World Economic Outlook database of International Monetary Fund (IMF). The GDP growth from 2014 to 2019 is estimated by the IMF.

According to Figure 2.2, before 2012, all annual GDP growth of China since 2000 had been above 8 percent, which reflects its tremendous economic performance. However, such fast growth indicates that the Chinese economy experienced an unbalanced growth model. To achieve a more balanced growth model, the Chinese government has been conducting a comprehensive economic reform, as a result of

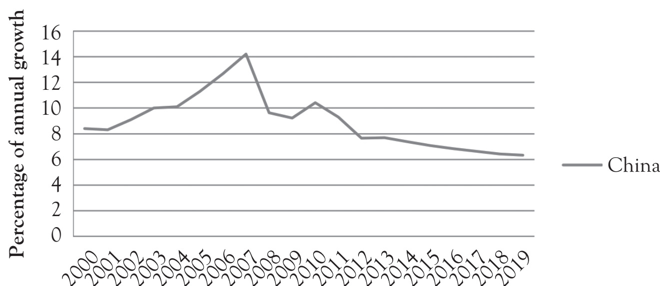

Figure 2.2 Chinese real GDP growth from 2000 to 2019

Source: IMF.org (2014).

Note: The GDP growth from 2014 to 2019 is estimated by the IMF.

which the annual GDP growth was 7.7 percent for 2012 and 2013, which reflects a structural transformation of the country's growth model. The IMF estimated that there is a steady decrease in the annual GDP growth of China from 2014 to 2019, which also shows that the Chinese government wants to achieve a more sustainable and healthier economic growth in the long run. The Economist Intelligence Unit (EIU) projected that China's real GDP growth will slow considerably in the following years; the EIU predicts that this will be 6.1 percent on average from 2014 to 2020, and 2.3 percent from 2021 to 2030 (Morrison 2014).

Global Competitiveness

Since 2005, the World Economic Forum has conducted the competitiveness analysis based on its Global Competitiveness Index (GCI), a comprehensive tool measuring the microeconomic and macroeconomic foundations of national competitiveness. Figure 2.3 shows the GCI framework, which includes the three subindexes based on the 12 specified pillars.

According to the figure, the three subindexes are the basic requirements subindex, the efficiency enhancers subindex, and the innovation

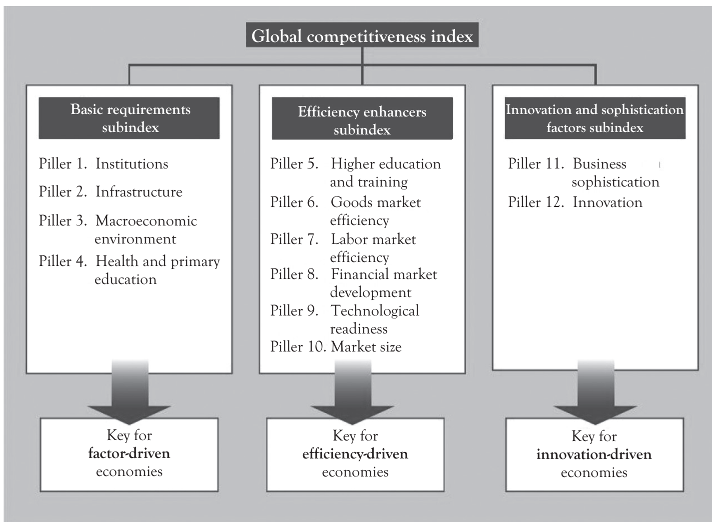

Figure 2.3 The GCI framework

Source: Schwab (2014).

and sophistication factors subindex. First, the basic requirement subindex includes the four specified pillars. The first pillar is *institutions*, which depicts the institutional environment determined by the legal and administrative frameworks within which various actors in the market interact to generate wealth. The Global Competitiveness Report suggests that the quality of institutions has a strong relationship with competitiveness and growth. The second pillar is *infrastructure*. The Report indicates that efficient infrastructure is critical for ensuring the effective functioning of the economy. The third pillar is *macroeconomic environment*, the stability of which is vital for business, and thus, is important for the overall competitiveness of a country. The fourth pillar is *health and primary education*, which is also an important indicator of a country's competitiveness and productivity (Schwab 2014).

Second, the efficiency enhancers subindex contains six pillars, which are *higher education and training*, *goods market efficiency*, *labor market efficiency*, *financial market development*, *technological readiness*, and *market size*. Third, the innovation and sophistication factors subindex contains the remaining two pillars, *business sophistication* and *innovation*.

As a result, countries can be classified into different stages of development, according to their various primary factors that contribute to their economic development. For example, the economy is *factor driven* if its primary factors for economic development lie in the pillars 1 to 4; the economy is *efficiency driven* if its primary factors lie in the pillars 5 to 10; and the economy is *innovation driven* if its primary factors lie in the pillars 11 to 12.

According to the Global Competitiveness Report 2014–2015, China ranks 28th out of the total 144 countries in the world, which is one position up from the position identified in the 2013–2014 Report. China is classified as an efficiency-driven economy based on the fact that its primary factors for economic development lie in the pillars 5 to 10. Table 2.2 shows the rankings for each subindex and for each pillar of China in 2014 to 2015 based on the Global Competitiveness Report (Schwab 2014).

For a detailed ranking information of China, Table 2.2 shows that, for the basic requirements subindex, the institutional environment, infrastructure, and health and primary education are relatively weak, compared with both China's total ranking and the rankings of other developed countries.

Table 2.2 China's rankings of each subindex and each pillar

	Subindex	**Pillar**					
China's rank	Basic requirements	*Institutions*	*Infrastructure*	*Macroeconomic environment*	*Health and primary education*		
	28	47	46	10	46		
	Efficiency enhancers	*Higher education and training*	*Goods market efficiency*	*Labor market efficiency*	*Financial market development*	*Technological readiness*	*Market size*
	30	65	56	37	54	83	2
	Innovation and Sophistication factors	*Business sophistication*	*Innovation*				
	33	43	32				

Source: Adapted from Schwab (2014).

For the efficiency enhancers subindex, market size is very large, but higher education and training, goods market efficiency, financial market development, and technological readiness remain weak. For the innovation and sophistication factors subindex, business sophistication is still weak.

Thus, China has shown strong competitiveness in the pillars of macroeconomic environment and market size. However, the indicators showing the quality of corporate governance such as institutions and financial market development are still weak. In the rest of the book, we review the current development of corporate governance in China, identify its major problems, and make suggestions for its improvement.

Stock Market Capitalization

The development of the Chinese stock market took off in the early 1990s, roughly at the same time as the stock markets of other transitional economies did (Pistor, Raiser, and Gelfer 2000). China's stock market, however, is performing better than the markets of most other transitional economies, when comparisons are drawn between them using standard measures of stock market performance such as the number of listed firms, market capitalization, liquidity, and fundraising capacity (Pistor and Xu 2005, 191). By 2014, although many stock markets within the transitional economies have suffered from low market capitalization and low liquidity, China's capitalization levels jumped to US$54 trillion—the equivalent of a 19 percent share of global capital markets. China is currently the fourth largest global equity market and is expected to overtake the United Kingdom and Japan to become the second largest global equity market after the United States by 2030.

China's stock market has three unique characteristics. First, the government uses the stock market largely as a fundraising vehicle for funding state-owned enterprises (SOEs) and expects that it could play an important role in reshaping China's traditional bank-dominated financial system. There are three types of shares within the Chinese stock exchanges: nontradable shares issued by SOEs, legal person shares (also nontradable), and tradable shares issued to private individual investors or partially issued by SOEs shares. The government controls both state and legal person shares. Negotiable market capitalization refers to the market value

of all shares issued to private individual investors. The state retains control of about three-quarters of all shares, making it the controlling owner of most listed companies, particularly the larger ones. As a result, most listed enterprises were state controlled, with only one-third of the enterprises' equity capital sold to private shareholders during initial public offerings (IPOs). The government forbade the trading of the nontradable share of SOEs on China's two exchanges without approval, in case of loss of state control. By 2000, more than 90 percent of the enterprises listed on China's two stock exchanges remained state controlled, with state-owned entities as their controlling shareholders.

The second feature is that China's stock market is operating under dual financial supervision, which is created through a combination of capital controls on international capital flows and administrative measures imposed by the central government. Although the capital controls help to prevent capital from flowing out of the country, the competition-mitigating administrative controls seek to avoid the driving up of returns on various financial assets and thus to allow the government to maintain a source of cheap capital for financing SOEs' investments (Gordon and Li 2003; Li 2001).

The third feature is that China's stock market has been developed under a weak legal framework that offers little shareholder protection. According to the indicators of shareholder rights protection, which have been widely used in the literature (e.g., La Porta et al. 1998), the level of China's legal system still remains below the average level of that of other emerging economies (Pistor and Xu 2005, 191). However, the actual protection for shareholders in China is lower than that suggested in the literature, mainly because of the weak legal enforcement in China (Allen, Qian, and Qian 2005; Pistor and Xu 2005; Tenev and Zhang 2002). Thus, the current development of China's stock market offers a puzzling case for economists and financial analysts who hold that legal shareholder protection is a prerequisite for the development of a functioning capital market (La Porta et al. 1997, 1998; Pistor and Xu 2005; Shleifer and Vishny 1997).

Publicly Held Firms Versus Privately Held Firms

Before the economic reform in 1978, China's government controlled all the social resources and the operations of enterprises in line with various

political goals. The ownership of these enterprises belonged to the government, and these enterprises were the so-called SOEs, which mainly operated in urban areas. Another kind of enterprise, which was also controlled by the government, is the collectively owned enterprise (COE), which is mainly composed of town and village enterprises. Both SOEs and COEs are so-called public sector enterprises. However, one of the most important aims of the economic reform is to improve the efficiency of SOEs, which are the backbone of China's economy. By the process of shifting resources from agricultural firms to industrial ones, more and more labor forces are able to pursue employment in industrial sectors. The government erased high barriers to some industries and opened up the market to a range of capital sources, including private and foreign direct investment, according to the market-oriented principles. The development of private enterprises and foreign-funded ones, which have more productive activities, not only contributed to the growth of the economy, but also helped to cultivate a more competitive environment to improve the efficiency of SOEs.

Indeed, among the enterprises listed in Fortune Global 500, those belonging to China are the second highest in number, and most of which are SOEs. However, compared with the higher productivity of private enterprises and the more mature status of the foreign ones, SOEs in China are always regarded as *black boxes* with low efficacy and large resource wastage. On the one hand, China has proactively promoted the development of private firms and investment of foreign capital based on the market-oriented principles. On the other hand, the state still plays a significant role in the development of the economy by controlling SOEs, which is one of the most efficient means to achieve the balance of power in society. A large number of SOEs hold dominant positions in the sectors that are shielded from competition. The monopoly of SOEs endowed by China's government makes them giants in regard to size, but dwarfs in efficiency.

Although the Chinese government has conducted a systematic SOE reform, a modern operational mechanism toward the market-oriented economy has not been fully established. Inefficiency is one of the major drawbacks for which SOEs have been criticized (Lee 2009), although they continue to play a key role in China's economy. Moreover, the government, which has the ownership of the SOEs, also plays the role of

managers who operate these state properties at the same time. SOEs have to achieve numerous social policy goals as well as retain their economic function under the bureaucratic leadership of the government. Therefore, SOEs lack flexibility in operating decisions within market-oriented conditions, and such extensive government interventions lead to poor performance. According to the recent report of HSBC, SOEs are increasingly inefficient and have experienced large losses in recent years. By the first half of 2014, SOEs' profits (including the central and local SOEs) had declined and even gone into the red. So much money has been lost that some of the enterprises have to be supported by subsidies, taking advantage of abundant cheap resources, mainly through state banks. But then, escalating debt burden is also a big problem, which raises the operating risk of corporates and reflects serious misallocation of social resources. By 2014, the average debt-to-asset ratio of SOEs was approximately 65 percent, which is higher than the industrial average level. Another problem that inefficiency leads to, for SOEs, is overstaffing. More than 40 million people work in SOEs and nearly one-third of them have been made redundant. More labor had to be hired to keep production going in an inefficient management system of SOEs, which aggravates the inefficiency and leads to a huge social welfare burden. More than 10 million retirees, compared with 40 million on-the-job employees, cost over 60 billion yuan on pensions and welfare each year. There will be more than half of the annual overhead of SOEs paying for the huge social welfare bill, when taking other welfare facilities for all the employees into account.

Even if the inefficiency and unprofitability of SOEs poses a huge risk of bankruptcy theoretically, they actually have an invisible insurance policy from the state-owned banks. These state-owned banks have to allocate much of their low-interest loans to certain SOEs under the pressure of central government, although a large number of loans are not likely to be repaid. The large debt burden prevents the government from shifting resources into potentially more efficient and profitable enterprises. Even more, the poor performance of SOEs makes it difficult for the government to reduce industrial barriers, for fear of widespread bankruptcies and unemployment.

Facing such major drawbacks in SOEs, China's government has made great efforts to conduct a comprehensive SOE reform and develop the

modern corporate governance mechanisms. Next, we retrospectively examine the evolution of governance mechanisms in China's SOEs.

The Evolution of Governance Mechanisms in China's State Sector

Precorporatization: SOEs' Inefficiency and Corporate Governance

After more than 30 years of reform, SOEs in China have evolved from a model in which the government held all the property ownership and managerial decisions, to a contracting model in which the enterprise became responsible for its own profits and losses, which reflects the framework of modern enterprises within most developed countries. The various governance models which SOEs experienced are listed in the next paragraph.

First, in the traditional model, during the period from 1950 to 1984, China's SOE governance can also be described as a state-owned and managed model. State ownership was generally assumed to be the only legal form available to safeguard state property. Not only did the state have ownership of all the property of the SOEs, but it also enjoyed managerial powers. All the resources, such as labor force and financial resources, were planned and allocated by the government; and this centrally planned economy impeded the growth of the private sector. Moreover, the SOEs were deprived of economic and legal independence. The SOE executives were required to fulfill the production plans of the government rather than enhance profits: In other words, SOEs were not real modern business enterprises during the central-planning period.

Accordingly, the governance structure of SOEs was an integral part of the general governmental framework. Executives of SOEs were appointed and dismissed by the government and enjoyed the same political and economic treatment as government officials. Their achievements were not evaluated by the enterprises' financial performance, but by the executives' ability to satisfy the plans set by the government.

The SOEs in this period were just tools to serve the government, rather than economic entities. If one worked within an SOE, the individual would be guaranteed salary, housing, medical treatment, and pension for the whole of life without the risk of becoming unemployed.

Unfortunately, most of SOEs in this traditional model were static and uncompetitive.

Second, in the transitional model during 1984 to 1993, the transitional model of SOE governance is also referred to as the state-creditor's rights model at the early stage of reform, when the Chinese Corporate Law of 1993 was enacted. The reform intended to confer legal status on SOEs so they would have full responsibility for their own profits and losses. The government retained the property ownership and separated ownership rights from management rights, holding a belief that the competiveness of SOEs could be enhanced.

During this period, due to the SOE Law issued in 1988, the corporate governance structure of SOEs underwent several improvements. First, the governance mechanism treated the managers of SOEs as legal representatives and endowed them with full responsibility for the operation of the enterprises, which required each SOE to establish a management consulting committee to assist the managers in making decisions on important issues. Second, each SOE established a local organization of the Chinese Communist Party to supervise the implementation of the government's policies. Third, the democratic activations of employees (such as management and supervision) are permitted through the employees' congress, and trade unions are permitted to represent and safeguard the employees' interests. The basic principle of the contracting system was that the government gave up the management rights, and only annually collected a fixed amount of profit from SOEs. As a result, the more profit SOEs earned, the more they retained for themselves. In this way, SOEs gained more freedom to make their own business decisions, and most of them became profitable. However, because the agency problem was still serious within SOEs, the SOE reform based on the contracting system could not progress further; most SOEs still had the problem of debt overhang and only limited profit was reinvested in development, resulting in insufficient, unsustainable, and diminishing profit. Thus, the government implemented the third SOE reform in 1993, with the aim of establishing a modern corporate system in line with the market-oriented economy. The policy makers began to investigate the modern corporate model within the Western world in a search for possible efficient solutions.

China's Corporatization Program

SOEs reform policies had promoted the restructuring of traditional SOEs, and accelerated the process of corporate legislation, which was taken as an essential legal instrument for the corporatization of SOEs. Compared with the previous SOE governance model, the most recent corporatization of SOEs has set clear definitions, mainly in the aspects of responsibilities, rights, and interest, according to the Corporate Laws of 1988 and 1993.

According to the Corporate Law of 1993, shareholders of modern SOEs are entitled to enjoy their shareholders rights in proportion to their shares and are obligated to transfer ownership of their investment to the corporation. Corporations enjoy full ownership over the capital contributed by shareholders, as well as ownership of the profits and properties subsequently acquired by the corporation. Shareholders are also entitled to dividends after the dividends are declared and to net assets when the corporation is liquidated. Moreover, shareholders' personal property, including their capital investment, is separate and independent from the corporation's property. The reform also sets out a clear definition of rights, obligations, and liabilities among the corporation, shareholders, employees, creditors, consumers, and other stakeholders. As a result, eight legal relationships are specifically clarified: (1) the relationship between the corporation and its shareholders, including a corporate parent; (2) shareholder relationships among themselves; (3) the fiduciary relationship between a corporation and its directors, supervisors, and top management; (4) the relationship between a corporation and its creditors; (5) the relationship between shareholders and creditors; (6) the legal relationship between a corporation and its employees; (7) the relationship between a corporation and its competitors; and (8) the relationship between the corporation and its consumers.

The government considers the corporatization of SOEs as an integral part of its economic modernization strategy. The SOE reform was conducted by the assistance of capital market. The government allowed SOEs to be partially privatized by issuing new and minority shares to individual investors, who could trade their shares freely on the newly developed Shanghai and Shenzhen stock markets, which had been set up in early

1990 and 1991, respectively. By 1999, a typical listed SOE in China had over 60 percent of its equity held by the government in the form of nontradable shares, with the remainder of the firm's stocks being listed on the exchange and held by private investors.

In addition, China's SOEs underwent significant reforms, about 80 percent of all small- and medium-sized enterprises had been sold to employees and outside investors, and more than 1,200 large enterprises were restructured into public limited companies. Meanwhile, the stock market had been growing rapidly, which is expected to play an important role in reshaping China's traditional bank-dominated financial system. The government implemented the share issue privatization by selling shares of SOEs to private investors, which had been successful in improving firm efficiency and profitability to some extent.

Indeed, China had adopted a two-step approach to privatization. The first step was *partial* privatization, which involves SOEs selling a minority stake to public investors. The second step was the conversion of nontradable shares into tradable shares by applying the legal reform, which is expected to gradually eliminate China's two-tier share structure. One salient feature of the ownership structure in partial privatization is that the government remains the largest controlling shareholder in the privatized firms (Sun and Tong 2003) and, usually, its ownership far exceeds that of the second largest shareholder.

Has Corporatization Improved Corporate Governance of the Firms?

The most difficult and fundamental task for reforming SOEs is to solve the agency problems. Thus, the question "Has corporatization improved corporate governance of the firms?" is indeed equivalent to the one that asks "Has corporatization established effective corporate governance for the firms to overcome the agency problems associated with public ownership resulting from a centrally planned economy?" Although the SOE Law in 1993 promoted a policy aimed to separate the government from the enterprise, current corporatization in China seems to be experiencing some difficulty in achieving its goal.

Share-issuing privatization has been one of the major forms of privatizing SOEs around the world since the 1980s, as shown in many successful

reform cases within developed countries (Megginson and Netter 2001). Evidence from developed countries indicates that corporate governance has a significant impact on the performance of public-listed firms (Jensen and Meckling 1976; Shleifer and Vishny 1986, 1997). The objective of such an action in China is also expected to introduce elements of corporate governance that can facilitate improvements in a firm's performance, but it should be noted that China's reform case is very different from those within developed countries. In fact, it is neither the market nor the motivation to obtain private benefits that determines the presence of shareholders in China, where ownership structures are largely determined by the government. According to listed companies, a significant proportion of shares are held back by the government (state-owned), and a large proportion of shares are transferred to state-owned investment trusts and asset management companies owned by legal persons. The distinction between state and legal-person shareholders is, in many cases, superficial because most legal persons are government officers. As a result, the state and legal-person-owned shares account for approximately 70 percent of the total share issuance, whereas institutional shareholding accounts for only a small proportion within the listed firms. Therefore, it is hard to see that the process of transformation from the state-owned shares to legal person-owned shares in listed companies might include some monitoring functions. The public-listed shares are dispersed and minorities have little legal protection. Whether a company can make an IPO is still largely determined by an administrative process rather than by a market process, which has been the case within developed economies. When an SOE wants to go public, it must seek permission from the local government and its affiliated central government ministries, which could set an IPO quota received from the China Securities Regulatory Commission (CSRC).

In addition, corporatization has not fundamentally changed the ownership structure of corporatized firms as the state still retains a majority shareholding. Unless the state is a passive owner, it is not clear how the state can be truly separated from enterprises. If the state indeed withdraws its control over corporatized firms, there is no current mechanism in place to prevent enterprise managers from abusing their newly acquired power. In fact, many managers of corporatized SOEs tend to

use their new independence to pursue reckless operations or engage in self-seeking activities (He 1998). For example, a CEO within one of the largest department stores in Zhejiang Province caused huge losses to the company by "blindly providing credit guarantees" without the consent of the board of directors due to the lack of monitoring and supervision.* Neither the employees as shareholders nor the board of directors had the ability or motivation to exercise any control over major business decisions and to monitor the chairman and the CEO of the company. A more serious misbehavior by managers of corporatized SOEs is asset-stripping, which is the quickest way to get rich. He provided several detailed cases that vividly illustrate some of the methods used by managers to divert state assets into their own pockets (1998). If corporatized SOEs are not performing, the government would still bail them out, whereas in developed countries, they will go into bankruptcy.

Furthermore, based on a survey conducted by the China Confederation of Enterprises in 1999, only 14 percent of the 1,235 SOE managers reported better financial performance following the corporatization, whereas 55 percent of the respondents reported better corporate governance. Approximately 49 percent of large- and medium-sized Chinese SOEs reported that they had suffered a loss by 1999 (China Confederation of Enterprises 1999). Internal corporate governance needs to be improved within most SOEs, although the corporate governance mechanisms in many SOEs have been established.

In 2005, China promoted privatization for the SOE reform by introducing more comprehensive corporate governance mechanisms from various capital markets, and it indeed succeeded to some extent. However, in the view of the weak legal enforcement, the monitoring role of private ownership over companies is questioned. For instance, Lin, Zhang, and Zhu reported that bank ownership in China is associated with poorer operating performance (2009).

Moreover, most managers have very limited ownership in the partially privatized SOEs (Wei, Xie, and Zhang 2005), and this shareholding structure fails to align the incentives of managers with firm performance (Hu and Zhou 2008). This phenomenon is more prevalent in larger SOEs

* *Beijing Youth Daily*, December 13, 1997.

whose managers are governmental officers. The evaluation or promotion standard for these managers is based on many other political goals rather than on the firm's performance.

Major Corporate Scandals in Recent Years

Recent corporate scandals in some once distinguished companies such as Adelphia, Tyco, Enron, and Worldcom in the United States and in European countries have greatly affected investors' confidence. As a punishment, many of these firms experienced a sharp decline both in the stock market and in the credit ratings of their debt issues; and some of them eventually went bankrupt. These scandals have largely been blamed on weak internal controls and weak corporate governance. The implementation of the Sarbanes–Oxley Bill issued in 2002, which imposes a number of corporate governance rules on all public companies with stock traded in the United States, has reduced the incidence of such scandals.

Corporate scandals are more likely to happen in an emerging market such as China, which has weak legal enforcement and less-developed corporate governance. In fact, there are many fraudulent activities and financial scandals that have occurred in Chinese companies; we summarize some major recent corporate scandals that have happened in China.

The first scandal concerns a firm called Yin Guang Xia. This is a typical case of disclosing false statement to cheat investors when Yin Guang Xia with ID number 000557 went to IPO on the Shenzhen Securities Exchange in 1994. Because of its sustainable excellent performance, the stock price of Yin Guang Xia skyrocketed from 3.98 yuan to 35.83 yuan in 2000, and the earnings per share began at 0.51 yuan in 1999 and rose to 0.827 yuan in 2000. This company was once called China's First Blue-Chip Stock. After ex-right, the stock price of Yin Guang Xia totally recovered to 37.99 yuan, which was a new high level of the stock price on December 29, 2000, with an annual rise of 440 percent, ranking top among all the stocks listed in Shenzhen and Shanghai Securities Exchanges. However, on August 2, 2001, an article entitled "Trap of Yin Guang Xia," printed in the magazine *Caijing*, disclosed that most financial results of Yin Guang Xia from 1999 to 2000 were falsified. Nobody had expected that an incident like this would trigger such a great turbulence.

After Yin Guang Xia's counterfeiting was unveiled, its stock price plunged below 6 yuan through 16 unparalleled historical limit-downs. Many small and medium investors suffered from great loss. Such a rollercoaster of boom and slump struck a deadly blow to the new-fledged Chinese security market in 2001. All of a sudden, the security stock rolled on with full force, in the light of the fury of the investors and the strong oppositional response by the supervision organization. The fraud of Yin Guang Xia severely destroyed the fiduciary faith in China's security market and even in all aspects of the society to an extent that was unparalleled. After the start-up of the civil procedure, Zhuhai Intermediate People's Court dealt in total with 103 cases of civil compensation for damages caused by the false statement published by Yin Guang Xia, involving 847 investors, covering more than 20 provinces, municipals, and autonomous areas, and amounting to 180 million yuan. The case broke through the records of civil compensation for damages caused by false statement in China's securities market, due to its tremendous coverage and the greatly negative influence on the Chinese society. On May 25, 2007, Yin Guang Xia completed its compensation to the plaintiff by transferring its stock ownership. This case exerted a far-reaching influence on civil compensation cases for damages caused by false statement in securities market, and the legalization of the entire securities market in the long term.

The second scandal concerns Lantian Company Limited. Lantian was China's first state-owned agricultural enterprise, which had undergone the corporatization reform in the 1990s and went to list in 1996. Lantian Stock had recorded a sensational performance. However, in October 2001, its resplendent image was smashed by an academic investigator, Liu Shuwei, who wrote a 600-word article that mentioned the liquidity crisis of Lantian Stock. Consequently, all the banks in China rejected the provision of additional loans to this company. Meanwhile, Liu Shuwei faced prosecution for defamation. This defamation charge was dropped eventually since the Chinese government began to unveil the hidden truth that Lantian Stock was indeed associated with misreporting and perpetrating accounting fraud, and the Chinese media further detected the previous fraud record of Lantian Stock. Then Liu Shuwei uncovered the misstatement based on some rudimentary financial ratio analysis and raised the question of why such fabricated statements had not been previously discovered by the regulators and other

investors. The auditing firm of Lantian Stock blamed the institutional environment, whose weak legal regulations and poor corporate governance perpetuated such fraud.

The third is the scandal of the Mingxing Electric Power Company Limited (MXEP), which was reformed from an SOE company and went public on the Shanghai Securities Exchange in 1997. The annual reports showed a sharp decline in the earnings of the MXEP in 2005, and it continually experienced weak profitable performance in 2006, because of its bad loans, debt, and investment losses caused by a series of behaviors of securing credit for its related companies, and aggressive expanding of investment in different industries. The company then sold its assets and restructured one of its subordinate companies to dispense with special treatment in 2007. (The term *special treatment* is used to remind investors of the risky stocks of a certain company, which means that the company's shares may be forced to delist from the Exchange if it continues to fail to make profit in the next financial year.)

But then, the Sichuan Regulation Bureau of the CSRC noticed an unusually high increase in the amount of bank loans taken by the company as well as investment in some industries that deviated from its main businesses. The Sichuan Regulation Bureau then asked the MXEP to take control in 2004. However, the MXEP had not taken measures before it became involved in a series of law suits with several banks. Moreover, the manager of the MXEP was detained by Suining Security Institution—that is, the local security regulatory institution—because the manager was suspected of having embezzled huge amounts of capital from the company in 2005. Other directors and key management members from the MXEP were also detained by this local security regulatory institution. As a result, according to the preliminary results of the investigation undertaken by the Suining Security Office, it was estimated that the MXEP suffered a capital loss of about 476 million yuan caused by the majority shareholder's behavior of malicious external investment and false trading. In 2006, some of its shares were auctioned and an SOE won the bid, becoming the largest shareholder within the company. Recently, the MXEP implemented a series of measures, which included revising its corporate regulations and information disclosure rules, selling some of its investment projects and establishing its internal financial management rules, in order to improve its internal governance.

The fourth is China's milk scandal. In 2008, various milk products from Sanlu, a famous milk corporate group in China, were found to contain melamine as reported by China's food safety watchdog, Chinese State Administration of Quality Supervision, Inspection and Quarantine. Melamine is an industrial chemical used in producing plastics and fertilizers. Sustained consumption of the contaminated milk, particularly by infants, may cause kidney stones and kidney failure. This was a severe event concerning food safety. As a result, 861 infants were found to have kidney disease because of consuming the Sanlu milk products, and 154 of them suffered severe kidney disease.

The failure of corporate governance played a key role in this milk scandal. The aim of corporate governance is to ensure that companies are run by their managers in a way that maximizes the interest of their shareholders. The managers and the board of directors need to adopt strict internal control systems to ensure that the company meets its legal and social responsibilities. Coupled with a large increase in demand for its milk products, Sanlu tended to expand its milk sources by the most *cost-effective* means, purchasing raw milk from small-scale but merged quality dairy farmers, instead of developing their own dairy farms. The effectiveness of its impressive internal control systems as detailed in the annual reports was questioned because of its failure to discover the melamine in the aftermath of the scandal. As a result, only the chairperson and three other executives of Sanlu were prosecuted and subsequently convicted under the criminal law for producing and selling the toxic milk products. Moreover, the scandal of Sanlu suggests a special example of overlooking corporate social responsibility in the name of business survival demand. When the scandal first broke, the strategy of Sanlu was to attempt to hide the scandal, in the name of internal inquiries conducted by the company.

The last case, the Shanghai Pension scandal, is perhaps one of the biggest corruption cases in modern Chinese history. The scandal was revealed in early August 2006 when the central government sacked Zhu Junyi, Director of the Shanghai Municipal Labor and Social Security Bureau, who supervised the city's pension funds, for the reason that he lent 3.2 billion yuan from pension funds to a private toll road company, Fuxi Investment Holding Company. This company used the funds to help bid for the contract to run the operations of a Shanghai–Hangzhou

expressway. Fuxi's Chairman, Zhang Rongkun, was detained later. Through his personal connections with the political officers in Shanghai, Zhang Rongkun quickly amassed a fortune of US$605 million. In 2005, *Forbes* magazine ranked him as China's 16th richest man. Subsequent investigations led to the arrest and conviction of dozens of government officials and business people, including Chen Liangyu, Shanghai's Secretary of the Communist Party of China.

CHAPTER 3

External Corporate Governance Mechanisms

The corporate governance mechanisms can be categorized into two types: internal and external governance mechanisms (Denis and McConnell 2003; Gillan 2006). The *internal* governance mechanisms primarily focus on boards of directors, ownership and control, and managerial incentive mechanisms, whereas the *external* governance mechanisms cover issues related to the external market and laws and regulations (e.g., the legal system).

The simple balance sheet model of the firm, as shown in Figure 3.1, captures the essence of the rationale of such categorization, that is, internal and external corporate governance mechanisms. The left-hand side of the figure shows the basic components of internal governance mechanism. Management, acting as shareholder's agent, decides which assets to invest in, and how to finance those investments. The board of directors, which is at the top of internal governance systems, is in charge of advising and monitoring the management and has the responsibility to hire, fire, and compensate the senior management team (Jensen 1993). The right-hand side of the figure shows the elements of external governance mechanisms arising from a firm's need to raise capital. Furthermore, it highlights that, in the publicly traded firm, there is a separation between capital providers and those who manage the capital. This separation creates the demand for corporate governance structures. The figure also illustrates the link between shareholders and the board. Shareholders, the residual claimants, elect board members, and boards, in turn, owe a fiduciary obligation to shareholders (Gillan 2006).

In addition to the firm-level picture of corporate governance mechanisms, which includes the links between boards, managers, shareholders,

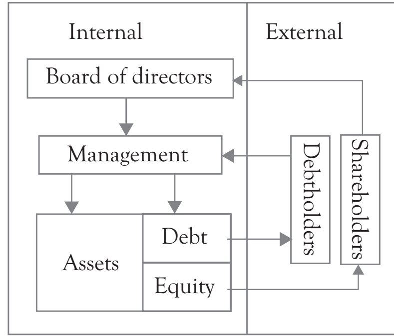

Figure 3.1 Corporate governance and the balance sheet model of the firm

Source: Adapted from Ross, Westerfield, and Jaffe (2005).

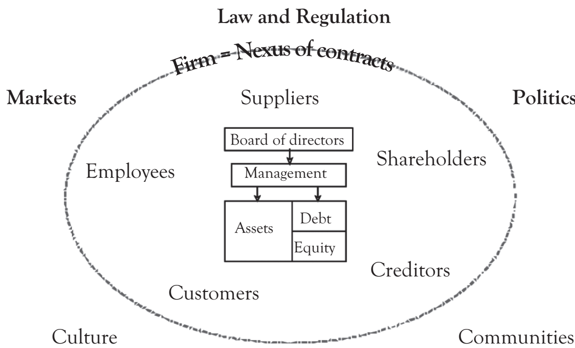

Figure 3.2 Corporate governance: beyond the balance sheet model

Source: Gillan (2006).

and debt holders, Figure 3.2 provides a more comprehensive perspective of the corporate governance system surrounding the firm. It draws a circle between the internal and external corporate governance mechanisms by introducing the nexus of contracts from the view of firms, as suggested by Jensen and Meckling (1976). This figure depicts other participants in the corporate structure system, including employees, suppliers, and customers. These participants are viewed as internal aspects of the corporate governance system in a broader sense when drawing comparisons

with Figure 3.1. Figure 3.2 also captures the elements of the governance environment from a stakeholder perspective, which includes the political environment, laws and regulations, and the markets where firms operate. In Figure 3.2, markets and law and regulations are represented in bold font as these two external governance elements are of particular interest to researchers, especially in the context of corporate governance in China.

On the basis of the aforementioned theoretical classification of the corporate governance system, the following section discusses the corporate governance mechanisms in China from the external governance perspective.

Law, Regulation, and Corporate Governance Codes in China

Corporate governance in China has been explored and established, mainly coupled with the process of state-owned enterprises' (SOEs) reform and private enterprises' growth. Corporate governance experience and the model based on Chinese characteristics have come into being in light of the actual situation in China (OECD 2011). The construction and improvement of the legal framework within the corporate governance system was led by the government and developed by market participants. The legal system of corporate governance in China has been established and gradually improved over the last several decades. On the basis of the framework of China's Company Law and Securities Law, the China Securities Regulatory Commission (CSRC) plays an important role in the improvement of corporate governance, particularly in the aspects of independent directorship, information disclosure, interest-related party transaction, general shareholders' meeting, merger and acquisition, and reorganization and investor protection. The CSRC issued a series of department rules and normative documents over the last few decades, including (1) Code of Corporate Governance of Listed Companies, (2) Regulations on Information Disclosure of Listed Companies, (3) Guidelines on Articles of Association of Listed Companies, and Rules on Shareholders' Meetings of Listed Companies, (4) Guiding Opinions on the Establishment of the System of Independent directors in Listed

Companies, (5) Provisions on Strengthening the Protection of the Rights and Interests of Public Shareholders, (6) Regulations on the Takeover of Listed Companies, (7) Regulations on Major Asset Reorganization of Listed Companies, (8) Provisional Code of Corporate Governance for Security Companies, and (9) Regulations on Option Incentives of Listed Companies (Trial). In 2005, the CSRC launched a campaign to reform nontradable shares, aiming at clearing outstanding debts from controlling shareholders. The implementation of these regulatory provisions and normative documents is a milestone in the process of China's corporate governance reform. As a result, the quality of corporate governance in the view of listed companies in China has been improved. As a leading emerging market, China's achievement and progress in the development of the legal system and the resulting corporate governance may be of reference to other developing countries. However, the gap between China and developed countries concerning the quality of governance still exists. Corporate governance reforms and development are still a dynamic ongoing scheme on China's economic development agenda.

Major Corporate Governance-Related Legislation Since 1978

The emergence and development of corporate governance in China is because China has shifted from a planned economy to a market economy. The establishment and growth of China's capital market and the evolution of Chinese enterprises from government affiliations to modern companies have made it necessary to establish a new corporate governance framework.

Until 1978, most Chinese enterprises were state owned. A major characteristic of the state-owned enterprise management mechanism was its administration-driven, unified, and collective governance. Enterprises were mainly managed by *administrative* means and ranked in accordance with the levels of government officials involved and the size and affiliation of the company. Corporate production plans were not decided by the market, but by the government, according to a national plan and its subplans. Business performance was measured by the number of planned targets stipulated by the government, rather than by the market value realized. Political entitlement was the major incentive for managers and

employees. Managers had no independence in business activities, nor could they share the fruits of successful business operations, and therefore lacked the drive to improve enterprise management. As managers' autonomy and corresponding administrative ranks were mainly decided by the size and economic resources of their companies, they were inclined to expand the size of the enterprise while paying little attention to its business performance.

Economic reform was introduced into China's urban areas after the Third Plenary Session of the 11th Communist Party of China's (CPC) National Congress in 1978. The core of the reform was the revitalization of SOEs to make them more efficient by restructuring the old enterprise system. Driven by the reform of SOEs, China's attention to corporate governance grew as the SOEs strove to put in place a modern enterprise system. China's corporate governance made steady progress as more and more companies were gradually listed.

China's corporate governance development to date has been a 30-year process, which can be divided into four stages. The first stage is from 1978 to 1984, and the major feature of this stage was decentralization. In 1979, the State Council promulgated a number of rules and regulations for reforming the enterprises' management mechanisms. These new rules were geared to readjust the relationship between the state and its enterprises, to give SOE managers more freedom in business activities, and to replace the state's direct administrative control over the SOEs with a management model in which direct state control is supplemented by economic incentives. Favorable measures including fixed-asset investment, asset depreciation, and working capital management were provided to the SOEs to expand their incentives for better business performance. Pilot programs to enhance SOEs' business independence were introduced and the successful experiences of the SOEs were summarized and formulated into the SOE Management Responsibility System in 1981, which was set by the state as the key goal of SOE management mechanism reform.

The second stage is from 1984 to 1992. The major feature of this stage was the change in SOEs' profit distribution and the formation of the management responsibility system. Before the reform, SOEs' profits were all claimed by the state. After the reform, the profits of large and

medium-sized SOEs were taxed, after-tax profits were shared by the state and enterprises, and the SOE Manager Accountability Mechanism was put in place. In 1984, the idea that the ownership and management of SOEs could be separated as appropriate was proposed for the first time. In 1986, the CPC Central Committee, together with the State Council, issued a number of documents, one of which is the Terms of Reference for Managers of State-Owned Industrial Enterprises, explicitly stipulating that the manager is a company's representative of a legal personality, and that a new type of corporate leadership system featuring overall responsibility of the manager, a supervisory and guarantee role for the company's CPC subcommittee, and democratic management by the employees was also established.

From 1987 onward, the transformation of the SOEs' operational mechanism became the priority of SOE reform. According to the principle that ownership and management of companies should be separated, a major reform of SOEs' business operation models was initiated and a contract-based responsibility system was set up. In the transitional period from a planned to a market-based economy, the contract responsibility system played a positive role in guaranteeing the steady growth of government revenue, promoting the separation of enterprise ownership from management, and the separation of the government from enterprises, providing SOE employees with greater autonomy and incentives, and making SOE development more sustainable. However, experience has shown that the contract responsibility system had revealed weaknesses as well, especially, it failed to avoid the short-term performance-oriented behaviors. The basis of the contracts was often arbitrarily decided and was neither fair nor objective: The contractors shared the gains when enterprises were profitable but were not personally liable when they incurred losses. To a large extent, the system failed to find a fully satisfactory solution to the challenge of separating the role of the government from that of enterprises.

In July 1992, the State Council formulated and promulgated the Regulation on the Transformation of Operational Mechanisms of Industrial Enterprises Owned by the Whole People, delegating 14 independent officers for SOE operations, thereby accelerating the pace at which SOEs moved from a planned economy to a market economy.

The third stage is from 1993 to 2003. The establishment of a modern enterprise system was at the core of the SOE's reform during this stage. In 1993, it was made clear that efforts were needed to transform the SOE management mechanism and establish a modern enterprise system that suits the needs of a market economy, with clearly defined ownership, rights, and responsibilities, and which features the separation of the government from enterprises and scientific management. Modern enterprises can take many organizational forms on the basis of the composition of capital. Practicing the modern corporate system in SOEs proved to be a useful way to start building a modern enterprise system.

The Company Law, which was promulgated in December 1993, provided legal support to the establishment of a modern enterprise system and laid a foundation for China's corporate governance framework. The Chinese government defines its basic economic system as the one in which state ownership is the main feature, with the common development of diverse forms of ownership. In line with this definition, efforts were made in the two aspects. First, the SOE reform and the structural adjustment of the national economy were accelerated toward the direction of building a system in which enterprises as major market players would become legal entities responsible for their own business operations, profitability, development, self-discipline, and risk portfolio. Some SOEs were restructured into limited liability companies or limited joint-stock companies. With drafted articles of association, shareholders' meetings, boards of directors, established supervisory boards, and appointed senior management, a basic framework for a corporate governance structure was formed. Second, as the nonstate sector of the economy was promoted from a previously subordinate position to the one which holds the same important status as the public sector, the policy and institutional obstacles limiting its rapid development were removed. As a result, the number of nonstate firms has continued to grow steadily.

Since the early 1990s, a nationwide capital market, coupled with stock exchanges acting as the main agent, has gradually developed, and the number of listed companies has grown exponentially. Most of the listed companies were restructured SOEs that had undergone shareholding reform. As the state or state-owned companies still held controlling shares of those listed companies, many of the old SOE management styles

and mechanisms were maintained. Meanwhile, as the number of listed nonstate holding companies grew, their governance increasingly became an issue. The improvement of the corporate governance of listed companies was a major issue on the agenda of China's capital market development at that time.

In 2001, China joined the World Trade Organization and undertook to adopt the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance and to improve corporate governance of Chinese listed companies. The CSRC and the National Economic and Trade Commission jointly issued the Code of Corporate Governance of Listed Companies in early 2002. This document is based on the OECD Principles of Corporate Governance and gives particular consideration to the circumstances and outstanding issues of listed companies in China. It expounds the basic principles of corporate governance, the means to achieve investor protection, and the basic code of conduct and professional ethics that needs to be observed by directors, supervisors, managers, and other executives of listed companies.

The last stage runs from 2004 to the present day. Gradually, historical constraints to good governance of listed companies were addressed from 2004 onward. With the help of government regulators, such as those represented by the CSRC, the level of corporate governance among listed companies has been constantly improving. The State Council issued Opinions on Promoting the Reform, Opening and Steady Growth of Capital Markets in January 2004, clarifying the strategic importance of capital markets in national economic development, and charting the course for resolving some long-standing problems. In April 2005, under the guidance of the State Council, the CSRC introduced a reform designed to address the issue of nontradability of certain shares held by a company's shareholders, a residual problem even before the companies went public. The smooth progress of this reform successfully solved the problem of dividing interests and prices among the state-owned shares, institutional shares, and tradable shares in a company's share structure, and enabled equal rights to the trading of and earnings on shares among all categories of shareholders. All categories of shares are now valued by the market mechanism, which constitutes the basis for common interests among all categories of shareholders.

The Company Law and the Securities Law, both of which were introduced in 2006, have provided the foundations for drawing up and developing a corporate governance framework in China. The revised Company Law improved companies' governance structure and mechanisms to protect lawful shareholders' rights and public interests. It highlighted the legal obligations and responsibilities of those in actual control of the company—the directors, senior management, and supervisors. It improved companies' financing, their financial accounting systems, and the systems that govern corporate mergers, divisions, and liquidation. While ensuring that the lawful rights and interests of the creditors are well protected, the revised Company Law facilitated the reorganization of companies.

The revised Securities Law improved the system governing the issuance, trading, registration, and settlement of securities, and provided for the establishment of multitiered capital-market architecture. It improved the supervision of listed companies, made issuance examination more transparent, and established the mechanism of introducing a system for recommending or sponsoring a listing. It also increased the legal responsibilities and rules on integrity obligations of the controlling shareholders or those actually in control of firms, namely, the directors, supervisors, and senior management of listed companies. The revised Securities Law strengthened investor protection, particularly for minority investors, established a securities investor protection fund, and defined the system of civil responsibility to compensate for damages to investors. Following the revision, related agencies made corresponding adjustments to other relevant laws, regulations, and documents to ensure that they better reflect market rules.

The state-owned Assets Supervision and Administration Commission of the State Council carried out corporatization reforms of large SOEs controlled by central government and piloted the establishment of boards of directors according to the Company Law and in light of the OECD Guidelines on Corporate Governance of State-Owned Enterprises.

The issue of fund misappropriation by major shareholders and other related parties was a problem that seriously affected the healthy development of listed companies. To address this issue effectively, the CSRC drafted regulations imposing a strict limitation on fund misappropriation in listed companies by controlling shareholders and other related parties.

The CSRC conducted pilot programs on *shares for debt* and co-operated with local governments and other relevant agencies to deal with the difficult problem of debt repayment arrears. At the same time, it focused on the establishment of a long-term mechanism to forestall new debt repayment arrears, while old arrears were being repaid. The criminal law was amended to inflict greater penalties on major shareholders and actual controllers involved in fund misappropriation of listed companies. This problem was essentially resolved by the end of 2006.

Following the completion of the reform on nontradable shares and collection of debt repayment arrears, the CSRC launched a three-year campaign in March 2007 to strengthen the governance of listed companies. During the campaign, listed companies were required to look into existing problems in corporate governance and to conduct in-depth, effective rectification of misappropriation of company funds by major shareholders; incomplete separation of funds and personnel between a listed company and its controlling shareholder; irregular operations of listed companies' boards of directors, shareholders' meetings, and supervisory boards; and inadequate internal controls.

During this campaign, the listed companies gained greater awareness of standard operations and improved their level of governance, and some of them gradually introduced effective corporate governance models into their organizations. The main achievements derived from the campaign are as follows:

- Listed companies were marked by greater independence and the diversification of directors has started to play an important role in the ongoing improvement of corporate governance and internal controls.
- Operations of the board of directors, supervisory board, and general shareholders' meeting are more standard and effective. Online voting at general shareholders' meetings has increased and the use of accumulative voting is more extensive. The rules of procedures for board meetings are more standardized and relevant decision making is more scientific. The functions of the specialized committees within the board of directors have been further strengthened, with many companies

adopting work procedures and detailed responsibilities, and clarifying procedures for the specialized committees.
- The system of internal control has been further improved, with many listed companies systematically sorting out and improving their internal controls by drawing up rules and improving them where necessary.
- The information disclosure systems of listed companies have become more fully fledged and detailed. Meanwhile, companies are more likely to take the initiative to disclose information with more indepth and extensive coverage. They are also more sensitive and respond faster to substantive information.
- The relationship between management and investors has greatly improved. Most listed companies have improved their investor management relation system, appointed full-time staff responsible for investor relations, set up hotlines, and designated website modules for investors, which are used to interact and exchange information with investors on an ad hoc basis. They are also more active in implementing corporate social responsibility.

As a result, China has established the current Corporate Governance Framework of Listed Companies in China as shown in Figure 3.3.

Concerning allocation and balance of company powers, according to Figure 3.3, the four specific company organs with power and work division are set up to form the organizational structure, as described in the following paragraph.

First, the *general shareholders' meeting* is the power and decision-making organ of the company and has decision-making power concerning major issues. Second, the *board of directors* is the operations implementation organ of the company, being responsible for the general shareholders' meeting, and has the decision-making power concerning management issues under the authority of general shareholders' meeting. The board of directors may, according to the resolution of the general shareholders' meeting, set up special committees, such as strategy committee, auditing committee, nomination committee, and remuneration and appraisal committee. Third, the *management* is responsible for the board of directors, and is in charge of the

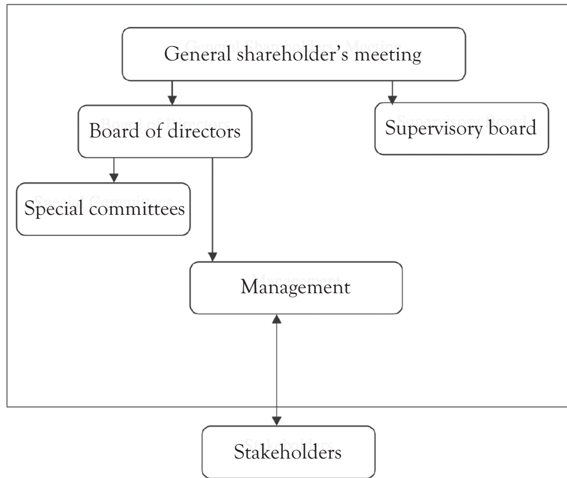

Figure 3.3 Current corporate governance framework of listed companies in China

Source: OECD (2011).

daily operations and management of the company. Fourth, the *supervisory board* supervises whether directors and managers violate laws or articles of association of the company when accomplishing corporate duties and has the power to inspect the company's finance.

Legal System Related to Corporate Governance in China

La Porta et al. argued that the legal system is a fundamentally important corporate governance issue (1998). Early studies on corporate governance normally focused on board structure, executive compensation, ownership structure, or external control mechanisms. Recently, researchers have paid more attention to the importance of legal system (Denis and McConnell 2003). Aspects of the legal and regulatory environment are integrally related to corporate governance. In this section, we review important laws, regulatory provisions, and normative documents, which are related to corporate governance as a vital part of China's legal system, such as the Company Law (2006), the Securities Law (2006), the Criminal Law Amendment Act (6) (2006), the Law on the State-Owned Assets of Enterprises (2009), Accounting Law (2000), and other regulatory documents.

The Company Law (2006) is formulated to standardize the organization and behavior of companies, to protect the legitimate rights and interests of companies, shareholders and creditors, to safeguard socioeconomic order, and to promote the development of a socialist market economy. It governs the incorporation and organizational structure of limited liability companies; equity transfers of limited liability companies; the incorporation, organizational structure, and issuance and transfer of shares of companies limited by shares; the qualifications and obligations of company directors, supervisors, and senior executives; corporate bonds, corporate finance, and accounting; company mergers and splits; capital increases and reductions; company dissolution and clearance; branches of foreign companies; and legal liabilities.

The Securities Law (2006) was drawn up to standardize securities issues and transactions, protect the legitimate rights and interests of investors, safeguard socioeconomic order and public interests, and promote the development of a socialist market economy. It governs securities issues, securities transactions, general provisions, listing of securities, disclosure of information, prohibited transactions, acquisition of a listed company, stock exchanges, securities companies, securities registration and clearance institutions, securities service organizations, securities industry associations, securities regulatory institution, and legal liabilities.

The Criminal Law Amendment Act (6) (2006), that is, Amendment VI to the Criminal Law, was designed to match the amended Securities Law and Company Law, to give a more complete definition of legal liabilities in the securities field, to improve the laws governing the securities market, and to promote its healthy development. This amendment governs the following corporate governance-related offences: disclosure breaches, nondisclosure of major information, breach of trust and damage of listed company's interests, insider trading and leakage of insider information, and manipulation of securities or futures market.

The Law on the State-Owned Assets of Enterprises (2009) was promulgated to safeguard the country's basic economic system, consolidate and develop the state-owned sector, strengthen the protection of state-owned assets, allow the state-owned sector to play a dominant role in the national economy, and promote the development of a socialist market economy. This law governs the institution that performs the function of

investor and enterprises with funds from the state. It also governs the selection of managers of state-funded enterprises, the assessment of their performance, and significant matters that have a bearing on the rights and interests of the investor(s) in state-owned assets, operational budgets of state-owned assets, supervision of state-owned assets, and legal liabilities.

The Accounting Law (2000) was introduced to standardize accounting behavior; the aim was to ensure the truthfulness and completeness of accounting materials, strengthen economic administration and financial management, improve economic performance, and safeguard the order of the socialist market economy. This law lays out requirements regarding accounting practices, special provisions on companies' accounting practices, accounting supervision, accounting offices, accounting personnel, and legal liability.

Among the important regulatory documents, the first is the Regulations on the Administration of Company Registration (2005). These regulations are able to ensure that a company qualifies as a legal personality by conducting standardized company registration; ensuring complete and standardized provisions concerning the establishment, alteration, and termination of companies in terms of registration, registered items, registration of establishments, changes, and cancellations; and ensuring registration procedures are in place.

The second regulatory document is the Opinions on Promoting the Reform, Opening-up, and Steady Growth of Capital Markets (2004). These opinions focus on the need to fully appreciate the importance of capital market development, the guiding ideology and tasks for promoting reform, and the opening-up and steady growth of capital markets. These opinions suggest that efforts are needed to improve relevant policies to promote the steady growth of capital markets. The structure of capital markets needs to be optimized and the range of investment securities needs to be expanded. The quality of listed companies needs to be improved and their operation should be standardized; efforts should be also made to promote the standardization of intermediaries in the capital markets and strengthen their professional skills. The development and integrity of the legal system need to be promoted to raise the level of supervision over capital markets; emphasis should be on coordinated efforts to fend off and monitor market risks. To steadily promote

implementation of the opening-up policy, past experiences and lessons learnt should be reviewed.

The third piece of legislation is the Circular of the State Council on Its Approval of the CSRC's Opinion on Improving the Quality of Listed Companies (2005). This document suggests that the need to improve the quality of listed companies must be viewed as a priority. Corporate governance must be improved to enhance listed companies' business performance and management and raise their level of standardized operations. Efforts need to be made to address both the symptoms and root causes of the quality issues pertaining to listed companies, particularly related to outstanding problems. Effective measures must be taken to help listed companies grow and become excellent performers. Their supervision and management mechanisms must be improved and regulatory coordination strengthened. Better leadership and guidance should be provided to create a favorable environment for the healthy development of listed companies.

The fourth document is the Regulations on Listed Companies' Information Disclosure (2007). These regulations set out the requirements and listing particulars of the issuance of an Initial Public Offering (IPO) prospectus, offering circular, periodic reports, ad hoc reports, information disclosure management, supervision, and legal liability.

The fifth is Guidance on Listed Companies' Articles of Association (2006). This document provides guidance on business purposes and scope, shares, shareholders and shareholders' meetings, boards of directors, managers and other executives, supervisory boards, financial and accounting systems, profit distribution and auditing, public announcements and notices, mergers, divestments, capital increases and reductions, dissolution and liquidation, and revision of the articles of association.

The sixth regulatory document is the Rules on Listed Companies' Shareholders' Meetings (2006). These rules relate to the convening of shareholders' meetings, their resolutions and related notifications, and supervisory measures.

The seventh is the Guiding Opinions on the Establishment of the System of Independent Directors in Listed Companies (2001) provides guidance on independent directors, who must truly be independent and have the necessary qualifications to perform their duties. The nomination, election, and appointment of independent directors must be conducted

according to the law and relevant regulations. Listed companies must comply with the content of the appropriate functioning to independent directors and the role they play. Independent directors must have independent opinions on major issues affecting the listed company, which should provide its independent directors with the required conditions to fulfill their roles.

The eighth publication is the Provisions on Strengthening the Protection of the Rights and Interests of Public Shareholders (2004). These provisions cover the introduction of a trial public shareholder voting system on major issues pertaining to a company and the enhancement of the independent directors' system, conferring more importance to the role played by independent directors. They also seek to improve investor relations management and raise the quality of information disclosure by listed companies, including those with active profit distribution plans, and seek to reinforce the supervision of listed companies and their senior management.

The ninth is the Regulations on the Takeover of Listed Companies (2006) outline listed companies' requirements in relation to the disclosure of rights and interests, tender offers, block purchases, indirect purchases, exemption applications, financial advisors, ongoing supervision, supervisory measures, and legal liability.

The tenth one is Regulations on Major Asset Reorganization of Listed Companies (2008). These regulations outline listed companies' requirements in relation to the principles and standards, procedures, and information management governing major asset reorganization. They also include special provisions on issuing shares for asset purchase, applications for issuing new shares or company bonds after a major asset reorganization, supervision management, and legal liability.

The eleventh document is the Regulations on Equity Incentives of Listed Companies (Trial) (2005), outlines listed companies' requirements in relation to general provisions, restricted shares, stock options, implementation procedures and information disclosure, supervision, and penalties for breaches of regulations.

The twelfth is the Regulations on the Registration and Settlement of Securities (2006). These regulations outline listed companies' requirements regarding institutions in charge of registering and settling securities,

managing security accounts, trusteeship and depository of securities, the clearance and delivery of securities and money, risk prevention, and handling delivery defaults.

The last is the Basic Standard for Enterprise Internal Control (2008). The Basic Standard sets out the objectives, principles, and elements that enterprises should establish and implement regarding internal controls, internal environments, risk assessment, control activities, information and communication, and internal supervision.

Corporate Governance Code in China

To establish a complete, modern enterprise system and standardize the operating process of listed companies and security companies, the CSRC has issued a few regulations on corporate governance. In 2002, the CSRC issued a Code for Corporate Governance of Listed Companies in China (hereafter the LC Code), which was drafted in line with the basic principles established by the original Company Law, Securities Law, and other relevant laws and regulations. The LC Code is applicable to all listed companies within the boundary of the People's Republic of China; it aims at the protection of investors' interests and rights, and of the basic behavior rules and moral standards for directors, supervisors, managers, and other senior management members of listed companies. The LC Code comprises the main measurement criteria used to judge whether a listed company has a sound corporate governance structure. The securities regulatory institution has the power to instruct the listed companies that have major problems in corporate governance to rectify them according to the LC Code. The CSRC is making active preparations to amend the LC Code, along with the amendments to the Company Law, Securities Law, and other relevant laws and regulations, in order to adapt to the changing market environment, enhance the effectiveness of listed-company governance, and encourage companies to improve quality and promote the healthy development of Chinese capital markets.

In January 2004, the CSRC issued a Provisional Code of Corporate Governance for Security Companies in China (hereafter the SC Code). The SC Code is applicable to all listed companies with the boundaries of the People's Republic of China, and pays specific attention to the operations

of securities companies, ensuring the legitimate interests of shareholders, clients, and other interested parties of the securities companies.

These two Codes form the major standard against which the corporate governance of a listed or security company is assessed. If major problems exist within the aspect of the corporate governance structure of a listed or security company, the securities supervision and regulation authorities may instruct the company to make corrections in accordance with these two Codes.

The LC Code contains seven main chapters, which are involved in dealing with shareholders and shareholders' meetings; the listed company and its controlling shareholders, directors and the board of directors, the supervisors and the supervisory board, performance assessments and incentive and disciplinary systems, stakeholders, and information disclosure and transparency. The SC Code has the same content structure as the LC Code, and also addresses the issues related to management personnel and the basic principle of relationships between securities companies and clients. On the basis of the structures of their content, the LC and SC Codes are summarized in the following paragraphs, in brief.

First, concerning shareholders and shareholders' meetings, the LC Code suggests that listed companies should ensure fair treatment toward all shareholders, and all shareholders should enjoy the legal rights stipulated by laws, administrative regulations, and the company's articles of association. They should have redressal through legal action if their rights are violated. The listed company should establish efficient channels of communication with its shareholders, and shareholders should be informed of major matters that affect the company. Directors, supervisors, and managers of companies should bear the liability of compensation if they breach laws and regulations. In related party transactions, these transitions should, in principle, be completed at market value.

Additionally, according to the SC Code, requirements related to security companies suggest that shareholders and actual controllers of a security company have the relevant qualifications required by the laws, administrative rules, and CSRC regulations. Security companies and their major shareholders are not required to provide financing or guarantees to related parties or other shareholders, directly or indirectly. Moreover, security companies are required to notify the CSRC if the company has a

major change in the management team or ownership or if the company has a heavy financial loss. There is also a legal requirement if a securities company suspects major illegal activities.

Second, for controlling shareholders, these companies must comply with laws and regulations while exercising their rights as investors, and should be prevented from harming the listed company's or other shareholders' legal interests. Meanwhile, the controlling shareholders have the right to nominate candidates for directorships and supervisory committee positions based on their professional skills, knowledge, and experience. The decision-making rights belong to the general shareholders' meeting or to the board of directors. Listed companies should operate independently of their controlling shareholders in aspects such as personnel, assets, and financial affairs. The board of directors, the supervisory committee, and other internal offices of listed companies should operate in an independent manner.

Third, for directors and board of directors, the LC Code suggests that the election of directors should be organized following a transparent, independent, open, and fair procedure. The detailed information about the candidates for directorship should be disclosed prior to the shareholders' meeting; and the election for directors should fully reflect the opinions of minority shareholders. The elected directors should *faithfully, honestly, and diligently* perform their duties in the best interests of the company and all shareholders, and they should contribute adequate time and energy to their duties. For the independent directors of a listed company, they should be independent from the listed company and its major shareholders and also fulfill their duties faithfully and diligently. The board of directors should be accountable to shareholders, treat all shareholders equally, and ensure that listed companies comply with the relevant laws and regulations. The LC Code specified that by June 30, 2003, at least one-third of the board should comprise independent directors.

Further, the SC Code requires that insider directors of a securities company should not exceed half of the total directors, and encourages the appointment of directors from outside professionals. Independent directors of a security company should have basic knowledge of the securities markets and be familiar with relevant laws and regulations. They should be honest and creditable, and have more than five years' working

experience in related fields. The term of office of independent directors should be the same as that of other directors, but should not be renewed twice consecutively.

Fourth, for supervisors and supervisory boards, both the LC and SC Codes suggest that the supervisory board of a listed or securities company should supervise the finance decisions of the corporation, monitor directors' performance, and protect the company's and shareholders' legal rights and interests. Supervisors should have professional knowledge or relevant work experience in the areas such as law and accounting. The structure should be such that the members of the supervisory board should be able to independently and efficiently fulfill their duties. The supervisory board may require the directors, management personnel, or other related persons to attend the supervisory board meetings and answer the questions that the board cares about, and all meetings should be recorded. Securities companies are encouraged to appoint external professionals as their supervisors.

Fifth, for performance assessments and incentive and disciplinary systems, both the LC and SC Codes suggest that the performance of directors, supervisors, and management of a listed or security company should be assessed through a fair and transparent procedure, and evaluation processes should be conducted through a combination of self-review and peer review, and be approved by the board of directors. The evaluation results and compensation of directors and supervisors should be reported to the shareholders' meeting. The appointment and removal of senior management staff should comply with legal procedure in a fair, independent, and transparent manner, and should be publicly disclosed. The compensation for management personnel should be related to the company's performance and the individual's work performance.

Sixth, for stakeholders and clients relationship, both the LC and SC Codes suggest that a listed or security company should respect the legal rights of the various stakeholder groups and provide protection to the interest-related parties, such as creditors, employees, consumers, suppliers, and communities. Employees in particular are encouraged to provide relevant feedback to improve the company's overall performance. Moreover, securities companies should abide by the laws and regulations when supplying products or services to clients, should give full disclosure

of the contents and risks of the products or services, and should not infringe the client's property rights, options, right to fair deals, right to be informed, and other legitimate rights and interests. In addition, securities companies should not misappropriate the clients' settlement funds for transactions, properties entrusted by the clients for management, or the securities deposited by the clients in the company. Securities companies are encouraged to release their audited annual financial report to the public, making sure that the content of such disclosure is true and accurate.

Seventh, regarding information, disclosure, and transparency, a listed company should disclose all information that may affect the decisions of both shareholders and stakeholders. Both the LC and SC Codes emphasize the importance of the provision of truthful, complete, and timely information from listed companies. The disclosed information should be accessed by the shareholders and stakeholders in an economical, convenient, and speedy manner. The corporate governance information of the company should be available to the public; if there is a gap between the company's corporate governance and the Code, an explanation for this must be provided. Furthermore, detailed information on and changes in major shareholders should be disclosed to the public in an accurate and timely manner.

To further strengthen the transparency of information disclosure activities of listed companies in the Chinese market, the CSRC has issued a series of regulations called Standards Concerning the Contents and Formats of Information Disclosure, which is applied for shares, bonds, and other types of securities issued by listed companies since August 2003. These regulations aim to standardize information disclosure activities for public offering of securities by the listed and securities companies and to protect the legal rights and interests of investors.

Discussions on China's Legal System

Most researchers have identified the two main secular legal origins: *common law* and *civil law* (La Porta, Lopez-de-Silanes, and Shleifer 2008). The common law legal tradition contains the law of England and its former colonies. The common law is formulated by appellate judges who set precedents by solving specific legal disputes. Dispute resolution tends

to be adversarial rather than inquisitorial; and it is crucial for judicial independence on the part of both executive and legislature. The civil law, on the other hand, has its origins in Roman law; it employs statutes and comprehensive codes as a primary means of ordering legal material, and relies heavily on legal scholars to formulate rules. Dispute resolution tends to be inquisitorial rather than adversarial (La Porta, Lopez-de-Silanes, and Shleifer 2008). The civil law has several suborigins, including French, German, Socialist, and Scandinavian laws.

China's legal system belongs to the legal origin of German law, which also belongs to civil law. The literature has identified that civil law is related to a heavier hand of government ownership and regulation than common law and that civil law is more often associated with higher formalism of judicial procedures and lower judicial independence than is common law (La Porta, Lopez-de-Silanes, and Shleifer 2008). Thus, the law enforcement is particularly important for the countries which belong to the legal origin of civil law.

Although China's government has made great efforts to build a sound legal system, this is still relatively weak when compared with its economic growth achievement and its GDP ranking as the second-largest economy in the world. According to the Global Competitiveness Report 2013–2014 conducted by the World Economic Forum, among 148 countries, China remained stable at 29th position in that year. Although Chinese institutional framework has improved slightly to the 47th position, there are still large weaknesses in the areas including corruption (68th), security issues (75th), low levels of accountability (82nd), and ethical standards (54th) among businesses (Schwab 2014).

In addition, one of the major problems facing China's legal system is that the law enforcement is very weak. La Porta et al. found that enforcement of laws is more effective than just having strong regulations, particularly for China (2008). Allen, Qian, and Qian argue that the inefficiencies in the Chinese market can be attributed to poor and ineffective law enforcement (2005). Lin identifies four areas of weakness in the Chinese external governance structure, one of which is weak legal enforcement (2004). Allen, Qian, and Qian reported that China has the middle level of investors' protection (2005). However, the poor record of law enforcement and severe corruption problems have brought down

China to the bottom of the list of selected countries, irrespective of its legal origins.

Allen, Qian, and Qian (2005) state that China has an restrictive government in terms of political freedom and property rights protection, which is consistent with the findings of La Porta et al. (2004). In addition, the Chinese government still has the power to intervene in the practice of law enforcement. In other words, China has no independent and effective judicial system or sufficient number of qualified legal professionals yet. Allen, Qian, and Qian conclude that China's legal system is not ahead of any of the other major emerging economies despite its remarkable economic achievements (2005).This implies that, at this stage, without strict law enforcement, corporate governance rules and regulations lack any creditable role in formulating an efficient domestic market.

Regulatory System Related to Corporate Governance in China

The regulatory system and institutional framework of China's corporate governance is composed of two parts: the CSRC, that is, the agency in charge of securities and futures markets, and corporate governance-related government agencies. The government agencies related to corporate governance mainly include the Ministry of Finance, the state-owned Assets Supervision and Administration Commission, General Administration of Industry and Commerce, China Banking Regulatory Commission (CBRC), and China Insurance Regulatory Commission (CIRC), and stock exchanges and companies registering and settling securities. We introduce some of these important institutions here.

First, the CSRC is a public institution under the direct management of the State Council. In terms of relevant laws and regulations, and the mandate of the State Council, the CSRC performs a unified regulatory function over China's securities and futures markets to make sure that market order is maintained and that capital market operations comply with the law. The CSRC is located in Beijing and has 18 functional departments, one inspection division, and three centers. The CSRC also has a public offering review committee and a merger and acquisition reorganization review committee, which are composed of both the CSRC professionals and independent experts.

The CSRC performs the following regulatory functions in the securities markets:

- Devises the relevant rules, regulations, and measures for the securities markets according to law, and exercises the right to examine, approve, and review according to law; and regulates the issuance, listing, trading, registration, custody, and settlement of securities according to law;
- Supervises securities-related businesses of issuers of securities, listed companies, stock exchanges, securities companies, securities registration and settlement institutions, securities investment fund management companies, and securities services organizations;
- Formulates qualification standards and codes of conduct for securities professionals and oversees their implementation; oversees and inspects the issuance, listing, and trading of securities and information disclosure; provides guidance and supervision over the activities of securities industry associations according to law; deals with activities in violation of market supervision and management laws and administrative regulations; and performs other duties as provided for by law and administrative regulations. The CSRC can enter into cooperation with counterparts in other countries and regions, and carry out cross-border supervision. The CSRC has established 36 securities regulatory bureaus in the provinces, autonomous regions, municipalities directly under the central government, and cities specifically designated in the state plan. It also has a Shanghai Commissioner's Office and a Shenzhen Commissioner's Office. With regard to the supervision of listed companies, CSRC has established a local supervision responsibility system that features local supervision, clear responsibilities, individual accountability, and mutual cooperation. This system has further clarified the terms of reference and positioning of the local branches of the CSRC, and their role as *onsite* supervisors, and made supervision more timely, targeted, and effective. Due to this system,

regulatory resources have been integrated and strengthened, and thus the work of the CSRC has been able to advance in greater depth and with greater momentum. To put the local supervision responsibility system into operation, the CSRC has accelerated the construction and improvement of the comprehensive regulatory framework for listed companies, a framework that involves the participation of many departments and local governments, which will make the regulatory work more authoritative and effective. The main authorities responsible for the comprehensive regulatory framework for listed companies is the task force for standardized operations of listed companies. This interagency task force was established in April 2005 under the mandate of the State Council and with the participation of representatives from 12 ministries comprising of the National Development and Reform Commission (NDRC), Ministry of Public Security, Ministry of Finance, Ministry of Commerce, People's Bank of China, State-Owned Asset Supervision and Administration Commission, General Administration of Customs, State Administration of Taxation, State Administration for Industry and Commerce, CBRC, and CIRC. The goal of this task force was to conduct a joint study on the major issues concerning the standardization of listed companies, coordinate the activities of various departments, achieve regulatory synergy, and jointly promote standard practices among the listed companies. Since its inception, the task force has accomplished a great deal in building a comprehensive regulatory system for listed companies, which is now in place. It has gone a long way toward strengthening coordination among relevant supervisory authorities, promoting the nontradable share reform, preventing the misappropriation of funds by majority shareholders of listed companies, and promoting the standardization of listed companies.

The law enforcement structure of the CSRC comprises four aspects: (1) the enforcement bureau, whose main responsibilities include

organizing, coordinating, guiding, and supervising the investigation of cases, case filing, and review; and enforcing administrative punishment, cross-border law enforcement co-operation, and anti-money laundering; (2) the enforcement contingent's major responsibilities include investigating major cases of insider trading, market manipulation, and false statements; and other important, urgent, or sensitive cases affecting a wide range of sectors and areas; (3) local enforcement bureaus and their enforcement officials, whose major responsibilities include investigating cases within their jurisdictions, informal investigations, and all sorts of co-operative investigation; and (4) the administrative disciplinary bureau, which takes care of the trial of all cases.

Second, the Ministry of Finance, a department of the State Council, has the responsibilities related to corporate governance, which include (1) drafting laws and regulations pertaining to financial and accounting management, devising and executing regulations and rules of financial and accounting management; (2) drafting distribution policies between the state and enterprises, managing the central government budget that is allocated to support enterprises, drafting, and organizing the implementation of the General Rules of Finance for Enterprises, supervising the financial affairs of enterprises, reporting directly to central government, managing the returns on state-owned assets, and administration over the asset-appraisal industry; and (3) drafting and supervising the implementation of accounting rules and regulations and the Accounting Standards for Business Enterprises, drafting and supervising the implementation of the general government budget and the accounting system governing administrative institutions and industries, guiding and supervising the work of certified public accountants and accounting firms, guiding and managing social auditing, and examining and approving the establishment of branches of foreign accounting firms in China.

Third, the State-Owned Assets Supervision and Administration Commission, a special agency reporting directly to the State Council, has the responsibilities related to corporate governance, which mainly include the following: (1) authorized by the State Council, this Commission oversees shareholders' responsibilities according to the Company Law, other laws and administrative regulations, supervises and manages the state-owned assets of the enterprises under the supervision of the central government

(excluding financial enterprises), and enhances the management of state-owned assets; (2) it supervises the preservation and enhancement of the value of supervised enterprises' state-owned assets, including thorough statistics and auditing, and the introduction of a system that establishes targets or objectives and enhances the value of state-owned assets; (3) it also devises assessment criteria, which apply to the management of wages and remuneration of supervised enterprises, and drafts and implements policies regulating the income distribution of their senior executives; (4) it guides and drives forward the reform and restructuring of SOEs, advances the establishment of a modern SOE enterprise system, improves corporate governance, and promotes the strategic adjustment of the layout and structure of the national economy; (5) it allocates directors and supervisors to state-controlled companies and companies with state-owned assets according to the relevant regulations and the respective companies' articles of association; and (6) it is responsible for supervising enterprises in turning state-owned capital gains over to the state, and it participates in devising management systems and methods for the state-owned capital operational budget, which it calculates and implements along with the final accounts, in accordance with related regulations.

In addition, for stock exchanges, security registration, and settlement companies, first, the Shanghai Stock Exchange (SHSE) was founded on November 26, 1990, and the Shenzhen Stock Exchange (SZSE) on December 1, 1990. Both are independent legal entities directly governed by the CSRC. They provide venues and facilities for centralized securities trading, organize and supervise securities trading, and exercise self-regulatory management. Their functions include providing a marketplace and facilities for securities trading; drawing up business rules; accepting and arranging listings; organizing and monitoring securities trading; regulating members and listed companies; and managing and disseminating market information.

Second, founded in 2001, the China Securities Depository and Clearing Corporation Limited is a nonprofit legal entity directly governed by the CSRC, providing centralized registration, and depository and settlement services for securities trading. Its main functions include establishing and managing securities and settlement accounts; providing a venue for the depository and transfer of securities; registering securities holders'

names and rights; managing securities and financial clearing and settlement; distributing warrants on behalf of issuers; and providing securities registration and settlement of business-related queries, information, advisory and training services according to the related laws.

Market as External Corporate Governance Mechanism in China

Capital Markets

Since the late 1970s, China's economic reforms have given birth to the emergence and development of domestic capital markets. Over the last three decades, China's capital markets have rapidly developed into a single national market from the originally small and regional markets, a process that has taken many advanced economies several decades or even a hundred years to accomplish. Because the market size is steadily expanding, market mechanisms are continuously improving, financial institutions are becoming more competitive, and investors are growing more mature, China's capital markets have gradually developed into a marketplace whose legal system, trading rules, and regulatory frameworks are increasingly aligned with international standards and principles. China's corporate sector also benefited from the development of its capital market, which promoted improvements in management and governance. It is fair to say that the emergence and development of China's capital markets can be regarded as one of the major achievements during China's transition from a planned economy to a market economy. Lessons learned and experiences accumulated from the reforms in the capital markets also constitute a major part of the valuable experience of China's economic reform.

The development of the capital market has promoted the establishment of a modern enterprise system in China. Listed companies—particularly outstanding representatives of Chinese enterprises—are the cornerstone of sound capital market development. The improved governance system and higher governance level of listed companies have consolidated the foundation of the capital market, increased its attractiveness and vitality, given an effective boost to the capital market's role in optimizing resource allocation, and promoted the healthy and steady development of the Chinese capital market. According to the China Capital

Market Development Report issued by the World Bank in 2008, there are three stages in the development of China's capital market.

- Stage I: From early 1978 to 1992, China initiated full-scale economic reform. China's capital markets began to emerge in response to the incorporation process of Chinese enterprises.
- Stage II: From 1993 to 1998, with the establishment of CSRC as a key milestone, China consolidated the supervision of capital markets. The regional pilot programs were expanded nationwide, and national capital markets began to emerge and evolve.
- Stage III: From 1999 to 2007, with the promulgation of the Securities Law as a key milestone, the legal status of China's capital markets in the economy was formalized and strengthened, and a series of major reforms were implemented to facilitate further development of the capital markets (Qi 2008).

Indeed, China is facing tremendous opportunities as well as challenges in the future development of its capital markets. First, China's capital markets are expected to provide a full range of financial support to the sustained development of the economy. Second, the need to transform China's industrial structure and improve the economic development pattern in the future will require better resource allocation through the capital markets. Third, the diversification of financial risks from the banking sector can only be achieved if the capital markets are active and viable. Fourth, capital markets are expected to provide financial services and products to facilitate the reforms and management of the pension system, the health care system, and the rural economy, therefore contributing to the building of the "harmonious society." Fifth, with the globalization of the financial markets, competition among capital markets and financial centers around the world is becoming more intensive. The competitiveness of capital markets has become an important component of national strength.

In contrast to many more mature markets which evolved naturally with economic development, China's capital markets' development has been driven by both the government and market participants. Some

lessons and principles can be drawn from this development process, including, but not limited to:

- Promoting capital markets as part of a national development strategy and increasing public awareness of their importance;
- Incorporating capital markets into the national economy, while coordinating development with economic and social goals;
- Engaging in further market liberalization to provide incentives for market participants;
- Enforcing the rule of law and strengthening market regulations;
- Gradually opening up the market to improve China's global competitiveness.

According to the 2020 vision of the World Bank, China's capital markets will have completed the transition from the *emerging markets* to more sophisticated markets with the necessary width and depth by that year. In other words, fair and efficient capital markets will play their role to promote innovations in the economy and in building a harmonious society. China's capital markets will be more open, dynamic, and competitive and will contribute to global financial stability and financial system development. To be fairly specific on the prospects of China's capital market, in 2011, the Securities Association of China (SAC) predicted that China's capital market will develop mainly in the following four aspects: (1) in terms of regulatory environment, it is expected that the deregulation will be further promoted and the combination of self-regulation by securities market and government supervision will be progressively realized; (2) the financial products innovation mechanism will be gradually established, with the enriching of risk management tools alongside; (3) reinforce investor protection by promulgating Suitability Guidelines for Securities Investors and the further emphasis on the significance of investor protection; and (4) as the industrial self-regulation organization, the functions of the SAC are expanding, Advisory Committees and 15 Professional Committees are being established, institutional arrangements are being improved, and the capacity to serve the industry development is also increasing.

Market for Corporate Control

The literature on the market for corporate control indicates that external markets are important for facilitating mergers and takeovers of listed companies. In this context, well-functioning regulations and laws protect the benefits of investors, particularly small investors. It can be argued that high product market competition is the most powerful force for achieving economic efficiency. In the long term, the product market competition can force companies to minimize costs, upgrade technology, and form suitable corporate structures to fit the needs of the market (Shleifer and Vishny 1997). In a market which facilitates the market for corporate control, the share ownership is widely dispersed. Therefore, the influence of the shareholder on management is weak. Unsatisfactory performance is often disciplined by shareholders selling and by subsequent takeovers.

Takeover activity and an active external market however are not always a component of the governance mechanisms around the world. China is a typical example. As mentioned above, free market-style mergers and acquisitions are not allowed in China. In April 2005, Chinese authorities announced the gradual floating of nontradable state-owned shares for all domestically listed companies. All listed companies are required to propose a reform plan to transfer the status of nontradable shares and to develop a compensation package for existing tradable shareholders comprising flexible combinations of cash, warrants, and bonus shares. In addition, the authorities announced plans to allow foreign firms to acquire substantial holdings of tradable shares through the market, up to an initial limit of 10 percent of the target's stock. The central purpose of this reform is to convert nontradable shares to tradable shares at a price acceptable to minority investors. Thus, it is understandable that these sweeping ownership reforms will affect the performance of Chinese listed companies and by implication, the performance of China's economy. The reforms are also having a major impact on the investing community and financial system in China. As a result, we are expecting a more active market for corporate control to have a significant impact on corporate governance practice.

Equity Markets

In 1989, the State Council took the decision to establish two primary national stock exchange markets. With the opening of the SHSE and

SZSE in 1990 and 1991, respectively, listed companies were able to raise funds from domestic and foreign investors. The primary initial purpose of opening the two stock exchanges was to raise funds for restructuring and fostering a more effective management system in the selected listing SOEs. Even if the market was immature, the number of listed companies, trading volume and the total market capitalization grew quickly during the 1990s, making it one of the largest in the region. According to the latest figures issued by the two stock exchanges as of September 2014, there are 1,589 companies listed on the SZSE with a total of 2,461 stocks issued, accounting for a total market value of more than RMB 11,207 billion yuan. As to the SHSE, as of September 2014, 971 companies had stocks issued on it, for a total of 3,485 stocks issued with a total market value of more than RMB 2,661 billion yuan. The emergence of the stock market characterizes a major change in the ideological framework of reforms in China, which represents an important constituent of the process of ownership changes.

Until recently, the NDRC and the CSRC together determined how many companies in total should be listed each year in accordance with development objectives. As we can see, this process of selecting listing companies in China differed considerably from a mature market economy, where the decision to list an enterprise is normally governed by the listing rules of the stock exchange, and firms make their listing decisions in collaboration with investments' banking advisors.

China's listed firms were burdened with poor corporate governance because of state control via majority ownership of shares. Some analysts argued that share prices had fallen over several years because individual investors had no effective control over how firms were managed. As previously mentioned, on 29th April 2005, the Chinese authorities announced that there would be a gradual market float of nontradable state-owned shares for all domestically listed companies. The reforms undertaken involve a dramatic ownership structure change, by way of an increase in the supply of tradable company shares in the share market as it is rapidly opening up to strategic foreign investment by single-share holding up to 10 percent. At this moment, the reform is still far from the final stage, so this might be a future research direction on the Chinese corporate governance system. The gradual floating of all issued shares and the opening

up of the market to foreign investors creates the potential for an active market for corporate control in China.

Problems of and Suggestions for the Current Corporate Governance Model in China

Seemingly, the Corporate Governance Codes in China provide similar guidelines to those contained in the governance codes issued in many advanced economies in the world. According to these codes in China, the Chinese government should have established a corporate governance system for its listed firms and securities companies, which has similar characteristics to a system in a mature market economy; however, the quality of corporate governance in China remains weak.

For example, Clarke argues that the fundamental dilemma of the SOE reform stems from the state policy of maintaining a full or controlling ownership of companies within several important sectors (2003). Clarke further suggests that the state has a desire that SOEs should be efficient, but wealth maximization is not the sole objective of SOEs; otherwise, there would be no rationale for maintaining state ownership (2003). Claessens and Fan also argue that the issue of the ownership of a firm's value is more complicated when the state is the controlling owner (2002). First, the state is not the ultimate owner, but the agent of the ultimate owners, that is, the citizens. However, the value maximization is not a major incentive for the state because of other political priorities, as well as the corruption that is prevalent in China (Che and Qian 1998; Lin, Cai, and Li 1997; Peng 2001). Second, there are many different types of governmental agencies that control the equity stake of companies. For example, ownership controlled by the central government may have different incentives from ownership controlled by local or regional governments, or state institution ownership. Third, it is hard to identify the relationship between state ownership and firm performance, particularly in socialist countries, such as China, because other institutional structures must also be taken into account. Faccio reported that companies with stronger links to the government have higher leverage, lower taxation, and higher market shares, but they underperform compared with no politically connected companies based on accounting measures

(2006). Furthermore, Faccio points out that this phenomenon is more popular in countries with higher levels of corruption, with barriers to foreign investment, and with less transparent systems (2006).

In addition, several key problems in the Chinese corporate governance system are well documented (Allen, Qian, and Qian 2005; Clarke 2006; Hovey, Li, and Naughton 2003; Lin 2004). The first is the highly concentrated ownership structure. Companies with a widely dispersed ownership structure where no individual owns a controlling block of shares are virtually nonexistent (Clarke 2006). Despite the fact that private blockholders own controlling blocks of shares in China, the findings of Hess, Gunasekarage, and Hovey (2010) indicate that expropriation of minority investors does exist. Market liquidity is severely impeded because the state and legal person shares cannot be traded on the stock market because of trading restrictions, resulting in only approximately 35 percent of total shares being freely tradable. This has significantly reduced market liquidity and has become a major obstacle to market efficiency. In addition, those large investors may only act in their own interests at the expense of individual investors, suggesting individual shareholders' interests are not well protected, irrespective of whether blockholders are state or private-sector investors.

The second set of problems is from insider trading, self-dealings, collusion, and market manipulation, although the Chinese government has policies against these activities (Tam 2002). The major reason for the occurrence of these issues is the absence of effective monitoring from companies by their directors and supervisory boards and from the market by regulatory authorities. Moreover, to attract outside investors, companies were found to provide falsified financial information to the public in order to hide their inefficiency and mismanagement, and those companies, without doubt, severely damaged the reputation of the Chinese stock market.

The third major problem is the dysfunction of the board of directors, board of supervisors, and other relevant committees (Schipani and Liu 2002; Tam 2002). By law, large shareholders have more power over directors' appointments due to the one-share one-vote principle, and it is hard to see that directors represent minority shareholders' interests even though the LC Code requires recognition of minority interests for

appointment (Clarke 2006). One of the major reasons is that politicians and state-controlling owners sit on most boards and committees because of the highly concentrated ownership structure. As a result, these boards and committees are lacking in independency. Chen, Fan, and Wong reported that approximately 80 percent of directors on Chinese boards are closely connected to the government or governmental agencies, and only a few are professionals (lawyer, accountants, or finance experts) (2002). The likelihood that a director is concerned with or represents minority shareholders is very small. Moreover, Clarke (2006) claims that supervisory boards lack the power to supervise directors and the management team, and play no important role in corporate governance in China.

To solve these problems, a number of suggestions have been proposed by researchers (Allen et al. 2007; Clarke 2006; Lin 2004). Generally speaking, a well-discussed suggestion is to make the nontradable shares tradable. The limitations of large blocks of nontradable shares have been well documented, and the Chinese authorities have previously attempted to resolve this problem in 1999 and 2001. However, these two attempts did not receive a positive market response as the proposals were not attractive to tradable shareholders. In 2005, the Chinese authorities made the third attempt to introduce a program of gradual floatation of nontradable shares for all domestically listed companies. As a result, more than 1,500 listed companies were involved and each company was required to provide a compensation package for existing tradable shareholders, which comprises flexible combinations of cash, warrants, and bonus shares, and is approved by the general shareholders' meeting. While the bulk of state and legal person shares are now technically tradable, there are restrictions in place on the quantity that can be traded for several more years. This ongoing reform will have an extensive impact on the investment community and financial system in China in the long run.

Second, the functions of boards of directors and supervisors have to be clearly defined, strengthened, and made more independent. To improve the quality of the board's operations, more professional or independent directors and supervisors are required to sit on boards, and minority shareholders' interests should be explicitly considered during the process of director appointment. There is also a need to strengthen and enforce

requirements to operate specialized committees of boards of directors, such as corporate strategy committee, nomination committee, remuneration committee, and auditing committee. The LC Code is weak in this respect, and the legal and regulatory systems must be given greater powers of enforcement. All these committees should be composed entirely of independent directors. Moreover, a more clearly defined performance-related compensation mechanism should be implemented for directors and supervisors.

Third, as observed previously, China needs to have well-functioning investor protection laws and more efficient legal enforcement systems. The enforcement of laws and regulations must be effective enough to deter irregularities in China. More specified explanations of laws and regulations should be implemented to minimize the legal *gray area*. From the corporate governance perspective, the major concern is to monitor the expropriation of the investors by senior managers. Therefore, managers also should be properly motivated instead of expropriating investors by entrenching themselves by staying in their position even though they are not qualified for the job or are no longer effective.

Fourth, there is a need to provide better protection for the interests of individual investors and enforce their rights. Several approaches need to be introduced: (1) enhancing shareholders' voting mechanisms, (2) entitling shareholders to question the company's business operations, (3) lowering the minimum required number of shares for the shareholders to raise proposals, (4) safeguarding the interests of minority shareholders, and (5) increasing the legal obligation of controlling shareholders (Lin 2004).

The Chinese government appears to have realized the existing flaws in the current corporate governance system and has implemented several policies to improve the market efficiency and the overall quality of public companies in China. Although there are many laws and regulations governing the corporate behavior of companies, further attention should be paid to the political or legal will and efficiency and transparency of legal enforcement. Evolution in the corporate governance in China provides a framework for corporate governance experiments. We argue that China has undergone considerable corporate governance evolution but has yet to establish a unifying system that balances socioeconomic forces with

the economy. China has a unique environment and the evolution of corporate management, supervision, and governance is likely to continue to develop into a uniquely Chinese system. China has the opportunity to capture best international practice while controlling the excesses of the existing internal weaknesses.

CHAPTER 4

Internal Corporate Governance Mechanisms

Boards of Directors

Board Structure and Composition

In developed economies, two broad types of governance structure can be distinguished (Shleifer and Vishny 1997). One is the *insider* or *neo-corporatist model*, such as the Japanese–Germanic model, which relies on large institutional stakeholders such as banks for effective governance. The other is the *outsider* or *neoliberal model*, such as the Anglo-American model, which relies on capital market discipline and the legal system. China should not try to copy microlevel corporate governance models from developed countries, whether neoliberal or neocorporatist. Nevertheless, it is argued that for former state-owned enterprises (SOEs) a neocorporatist approach to the structure and composition of the board of directors, with a two-tier board structure, may have advantages over a neoliberal approach with a single board, particularly when external monitoring devices, such as the stock market, are not well developed.

The two-tier board system of corporate governance, which is common in the European countries, is highly appreciated by the Chinese and is regarded as a means of enhancing internal unity and performance of companies. China has adopted this system since 1994 for publicly listed companies. The Chinese practice, however, is somewhat different from that followed in Europe.

Specifically, the Company Law of China revised in 2005 outlines that Chinese listed companies are required to have a two-tier board structure, including a board of directors and a board of supervisors. These

two boards, general shareholders' meeting, and management altogether form the current corporate governance framework of listed companies in China (OECD 2011). The Chinese two-tier board structure is analogous to the German model, in which the management board makes decisions on day-to-day operations and the supervisory board oversees the management board and approves major business decisions. In spite of having a two-tier board structure, the Chinese board is actually more similar to the one-tier board in the United States. The Chinese supervisory board is notably much smaller than the German one. The boards of supervisors in China do not have the authority to select or dismiss board directors or the management, and they often lack the knowledge and experience to effectively supervise the directors and the management (Kang, Shi, and Brown 2008).

Concerning general shareholders' meetings in China, the Company Law empowers the general meeting of shareholders to be the ultimate decision-making entity for a corporation. Its functions include deciding policies on the business operations and investment plans of the company, reviewing and approving the annual financial budget, the final accounts, and the plan of profits' distribution; and deciding on the increase or reduction of the registered capital of the company and the issuance of debentures by the company. This differs from the normal functions of a shareholders' meeting in European countries, such as passing resolutions on mergers, division, dissolution, and liquidation; electing and removing directors and supervisors; and amending the articles of association of the company. According to Article 101 of the Company Law, the general meeting of shareholders is required to be held once a year except under the following special circumstances, when a temporary meeting must be called within two months (Kang, Shi, and Brown 2008): (1) when the number of board directors is fewer than two-thirds required by law or the company bylaw, (2) when the uncompensated losses of the company exceed one-third of the actual capital at the request of the shareholders separately or collectively holding 10 percent or more of the company's shares, (3) when deemed necessary by the board of directors or supervisory board, and (4) in other situations specified by the company bylaw.

A shareholders' general meeting is convened and presided over by the chair of the board of directors, which has a wider range of decision-making

powers on financial matters, such as deciding policies on the business operation and investment plan of the company; reviewing and approving the annual financial budget, the final accounts, and the plan of profits' distribution; and deciding on the increase or reduction of the registered capital of the company and the issuance of debentures by the company. The board of directors is responsible for the meeting agenda. Article 103 of the Company Law provides that shareholders individually or jointly holding 3 percent of the shares of the company may—10 days prior to the general shareholders' meetings—submit a written proposal to the board of directors (OECD 2011). However, some commentators have suggested that the threshold is too high for small and medium investors to make their voices heard in the shareholders' meeting (Kang, Shi, and Brown 2008). The principle of one share, one vote is included in the 1994 Chinese Company Law. Regarding the voting rights attached to different shares, there are different practices in Western countries. The Chinese remain silent on whether companies can issue nonvoting shares or preferential shares and leave room for issuing special kinds of shares, if necessary; but one of the legislative defects in China is that it fails to stipulate the quorum of shareholders at shareholders' meetings and the minimum holdings of shareholders. Therefore, theoretically, a shareholders' meeting can be held with any number of shareholders holding only one share. The state, even if it is only a minority shareholder, can take part in shareholders' meetings and become involved in the decision-making process.

Article 104 of the Company Law promulgates that the general decision rule of the meeting is one share, one vote. In order to be adopted, a resolution has to win at least half of the voting rights at the meeting. For important issues, such as modifying the company's bylaws, mergers and acquisitions, and divestitures, a supermajority of two-thirds of the voting rights is required (Kang, Shi, and Brown 2008; OECD 2011). Furthermore, according to Article 106, which is a major revision in the 2005 Company Law, a company may adopt an accumulative voting system during the shareholders' meeting, in selecting board directors and supervisors. Also, in terms of Article 107, which is another major revision of the 2005 Company Law dealing with proxy voting, shareholders can now entrust proxies to attend the general meeting and exercise their voting rights under authorization. Proxy voting can help dispersed minority

investors to act collectively, and to have their voices heard. However, the law does not specify how proxy voting should be implemented and monitored (Kang, Shi, and Brown 2008; OECD 2011). However, Kang, Shi, and Brown suggest that attendance at general meetings of shareholders in China has traditionally been very low, and dominated by the controlling shareholders; they also posit that most individual shareholders choose not to attend the general meetings because they feel their votes have very limited influence on companies' decisions and that the high costs in transportation and time are not justified (2008).

Concerning the board of directors, it plays a vital role in corporate governance structure and mechanism. The OECD Principles of Corporate Governance states the responsibilities of the board: "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders" (2004). Therefore, the board of directors is mainly responsible for advising and monitoring managers on behalf of shareholders, in order that shareholders can affect managers' behavior to align the firm's interests with shareholders' value. Specifically, the advising function implies that the board can help the management make efficient decisions concerning the strategic and operational directions of the company, whereas the monitoring function ensures that the management is acting diligently in the shareholders' interests (Larcker and Tayan 2011).

In China, the board of directors is the de facto authority of decision making, and the chairman of the board is normally the most powerful person in all firm decisions. The chair often surpasses the chief executive officer (CEO) and other senior executives to engage in daily management (Kang, Shi, and Brown 2008). Both, the Code on Corporate Governance for Listed Companies issued in 2002 and the Company Law of 2003, explicitly emphasize the duty of loyalty and diligence of the directors to shareholders. If a director violates the law, a regulation, or the company's bylaws and impairs shareholders' interest by doing so, shareholders can sue the director in court and ask for compensation (Article 153 of the Company Law). Nevertheless, the monitoring role of boards of directors is questionable in China, based on the fact that they are often dominated by representatives from parent companies, by party secretaries or government

officials, or both (Kang, Shi, and Brown 2008). The quality of the board is also low. Chen, Fan, and Wong examined the boards of directors of 621 companies from 1993 to 2000 and found out that approximately 52 percent of the directors were former or current employees of the largest shareholders and that roughly 32 percent were current or former government bureaucrats (2002). Directors with professional backgrounds, such as in law, accounting, and finance, are rare, accounting for only 5 percent of board members on average (Kang, Shi, and Brown 2008).

However, whether the board of directors behaves effectively is closely related to its structural attributes. The board structure in China generally consists of board size, board leadership, independent directors, and board committee structure—that is, board subcommittees (Guo, Smallman, and Radford 2013; Larcker and Tayan 2011). Thus, in this chapter, we first examine these four important structural attributes and then investigate the board of supervisors in China, identifying which attribute(s) can contribute to the effectiveness of the current corporate governance framework in China.

Research on board size in China has been well documented, based on the fact that board size can affect the effectiveness of both advising and monitoring functions of the board and therefore the performance of companies. The revised Company Law of 2005 stipulates that the board of directors in China should have between 5 and 19 members; however, the empirical findings on board size in China are inconclusive. For example, Yu (2001) and Zheng (2004) find no significant relation between board size and firm performance in Chinese listed firms. Yu and Chi (2004) and Qu (2007) suggest that there is a reverse U-shaped relation between board size and firm performance in listed companies in China. Wei and Zhengfei (2008) find out that there is a positive relation between board size and accounting information transparency, although Sun and Zhang (2000) implies that there is a negative relation between board size and firm performance.

Board Leadership

One of the most important structural attributes affecting the effectiveness of the board of directors and organizational performance is board

leadership. The central point of board leadership usually refers to the same person holding the positions of both the board chairman and the CEO. We refer to *CEO duality* when one person serves as both a firm's CEO and the board chairman. Agency theory suggests that CEO duality could fail to fulfill the separation between decision management and decision control, may constrain board independence, put the board in a less powerful position relative to that of the CEO and therefore impair the board's effectiveness in executing its oversight and governance roles (Daily and Schwenk 1996, Fama and Jensen 1983, Finkelstein and D'Aveni 1994). Jensen implies that it is difficult for the board to implement its monitoring function without an independent leadership (1994). MacAvoy and Millstein stress the evidence that the failure of independent board leadership could bring about challenges associated with directors' duty of good faith (2004).

In China, however, to date, neither the Company Law nor the regulations issued by the China Securities Regulatory Commission (CSRC) have included any stipulation about whether the chairman can also hold the position of CEO. CEO duality is usually taken as a crucial obstacle that affects the board effectiveness and firm performance in China. However, the empirical evidence shows that the effect of CEO duality on firm performance is inconclusive. For example, Bai et al. find that there is a negative relation between CEO duality and firm performance (2004). Kato and Long indicate that CEO duality decreases the probability of CEO turnover (2006). However, Tian and Lau suggest that there is a positive effect of CEO duality on firm performance (2001). Indeed, whether such a single board factor, that is, CEO duality, has a positive effect on firm performance or not, hinges on the type of ownership. Specifically, Peng et al. have investigated the effect of both CEO duality and organizational slack on performance of the firms with distinct ownership types, concluding that CEO duality is negatively related to SOEs' performance, but positively related to private-owned enterprises' performance (2010).

Independent Directors

Another important structural attribute is the proportion of independent directors in the boardroom. An independent director is a director who

holds no other position than that of independent company director. The independent director has no relations that prevent him or her from making an independent and objective judgment, thereby improving the level of the company's corporate governance and offering better protection for minority investors (OECD 2011). The CSRC issued Guidelines on the Establishment of the System of Independent Directors in Listed Companies in 2001, in which all publicly listed firms should not only have a third of board members as independent directors, but also ensure that independent directors have enough time and energy to effectively perform their duties (OECD 2011). Furthermore, the CSRC issued the Code of Corporate Governance for Listed Companies—the first of corporate governance codes in China, in 2002—emphasizing the independence and responsibility of independent directors. For example, the Code implies that independent directors should be independent of their employer and the company's main shareholders, and thus perform their responsibilities and duties independently; also, the independent directors should bear the duties of good faith and due diligence toward the listed company, protect the interests of minority shareholders, and not subject themselves to the influence of the company-related entities (Guo, Smallman, and Radford 2013; OECD 2011). Thus, the revised Company Law of 2005 turned the 2002 CSRC requirement of independent directors into a legal necessity (Kang, Shi, and Brown 2008).

As a result, the independent director system in China can be taken as a complement to the board of supervisors, because of the fact that the independent directors are able to effectively monitor management, by eligibly voting on managerial and financial decisions related to listed companies' merger and acquisition activities, related party transactions, major investments, information disclosure, and financial statements (Yang, Chi, and Young 2011). Thus, from a theoretical perspective, a high proportion of independent directors in the boardroom alleviates the agency problem, that is, the conflict of interest between managers and shareholders, and implies good shareholder protection. However, from a practical perspective, empirical evidence on whether independent directors are an effective corporate governance mechanism in China is mixed.

Some studies find the positive effect of independent director on the quality of corporate governance in China. Peng investigates 405 Chinese

listed companies from 1992 to 1996 and finds that outside directors were related to improved organization performance measured by sales growth (2004). Kato and Long (2006) find that the introduction of independent directors can improve the linkage between stock return and CEO turnover, enhancing the disciplinary functions of the stock market, whereas Cho and Rui (2009) indicate that there is a positive relationship between the proportion of independent directors on the board and firm performance, by examining 4,623 firm-year observations for Chinese listed companies from 1999 to 2003. Lo et al. (2010) suggest that firms with more independent directors and with a separation between the roles of CEO and chairman are less likely to engage in transfer pricing manipulations, and Conyon and He (2011) find out that companies with more independent directors on the board have a higher pay-for-performance link and are more likely to replace the CEO for poor performance.

Other studies, however, suggest that the real effect of independent directors on corporate governance was questionable. For example, Qiu and Yao (2009) find out that there is no positive relationship between independent directors and firm's performance before or after the non-tradable share reform, whereas Tian and Lau (2001) find no significant relationship between the proportion of independent directors and firm's performance in Chinese listed companies. Furthermore, because of weak corporate governance in China, there are some unique phenomena within China's listed companies. For example, Guo, Smallman, and Radford suggest that many independent directors in China's listed firms built their careers at SOEs in China and have not internalized the need for the effectiveness of board control, as a result of which an increase in independent directors cannot influence the effectiveness of the board (2013). Liao, Young, and Sun (2009a) find out that 13.9 percent of independent directors are politically connected; they also imply that, except for the firms whose board sizes have already been assessed as too large, Chinese listed firms tend to increase independent directors by adding extra members in the boardroom instead of removing inside directors (2009b). Kang, Shi, and Brown (2008) suggest that qualified independent directors were a scarce resource in China. By May 2003, it was reported that only 62 percent of listed companies met this requirement. The proportion of independent directors has significantly increased since

then, but it remains doubtful how well they represent the interests of minority shareholders and how much influence they may have on the management and other directors of the board.

Board Subcommittees

The Code of Corporate Governance of Listed Companies of 2002 issued by the CSRC stipulates that the board of directors in a listed company may set up special committees, such as auditing committee, nomination committee, and remuneration and appraisal committee, in terms of the resolution of the general shareholders' meeting. These special committees are not only in charge of the daily operations and decisions in comparatively independent fields, but also offer consultation services and advice to the board on important matters in the field (OECD 2011). The Code also implies that the special committee system, to a large extent, is the extension of the independent director system, which is used to improve the independence and effectiveness of the board's operations as well as to control risks. Independent directors should chair these specialized committees, should account for more than half of all committee members in each committee, and should act as conveners at these committees (OECD 2011). However, the companies listed in China are not required to establish these committees unless they choose to list their shares on foreign exchanges that require them (such as the New York Stock Exchange [NYSE]).

The *audit committee* is responsible for the accuracy of corporate financial information and other relevant matters of the company. In audit committees, at least one independent director should hold an accounting background. According to the Code, the main duties of the audit committee include (1) recommending the engagement or replacement of the company's external auditing institutions, (2) reviewing the internal audit system and its implementation, (3) overseeing the interaction between the company's internal and external auditing institutions, (4) inspecting the company's financial information and its disclosure, and (5) monitoring the company's internal control system (OECD 2011).

The *nomination committee* is responsible for identifying, evaluating, and nominating new directors and for taking charge of leading the

managers' succession-planning process. The main duties of the nomination committee include (1) studying the standards and procedures for the election of directors and managers and for making suggestions, (2) seeking qualified candidates for new directors and managers, and (3) reviewing the candidates and making recommendations.

The *remuneration and appraisal committee* is responsible for setting and assessing the remuneration of managers and for advising managers on the remuneration of other senior executives. The main duties of this committee include (1) studying the appraisal standard for directors and management personnel, (2) conducting an appraisal and making recommendations, and (3) studying and reviewing the remuneration policies and schemes for directors and senior managers.

Despite having relatively complete stipulations on board subcommittees in China, there are only a few empirical studies about these committees, reflecting the gap between their stipulations and their actual practices. Existing studies on these specialized committees mainly involve research on the audit committees. For example, Lin, Xiao, and Tang conducted a survey to examine the perceptions of the roles, responsibilities, and basic characteristics of audit committees in China, finding that the roles and duties of audit committees have been generally accepted by their respondents, but its actual operations in practice are ineffective even if the majority of the listed firms in China have established audit committees (2008). Chambers compares the practice, rules, and enforcement of audit committees in the United Kingdom and China, implying that enforcement by regulators cannot be weaker in China than in the United Kingdom (2005). Lin, Hutchinson, and Percy investigate to what extent the audit committee in China can be independent based on the top 50 Chinese companies listed in Hong Kong from 2006 to 2007 (2009). They find that 67.4 percent of the examined companies have at least one government officer on the audit committee, showing that these companies are more likely to be aligned with the state by these government officers. Concerning research on the remuneration and appraisal committee in China, Zhu, Tian, and Ma investigate the effect of a compensation committee on the CEO pay–performance relationship in Chinese listed companies, finding that a stronger relationship between them is present in the companies that have a compensation committee (2009).

Board of Supervisors

Unlike the corporate governance structure in the Anglo-American system, Chinese listed companies have a board of supervisors other than a board of directors. According to the Chinese Company Law, the board of supervisors for Chinese listed companies is required to have at least three members, one-third of whom should represent employees, and at least one should represent shareholders. Moreover, to ensure the independence of the board of supervisors, no members of the board of directors or management are allowed to serve on the supervisory board.

The revised Company Law of 2005 has extended the functions and power of the supervisory board; the main role of the board is to implement the comprehensive supervision of the company's operations and management. Its duties are to (1) inspect the company's financial status, supervise the performance of duty by directors and senior executives, and propose to remove from office any director or senior executive who has violated the law, regulations, articles of association, or resolution of the shareholders' meeting; (2) request directors and senior executives to rectify their behavior when it undermines company interest, initiating ad hoc shareholders' meetings; (3) convene and preside over shareholders' meetings when the board of directors fails to do so; and (4) draft resolutions for the shareholders' meetings and file suit against directors and senior executives under certain conditions (OECD 2011). The board has powers to supervise the work of the directors and managers and to propose the holding of interim shareholders' meetings. In developed countries, Germany for example, supervisory board members include representatives of large institutional shareholders, such as banks that provide share capital as well as loans to companies. However, in China, independent institutional investors, including banks, are rare and they have not traditionally played this monitoring role in the system. Further, there is a lack of provision for implementing the powers and duties; for instance, there are no provisions concerning rules of procedure, rules of voting, and rules of proposing and holding meetings of the supervisory board. Moreover, the board usually consists of quite a few government appointees who play a leading role in monitoring, although in Germany, government representatives on supervisory boards play a secondary role

to that of private shareholders in monitoring. Therefore, in China, the supervisory function of the supervisory board in terms of monitoring management and reducing agency costs is very limited. The Company Law confers supervisory powers to supervisors, but does not describe how to exercise that power, or clarify the liabilities of supervisors if there is a breach of duty. In a country like China where awareness of shareholders' rights is not well developed among the general public, it is even more important to provide a means of enhancing the supervisory capacity of the supervisory board.

In addition, the related literature has consistently denoted the inefficiency of the performance of the board of supervisors in China. For example, Dahya et al. examine the usefulness of the supervisory board report in China, by both an event study and interviews with directors, supervisory board members, and senior managers of 16 listed companies (2003). They find that the supervisory board is important and that its usefulness hinges on whether the board of supervisors is independent. They also suggest that there is a strong need to strengthen corporate governance and control based on the current economic environment in China and therefore to improve the usefulness of the supervisory board. Xiao, Dahya, and Lin investigate the role of the supervisory board in Chinese listed firms through a series of interviews (2004). Based on the majority of their sample, they suggest that supervisors are considered as honored guests, friendly advisors, or censored watchdogs. They conclude that the inefficient performance of the supervisory board can be attributed to some factors, including the strong influence of the government, the inadequate legal stipulation on its rights and duties, and the biased power relations between the board of directors and the supervisory board. Hu, Tam, and Tan suggest that the supervisory board in China lacks independence, based on the fact that supervisory board must include shareholder and employee representatives (2010). Kang, Shi, and Brown indicate that the supervisory board in China has not yet played a significant and effective governance role, based on the fact that the overwhelming governmental dominance of Chinese boards of directors is caused by ownership concentration (2008). Yang, Chi, and Young imply that Chinese supervisory boards are more of a decorative feature than an effective committee (2011).

Ownership and Control of Listed Companies

Ownership Concentration

Since the building of Chinese stock markets in the early 1990s, its listed companies have issued three types of shares: those held by the state, those held by founders and employees, and those held by the public; the first two of which belong to nontradable shares, and the last of which belongs to tradable shares. Such a partition is based on the idea that the state expects to maintain control of most listed firms. Shares held by the public fall into three categories: A-shares, B-shares, and H-shares. A-shares trade on both the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), denominated in Chinese yuan. Its ownership is restricted to domestic investors. B-shares also trade on the Shanghai and Shenzhen markets, but are denominated in U.S. dollars. H-shares trade on the Hong Kong Stock Exchange, denominated in Hong Kong dollars, which are available to foreign investors.

As of April 2005, before the beginning of nontradable share reform, approximately two-thirds of shares were issued by the nontradable type (Li, Shen, and Su 2011). There are two major categories of nontradable shares: state-owned shares and *legal-person* shares. On average, a typical listed company in China has 30 percent of state-owned shares, 30 percent of *legal-person* shares, and 40 percent of individual shares (Fan, Lau, Yong 2007). The state-owned shares are usually owned by the state (both central and local governments) and their agencies. Even if *legal persons* are referred to as enterprises or economic entities with a legal status, most of the owners of legal person shares are enterprises or institutions ultimately controlled by the central government or a local government, showing the complexity of legal person share arrangements (Chen, Firth, and Xu 2009). Liu and Sun find that 81.6 percent of all shares of listed firms were ultimately owned by the state at the end of 2001, 9 percent of which were directly held by the government, whereas the other 72.6 percent were indirectly controlled by the government through pyramid stock holdings (2005). A 2007 annual report from SHSE displays that 65 percent of the listed companies are SOEs (Liu 2008).

Agency theory suggests that there are two types of conflicts of interest in corporate governance, one of which is between management and

shareholders, and the other between majority and minority shareholders. These two types are displayed in distinct ways with different ownership structures. Generally, when ownership is spread among many shareholders, the conflict of interest between management and shareholders is more prominent; whereas, when the ownership is relatively more concentrated, the conflict of interest between majority and minority shareholders becomes comparatively more prominent. OECD suggests that even though the level of ownership concentration shrank after the 2005 nontradable share reform of the capital market, Chinese listed companies show a high ownership concentration levels in comparison with those in the United States and the United Kingdom (2011). As a result, conflict of interest between majority (controlling) and minority shareholders is the major problem in Chinese corporate governance. Managers in Chinese listed companies with concentrated ownership are usually appointed by controlling shareholders and thus represent the interests of controlling shareholders. Zou et al. suggest that this major conflict of interest was exacerbated in China, due to the fact that the shares of listed firms were split into nontradable shares held by controlling shareholders and tradable shares held by minority shareholders (2008).

The existing studies have been well archived on investigating the effect of concentrated ownership structures on the performance of Chinese listed companies and other important corporate factors. For example, Kang, Shi, and Brown suggest that the dominant state shareholder tends to divert resources from the jointly owned company, showing an important negative impact from state ownership concentration (2008). Liu and Sun also find that partially listed firms in China tend to underperform against its wholly listed firms (2005). Liu and Lu investigate the relation between earnings management and corporate governance in China's listed firms by introducing a tunneling perspective, and find a nonlinear relationship between the largest shareholder's holdings and firms' earnings management behavior (2007). Specifically, they suggest that the largest shareholder's opportunistic behavior increases as their interest in the company increases. However, when such a holding reaches a certain level, the incentive to divert the firm's wealth may lessen, since the net gain of *tunneling* is no longer significant. Based on a sample of 461 public listed manufacturing firms in China from 1999 to 2002, Lin, Ma, and Su

investigate whether and to what degree various distinct corporate governance practices affect productive efficiency, finding that firm efficiency is negatively related to state ownership, and that the relationship between ownership concentration and firm efficiency is U-shaped (2009). Qiu and Yao (2009) also show that there is a U-shaped relationship between a firm's value and its largest shareholder's holding, whereas Chen, Firth, and Xu (2009) document an alignment effect where higher ownership of the dominant shareholder is associated with better firm performance.

Some studies imply that there is a positive relationship between noncontrolling shareholders' holdings on firm valuation and other important corporate factors. For instance, Berkman, Cole, and Fu identify and analyze a sample of publicly traded Chinese companies that issued loan guarantees to the controlling blockholders, finding out that noncontrolling blockholders (ranked from the second to the 10th largest shareholders) have the strongest incentives to monitor the controlling blockholder and prevent tunneling (2009). Qiu and Yao find that there is a positive relationship between the shareholding of noncontrolling blockholders and the firm performance (2009). This empirical evidence is in accordance with the literature that suggests dispersed ownership can alleviate the agency conflict between controlling and minority shareholders.

Other studies investigate the effect of shareholdings of managers in China. Most of them find it has a positive effect on various corporate factors, suggesting that managerial shareholdings are taken as an effective corporate governance instrument. For example, Li et al. investigate the relationship between managerial ownership and firm performance for a sample of Chinese SOEs privatized over the period 1992 to 2000, indicating that managerial ownership has a positive effect on firm performance (2007b). Gao and Kling (2008) find that managers' shareholdings are an effective governance mechanism for mitigating tunneling activities, despite the small economic significance, whereas Yang, Chi, and Young (2011) suggest that even though managerial shareholdings have been widely referred to as a useful corporate governance mechanism in Western nations, the positive effect of managerial shareholdings in China is limited, given their small magnitude in China and the strong connections between firm management and the controlling shareholder, that is, the state.

Types of Investors and Typical Dominant Owners

In China, there are different types of investors, including individual investors, institutional investors, foreign investors, and state-owned investors. *Individual* investors in China generally do not have enough knowledge or experience to assess companies' management, which indicates that it is often hard for them to act collectively and exert significant force on corporate governance issues. Moreover, individual investors' interests are poorly guarded and often expropriated by controlling shareholders and management (Kang, Shi, and Brown 2008). Individual investors usually ended up engaging in speculative behavior rather than in investment behavior. In spite of the fact that the Company Law in China has had a far-reaching impact on corporate governance and the economy as a whole, state shareholders still enjoy overwhelming favoritism over individual investors. Because of the weak governance system in China, individual shareholders choose not to attend the general meetings because they feel their votes have very limited influence on companies' decisions. However, the revised Company Law of 2005 has stipulated the related legislation aimed at balancing the power asymmetry between state shareholders and individual shareholders in companies.

Institutional investors play a crucial role in corporate governance, based on the fact that they typically have highly trained research and management teams that are better able to monitor and communicate with corporate management. In China, institutional investors started to emerge in the late 1990s: the first closed-end fund[*] was established in 1997, and the first open-ended fund[†] was set up in 2001 (Allen et al. 2012). As blockholders of stocks, institutional investors in China can exert great influence on corporate governance and management by sponsoring shareholder initiatives and by playing a role in the takeover voting processes in some firms (Kang, Shi, and Brown 2008). Institutional investors in China usually consist of securities investment funds, insurance companies, pension funds, securities companies, and commercial banks (Xi 2006).

* The first closed-end fund is the fund from which investors cannot withdraw capital after initial investment.

† The open-end fund is the fund from which investors can freely withdraw capital under share redemption restrictions.

In the last decade, the percentage of tradable shares in listed firms of China owned by institutional shareholders has drastically increased, from 4.9 percent in 2001 to 54.62 percent in 2009, mainly due to two reasons: (1) governmental facilitation of the development of investment banks and (2) nontradable shares being gradually transferred to tradable shares since 2005 (Gong 2011). By November 2009, there were 65 fund companies, which managed 551 funds with 520 open-ended funds and the remaining 31 being close-ended. The total net asset value expanded from RMB 11 billion (or US$1.3 billion) in 1998 to RMB 2.26 trillion (or US$328 billion) in November 2009 (Allen et al. 2012).

Foreign investors in China are mainly involved in the Qualified Foreign Institutional Investors (QFII), which is a program that was launched in 2002 to allow licensed foreign investors to buy and sell A-shares denominated in Chinese currency in China's mainland stock exchanges; that is, SHSE and SZSE. In 2003, a few QFIIs, which have been operating through joint ventures with Chinese companies, entered China's asset management industry (Allen et al. 2012). By the end of April 2011, 103 QFII investors with licenses had been granted a combined quota of US$20.7 billion to invest in China's capital markets under the QFII program. UBS AG currently holds the greatest single share of the quota. However, foreign access to China's A-shares is still limited, with quotas placed under the QFII program amounting to US$30 billion. In April 2012, there was an increase in the QFII quota from US$30 billion to US$80 billion. In March 2013, China granted US$910 million worth of investment quotas to 11 foreign institutional investors. By the end of March 2013, China had awarded a combined US$41.745 billion of QFII quotas to 197 foreign institutions.

The typical dominant owners are *state-owned investors*. Since most large companies in China are transformed from original SOEs, the state still holds the majority shares after the corporatization of Chinese SOEs, which means that the state plays a dominant role in most Chinese listed companies and thus in controlling the shareholders.

Shareholder Activism

Shareholder activism refers to the active influence by the use of ownership position on company policy and behavior, which can be achieved

through direct dialogue with corporate management or the board, attending open sessions in corporate general meetings, writing open letters, or filing formal shareholder proposals (Sjöström 2008). Shareholders conducting activism can be a single minority investor, a blockholder, or institutional investors with majority stakes in the organization (Judge, Gaur, and Muller-Kahle 2010). These institutional investors are usually pension funds, mutual funds, and hedge funds. Labor unions and labor-affiliated organizations and sovereign wealth funds can also act as shareholder activists (Ghahramani 2013; Prevost, Rao, and Williams 2012).

There are two types of shareholder activism—*defensive* and *offensive* (Armour and Cheffins 2012). Investors holding a stake in a company take a defensive stance when they are dissatisfied with corporate performance or corporate governance practices; this stance can be taken through the election of directors they support, in order to protect their pre-existing investment. Otherwise, investors take an offensive approach when they lack a substantial stake in a firm, and thus build up their holdings, based on their view that, after their active behavior, organizational changes will overcome failures, and thus maximize shareholder returns. The incentive behind shareholder activism can be driven in a social or financial manner (Judge, Gaur, and Muller-Kahle 2010). Socially motivated activism usually involves its activists seeking more justice in society, which consists of the shareholder community or nonprofit nongovernmental groups including religious, environmental, labor organizations, and interest groups pursuing social issues for principle-based purposes (Chung and Talaulicar 2010). Financially driven activism usually involves entrepreneurs as activists, which may include individual investors, hedge funds, private funds, asset management groups, and venture capital funds. They generally use stock lending or a derivative to obtain voting rights without the need to own a long position in the firm's underlying stock (Klein and Zur 2009).

Shareholder activism in China mainly involved institutional shareholders as activists. Although there is an unprecedented level of institutional shareholder activism in China, institutional shareholder involvement in China is relatively passive, compared with developed economies such as the United Kingdom and the United States. Some studies suggest that certain factors have been identified as barriers to the expansion of Chinese institutional shareholder activism. For example, Xi identifies various

factors that are responsible for generating the characteristic passivity of Chinese institutions, including the ownership structure, self-interest of institutional investors, the conflict of interest faced by institutions, collective action problems, and legal and regulatory rules (2006). Specifically, he emphasizes the concentrated ownership structure of Chinese listed firms and immature legal rules such as insider trading rules, shareholding disclosure rules, and cumulative voting rules as the main barriers to a high degree of institutional engagement. Gong implies that such legal barriers will increase the costs of activism and thus decrease the motivation of institutional engagement (2011). Yuan et al. investigate the role of Chinese financial institutions as activists in the corporate governance of listed firms by means of interviews with both senior managers of financial institutions and board directors of listed firms (2009). They find that the factors that limit the role of these institutions are highly concentrated state ownership, an immature regulatory environment, inadequate transparency and disclosure of financial information, and weak corporate governance.

Statutory Audit

Statutory Audit Processes

The modern auditing system in China has evolved over the last two decades. The organizational framework of the Chinese auditing system is made up of government audit institutions, internal audit institutions, and public audit institutions (Cooper, Chow, and Wei 2002). Government auditing is conducted by auditors in the Audit Administration of the People's Republic of China (AAPRC) and by its agencies. Established by the State Council, the AAPRC and its agencies have the independence and authority to audit administrative institutions, public organizations, or individuals. The AAPRC is the highest audit institution in China, and organizes and guides the audit activities for the whole country, implementing auditing that is under its direct jurisdiction. The Audit Law of the People's Republic of China was promulgated by the Ninth Plenary Session of the Standing Committee of the Eighth National People's Congress in the early 1990s (Cooper, Chow, and Wei 2002). The Ministry of Finance (MOF), which was charged with the administration of national accounting affairs under this audit law, has an overlapping of responsibilities with

the AAPRC, which gives rise to some areas of confusion in the development of the profession of public auditing (Tang 2000).

Established in 1988, the Chinese Institute of Certified Public Accountants (CICPA) under the authority of the MOF mainly organizes and supervises accounting and auditing professions in China. CICPA implements general administration for the profession, such as organizing the national qualification examinations. CICPA became a member of the International Federation of Accountants (IFAC) in 1997, and has been an observer on the Board of the International Accounting Standards Committee (IASC) since July 1997 (Bertin and Jaussaud 2003).

As a more efficient response to monitoring foreign funds invested in China at the beginning of reform and openness, the system of certified public accountants (CPA) was established in the early 1980s. Specifically, the Law on Chinese Foreign Equity Joint Ventures initially introduced statutory audit in 1979. Then the Law on Wholly Foreign Owned Enterprises issued in 1986 and the Law on Chinese Foreign Contractual Joint Ventures issued in 1988 extended statutory audit to all kinds of structures receiving foreign capital, where audit reports are mainly addressed to the administrative authorities supervising joint ventures (Bertin and Jaussaud 2003). On the other hand, the Company Law extended statutory audit to limited liability and joint stock limited companies. The Securities Law issued in 1998 then extended legal audit to listed companies issuing bonds and securities firms. Earlier, the Law on Certified Public Accountants was passed in 1994 (Bertin and Jaussaud 2003), and since 1995 the MOF has enacted a number of professional standards. For example, the Chinese Independent Auditing Standards (CIAS), which is designed on the basis of the International Standards on Auditing (ISA) promulgated by IFAC, was released in 1995. The new standards, which are largely in line with international standards, were issued in two batches—that is, the first effective from January 1, 1996, and the second effective from January 1, 1997 (Lin and Chan 2000). Xiao, Zhang, and Xie attempt to identify various factors motivating the setting up of CIAS, finding that the main reason is that the previous auditing standards and procedures that were voluntary-based did not accomplish their objectives (2000). They also identify some major characteristics of the Chinese audit market, such as the lack of audit independence, the shortage of well-qualified auditors, an environment of extensive corruption, and the existence of

many misconceptions about the audit, suggesting that these features would largely hinder the further development of the Chinese audit profession. Cooper, Chow, and Wei investigate the early development of the Chinese auditing standards, finding that the major issues that have yet to be resolved are related to professional competence, independence, ethical standards, and auditing practice, even though the auditing standards are up to international practice standards (2002).

Lin and Chan investigate the framework of CIAS and draw a comparison between CIAS and the technical pronouncements issued by IFAC; they find that the Chinese audit standards are highly analogous to international standards and guidelines, with some important additional dimensions (2000). Despite the existence of the differences between the then CIAS and IFAC identified by Lin and Chan (2000), recent efforts have been made to bring CIAS into greater convergence with ISA. For example, the Chinese Auditing Standards Board (CASB)* and the International Auditing and Assurance Standards Board promulgated a joint statement, showing that the fundamental principle of drafting Chinese auditing standards is to ameliorate the Chinese auditing system and to facilitate its convergence with the ISA (Simnett and Sylph 2006).

In addition, in 2006, MOF released a new 48-point auditing standards system—China Auditing Standards—for CPA toward all domestic accounting firms. Based on the structure of international auditing standards, these new auditing standards cover almost all its items, including the auditing objective and principle, evaluation and risk management, access to auditing evidence and evidence analysis, and drafting and reporting auditing conclusions, as well as formulation of professional responsibilities. Furthermore, these new standards adopt all the basic principles and core procedures of the international auditing standards, showing their substantial convergence with international auditing standards (OECD 2011).

Chinese GAAP Versus IFRS

Each country has its own specific accounting standards, which brings difficulties when comparing them. To improve this situation, the

* Founded in 1988, CASB, which operates under CICPA, is responsible for developing practice standards for Chinese accounting firms.

International Accounting Standards Board (IASB) was founded in 2001, which replaced IASC. The IASB was founded for developing reliable accounting standards that could be employed worldwide. This organization expects that a single set of accounting standards will facilitate the efficiency of capital markets over the world by means of improved disclosure and transparency. Thus, the IASB issued its first International Financial Reporting Standard (IFRS) in 2003. By 2008, more than 100 countries worldwide were either required or allowed to employ IFRS (Larcker and Brian 2011). In China, regulators have moved to convert from Chinese Generally Accepted Accounting Principles (GAAP) to IFRS during recent years, by modifying its financial reporting system in 1992. Now, China has made significant progress toward convergence with IFRS.

The modern accounting standards in China have experienced the three significant stages of accounting reform (Peng et al. 2008; Peng and van der Laan Smith 2010). The first stage was from 1992 to 1997, during which period MOF and CSRC issued the Accounting Standard for Business Enterprises (1992 Standards) and the Experimental Accounting System for Joint Stock Limited Enterprises (1992 Accounting System, i.e., 1992 GAAP) in 1992. Such an issuance indicates that the Chinese authorities introduced a market-oriented accounting system, in which the introduced conceptual framework was taken as being in accordance with that of international standards (Chen, Gul, and Su 1999; Davidson and Gelardi 1996).

The second stage was from 1998 to 2000, during which MOF promulgated the Accounting System for Joint Stock Limited Enterprise (1998 Accounting System, i.e., 1998 GAAP), which replaced the 1992 Chinese GAAP and "was issued specifically to eliminate discrepancies between Chinese GAAP and International Accounting Standards (IAS) in the 1992 regulation" (Chen, Fan, and Wong 2002, 84). During this time period, MOF also launched 10 specific Chinese Accounting Standards (CAS) (1998 Standards).

The final stage of accounting regulation development was from 2001 to 2006, during which MOF promulgated the Accounting System for Business Enterprises (2001 Accounting System, i.e., 2001 GAAP) in 2001, replacing the 1998 accounting system. This 2001 accounting system has made CAS move further toward IFRS (Pacter and Yuen 2001).

The MOF also released 16 CAS in 2001, comprising six newly issued standards, five revised standards, and five original standards (2001 Standards) (Gillis 2011).

In addition, in February 2006, MOF released the Accounting Standards for Business Enterprises (ASBE), a major revision of accounting standards, effective from January 1, 2007. The ASBE consists of 38 standards that apply to all listed firms in China. The aim of this release was to facilitate further development of a market-oriented economy in China, raise the quality of financial information, and thus bring Chinese accounting practices largely in accordance with IFRS (Kang, Shi, and Brown 2008).

As mentioned previously, MOF, the only entity authorized to release CAS, has promulgated a series of accounting regulations to harmonize its accounting system, Chinese GAAP, with international practices. The regulation developments arising from the efforts made by the Chinese government have been reported by various studies on the convergence of Chinese GAAP with IFRS. For example, Chen, Jubb, and Tran (1997) identify and analyze the problems that existed in China at the earlier stage, which were triggered by the implementation of the Enterprise Accounting Standard (EAS) in 1993. They suggest that these problems are ascribed to the accounting regulatory framework itself and the inconsistency between the new accounting standards and the then prevalent socioeconomic environment. Ding (2000) conducts an overview of the Chinese accounting reform based on its different facets and its actual situation, indicating that the process of harmonizing its accounting regulations with international practices is gradual and difficult, mainly because such a process reflects the magnitude of the accounting changes, which can be expounded by some reasons such as change of public administration function, diversification of enterprise ownership forms and its operations, and the opening up of the economy.

Tang reviews the recent accounting development in China, implying that there are two main factors driving the internationalization of Chinese accounting: its economic reform and increasing international exchange activities, both of which changed the planned economy into a market-oriented economy and thus created a demand for accounting information from business managers, investors, and creditors (2000).

Xiang also suggests that the recent Chinese economic reforms, particularly the corporation reform, have altered the corporate landscape and thus the accounting environment, which is the main reason for the desirability of adopting accounting regulations in close consistency with IAS (1998). Xiao, Dahya, and Lin examine the role of political influence, accounting tradition and the equity market in China's recent changes in accounting regulation, finding that the Chinese government has been active in developing accounting standards for convergence with IAS. They also point out some problems that the Chinese uniform accounting system needs to address, such as the special circumstances of a transforming government, strong state ownership, a weak accounting profession, a weak and imperfect equity market, and the inertial effect of accounting tradition and cultural factors (2004).

Based on the annual reports of 79 Chinese listed firms from 1999 to 2002, Peng et al. investigate whether China's efforts to comply with IFRS accounting standards over the past 15 years have succeeded (2008). They evaluate such a convergence from three perspectives: (1) the level of compliance with Chinese GAAP and IFRS, (2) the consistency of accounting choices under Chinese GAAP and IFRS, and (3) identification of significant differences in the net incomes produced under Chinese GAAP and IFRS (earnings gap), finding that there has been improvement in both compliance with IFRS and in the conformity of the accounting methods used in annual reports prepared under Chinese GAAP and IFRS. However, they also find that Chinese listed firms' compliance with IFRS is significantly lower than their compliance with Chinese GAAP (2008). Peng and van der Laan Smith (2010) use a longitudinal analysis from 1992 to 2006 to investigate the process of Chinese GAAP's convergence with IFRS based on the issuance of four successive Chinese GAAPs, 1992, 1998, 2001, and 2006, finding them significant steps toward convergence.

The Role of Statutory Audit in Improving the Quality of Financial Reporting

The existing studies have well explored the consequences of adopting new Chinese auditing standards. For example, DeFond, Wong, and Li test the role of the new auditing standards in auditor independence by comparing

the relative frequency of modified audit reports during the periods before and after the implementation of the new standards (1999). They find that the frequency of modified opinions increased nine-fold subsequent to the adoption of the first batch (i.e., the January 1996 batch) of auditing standards, suggesting that the new standards increase auditor independence; but they also find that the increase in modified reports was followed by a decline in audit market share among large auditors (who have the greatest propensity to issue modified reports) (2000).

As a result, DeFond, Wong, and Li conjecture that this "flight from audit quality" results from a lack of incentives to demand independent auditors, implying that government regulation alone is insufficient to create financial markets that foster auditor independence (1999). Zhou examines the linkage between information asymmetry measured by bid–ask spread and accounting disclosure due to adopting new Chinese auditing standards, based on 210 firms whose financial statements were never audited under any auditing standards prior to releasing the new standards, and 61 firms whose financial statements were prepared and audited with IAS (2007). She observes that the 210 firms experienced a significant decrease in their bid–ask spreads subsequent to adopting the new standards; however, such a change in bid–ask spread is not observed in the 61 firms, indicating that auditing regulation can permanently reduce long-run information asymmetry risk in China (2007). Sami and Zhou examine the effect of the implementation of the first batch of Chinese auditing standards (i.e., the January 1996 batch) on the information environment, and find that, following the adoption of the new standards, companies experience a decrease in earnings management, and thus an increase in quality of earnings (2008).

Managers in Chinese Listed Firms

Institutional Environment

The reforms of the 1980s in Chinese SOEs significantly strengthened a nascent managerial labor market (Groves et al. 1995). The overall objective of the reforms was to move from a system under which enterprises followed detailed centralized commands to a decentralized system that rewarded enterprises for improved productivity. Being part of this

economic reform, an improved system of managerial resource allocation that is responsive to market forces was developed. Managers are required to sign contracts outlining their responsibilities and rewards, and enacting new incentives and punishments. The *profit responsibility system* was introduced, which links rewards to managers with improvements in firm performance; hence managerial efforts were rewarded and managerial resources were assigned in accordance with criteria established by market forces. At the time, these reforms worked well in improving the efficiency of enterprises as an incentive approach to introduce market force into the rigid, planned-economy-governed Chinese firms. However, from the managerial assignment perspective, in SOEs, manager selection was still governed by bureaucratic and political considerations, and managers are subject to rigid supervision and control.

After over 30 years of transformation of China's economy, large swathes of the old state-owned industrial monoliths have been corporatized and many of the profitable units of these enterprises have been listed on the SHSE and SZSE. However, the government is still often the major shareholder in listed firms through holding state shares and *legal person* shares, which together account for two-thirds of the total shareholdings, and there is no fundamental change in the ownership structure of listed firms (Chen, Liu, and Li 2010; Cheung et al. 2010). Moreover, there is a weak legal system and a negligible market control mechanism in place (Chen et al. 2006). However, the government is expected to avoid direct intervention in day-to-day management and, instead, take the role of a dispassionate profit-maximizing investor. Thus, the listed firms are charged with maximizing efficiency and profitability (Firth, Fung, and Rui 2006).

In addition to its economic reforms, new capital markets and financial institutions, and written laws that cover property rights and commercial transactions, were developed in China. Corporate governance rules have been promulgated and, in recent years, the Chinese government has also promoted a legal and regulatory environment to facilitate investors. However, the 2014 Index of Economic Freedom (Heritage Foundation) ranks China at 137 out of 178 countries and areas, considering 50 independent economic variables, including corruption in judiciary, the rule of law, and the ability to enforce contracts. According to the report of

the 2014 Index of Economic Freedom, the remark accompanying this rating says that:

> China's economic freedom has been almost unchanged in last 20 years, stuck near the lower boundary of the mostly un-free category. Although the boost in trade freedom has undoubtedly helped spur China's high overall growth rates, the deterioration in other categories (e.g. investment freedom, financial freedom, property rights, and the control of government spending) indicates that major economic reforms are still needed to create a more balanced and sustainable economy. The lack of political wills to undertake more fundamental restructuring of the economy has led to continued overreliance on public investment. The Communist Party's ultimate authority throughout the economic system undermines the rule of law, and institutionalised cronyism remains pervasive. (Gwartney, Robert, and Hall 2014)

Selection Processes

So far, there has been not a formal regulation on how to select the CEO on the executive labor market. Most Chinese listed firms promote their CEO internally. The state still plays a major role in corporate affairs in Chinese listed firms, even though sometimes the government is not the direct owner. The Communist Party still plays an important role in the recruitment and promotion of CEOs and other top executives, partly because of its direct ownership stakes and partly because of its pervasive influence over corporate matters (Bryson, Forth, and Zhou 2014). It does so directly both through its position on appointment and promotion committees and by recruiting executives to the higher echelons of the Communist Party (Cao et al. 2011; Li et al. 2007a); and it does so indirectly by setting the rules governing the compensation of executives. This last role is performed by CSRC. The regulator stipulates what can and cannot be done by firms in relation to the compensation methods they are allowed to adopt and the rules they must abide by in corporate governance matters.

As for the monitoring of CEO performance, the State Assets Supervision and Administration Commission requires that managerial

performance be assessed on the basis of financial performance measures. Anecdotal evidence suggests that, similar to their counterparts in mature markets, the operation of Chinese firms is highly profit oriented. For instance, the results of a survey carried out by the Chinese central government show that economic performance has become a primary consideration in assessing the performance of SOE managers, and the failure to reach predetermined economic performance targets has been cited as a major reason for the dismissal of corporate executives (Chinese Entrepreneur Survey System 2000). In addition, it is evident that corporate economic performance has replaced the fulfillment of social responsibilities as a primary consideration in decisions regarding CEO turnover in China. Chen, Lee, and Li show that local governments in China not only rely on accounting measures to evaluate state-owned companies, but also assist them in achieving targeted accounting measures (2008).

Turnover and Succession Planning

The reasons for China's CEO turnover are classified into 13 categories, recorded by the China Stock Market & Accounting Research (CSMAR) database and based on statements filed by CSRC and various newspaper announcements: (1) change of work assignment, (2) retirement, (3) expiration of contract, (4) change of share-controlling right, (5) resignation, (6) dismissal, (7) health reason, (8) personal reason, (9) corporate governance reform, (10) involved in litigation, (11) end of agency, (12) others, and (13) undisclosed. According to Lin and Su, the disclosed top five reasons for CEO turnovers are change of work assignment (29 percent), expiration of contract (21 percent), resignation (19 percent), corporate governance reform (11 percent), and dismissal (4 percent) (2009). Factors investigated in the extant literatures that may affect CEO turnover mainly comprise firm performance, ownership structure, and political connection.

First, for *turnover and firm performance*, the management should be accountable for a firm's operations, and managers should be replaced if performance is poor. If they are not replaced, then this implies weak governance. Shen and Lin find that when Chinese listed firms miss the performance target, firms tend to change their current routines and have

greater motivation to search for alternatives, thus leaving their CEOs at greater risk of being fired (2009). Chang and Wong also report a negative relationship between forced CEO turnover and firm performance in firms incurring financial losses, but not in those making profits, which indicates that CEOs in underperforming firms are under great pressure to keep their positions and have a personal incentive to improve financial performance (2009).

Second, for *turnover and state ownership*, in the absence of adequate legal protection and the lack of an external market for corporate control, shareholders must rely on internal mechanisms to monitor firm activities, including the removal of underperforming managers. In many listed firms, share ownership is highly concentrated and the government is often the dominant shareholder. The dominant shareholders have significant influence over the appointment and replacement of the chairman. In the same vein, by emphasizing the shield effect of powerful controlling shareholders, Chen et al. argue that the managers' accountability for the reported financial performance of member firms is determined, at least partially, by the incentive and ability of the controlling shareholder to direct the operations of the member firm (2012). As a result, the turnover of CEOs is less likely to be affected by the reported financial performance of the member firms.

Third, for *turnover and political connection*, when a CEO's leadership is threatened by poor performance, the possibility of being replaced severely affects his or her personal reputation, career prospects, future wealth, and so on (Stulz 1988). In this situation, however, the political networks established by a CEO may become a personal umbrella and reduce the possibility of being dismissed due to poor performance. Furthermore, as a CEO's political connections help firms to gain better access to key resources controlled by the government, the firm's performance is less important when assessing the ability of politically connected CEOs, which would weaken turnover–performance sensitivity. You and Du (2012) argue that, when faced with the risk of losing his or her job, a CEO will use political connections for his or her own benefit, which may decrease the possibility of forced turnover and weaken turnover–performance sensitivity. In other words, politically connected CEOs are less likely to be fired, and the relationship between forced turnover and

poor performance is weaker for politically connected CEOs than for their not politically connected peers.

In addition, concerning succession planning, in China, the shortage of executive talent is predicted to be one of the greatest barriers to current and future growth. Also, due to the high mobility of Chinese managerial talent, long-term planning and the early identification of potential incumbents are difficult (Hartmann, Feisel, and Schober 2010). In order to improve retention, compensation models that link the development of managers with predicted future salary increase. Previous research has indicated that competitive rewards play a major role in influencing job satisfaction and the turnover intentions of employees, particularly in China (Ma and Trigo 2008). In addition, the quality of corporate governance, including the share percentage held by top management, and CEO power are also reported to have an influence on succession planning in Chinese listed firms (Fan, Lau, and Young 2007).

Compensation Practices—Pay for Performance

Before embarking on the economic reform in 1978, Chinese enterprises were essentially the branches of a single giant firm under the Chinese command economy (Groves et al. 1995). Managers were only responsible for meeting output targets; they were hired and fired by officials in the industrial bureaus and they were remunerated according to the hierarchy orders and for subservience to political dogma, which was not based on performance. The components of compensation included cash compensation, social wages, and nonmaterial incentives (e.g., recognition and honors) (Chow 1992). Cash wages were paid based on region, industry, and employee characteristics, such as seniority, tenure, education, gender, and job title (Bai and Xu 2005; Kato and Long 2005). Cash bonuses were divided equally among the members of the group, making them more similar to wage supplements than to real bonuses (Chow 1992). Groves et al. report that managerial pay had little correlation with the firm's performance and profitability before the economic reform (1995).

Nevertheless, with the gradual opening up of the Chinese financial market and the market-oriented reform of SOEs, the SOEs started to introduce foreign investments, transform into corporations, and list on

stock markets. During the 1980s, transformations in the regulatory environment ushered in a new era of more liberalized compensation schemes. Mengistae and Xu report that the Chinese government implemented several reforms to modernize executive compensation practices (2004). Various profit retention schemes were introduced between 1980 and 1984. The output quota replaced the output target, which was below full production capacity. The excess over the quota could be sold on the market and firms could retain a portion of the profits. Starting from 1984, a profit tax rate of 55 percent was levied on firms, and a certain proportion of the after-tax profit could be distributed to managers and employees. Following this, contractual responsibility systems were implemented. Under contract, directors become responsible for meeting the minimum targets and the performance of the firm, and their personal wealth was often held as a performance bond. Because of this risk, the directors' compensation could be up to 10 times that of average workers (Adithipyangkul, Alon, and Zhang 2011).

As regards the recent trend of executive compensation practices, Lin, Shen and Su demonstrate that the executive pay structure at listed firms in China has started to resemble the one within developed market economies (2011). The firm-level practices and coporate governance standards of Chinese listed firms are complying with the international standard to ensure their position to compete in the international financial market. Executive pay dispersion is positively related to the variation in firm performance and negatively related to state ownership, consistent with the findings of Chen, Ezzamel, and Cai (2011) and Su (2011). Using Chinese listed firm data, Conyon and He document significant changes in CEO pay, ownership, and board structure, finding a positive correlation between CEO pay and both accounting and stock market performance respectively, although the link to accounting performance is more robust. They also find that firms with more independent directors on the board have a higher pay-for-performance link (2011, 2012).

Although the pay–performance link was tested and found in the extant literature as mentioned previously, other perspectives were investigated in an attempt to understand China's executive compensation. Yang and Yang argue that top executive compensation in China is significantly affected by its peer group pay level (using the median top executive pay level in

the same industrial category) (2009). Considering the global pay benchmark effects introduced by foreign investment, Chen, Liu, and Li report that the compensation committees' decisions on executive pay levels are largely influenced by the global peer group's pay levels, rather than the link to firm performance (2010). From the tournament theory perspective, Kato and Long find evidence that an increase in the winner's prize, that is, top-tier manager pay, will result in improved firm performance due to enhanced managerial effort, and that the performance effect of the winner's prize is greater for China's listed firms that are less controlled by the state (2011).

It is worth mentioning that despite the trend of rising executive compensation in China, U.S. executive pay (salary and bonus) is still approximately 17 times higher than in China (Conyon and He 2011).

Discussion on Internal and External Governance Mechanism

Corporate governance in China has evolved significantly during the transition process. However, like many transition economies, the weak external governance mechanism of China based on its imperfect legal system and inefficient market has directly caused a weak institutional environment in China. As a result, this environment makes its internal corporate governance mechanism less effective. It is hard to imagine that firms in a weak institutional environment could fulfill their obligations to their stakeholders, particularly external investors. Therefore, a concentration of ownership is probably a necessary consequence within such weak institutional environments. Despite the fact that ownership concentration is often found to improve corporate governance to some extent, in China, the ownership concentration by the government tends to expropriate the interests of minority shareholders, due to the weakness of law enforcement.

In order to improve the internal corporate governance mechanism, the first step is to strengthen the legal system and enforcement environment in China. Only in doing so will the overall economy gradually become an entire market-oriented economy and the information disclosure of listed firms will be more transparent, as a result of which the rights

of minority shareholders will be guaranteed. Thus, the overriding action that should be taken by the government is to introduce a robust legal and regulatory system with strong enforcement mechanisms in the corporate sector, which is regarded as a key factor in achieving both an efficient stock market and internal corporate governance mechanisms, including the well-defined functions of board of directors, board of supervisors, shareholder meetings, independent directors, and so forth.

CHAPTER 5
Conclusions

Based on the fact that high quality of corporate governance is a prerequisite to deliver sustainable economic growth in the long run, this chapter reviews the current corporate governance practices in China, mainly from the condition of its internal and external governance mechanisms. Specifically, this chapter reviews the evolution of governance mechanisms in China's state sector, particularly China's previous corporatization programs; the current legal and regulatory systems and major corporate governance-related legislation since 1980, within the context of external governance mechanisms; and board of directors, ownership and control of listed firms, statutory audit, and various issues relating to managers of listed firms, from the view of internal governance mechanisms. The major task of this chapter is to identify the main problems within both internal and external governance mechanisms since the economic reform in 1978, which have been seen as the current and future governance challenges facing the Chinese economy.

Current and Future Governance Challenges in the Chinese Economy

Concerning the internal governance mechanisms, there are two main problems facing the Chinese corporate governance system. The first is the concentrated ownership structure, which has given rise to severe agency problems. For example, insiders of state-owned enterprises (SOEs) are usually able to benefit financially by offering stocks. In spite of the fact that regulators have been fining or even delisting companies which engaged in rent-seeking behavior, prosecutions for crimes such as insider trading are rare (Kang, Shi, and Brown 2008). The highly concentrated ownership structure also brings about agency costs and information asymmetry, reducing the liquidity of the capital market and discouraging minority

investors from engaging in their investment activities. Meanwhile, this concentrated structure means that the state plays a dominant role in most large companies and thus becomes a controlling shareholder. A controlling shareholder has more power to make various decisions in a company; for example, the general shareholders' meeting has a right to elect or change directors as well as to determine their compensation. However, because of the existence of controlling shareholders, they may have a final say on the appointment and compensation of directors. Recently, protecting the interests of minority shareholders has been increasingly taken as a priority by legislators of corporate governance. However, generally, minority shareholders' interests have not been adequately protected. It is still commonly believed among major state shareholders that minority shareholders do not have the right to disagree with the majority shareholders (Kang, Shi, and Brown 2008).

The second problem is weak board of supervisors and independent directors. The highly concentrated ownership can directly give rise to the lack of independence among board directors. For example, Tenev and Zhang find out that only 3.1 percent of all directors have some degree of independence, and that the vast majority of directors remain under the dominant influence of the government (2002). Given the overwhelming influence of the government on boards of directors, in China, the board of supervisors has not played a significant and effective governance role (Kang, Shi, and Brown 2008; Tenev and Zhang 2002). Unlike the German model in which the board of supervisors has the power to appoint and dismiss directors, the Chinese supervisory board can only bring forward proposals on nominating and removing directors, the result of which is that members of the supervisory board have little say in the major corporate decisions, particularly when they oversee the board of directors. Currently, no law stipulates that supervisors have the right to dismiss board directors or senior managers when they detect company misconduct, thus rendering the other rights of the supervisors potentially meaningless. Furthermore, members of the board of supervisors usually lack experience, incentive, and information, impeding the competence of their performance.

For independent directors, first, the *independence* of independent directors is questionable. For example, independent directors may need

the support from controlling shareholders so as to be elected and to remain as directors, based on the fact that controlling shareholders are able to use their dominant role in general shareholders' meetings to control the right of nomination and remuneration of all directors including independent directors. Indeed, in practice, many independent directors are invited by the directors or senior managers of their peers. Second, most independent directors in China are academics and governmental officials, both of whom lack related experience, specific knowledge, and the energy to commit themselves to corporate governance issues. Kang, Shi, and Brown (2008) suggest that there are currently not enough qualified people to fill the role of independent directors in China. Specifically, they also argue that the skills required for effective independent directors cannot easily be developed by vocational training, and that companies in China cannot easily attract Chinese-speaking talent from overseas professionals to assume the sensitive position of independent directors.

Concerning the external governance mechanisms, there are two major problems. The first is an inefficient stock market. One of the major problems of market inefficiency is insider trading. Although Securities Law in China has stipulated related articles on the prohibition of people using insider information to trade securities, this law does not mention anything on specific private liability for such insider trading behavior, which has become a very serious problem among listed firms in China (Kang, Shi, and Brown 2008). The lack of the concept of fiduciary duty and inefficient enforcement is taken as the main reason for the rampant insider trading in China (Kang, Shi, and Brown 2008; Tomasic and Andrews 2006). Although the related regulation, that is, Regulatory Views on Limited-Liability Shareholding Companies (1992), stipulated that board members should bear fiduciary duty, the imported notion of common law liability did not fit in well with China's civil law tradition, indicating that China has not yet reached a commonly agreed translation of the legal concept *fiduciary duty* (Kang, Shi, and Brown 2008). In addition, the fact that judges in China generally lack adequate knowledge and experience to handle insider trading cases is the main reason for inefficient abolition of insider trading. Another reason for the existence of insider trading could be the absence of class actions in China (Kang, Shi, and Brown 2008).

The second problem is the weak enforcement environment within the legal and regulatory systems in China, despite the fact that the Chinese authorities have launched a series of laws and regulations related to corporate governance over the last three decades, in an attempt to improve the ineffective legal system. However, in spite of the great efforts by the Chinese government, China still has a nascent legal system, which will not rate well according to effectiveness or enforcement. We argue that the substandard enforcement of China's laws is the primary cause of the weak corporate governance practices in China.

Convergence Toward a Global Model?

Indeed, the Chinese authorities have recently been exerting efforts to make China's corporate governance system become convergent with the one based on global standards. For example, in 2011, collaborating with the Organisation for Economic Co-operation and Development (OECD), the China Securities Regulatory Commission (CSRC) generated a report on the ongoing OECD-China Policy Dialogue on Corporate Governance by self-assessing its institutional framework and the legal framework of corporate governance, based on the *OECD Principles of Corporate Governance*, for the purpose of providing a valuable reference for understanding how much has been accomplished in Chinese corporate governance and future reform efforts (OECD 2011). This report explicates that corporate governance in China has improved greatly since its stock market was founded in 1990, with large achievements in creating and developing the legal and regulatory frameworks. By stating the content of Chinese legal and institutional frameworks and comparing it with the *OECD Principles of Corporate Governance* (2004) in five major aspects comprising (1) shareholders' rights, (2) the equitable treatment of shareholders, (3) information disclosure, (4) board and supervisory board (responsibility and supervision), and (5) stakeholders and corporate social responsibility; this report shows that the OECD-China Policy Dialogue on Corporate Governance has proven very successful in promoting mutual understanding and supporting China's reform agenda. This report also suggests that priority areas for corporate governance reform may include curbing abusive related party transactions, enhancing the quality of

boards, improving shareholder protection and curbing market abuse; and that improving effective implementation and enforcement is also useful for all important corporate governance issues.

Recent amendments to the Company Law seek to enhance the effectiveness of implementation and enforcement of corporate governance regulations, which is taken as part of the efforts made for being convergent with global standards. For example, generally, the revised Company Law creates better rules about shareholders' meetings; it regulates related party transactions; it provides minority shareholders with some remedies if they are abused; it ensures information rights for minority shareholders; and it reinforces the power of the board of supervisors or other supervisory authorities (Feinerman 2007).

Forces Resisting Convergence

Although the Chinese authorities have greatly revised the laws and regulations related to improving the corporate governance system in China based on global standards, there are some unique barriers to converting such laws and regulations into good corporate governance practice. First, political factors cannot be neglected when involved in corporate governance in China (Yan 2011). For example, the Company Law requires companies to establish the Communist Party, which is in accordance with the Constitution of Communist Party of China (CPC). The companies should also provide necessary conditions for the activities of the CPC. Inevitably, the chairman or general manager as a party member needs to obey the instruction from the party. As a result, based on the fact that corporate decisions are either made by the party committee of a corporation or handed down through party channels, the system of internal checks and balances within a corporation envisaged by China's Company Law has failed to take root (Yan 2011). There also exist serious problems when the behavior of the party is not driven by profitability. The priorities of these cadres are to complete economic targets and help the party and the government to maintain local social and political stability. Consequently, the interest of minority shareholders whose purpose is mainly profit will be impaired.

Second, another factor impeding the effectiveness of governance practice of Chinese listed companies is that chairmen and senior executives

usually have their specific administrative ranks (Yan 2011). Academics have long raised criticisms that chairmen or senior executives, particularly those in large listed companies, may actually have a higher rank than their supervisors in the China Securities Regulatory Commission or in the two stock exchanges, meaning that, on many occasions, it is difficult for supervisors to implement their monitoring functions effectively. Indeed, in 2000, the State Council General Office of the State Economic and Trade Commission (SETC) drafted the State-Owned Enterprises to Establish Modern Enterprise System and Strengthen the Management of Basic Standards (Trial), which clearly proposes the abolition of corporate administrative ranks; however, in practice, such regulations are not implemented effectively (Yan 2011).

Third, the cultural factor also affects the effectiveness of Chinese listed governance practice of the firms. The prominent feature of such a cultural factor is the subtle interpersonal relationship, which is taken as a form of social currency through which people can have access to scarce information, resource, or influence and is also underlying most economic institutions and transactions in China (Yan 2011). Most Chinese people believe that interpersonal relationships are more secure than the law, based on the weakness of law enforcement (Tomasic and Fu 2006). Based on the fact that a good interpersonal relationship is an invisible social resource for individuals, most people involved in corporate governance prefer considering this subtle relationship prior to making their economic-related decisions. They also prefer to cultivate good relationships among themselves and even between supervisors and supervisees, which is harmful for the effective implementation of the laws and regulations related to improving the effectiveness of governance practice of listed companies in China.

Triggers for Change?

Although the rapid rise of China during the period of more than three decades has become one of the greatest economic success stories in modern times, there have existed (and continue to exist) huge challenges and potential risks facing the Chinese economy. For example, one of the major challenges and risks is that the current economic growth model based on the export-led policy and large-scale investment will not always

be maintained. Thus, in pursuit of sustainable economic growth in the long run, it is vital for the Chinese government to successfully conduct the structural transformation of its economy, by implementing a process of transforming an economy mainly driven by large government investment into an economy mainly driven by high technology, services, and consumption. However, whether such a transformation can be achieved hinges heavily on whether the government can offer a high quality of corporate governance practices in China. We have suggested that the current weakness of corporate governance can be entirely attributed to the incompleteness and ineffectiveness of law enforcement.

Thus, the key solution to maintaining sustainable economic growth is to establish both effective and complete law enforcement in its comprehensive reform package. Indeed, the Chinese government has realized the importance of the complete law system: For example, on October 23, 2014, the Chinese government held the fourth plenary session of the 18th CPC Central Committee, in which the government announced a communiqué focusing on comprehensively advancing the rule of law in China. The general target of this communiqué is to form a system serving the socialist rule of law with Chinese characteristics and build a country under the socialist rule of law. Some of the detailed aims are stated as follows: (1) to achieve the rule of law, the country should be ruled in accordance with the Constitution; (2) the system to ensure the implementation of the Constitution and to supervise the implementation should be improved; (3) the National People's Congress and its Standing Committee should play a stronger role in supervising the Constitution's implementation; (4) China will work to build a law-abiding government; (5) China will promote transparency of government affairs; (6) a mechanism will be established to record officials who interfere with judicial cases and to name them publicly to hold them accountable; and (7) the effectiveness of implementing the rule of law will be an important index in judging the work of officials at various levels, and will be added to their performance appraisal system.

Another major action recently taken by the government is anticorruption. Particularly, China's anticorruption watchdog has conducted a campaign and revealed corruption by the latest inspections of SOEs, which are expected to inspire SOE reform. The CPC's Central Commission for

Discipline Inspection has set the task of inspecting all major SOEs since the beginning of 2015, aiming to combat corruption in SOEs and to facilitate their root-and-branch reform.

In addition, the Chinese government has been conducting SOE pay reform. For example, according to the fourth meeting of the Central Leading Group for Comprehensively Deepening Reform on August 18, 2014, the income distribution system in SOEs will be gradually regulated to reduce the gap in the salaries of top- and bottom-level employees, based on the fact that most managers earn excessive executive pay, which is not strongly related to the firms' performance. Executives from state-owned companies will begin seeing smaller salaries this year. The SOE pay reform will first target some 200 executives from 72 state-owned companies in 2015, such as China Mobile and China National Petroleum Corporation, the nation's largest oil and gas producers. Under the new guidelines based on this reform, pay for senior executives will be reduced from approximately 12 times the pay of the average worker to approximately eight times, after the reform. The cutbacks will later expand to other state-owned companies.

Therefore, it can be seen that the Chinese government has been taking a series of actions for the accomplishment of the comprehensively deepening reforms, with great determination and confidence. We argue that only in doing so, will the country gradually attain a high-quality level of corporate governance by the establishment of an independent legal system, an effective monitoring system, and an efficient capital market, and thus supporting the country in maintaining its sustainable economic growth in the long run.

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A Primer On Corporate Governance
China

Jean Jinghan Chen

Since its opening up and economic reforms in 1979, China has undergone tremendous economic growth and social development, with a ten percent real gross domestic product growth per year on average through 2013. In spite of such an accomplishment, the current economic growth model in China, which is mainly triggered by the export-led policy and the huge government investment, has been challenged by potential external and internal risks, which do not support sustainable economic growth in the long run.

In this book, the author comprehensively reviews the corporate governance practices in China, identifying the major problems within such practices. It is contended that these problems have been seen as the major challenges facing the Chinese economy, and further, that the current weakness of corporate governance practices in China can be ascribed, to a great extent, to the incompleteness and weakness of law enforcement.

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