BONDING, LAW ENFORCEMENT AND CORPORATE GOVERNANCE IN CHINA

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Abstract

Protection of minority shareholders is crucial to developing a strong capital market. Yet, formal legal enforcement is one, but not the only effective mechanism to offer this protection. When a country’s formal legal enforcement is weak, to attract investment, entrepreneurs have incentives to develop functional alternatives to assure minority shareholders’ interests are protected, and, as such, entrepreneurs may voluntarily “bond” themselves. China’s experience provides many examples of company-initiated “bonding” practices. Among the various bonding mechanisms that have been utilized, diversifying the ownership structure and cross-listing are so far the most effective. As such, to improve corporate governance in China is not only a question of improving the quality of legal enforcement mechanisms, but also a challenge of finding ways to encourage, facilitate, and support voluntary bonding practices. In this article, three polices are proposed to improve corporate governance, with the common theme of facilitating voluntary bonding practice. First, companies who are willing to bond themselves and improve their corporate governance should be encouraged to cross-list their stock overseas and voluntarily subject themselves to higher disclosure standards and more stringent legal liability. Second, China should facilitate competition between exchanges within its jurisdiction and allow more non-state-owned enterprises to go public. And finally, the corporate law in China should follow the self-enforcing model, where private enforcement is emphasized and encouraged.

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INTRODUCTION

Conventional wisdom indicates that a strong capital market cannot be created in the absence of the effective protection of minority shareholders. However, must this protection come only from official law enforcement? Can parties in a transaction develop non-legal means to ensure that minority shareholders’ interests will not be expropriated? These remain unsettled and challenging questions; this article will explore them in the context of China. If formal law enforcement in China remains weak, can companies in China develop non-legal means to ensure good corporate governance with dispersed public shareholders?

I want to convince readers in this paper that although effective legal enforcement is probably the “best practice” to protect minority shareholders’ interests, when this is lacking, controlling shareholders and managers of a company may still arrange to protect minority shareholders by voluntarily “bonding” themselves so as to produce a better outcome for both investors and themselves. Therefore, the fact that China has yet to develop a robust and efficient stock market probably is not mainly because China lacks effective law enforcement; rather, the inquiry should also be focused on how to encourage, facilitate and support the

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1 See Franco Modigliani & Enrico Perotti, Protection of Minority Interests and Development of Security Markets, 18 MAMT. DECISION ECON. 519, 525 (1997) (discussing that lack of basic rules or poorly enforced regulation may explain why provision of funding shifts from risk capital to debt, and from markets to institution with long term relations); Rafael La Prota et al., Legal Determinants of External Finance, 52 J. FIN. 1131, 1149 (1997) (arguing that better legal protection leads investors to accept lower expected rates of return, and hence “expands the scope of capital market”); Rafael La Prota et al., Law and Finance, 106 J. POL. ECON. 1113, 1151 (1998) (arguing that common law countries have stronger capital market than civil law countries because legal system in the former can better protect minority shareholders); and, Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 781, 782-86 (2001) (discussing that a strong securities market is preconditioned on a complex network of legal and market institutions that ensure that minority shareholders receive reliable information about the company and protection from theft and mismanagement by executives or controlling shareholders).
controlling shareholders and managers of companies to voluntarily bond themselves and reduce
the agency cost. It is possible for China to develop non-legal mechanisms that would, to a
certain degree, substitute for and complement formal law enforcement to ensure good corporate
governance.

This paper consists of six sections. Section I is an overview of China’s stock market
and its fundamental problems. Section II will use the Jensen-Meckling model and game
theory framework to discuss, in principle, how it is possible to develop good corporate
governance with dispersed public shareholders through market mechanisms without reliance on
formal law enforcement. Section III will discuss to what extent current bonding practice has
improved the corporate governance of Chinese companies. Section IV will discuss the
weaknesses and challenges of relying on voluntary bonding practice. Section V will cover
policy recommendations, followed by conclusions in Section VI.

I. OVERVIEW OF CHINA’S STOCK MARKET AND ITS FUNDAMENTAL PROBLEMS

On February 28, 2007, the Shanghai Stock Exchange Composite Index, the benchmark
index for China’s stock market, unexpectedly dropped 8.84% in one day. This was the worst
one-day tumble in China’s stock market in a decade, and it “set off a tumult that rolled through
markets around the globe, from Tokyo to Frankfurt to Brazil to Wall Street.”

However, there was no logical reason for the severe drop in Shanghai. The Chinese

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2 James T. Areddy, Shanghai’s 8.8% Tumble Slams Emerging Markets, WALL ST. J., Feb. 28, 2007; David Barboza, From
3 Barboza, supra note 2.
government had reported several weeks earlier that its economy had grown by 10.7% in 2006, with little inflation.\textsuperscript{4} There was no particular bad news in the Chinese stock market around that time: no scandals broke; no subprime loans emerged; no terror attacks occurred. Indeed, there had been rumors that Beijing was considering new measures to tame the hot stock market before a bubble developed.\textsuperscript{5}

A little perspective helps.

China’s stock market started in the early 1990s, with formal stock exchanges opening in 1990 and 1991 in Shanghai and Shenzhen, respectively, and the first Company Law being passed in 1991 and first Security Law passed in 1997. According to reformers of China’s stock market, the purpose of establishing a stock market was threefold: first, to raise capital for the development of China’s state-owned-enterprises (SOEs); secondly, to facilitate the reconstruction of SOEs; and finally, to help improve the corporate governance of the SOEs that are listed.\textsuperscript{6} Unfortunately, this experience has been unsuccessful so far.

To date, the stock market in China is illiquid, inefficient, and unreliable; the performance of China’s stock index bears little correlation to China’s underlying economic growth.\textsuperscript{7} For the four years through 2005, the Shanghai and Shenzhen indexes were the world’s worst-performing markets out of 77 major benchmarks.\textsuperscript{8} The total market value of

\textsuperscript{5} Barboza, supra note 2.
\textsuperscript{7} Editorial, \textsc{Shanghaied}, \textsc{Wall. St. J.} March 1, 2007.
\textsuperscript{8} Bloomberg.com: \textit{China Regulator Plans to Allow Margin Trading, Short Selling} (April 17, 2006).
China’s capital market shrank 30.7% from 2003 to the end of 2005\(^9\) even though China, overall, had a higher than 10% annual growth during the same time.\(^{10}\) Partly because of investors’ disappointment in the market, the Chinese government decided to freeze all domestic IPOs twice in 2005.\(^{11}\) Even though the benchmark Shanghai Composite index rose 130% in the year 2006, none of the fundamentals of China’s stock market and listed companies has been changed, and a *Wall Street Journal* editorial still labeled the stock market as “more of a roulette wheel than a proper exchange.”\(^{12}\)

This fiasco can be attributed to many factors, with bad corporate governance considered the first and foremost reason by many critics.\(^{13}\) Controlling shareholders or managers cook their companies’ books and manipulate their financial reports, often with help from accounting firms. Interested dealings are rampant and listed companies’ assets are stripped away.\(^{14}\) Many blame this on weak legal enforcement. However, the reality in China is that effective law enforcement will not be attainable in the near future. Courts in China are not independent, are not sophisticated in dealing with complicated financial matters, and

\(^9\) Data on China’s stock market is available at China Securities Regulatory Commission (CSRC) website: www.csrc.gov.cn.

\(^{10}\) The GDP growth in 2003, 2004 and 2005 was 10%, 10.1% and 9.9%, respectively. China’s macroeconomic data are available at China National Bureau of Statistics website (http://www.stats.gov.cn).

\(^{11}\) AFX News Limited, *China to Resume Mainland IPO Approvals Soon—CSRC*, available at Forbes.com (last visited May 16, 2006). (“There have been concerns that a resumption of IPOs would flood the market with new issues, draining liquidity.”) Chinese authority only reopened the IPO market on August 2006, when the stock market appeared to be stronger.

\(^{12}\) Shanghaied, *supra* note 7.

\(^{13}\) See, e.g., Zhou Xiaochuan, then the Governor of the China Securities Regulatory Commission, was quoted by the People’s Daily as saying: “Chinese listed companies are in desperate need of improving their corporate governance as China’s capital market is suffering some problems from the old economic system and struggling to survive the economic globalization.” *World’s Top Financiers Advise China on Corporate Governance*, People’s Daily, September 11, 2001; OECD, *Reforming State Asset Management and Improving Corporate Governance: The Two Challenges of Chinese Enterprise Reform*, Chapter 10, in OECD: CHINA IN THE GLOBAL ECONOMY—GOVERNANCE IN CHINA (2005).

\(^{14}\) See X.L. Ding, *The Illicit Asset Stripping of Chinese State Firms*, 43 CHINA J. 1, 1-28 (Jan. 2000) (claiming that in China, the diversion of the assets and profits of state firms into the private hands of the managers and officials in charge of them has been occurring on a truly massive scale—far more massive than most observers of China have realized).
sometimes are corrupted. The China Securities Regulatory Commission (the CSRC), the executive branch body that is responsible for enforcing the securities law, has also not proven to be effective, independent, or professional based upon international standards. In 2003, there were 1,278 companies listed in Shanghai and Shenzhen together, but the number of total enforcement actions initiated by the CSRC or exchanges against listed companies only reached 51, implying that at most 1 in 25 companies was the subject of any kind of enforcement activity. Moreover, the sanctions administered were often benign, with only 22% of all enforcement actions resulting in fines as opposed to warnings or informal reprimands. If conventional wisdom is correct, then China’s efforts to develop a vigorous stock market are doomed to fail as long as China does not fundamentally change its law enforcement mechanism.

II. THEORETICAL FRAMEWORK

Official law enforcement is “third-party enforcement through government coercion.” In the context of a stock market, for official law enforcement to be effective, there must be an independent, sophisticated, and efficient judiciary and a government agency in charge of enforcing securities laws and regulations, whether it is the Securities and Exchange Commission (the SEC) in the United States, or the CSRC in China. Yet, strong official legal enforcement is by no means the only way to develop good corporate governance. Ronald

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15 See e.g., RANDALL PEERENBOOM, CHINA’S LONG MARCH TOWARD RULE OF LAW, 326-28 (2002); STANLEY B. LUBMAN, BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO, 120-21 (1999); Donald Clarke, Power and Politics in the Chinese Court System: the Enforcement of Civil Judgment, 10 Colum. J. Asian L. 1 (1996).
Coase argues that private parties can enter into contracts as they please, and as long as
transaction costs are not high, private transactions can obtain the same efficient result regardless
of the original state of property rights.\textsuperscript{18} Easterbrook and Fischel maintain that managers will
choose the desirable forms of firms because they must attract customers and investors “by
promising and delivering what those people value.”\textsuperscript{19} More recently, John Coffee suggests
that companies may “bond” themselves by cross-listing and voluntarily subjecting themselves
to higher disclosure standards and greater threat of enforcement, and if their “bonding” is
trustworthy enough, investors may find it acceptable to buy the companies’ stock at a higher
price.\textsuperscript{20} These approaches focus on different aspects of the same questions, but the most
fundamental theory is either a Jensen-Meckling model or a game theory model.

1. Jensen-Meckling

Jensen and Meckling explained in their seminal 1976 paper, \textit{Theory of the Firm: Management Behavior, Agency Costs, and Ownership Structure}, that if capital markets are
efficient, the prices of assets such as debt and outside equity will reflect unbiased estimates of
the monitoring costs and redistributions that the agency relationship will engender and that the
selling owner-managers will bear these agency costs.\textsuperscript{21} Jensen and Meckling also suggest

\textsuperscript{21} Jensen and Meckling mainly discuss the agency costs caused by a manager’s non-pecuniary benefits, such as “the physical appointments of the office, the attractiveness of the secretarial staff … a larger than optimal computer to play with, purchases of production inputs with friends,” but their analysis on who bears the cost should also be applicable regarding the agency costs caused by stealing or “tunneling,” as investors surely will also discount the price of the company based on their expectation of this kind of agency cost. Michael C. Jensen & William H. Meckling, \textit{Theory of the Firm: Management Behavior, Agency Costs, and Ownership Structure}, 3 J. FIN ECO. 305, 312 (1976).
selling owner-managers may voluntarily bond themselves or accept monitoring measures in order to sell the companies at a higher price. These efforts will lead to Pareto improvements. However, Jensen and Meckling assume that formal enforcement of contractual commitment is effective. They state that the selling owner-managers will “voluntarily enter into a contract with the outside equity holders” that gives the equity holders the right to monitor the owner-managers. They do not discuss whether, if the contract is not expected to be effectively enforced by the court, the selling owner-manager still can bond themselves.

The assumption of strong law enforcement unfortunately does not hold true in the Chinese context. If the contract cannot be effectively enforced, are there ways that investors can monitor managers or managers can bond themselves and thus provide Pareto improvements? This question is not answered in the Jensen-Meckling model.

2. A Sequential-move Game Framework

One of the favorite examples for game theorists is a game involving an extension of credit and the problems that arise when a lender and a borrower interact with each other over time. The basic scenario is that if the lender knows that the borrower will not return the money borrowed, the lender will not loan the borrower the money in the first place. To overcome this problem, legal enforceable contracts facilitate mutually beneficial trade between the borrower and the lender.

\[\text{Id. at 324 (The owner-manager will find bonding “desirable because it will cause the value of the firm to rise.”).}\]

\[\text{Id.}\]

\[\text{See Douglas G. Baird et al., Game Theory and Law, 53-57 (1994).}\]
The example of equity funding for entrepreneurs is more complicated and delicate. Let us consider a very simple game theory framework with two parties: an investor and an entrepreneur. Let us assume that both the investor and the entrepreneur are utility maximizers. The entrepreneur has a company that will have a 50% return in five years, but the entrepreneur needs a $100 investment from the investor now to make this venture possible. To solicit a potential investor to agree to invest, the entrepreneur offers to return the investment in full plus half of the profits five years later, that is, a $25 or 25 percent return. Let us also assume that the investor is the “first mover,” i.e., he or she needs to first decide whether or not to buy the stock issued by the entrepreneur. If the investor invests $100, the entrepreneur will use it to develop the business. Nevertheless, five years later, the entrepreneur still has the choices of whether or not to return the money. If the entrepreneur chooses to steal the money, he can keep all $150 to himself; alternatively, he may choose to be honest and return the $100 to the investor and then split the $50 profits with the investor and keep $25 for himself. The matrix below shows the possible outcomes and payoffs of this simple scenario:

<table>
<thead>
<tr>
<th>Investor (1st mover)</th>
<th>Steal</th>
<th>Not-Steal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Buy</strong></td>
<td>0/150*</td>
<td>125/25*</td>
</tr>
<tr>
<td>Not-buy</td>
<td>/</td>
<td>100/0*</td>
</tr>
</tbody>
</table>

* The number before / is the payoff for the investor, and the number after / is the payoff for the entrepreneur.

Clearly, the better response for the entrepreneur is to steal, because the benefit from stealing ($150) is larger than the benefit from not-stealing ($25). However, if the investor...
foresees that the entrepreneur will choose to steal, the investor will not invest in the first place. In this way, the investor has nothing to lose, but the entrepreneur gains nothing as well. Therefore, the Nash Equilibrium\(^{25}\) in this case is that the investor will not buy the stock and the entrepreneur will not have the opportunity to steal. Clearly, both parties and society are better off if both parties cooperate and use the money to develop the economy, but how can they get there?

Law seems to be the “best practice” to solve this problem. If there is a law prohibiting entrepreneurs from embezzlement or tunneling and investors can call upon the government to enforce the law when entrepreneurs violate the law, then investors will feel confident that their money will not be stolen or tunneled away, and thus they will buy the stock. The entrepreneur then is restricted by the legal system from embezzling; thus, to maximize their interests, they should work hard to make a bigger pie to have more profits to share. However, what if the law is not enforced effectively? Political corruption, lack of judicial independence and lack of expertise on the part of judges or law enforcement officers all may cause different levels of inefficiency in law enforcement.

Another possible solution is the repeat player scenario. If the entrepreneur is a repeat player, either the funding has different phases, or he will conduct other transactions with the investors, so that the entrepreneurs may choose to cooperate for the sake of future payoff. However, this assurance is weak. If the payoff from current cheating is higher or when there

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\(^{25}\) In a game involving two or more players, if each player has chosen a strategy and no player can benefit by changing his or her strategy while the other players keep theirs unchanged, then the current set of strategy choices and the corresponding payoffs constitute a Nash equilibrium. The Nash equilibrium is named after John Forbes Nash, who proposed it. See generally, Drew Fudenberg and Jean Tirole, Game Theory (1990).
is no possibility of future game playing, the entrepreneur will choose to cheat.

The other solution—which is the solution this paper will discuss in depth—is that after the entrepreneur makes a commitment not to steal, he can then “bond” himself to make his commitment very costly or even impossible to break. Compared to the outcome he would get without any investment, the entrepreneur is better off when the investor decides to invest. As such, the entrepreneur has strong incentives to assure the investor that the entrepreneur will not steal the money and that this assurance will be carried out. Therefore, the entrepreneur should have the incentives to assure the investor that their interests will be protected. The traditional solution economists often suggest—a detailed contract—will not do, because contracts cannot be divorced from bad law enforcement; the entrepreneur has to offer good “corporate governance.” Specifically, entrepreneurs can voluntarily allow investors to send their agents to control positions of important company oversight to keep entrepreneurs from embezzling. For instance, investors can control the board, set an independent auditing committee, or appoint company controllers. In addition, if it is possible to subject companies to other jurisdictions with stronger law enforcement systems, entrepreneurs may choose to list the companies’ stock in those jurisdictions.

Investors will then evaluate the effectiveness of the entrepreneurs’ commitment, taking into account reliability of legal enforcement. If the commitments seem to be hard to break, investors may buy the stock; otherwise, they may not buy or may demand a higher discount.

There is generally no information asymmetry regarding the quality of legal
enforcement. Weak legal enforcement is well known by both sides and may be taken as a given, and the entrepreneur has to take this into account when making his commitment. The key for the entrepreneur is to make the investor believe that his or her investment will not be expropriated. The investor will believe the entrepreneur only if the entrepreneur’s ex ante commitments on corporate governance make embezzlement too difficult, taking into account the weak legal enforcement. Therefore, the commitment the entrepreneur makes must not rely too much on the mechanism of formal law enforcement. The entrepreneur has to take the pains of reorganizing the internal corporate governance structure and to implement the “bonding” mechanism beforehand.

So far, our analysis suggests that, in principle, bonding is possible and desirable for both parties when law enforcement is weak. In the words of Easterbrook and Fischel, “[m]anagers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they have investor’s interests at heart.”26 The next section will discuss how this theory plays out in China.

III. BONDING AND BONDING PREMIUMS IN CHINA

Corporate governance practice in China has provided some evidence of bonding. Because various forms of bonding restrict controlling shareholders’ and insiders’ ability to expropriate other investors to a certain degree, voluntary bonding essentially signals to investors that either the company has better corporate governance and less agency cost, or that

26 EASTERBROOK & FISCHEL, supra note 19, at 4.
they are willing to improve corporate governance. As a result, investors are willing to pay a “bonding premium,” which is the monetary manifestation of increased trust of the investors that their investment will be managed honestly.

Needless to say, not all bonding practices are created equal. Bonding practices include adopting the stringent International Accounting Standards (ISA), hiring reputational outside auditors, having outside directors, diversifying ownership by having “foreign strategic investors” as block holders, and finally and most importantly, listing the companies in foreign stock exchanges. Some empirical research has proved the existence of bonding premiums, although the premium varies and corresponds to the level of restrictions the bonding practice imposes. Some bonding methods have proved to be more effective than others in preventing the controlling shareholders or company insiders from shirking or stealing.

1. **Stricter Accounting Rules and Reputational Intermediaries.**

   To have financial reports audited is a common practice for public offerings in any jurisdiction. Auditing shares the underlying philosophy of bonding, as auditing involving having a neutral, outside third party to evaluate the company’s performance. Generally speaking, auditing is not a voluntary bonding practice because to have financial reports audited is expressly required by Chinese law. Nevertheless, there are two peculiar measures related to auditing that Chinese-listed companies utilize that may constitute voluntary bonding.

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27 Note that in February 2006, Chinese authority adopted a new General Accounting Standard, which came into effect on January 1, 2007. How this new accounting standard will affect Chinese listed companies’ financial disclosure is an open question and has to be left to future research.

First, some companies voluntarily use IAS instead of China’s own accounting standard. Listed companies are only required to use China’s own accounting standard, which focuses more on how the government can collect tax from companies, with less emphasis on how to evaluate the company’s performance and give equity holders the benefits to which they are entitled. Companies’ earnings determined according to the Chinese accounting standard are on average 20% - 30% higher than those determined according to the IAS. However, some companies voluntarily adopt the IAS. By doing so, they are able to issue shares denominated in U.S. or Hong Kong currency to foreign investors or Chinese local investors with foreign currency bank accounts. This kind of special share is called a B-Share, and the normal shares issued to Chinese citizens denominated in Chinese currency are called A-shares. Both A-shares and B-shares are traded in the domestic market and carry the same voting power. Except for accounting methods, there is no other difference between them. However, the research of Qian Su, Wilson Tong, and Yujun Wu shows that there is a statistically significant “bonding premium” for those companies offering B-shares, as measured by higher market-to-book ratio (MBR ratio) and higher price-to-earnings ratio (P/E ratio). A possible explanation is that adopting international standards is a signal to investors that these listed companies have more transparent financial report and information disclosure systems.

Second, to have finance reports audited by reputational intermediaries may constitute

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30 Zhang & Zhao, supra note, at 45.

a bonding practice. Although outside financial auditing is required by law, choice of auditors, as long as the auditors have the credentials to practice auditing service, is not prescribed by regulations. Many listed companies in China retain prominent international accounting firms to conduct outside auditing, even though doing so is not required by the Chinese law in order to signal to the market the companies’ willingness to comply with a higher accounting standard.

Chinese regulators realize the possible merits of having reputational intermediaries to ensure the accuracy and reliability of listed companies’ financial reports. On December 31, 2001, the CSRC issued the *Temporary Measure Regarding Additional Auditing Requirement for Listed A Share Companies*, in which the CSRC required that all companies that will engage in an initial public offering, and all current listed A share companies that will conduct a secondary offering in China have their Annual Reports audited by a “world renowned accounting firm.”

This additional auditing is to supplement the current auditing requirement companies must satisfy. The “world renowned accounting firms” the CSRC referred to in the measure were actually only the then *Big Five* (Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and PricewaterhouseCoopers), as at the time the measure was enacted only these five foreign accounting firms were the only foreign accounting firms were authorized by the CSRC to provide auditing service for listed companies. Partly due to Arthur Andersen’s

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33 Now Big Four: Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and PricewaterhouseCoopers.
immediate implosion after the Enron scandal, this measure never came into force.\textsuperscript{35} Thereafter, the CSRC actually certified several Chinese firms’ qualifications to provide the additional auditing service, but the Big Four still dominate the auditing service for listed companies.

Unfortunately, as in other countries, including the United States, the independence of outside auditors and their role as gatekeepers is questionable. This may be due to the fact that outside auditors are hired by insiders of the company and report to them. According to recent empirical research by Feng Liu and Fuyuan Zhou, the auditing quality of the Big Four is not better than that of other Chinese auditing firms.\textsuperscript{36} Liu and Zhou’s research even shows that the Big Four have a worse record on the Conservatism.\textsuperscript{37} Therefore, the usefulness of bonding through hiring reputational intermediaries is limited. When independent auditors’ professional integrity is at doubt, the effectiveness of different accounting methods is consequently moot.

2. Independent Director

Another effort aimed at improving the corporate governance of listed companies is to have outside or independent directors sit on the companies’ boards. Wisely used, and with rules strictly followed, independent directors may become a meaningful way of bonding.

Starting in the late 1990s, academic journals and financial media in China began advocating having independent directors on the company boards as an effective way to improve corporate governance for China’s listed companies. Various initiatives encouraging listed companies to

\textsuperscript{35} Id.
\textsuperscript{36} Id. at 23.
\textsuperscript{37} Id.
appoint independent directors were taken at the level of local government and stock exchanges after 2000.\textsuperscript{38} In August 2001, the CSRC issued the Guidance Opinion on the Establishment of an Independent Director System in Listed Companies (the “Opinion”).\textsuperscript{39} The Opinion required listed companies to revise their articles of incorporation to provide for independent directors. By June 30, 2002, every listed company in China was required to have at least two independent directors, and such directors were to constitute at least one third of the board by June 30, 2003.\textsuperscript{40} By 2004, it was estimated that there were about 5000 independent directors for China’s 1300 listed companies.\textsuperscript{41}

Empirical research shows that the market response to the progress on appointing independent directors is moderately positive. Economists Chong-en Bai, Qiao Liu, Joe Lu, Frank M. Song and Junxi Zhang conducted a comprehensive and systematic empirical study on the relationship between Chinese listed firms’ market value and their corporate governance. According to Bai et al., the ratio of outside directors is positively related to the listed companies’ Tobin’s q\textsuperscript{42} and Market/Book Ratio.

However, using outside directors as a bonding measure in China has not been very effective either. As Donald Clarke observed, “independent directors” in a Chinese context are better described as “non-executive” directors that represent controlling shareholders’ interests.

\textsuperscript{38} See Donald Clarke, The Independent Director In Chinese Corporate Governance, 31 Del. J. Corp. L. 125, 176-80 (2005).
\textsuperscript{40} Section 1(3) of the Independent Director Opinion, supra note 39.
\textsuperscript{42} Tobin’s q compares the value of a company given by financial markets with the value of a company’s assets. It is named after economist James Tobin. It is calculated by dividing the market value of a company by the replacement value of its assets: Tobin’s q = market value / asset value. See James Tobin, A General Equilibrium Approach to Monetary Theory, 1 J. Money Credit and Banking 15 (1969).
against managerial attempts at shirking or embezzlement. Thus, in this context it is unrealistic to expect that an independent director can serve to protect minority shareholders. For instance, the Dean of the Changjiang School of Business, who serves as an independent director, made the following remark during an interview:

I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the state.

Those few independent directors who refused to act as merely a rubber stamp found themselves in an awkward situation. In February 2004, out of concerns for their company’s frequent financial guarantees for interested transactions, two independent directors of a Chinese listed company, Leshan Electronic, decided to engage auditing firms at their own personal expenses to audit Leshan’s financial situation. However, the executives of Leshan refused to cooperate, and eventually, the two independent directors were fired. In April 2004, an independent director for Lotus MSG, another listed company, publicly denounced the parent company, Lotus Holding Group, for the parent’s irregularities in taking advantage of the subsidiary’s funds. The dispute ended with the dismissal of the independent director as well. In June 2004, because he had requested independent auditing, Yu Bowei, an independent

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43 See Clarke, supra note 38 (arguing that the independent director cannot serve the purpose of improving corporate governance in China).
45 See The Lonely Don Quixote, supra note 41.
46 Id.
director, was ousted by Yi’Li, the listed company he served and one of the best known dairy companies in China.  

Independent directors who demonstrated their integrity and independence did not find much empathy from shareholders either. For instance, in the aftermath of the fight between Yu Bowei and Yi’Li, Yi’Li shares fell by 20% in a very short period. As a result, shareholders of Yi’Li were reported to be very angry at both Yu and the executives of Yi’Li.

3. Ownership Diversification

Chinese companies and their controlling shareholders soon realized that unless they changed the ownership structure of their companies, merely changing their accounting standards, hiring established accounting firms, or getting outside directors could not assure investors that controlling shareholders and insiders would not expropriate them. As a result, the next bonding mechanism that they adopted was to sell their companies’ stakes to “strategic investors” before going to IPO or secondary offering. This strategy is especially common in the financial sector, where the Chinese government feels serious pressure to open their financial industry to foreign investment by the end of 2007 under China’s WTO entry commitments.

47 See Yi’Li Bamian qi Duli Dongshi; Zhejieshi Duli de Daijia [Yi’Li Fired Independent Directors; this is the Price of being Independent], available at http://gb.chinabroadcast.cn/1827/2004/06/21/302@202914.htm (last visited Nov 2, 2006); see also Yi’Li Duli Dongshi Yu Bowei: Wo Hai You Hua Yaoshui [Yi’Li Independent Director Yu Bowei: I have more Things to Say], ZHONGGUO JINSHIBAO [CHINA FINANCIAL TIMES], June 30, 2004.

48 The Lonely Don Quixote, supra note 41.

49 China joined the World Trade Organization (WTO) at the end of 2001. The agreement entered into between China and the United States preceding China’s accession remains a good general guide to the obligations China assumed with its WTO partners. Regarding to financial service, the Sino-US agreement provides: China will expand the scope and geographic opportunities for foreign banks to conduct local currency business.

- Scope: Local currency business with foreign clients will be permitted upon accession, with Chinese enterprises two years after accession, and with Chinese individuals five years after accession.
- Geographic: Local currency banking will be permitted in four cities upon accession, four additional cities will be
In fact, as of 2005, 25 foreign banks had already taken stakes in twenty domestic banks, with some foreign banks investing in multiple domestic banks.\textsuperscript{50} As this trend continues through 2006, China’s biggest banks were receiving heavyweight strategic investors.

The following table shows the moves China has made regarding banking reform:

## Table 1: “Strategic Investors” In Chinese Banks Since 2005

<table>
<thead>
<tr>
<th>Chinese Companies</th>
<th>Foreign Investors</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>China Construction Bank (CCB)</td>
<td>Bank of America (BOA) bought 9% of CCB’s ownership for $2.5 billion(^{51}) in June 2005, and another $0.5 billion when CCB went public in Hong Kong; Temasek Holdings (the company that owns and manages the Singapore government’s direct investments) bought 5.1% of CCB’s ownership for $1.5 billion before CCB’s IPO, and bought another $10 billion at its IPO.</td>
<td>CCB is currently listed on the Hong Kong Stock Exchange.</td>
</tr>
<tr>
<td>Bank of China (BOC)</td>
<td>The Royal Bank of Scotland (RBS) led an investment of 10% in BOC for $3.1 billion, with the RBS itself investing $1.6 billion(^{52}) and the rest coming from Merrill Lynch International and Li Ka-shing Foundation.(^{53}) The deal was announced on August 2005.</td>
<td>BOC is currently listed on the Hong Kong Stock Exchange.</td>
</tr>
<tr>
<td>Industrial and Commercial Bank of China (ICBC)</td>
<td>Goldman Sachs Group, Inc., Allianz Group and American Express Company invested 3.78 billion in ICBC in exchange for 10% of ICBC. The deal was announced on January 27, 2006.(^{54})</td>
<td>ICBC went public in Hong Kong and Shanghai on October 27, 2006, raising $23 billion in total. ICBC’s IPO was so far the world’s biggest IPO.(^{55})</td>
</tr>
<tr>
<td>Huaxia Bank</td>
<td>Huaxia Bank sold a 9.9% stake to the Deutsche Bank (DB) group and 4.08% to Sal Oppenheim Jr. &amp; Cie (SO), a German private investment bank. DB also obtained the option to buy SO’s stake in Huaxia Bank within a certain period. If DB exercises its option, it will hold a total 13.98% stake in Huaxia Bank, making it the largest shareholder.</td>
<td></td>
</tr>
<tr>
<td>Shanghai Pudong Development Bank (SPDB)</td>
<td>Citigroup bought a 5% stake in 2003 and is now trying to lift that stake to 19.9%.</td>
<td></td>
</tr>
<tr>
<td>Guangdong Development Bank</td>
<td>A consortium led by Citigroup would buy 85.6% of the stake of the bank for $3.1. The consortium includes Citigroup, IBM, and several Chinese investors.(^{56})</td>
<td>As of Nov 16, 2006, the deal is subject to regulatory approval from the Chinese government.</td>
</tr>
</tbody>
</table>

Source: Caijing Magazine, Feb 6, 2006; verified with various sources.

\(^{51}\) This number is from CCB’s Prospectus dated on Oct 14, 2005. The number from Caijing Magazine is 25 billion Chinese Yuan.


\(^{53}\) http://news.xinhuanet.com/fortune/2005-08/19/content_3374494.htm

\(^{54}\) http://www.icbc-ltd.com/jsp/en/template/infoContentTemp.jsp?path=ROOT%3ElInvestor%3ELrelations%3EIr%3Espotlight&id=1138348278100&type=CMS.STD. It was a total surprised to the market, especially to Goldman Sachs, when ICBC announced that Goldman Sachs would not be an underwriter for its IPO. The Financial Time cites potential conflicts of interest as the reason for Goldman Sachs’ ousting.


To have sophisticated multinational companies own a significant number of shares in otherwise uncontrolled state-owned enterprises is one of the most effective assurances to the market of the controlling shareholders’ commitment not to expropriate other shareholders. For the purpose of protecting their own interests, the “strategic investors” often entered into *ad hoc* arrangements with the controlling shareholders—often, the holding company wholly owned by the Chinese government—to obtain certain rights such as board representation, information rights, rights against adversary Article amendments, etc. Simultaneously, the strategic investors were requested by the controlling shareholders to provide “strategic assistance” in certain areas, including corporate governance. As a result, other minority shareholders get a “free ride” for the improved and more transparent corporate governance. For instance, according to China Construction Bank’s prospectus, in connection with Bank of America’s billion-dollar investment in China Construction Bank, Bank of America has the right to nominate one candidate to the Board of Director of the China Construction bank and have that candidate serve on the audit committee and nomination and compensation committee as long as Bank of America holds at least 5% of the China Construction Bank’s shares.\(^{57}\) In addition, Bank of America agreed to provide the China Construction Bank “with strategic assistance” in the area of “corporate governance and management,” among other things, as part of the China Construction Bank’s “overall effort to adopt international best practice” in the banking business.\(^{58}\) According to the Prospectus, Bank of America promised that approximately 50 of


\(^{58}\) *Id.*
its personnel would assist the China Construction Bank “in reviewing, enhancing or developing policies, procedures and practices for [the China Construction Bank’s] operation.”

Goldman Sachs’ strategic investment in the Industrial and Commercial Bank of China provides similar arrangements. In connection with Goldman Sachs’ share purchase agreement, Goldman Sachs obtained the right to nominate one director, certain information rights, anti-dilution rights, and registration rights.\(^{59}\) In addition, the ICBC entered into a “strategic cooperation agreement” with Goldman Sachs and established “working procedures and processes” with Goldman Sachs and “a joint steering committee” that is responsible for “the overall implementation of the strategic cooperation.”\(^{60}\) The president of ICBC and the Chairman of Goldman Sachs Asia co-chair the joint steering committee.\(^{61}\)

Many high ranking Chinese officers share the same belief that improving the corporate governance of SOEs is a major reason for bringing foreign strategic investors on board. Wu Xiaoling, Deputy Governor of China People’s Bank, which is China’s Central Bank, said in an official statement, “the main purpose of inviting strategic investors is to introduce advanced business concepts and management skills so as to further improve the corporate governance of domestic banks.”\(^{62}\) According to Wu, the Chinese regulatory authorities have laid down guiding principles called “long stake holding, governance improving, business cooperation and avoiding peer competition.”\(^{63}\) Wang Jianxi, Vice-chairman of China

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\(^{59}\) ICBC: Prospectus for Global Offering, at 90-91 (Oct 16, 2006).

\(^{60}\) Id. at 91.

\(^{61}\) Id.


\(^{63}\) Id.
State Administration of Foreign Exchange Investments Ltd., the major shareholder of Bank of China, also had a similar viewpoint that bringing in international strategic investors is an important step in fostering the reform of state-owned commercial banks in China.\textsuperscript{64}

This observation is consistent with the perspectives of international organizations such as the World Bank. Prior to 2005, International Financial Corporation, a subsidiary of the World Bank, bought stakes in five banks (Bank of Shanghai, Bank of Beijing, Industrial Bank, Minsheng Bank, Xi’an City Commercial Bank and Nanjing City Commercial Bank).\textsuperscript{65} According to Javed Hamid, the Director of East Asia and the Pacific at IFC, “We [the World Bank] support shareholders’ and managements’ efforts to make progress on corporate governance and international standards every time we invest. ... Without involvement in this key process, minority shareholders may be unwilling to make strategic investments or buy shares at IPO.”\textsuperscript{66}

Empirical research has shown that the market response to the diversification of the ownership structure of the ownership is quite positive as well. Henk Berkman, Reble Cole, and Jiang Fu used the event-study methodology to analyze the share-price response to announcements of changes in ownership structure from the direct control of government agencies to indirect control through solely state-owned enterprise (“SSOEs”) or stated-owned enterprises controlled by the government but with private minority shareholders (legal-person


\textsuperscript{66} Id.
state-owned enterprise, or “LPSOES”).\(^{67}\) They examined 79 observations of negotiated block share transfers occurring during 1997-2000.\(^{68}\) They found that block shares transferred from a government agency to LPSOEs brought an average of 12.3% in excess returns associated with the announcement of the transfer, and 1.9% in excess returns for block transfers to SSOEs.\(^{69}\) Berkman et al. explained that this may be due to the fact that the market values the transfers as attempts to improve the corporate governance of the firms in question by partially re-attaching cash-flow rights to control rights.\(^{70}\)

Though there has yet to be extensive empirical research on the market’s response to bank reform, it seems the responses from the market are significant and positive. China Construction Bank went public on the Hong Kong Exchange in October 2005. The offering raised $8 billion for the issuer, “making the IPO the largest since Kraft Foods went public on the New York Stock Exchange in 2001.”\(^{71}\) One year later, the IPO of Industrial and Commercial Bank of China raised $23 billion, setting a new IPO world record.\(^{72}\) Considering the dismal outlook of Chinese banks based on their financial records as of a couple of years ago,\(^{73}\) this is a tremendous achievement. Stephen Green, senior economist at Standard Chartered Bank, was quoted in the *International Herald Tribune* as stating: “Now their performance won’t just be evaluated by the government - it’ll be reflected in the share price.

\(^{67}\) Henk Berman et al., *From State to State: Improving Corporate Governance when the Government is a Large Block Holder*, at 3-4, 2002 Working Paper.

\(^{68}\) Id. at 30.

\(^{69}\) Id. at 6.

\(^{70}\) Id. at 25.


\(^{72}\) See articles cited in footnotes 52 and 53.

\(^{73}\) According to OECD, even though the bank restructuring reform in 1998-99 committed resources that amounted to more than 16% of the GDP, “the results were nonetheless disappointing” and the financial quality of the biggest four state-owned commercial banks “remained rather poor, with low earnings, inadequate capital, and continued high levels of [non-performing loans].” OECD, *Governance of Banks in China*, in OECD, *supra* note 13, Chapter 13.
And there is a feeling that this will be a major catalyst for change.” All these are not imaginable should the ownership structure of CCB remain wholly state owned before its IPO.

4. Cross-listing: China’s Best Companies Go Public Overseas

Cross-listing has been recognized by many commentators as “a new and desirable form of regulatory competition.” Issuers migrate from “low disclosure” domestic exchanges to “high disclosure” overseas exchanges and voluntarily subject themselves to higher disclosure and corporate governance standards and greater threat of enforcement. Laws and regulations of a foreign jurisdiction, such the U.S., may effectively deter malfeasance by a foreign issuer’s insiders. Therefore, cross-listing will signal to their investors the strong commitment on the part of the issuer of not expropriating the minority shareholders’ interests. In accordance with this strategy, many Chinese companies choose to list themselves on overseas stock exchanges, including exchanges in Hong Kong, the U.S., Singapore, and the U.K. Among those foreign exchanges, exchanges in the U.S. and the U.K. are considered to have the highest disclosure standards.

Cross-listing has become a dominant phenomenon for Chinese companies since 2003. In 2003, there were 48 companies that had IPOs on overseas stock markets, raising about $0.7 billion. In 2004, there were 84 companies, a 75% increase, raising $11.51 billion from

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74 Barboza, supra note 71.
75 John C. Coffee, Racing Toward the Top, supra note 20, at 1757.
overseas IPOs, a 15 times increase.\textsuperscript{77} By contrast, only 98 companies had IPOs domestically in 2004, raising only $4.27 billion.\textsuperscript{78} Although the number of IPOs conducted overseas in 2004 was close to the number conducted domestically, the capital raised on the overseas market was almost 3 times that raised on the domestic market. The year 2005 saw an even more dramatic development. In 2005, only 15 companies went IPO on the domestic market, but 70 companies that IPO in overseas markets.\textsuperscript{79} Newly public companies only raised $684 million on the domestic stock market, about 3% of the $21.23 billion raised by those that went to overseas capital markets.\textsuperscript{80} In 2006, the number of companies that went IPO overseas was slightly more than those from the domestic market, but capital raised from overseas IPOs was 2.5 times that raised from domestic IPOs.\textsuperscript{81} Table 2 below shows the data for Chinese firms’ IPOs.

\textbf{Table 2: Chinese Firms’ Overseas IPO and Domestic IPO (2004 -2006)}\textsuperscript{82}

(Capital Raised In Million Dollar)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies</td>
<td>66</td>
<td>98</td>
<td>15</td>
<td>65</td>
</tr>
<tr>
<td>Capital Raised</td>
<td>$5,668</td>
<td>$4,270</td>
<td>$684</td>
<td>$17,113</td>
</tr>
<tr>
<td>Overseas</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies</td>
<td>48</td>
<td>84</td>
<td>70</td>
<td>86</td>
</tr>
<tr>
<td>Capital Raised</td>
<td>$7,000\textsuperscript{83}</td>
<td>$11,151</td>
<td>$21,230</td>
<td>$43,998</td>
</tr>
</tbody>
</table>

Source: CCIDNET, CSRC.

\textsuperscript{77} Id.
\textsuperscript{78} Id.
\textsuperscript{80} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Estimate based on 2004 Overseas IPO Report, supra note 76.
A company may have more than one reason to list its stock on overseas stock markets: to expand its shareholder base, to gain the advantages of increased liquidity, and to overcome market segmentation are all sound motives. However, bonding is one of the most important reasons for companies from a jurisdiction with weak law protection to go public overseas. John Coffee suggests that foreign issuers cross-list on foreign markets to bond themselves to the requirements of stricter securities regimes to encourage investment in the firm. When a firm lists in the United States, it makes a “credible and binding commitment . . . not to exploit whatever discretion it enjoys under foreign law to overreach the minority investor . . . [so as to] induce minority shareholders to invest in it.”

Issuers must make disclosures regarding ownership structures and material developments in the issuer’s business. They become subject to stricter insider trading prohibitions, limitations on tender offers, stricter corporate governance requirements, and private shareholder actions under Rule 10b-5 for fraudulent statements or omissions by the issuers.

Qian Su, Wilson H.S. Tong, and Yujun Wu tested this bonding hypothesis in the context of Chinese firms listed in Hong Kong and found strong supportive evidence. They contrasted a sample of 53 Chinese firms listed on the Hong Kong Stock Exchange (H-Share) against a control sample of domestic firms listed only on China’s domestic share market. They observed a general existence of cross-listing premiums of H-share firms.

85 Qian Su et al., Bonding Premium, supra note 31.
86 Id. at 13-27.
important, the cross-listing premium is larger for H-Share than for B-Share firms. They conclude that when firms from markets with a poor governance structure and weak legal protections are cross-listed on a market with a better governance system and stronger legal protection, the issuer can enjoy a significant bonding premium.

After listing the shares on an exchange with high disclosure standards, companies can then return to list on the Shanghai or Shenzhen exchanges. Utilizing this method, issuers can piggy-back on strong law enforcement and strong disclosure rules in foreign jurisdiction, and sell their stocks at a premium.

IV. PROBLEMS OF BONDING

In the previous section, we saw that if controlling shareholders want to make trustworthy commitment to improve the company’s corporate governance, they have a variety of mechanisms to do so; and investors are by and large willing to pay various bonding premiums for their efforts. This can be done even though law enforcement remains weak. If this is the case, then the question becomes, why has voluntary bonding not become a predominant force driving China’s listed companies to dispersed ownership?

1. Path Dependency: Lack of Incentive for Bonding

China’s stock market to date, unfortunately, does not follow the path of “commitment—IPO—keep the commitment.” Instead, China’s capital market was created

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87 Id. at 31-32.
88 Id. at 32.
nearly overnight by governmental orders, and public investors did not become aware of significant risks associated with having the state as the controlling shareholder until they had already bought shares. Controlling shareholders have incentives to bond themselves before they sell stock to potential investors; they do not have incentives to tighten their hands after they have received the money and taken control unless a secondary offering is envisioned.

As we discussed in the beginning of this article, the Chinese authorities’ main purpose in developing a stock market was to raise capital for the development of China’s SOEs and to facilitate the reconstruction of SOEs. In the early days of China’s stock market, it was nearly impossible for any private enterprises to get approved and listed on the Stock Exchanges. Until March 1998, only one non-state owned company, Sichuan New Hope Agriculture Stock Co., Ltd., was approved to be listed by the Chinese government and became the first listed private enterprise. Today, the vast majority of listed companies still are “reorganized state-owned enterprises.” At the end of 2001, of 1,160 companies listed on China’s stock market, approximately 1,103 were reorganized SOEs. By classifying various shareholdings in Chinese public corporations according to the principle of ultimate ownership and control, by the end of 2001, approximately 84% of companies listed on China’s stock market were ultimately controlled by the state.

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89 See supra 39 and the corresponding text.
90 A few private enterprises got access to a capital market by buying current listed companies (“buy shell”). See, WU JINGLIAN DANGDAIZHONGGOU JINGJI GAIGE (ECONOMIC REFORM IN CONTEMPORARY CHINA), 232 (2004).
93 Id.
with gambling on the stock market, and paid little attention to the underlying value of stocks. The turnover rate for A-shares in 2000 was 499.10% and 503.85% for the Shanghai and Shenzhen stock markets, respectively.\textsuperscript{94} Compared to the highest turnover rate of 78% during the Internet bubble period in the U.S., these figures were extremely high.\textsuperscript{95} When the whole stock market has already been locked in by companies with bad corporate governance, existing controlling shareholders do not have strong incentives to bond themselves and improve corporate governance.

Under this circumstance, controlling shareholders of many listed companies not only will not bond themselves, but also have incentives to resist the regulators’ or exchanges’ efforts to tighten the regulation. A very interesting phenomenon in China’s recent efforts to improve the law enforcement of securities regulations is that many security companies and listed companies argue that if the enforcement is stringent, the market will collapse and investors will suffer. These arguments sound absurd and self-serving, but surprisingly have often had some effects, and the Chinese government often took actions to “bail” the stock index out. The two most infamous examples of governmental intervention in China’s stock market happened in 1994 and 1999. On June 30, 1994, to respond to the low average stock price, the Chinese government announced three new policies—“freeze new issuing within a year, control secondary issuings, and inject more capital into the stock market.”\textsuperscript{96} As a result, the Shanghai

\textsuperscript{94} WU JINGLIAN, ZHUANGUI ZHONGGUO [CHINA IN TRANSITION], 182 (2002).
\textsuperscript{95} Id.
\textsuperscript{96} Deng Yang, Zhengcetoushi Buneng Jiejue Gengben Wangji, Dangju Mo Zai Zoushi Liangji [Governmental Support Market Cannot Solve Fundamental Problems, Authority Should Not Lose Valuable Opportunities Again], in CAIZHONG SHIBAO [FINANCE AND ECONOMY TIMES], June 14, 2005. See also, Tang Jun, Cong Guizhi Shichang Caozong Xingwei Kan Woguo Zhengquan Shichang Zhong Zilv Jiangguan De Queshi [Stock Market Manipulations Show the Absence of Self-Regulation in China’s Securities Market], 4 GANSU ZHENGFA XUEYUAN XUEBAO [JOURNAL OF ADULTS EDUCATION OF GANSU POLITICAL SCIENCE AND
index soared by 223% in one and half months. On July 15, 1999, when the stock market was in another low, the People’s Daily published an editorial, *Build Confidence for Orderly Progress*, expressing the Chinese government’s commitment to intervene the stock market if this was necessary. Days later, the Shanghai index jumped to a then historical peak.  

2. Potential Conflicts of Interest between Controlling Shareholders and Company Managers

There is another problem regarding SOEs in China. Most of their executives do not own their company’s stock. As of 2000, in Chinese listed companies on average, the top five executives only owned 0.02% of their companies’ shares. Because managers often cannot share the “bonding premium” but have to bear the bonding cost, insiders of these SOEs do not have enough incentives to bond themselves in the first place, even though the controlling shareholders—in this case, the state—may have incentives to sell the company’s stock at a higher price. The insiders’ incentives before and after IPO are most likely the same: to maximize their own interests; and a governance structure that would give them more leeway and less external control would serve their self-interest better than good corporate governance. As a result, insiders of SOEs rarely have the incentive to bond themselves even though the state as controlling shareholder may be willing to do so.

Most of the large SOEs that went public on overseas stock markets have one of two

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97 Deng Yang, *supra* note.
characteristics: the first is the SOEs are of particular political significance, so the central government is very eager to demand that the SOEs be listed on overseas stock markets. Banks are in this category. Because China had obligations under the WTO treaty to open its financial service industry to foreign investors before the end of 2006, the government had very strong motivation to prepare its banks before the deadline. This led to their fast, often impatient moves to speed up the bonding process. The second characteristic of large SOEs that wend public on overseas stock market is that the bonding has often successfully aligned the interests of managers with those of prior controlling shareholders—the state. Managers in Chinese SOEs usually are paid poorly, compared to their foreign counterparts. CEOs or general managers in traditional SOEs usually do not own shares, nor are they compensated with forms of options or other equity-based compensation. However, when those companies plan to go public overseas, many of them begin granting options with endorsements from foreign investment bankers and obtain approval from the government under the label of “international best practice.” As such, going public overseas becomes a necessary evil to become rich for managers, even at the cost of binding themselves by the listing laws and regulations when they do go public.

3. **Ex ante v. Ex post Incentives**

The third problem of bonding is related to the nature of bonding. Selling manager-owners have different incentives before and after the IPO. Companies or selling managers may have strong incentives to show that they are willing to comply with the mandates
of good corporate governance and will try to give the appearance of trustworthiness to the prospective investors before investors who want to buy the companies’ stake. But this incentive changes after the initial public offerings. Unless companies plan to have secondary offerings or to engage in other similar transactions with investors, they will naturally be less inclined to fulfill their prior commitment after the IPO. Without legal enforcement, measures such as auditing, accounting, and outside directors may not effectively stop a controller from tunneling or stealing if selling manager-owners still control the board after the IPO. As an executive officer of a public company admitted during an interview:

At the early stage, listing companies often do well [in complying with listing rules.] But, after a while they relax their compliance with the listing rules. This is because some directors do not treat these rules very seriously….

There are basically three possible ex post constraints for controlling shareholders or insiders and preventing such a scenario: an enforceable law against asset stripping, a safeguard corporate governance mechanism put in place beforehand, and greater benefits from cooperation in the future. When minority shareholders cannot call upon the Chinese government or courts to protect their interests, and controlling shareholders do not have incentives to repeat the game, the minority shareholders’ only hope is that the corporate structure that the controlling shareholders put in place before their investing, such as an independent board, auditing committee, etc., can function as safeguards to protect their interests. This is often hard to achieve in practice and investors often will not feel confident enough until a company decides to cross-list its shares in a foreign exchange with stronger law enforcement.

4. Exchanges’ Motivations and Their Failure to Carry Out Extraterritorial Law Enforcement

Foreign stock exchanges, including the Hong Kong Stock Exchange, the New York Stock Exchange and the NASDAQ, are affiliated with marketplaces, have interests in getting more profits, and often compete with each other to attract and retain listings. Also, for historical reasons, exchanges and domestic laws often have different rules for foreign firms.

In the United States, the SEC allows foreign companies to have different corporate governance and often applies different disclosure standards to them.\(^\text{100}\) Under U.S. law, foreign private issuers are not bonded in the same way that American issuers are because disclosure requirements are less stringent for foreign firms. The SEC requires foreign private issuers disclose interim reporting only on the basis of home country and stock exchange practice rather than quarterly reports.\(^\text{101}\) Foreign private issuers are exempted from the proxy rules and the insider reporting and short swing profit recovery provisions of Section 16.\(^\text{102}\) They were allowed to make aggregate executive compensation disclosure rather than individual disclosure, if so permitted in an issuer's home country.\(^\text{103}\) Foreign issuers must disclose the names of controlling shareholders only when those shareholders hold 10\%\(^\text{104}\) or more of voting

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\(^\text{100}\) See Amir N. Licht, *Cross-listing and Corporate Governance: Bonding or Avoiding?* 4 Chi. J. Int’l L. 141, 152 (“The United States thus has two securities regulation regimes: one for domestic issuers and one for foreign ones. … Apparently, the SEC correctly analyzed how the foreign listing decision is reached and purposefully watered down the provisions that bothered insiders most.”).

\(^\text{101}\) SEC: *International Reporting and Disclosure Issues In the Division of Corporation Finance* (October 1, 2003), available at the SEC website: http://www.sec.gov. See also general instructions for SEC Form 20-F and Form 10-K.

\(^\text{102}\) SEC: *International Reporting and Disclosure Issues In the Division of Corporation Finance*, supra note.

\(^\text{103}\) Id.

\(^\text{104}\) Instruction of Form 20-F.
securities, as opposed to the 5% threshold \(^{105}\) for domestic issuers. The disclosure rules that foreign issuers can avoid seem to be those that would be particularly useful for the market to be able to monitor the issuer for agency problems and minority shareholder expropriation.\(^{106}\)

There are also serious concerns about the enforcement effectiveness of the Hong Kong Securities and Futures Commission (SFC) when mainland Chinese companies listed on Hong Kong Stock Exchange are involved in securities regulation violations. Hong Kong is a “Special Administrative Region” of the People’s Republic of China that exercises “a high degree of autonomy” and enjoys “executive, legislative and independent judicial power, and maintains its separate and independent judiciary.”\(^{107}\) As such, in the absence of special agreement or arrangement, Hong Kong is not obligated to enforce any judgment or ruling made by the mainland China courts or government agencies. By the same token, decisions, judgments or rulings made by courts or other government agencies in Hong Kong are not enforceable in mainland China unless they are recognized by courts or other authorities in mainland China pursuant to special arrangements.\(^{108}\) Up to October 2006, only final arbitral awards and certain commercial judgments made in Hong Kong were enforceable in mainland China after the party of interest obtains the acceptance of enforcement in a mainland court.\(^{109}\)

\(^{105}\) See 17 CFR § 229.403(a) (2002).

\(^{106}\) Amir N. Licht, supra note 100, at 148-49.

\(^{107}\) Article 2 of The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (Apr 4, 1990) ("Basic Law of Hong Kong").

\(^{108}\) See Article 95 of the Basic Law of Hong Kong.

\(^{109}\) See The Arrangements on Reciprocal Enforcement of Judgments in Civil and Commercial Matters Between Hong Kong SAR and Mainland China (July 14, 2006) (providing that monetary judgment made by designated courts of either the mainland or the Hong Kong SAR, exercising their jurisdiction pursuant to a valid exclusive choice of jurisdiction provision stipulated in a commercial agreement, can be recognized and enforced reciprocally pursuant to procedure), and The Arrangement on Mutual Enforcement of Arbitral Awards Between Hong Kong SAR and Mainland China (June 18, 1999) (providing enforcement of commercial arbitral awards). In addition, The Arrangement on Mutual Service of Judicial Documents in Civil And Commercial Between Hong Kong SAR and Mainland China (Dec 30, 1999) provides service of process for civil and commercial litigations between the mainland and the Hong Kong SAR. For a discussion of these three Arrangements,
This has created serious enforcement problems when it comes to enforcing the Hong Kong securities law and regulations in mainland China. As Martin Wheatley, the current chairman of the Hong Kong SFC admitted in a speech delivered on May 10, 2006, “the SFC has no jurisdiction on the Mainland; [SFC’s] power under the Securities and Futures Ordinance are exercisable exclusively within the territorial limits of the Hong Kong SAR.”

From May 1998 to May 2006, the SFC has only initiated one case against mainland companies listed in Hong Kong. The case involved expropriating shareholders’ funds and it resulted in banning a director from holding the directorship of a listed company for certain period.

There is also anecdotal evidence on how the SFC has difficulties in enforcing its disclosure requirements. On December 22, 2005, Caijing Magazine published a story regarding Beijing Youth Media, a mainland company that is listed on Hong Kong Exchange. According to the Caijing article, six members of senior management had been arrested by the Beijing Public Prosecutor between June 9 and September 26, 2005 and charged with serious corruption. Beijing Media was obligated to report the incident as promptly as possible under Hong Kong law; however, during this period, the company never disclosed any information to the SFC, and Hong Kong investors did not know of the development until the news broke in Caijing Magazine. According to Caijing, as of September 30, 2006, neither the public prosecutor in Beijing nor the Hong Kong

especially The Arrangements on Reciprocal Enforcement of Judgments in Civil and Commercial Matters, see Reciprocal Enforcement of Court Judgments in Civil and Commercial Matters between Hong Kong SAR and the Mainland, HONG KONG LAWYER, Oct 2006.


111 Id.

112 Duan Hongqing, Beijing Chuanmei San Gaoguan Shexian Juangru Jingji’an [Beijing Media Three Executives Arrested for Corruption], Caijing Magazine, Issue 143 (Oct 3, 2005).

113 Id.
Exchange had revealed further information on the Beijing Media case. Before this, there were other similar incidents, such as the chairman of Agricultural Holdings Company being arrested for misreporting the amount of registered capital, the chairman of Fareast Pharmacy being arrested due to misconduct, and the chairman of Kelong Electric being arrested for misappropriating company funds and disclosing falsified information. In all these cases, the companies involved did not fulfill their disclosure obligations under the Hong Kong law; yet were also no actions against them by Hong Kong SFC related to the insufficiency of full disclosure.

The Hong Kong SFC and the CSRC have recently made an arrangement to enhance cooperation between them, but the effectiveness of the arrangement remains to be seen. In April 2007, the Hong Kong SFC and the CSRC reached an agreement to enhance cross-border enforcement in the investigation of cross-border crimes and regulatory breaches. According to this new arrangement, if the Hong Kong SFC decides to seek information from a person located in mainland China and such person refuses to comply, the Hong Kong SFC may ask the CSRC for assistance and the CSRC will seek court sanctions against that person. The SFC in turn, will also exercise its investigatory powers to help the CSRC in its investigations that

\[\text{\textsuperscript{114}}\text{Caijing, Issue 143.}\]
\[\text{\textsuperscript{115}}\text{See Qian et al., supra note 31, at 10-11.}\]
\[\text{\textsuperscript{116}}\text{To Hong Kong SFC’s credit, SFC instituted disciplinary proceedings against ICEA Capital Limited (ICEAC), the sponsor (underwriter) of Euro-Asia Agricultural Holdings Company. The SFC alleged that ICEAC had not exercised due skill, care and diligence in the course of performing its duties as the sponsor for the listing of Euro Asia Agricultural. Without admission of liability, ICEAC has agreed to pay HK$30 million in full and final settlement of the SFC’s case. See Press Release by SFC, available at \text{http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?save=1&docno=05PR17}.}\]
\[\text{\textsuperscript{117}}\text{Hong Kong SFC Press Release, } \text{Cross Border Enforcement Enhanced}, \text{available at Hong Kong SFC website, www.sfc.hk (last visited on April 24, 2007). See also, Jeffery Ng, } \text{Regulators Broaden Ties}, \text{WALL. ST. J. April 4, 2007.}\]
\[\text{\textsuperscript{118}}\text{Cross Border Enforcement Enhanced, supra note.}\]
have a Hong Kong element.\textsuperscript{119} However, observers remain concerned that this arrangement may not significantly enhance cross border enforcement. David Webb, a shareholder advocate on the board of Hong Kong’s stock exchange, was quoted by \textit{The Wall Street Journal} as saying, “This [the agreement] is just an information-exchange agreement that stops short of any extradition arrangements. As a result, it is still very difficult to prosecute officials and directors of mainland companies listed in Hong Kong when they do wrong.”\textsuperscript{120}

\section{V. Policy Recommendations}

Improving law enforcement is one way to protect minority shareholders and improve the efficiency of the economy by fostering a vigorous stock market. Unfortunately, improvement to law enforcement requires the integrity, professionalism, and independence of judges and civil servants, and this often takes decades to achieve. Policymakers and lawmakers have to take the level of law enforcement as a given, and find the best ways to utilize the will and minds of the market players to provide Pareto improvement. As we have discussed in section II, in principle, it is in the issuers’ and investors’ best interests to have strong corporate governance; the problem is how to get there. In section III, we discussed several means of enforcement. The real challenge is how to implement these methods in a manner that takes into account the problems we have to deal with described in section IV. I believe the following polices can provide meaningful assistance to address this issue:

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{119} \textit{Id.}
\item\textsuperscript{120} Ng, supra note 117.
\end{enumerate}
\end{footnotesize}
1. Encourage Cross-listing

Even though the Chinese government currently seems to encourage its large SOEs to go public on overseas stock markets, the stability of this policy is uncertain. There are different opinions among government agencies. The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) is a strong believer in improving SOEs’ corporate governance through cross-listing and bonding.\textsuperscript{121} The CSRC, however, is not a big fan of sending the “blue-chips” such as Bank of China, China Construction Bank, and Industrial and Commercial Bank of China to be listed on Hong Kong or NYSE. This is considered, in a Chinese sense, “losing face,” as it is a sign that the public does not have confidence in their own ability to protect investor interests.\textsuperscript{122} Because Chinese companies seeking to list in Hong Kong need the CSRC’s approval first, the CSRC sometime uses this power to set obstacles to Chinese companies’ overseas IPO plans. According to an article published in \textit{The Wall Street Journal} on April 18, 2007, as an “unofficial policy,” the CSRC has recently requested that Chinese companies first list in a domestic exchange before they can get approval from the CSRC for their Hong Kong public offering.\textsuperscript{123} As we have discussed, cross-listing is actually the issuers’ effort to piggy-back on the strong law enforcement capacity of foreign jurisdictions to bond themselves and assure investors of their commitment to follow good corporate governance practice.

\textsuperscript{121} SASAC has identified going public overseas as a strategic move, according to Chinese media. \textit{See Guonei Gushi Rrongzhi Kunjing, Yejie Jibian Zhongguo Qiye Haiwai Shangshi “Matai Xiaoying” [Domestic Stock Market Faces Capital Raising Predicament; Going Public Overseas Brings Matthew Effect], CAIFU ZHISHU (FORTUNE INDEX) (2005).}

\textsuperscript{122} \textit{Id.}

\textsuperscript{123} Nisha Gopalan, \textit{China Crimps Hong Kong IPOs: Regulator Steers New Listings to Mainland, WALL. ST. J.,} April 18, 2007.
Currently, some, but not all, companies listed overseas also simultaneously list on the domestic stock exchange. There are, not surprisingly, arguments against these companies’ return. One major, but absurd, argument that has been voiced of is that their coming back will drive up the supply of stock in the domestic stock market and that without a corresponding increase of demand, the stock price in the domestic market will go down.\textsuperscript{124} This effect may appear, but it should be exactly the effect that the policy maker would like to see. A strong commitment to protect minority shareholders can improve the company’s value, and managers-issuer should bond themselves with this strong commitment.

2. Encourage Bonding Domestically

A. Stock Exchange Autonomy and Competition Between Exchanges

On October 27, 2005, the Standing Committee of China’s National People’s Congress amended the Securities Law. The new law states that stock exchanges should have autonomy regarding their management. Article 102 of the new Securities Law defines a securities exchange as a legal person that applies “a self-regulating administration”\textsuperscript{125} Stock exchange autonomy is a new norm that has a long way to go before it becomes a reality in China. The two stock exchanges in China, the Shanghai Exchange and Shenzhen Exchange are more like

\textsuperscript{124} In March 2004, a report that Bank of China will issue RMB 90 billion stock in domestic market “shocked” China’s stock market. It was suggested that this “dinosaur” will drain money from the stock market. 21 SHIJINGJI BAODAO [21 CENTURY ECONOMY REPORT], December 8, 2005.

\textsuperscript{125} Article 102 of China’s new Securities Law provides that:

"For the purpose of the present Law, the term “stock exchange” refers to a legal person that provides the relevant place and facilities for concentrated securities trading, organizes and supervises the securities trading and applies a self-regulating administration.”
two subsidiaries of the CSRC, rather than independent bodies. But the amendment at least signals that the country is willing to move in the direction towards more stock exchange autonomy.

There have been a few experiments in both developed countries and emerging markets with thin stock markets by setting up separate, higher-listing-standard stock exchanges. It is often shown that emerging markets with relatively weak legal regimes can offer value-relevant bonding mechanisms to local firms. There are several notable examples of local exchanges attempting to offer bonding mechanisms: the Neuer Markt in Germany, the Novo Mercado created by Brazil’s Sao Paulo Stock Exchange (Bovespa), and the Korea Securities Dealers Automated Quotation System (KOSDAQ). The German Neuer Markt, established in 1997, was called by The Wall Street Journal the “most regulated market in Europe.” The Novo Mercado publicized the listing firm’s ability to “better advertise the efforts of the company to improve the relations with its investors.” KOSDAQ is better known for its stricter ongoing performance thresholds (or, “delisting criteria”). Each of these three systems offers local firms the opportunity to select a listing regime with more stringent governance and reporting.

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126 According to the Stock Exchanges Regulation (Zhengquan Jiaoyisou Guanli Banfa) approved by State Council of China in 1997, the chairperson (Lishizhang) and vice chairperson (Fu Lishizhang) of Stock Exchanges must be “nominated” by CSRC and “elected” by the board. Section 22, Stock Exchanges Regulation, approved by State Council of China on Nov. 30, 1997 and published by Securities Regulation Commission of State Council of China.

127 Sometime also referred to as “Neuer Market” in English. For a detailed discussion of the rise and fall of the Neuer Markt, see Hans-Peter Burghof & Adrian Hunger, Access to Stock Markets for Small and Medium Sized Growth Firms: The Temporary Success and Ultimate Failure of Germany’s Neuer Markt, (Working page, October 2003).


132 “A review of the listing requirements shows that … KOSDAQ’s delisting rules are more stringent and its enforcement efforts more active than [the Korean Stock Exchange] over the sample period, 1999-2002.” See Dewenter et al., supra note 129.
practices than the original local exchanges. Stringent reporting requirements improve external
monitoring by making it easier for investors to detect management decisions that are driven by
opportunistic behavior and to punish the firm accordingly through lower stock prices.

However, the trade record of these “new” markets has been mixed, with the ultimate
failure of Germany’s Neuer Markt, and promising progresses of KOSDAQ of South Korea and
Novo Mercado of Brazil.133 There is no assurance of success for this experiment, but if China
can allow competition between the Shanghai and Shenzhen exchanges, or even set up an
exchange with higher list standards and stricter and better-enforced de-listing criteria, China
may be able to provide value-add bonding mechanisms within its own jurisdiction. If China
can take a bold step further by allowing the Hong Kong Stock Exchange to acquire a domestic
exchange or set up a branch within mainland China, it may provide an even bigger effect and
ample opportunities to companies, especially non-state-owned companies with small capital
size, to commit themselves to better corporate governance.

B. Non-state-owned Enterprises Go Public

As we have discussed in Section IV, a severe problem preventing companies from
committing themselves to good corporate governance is the path dependency issue. Those
companies already on the stock market do not have strong incentives to bond themselves as do
companies that have yet to go public. Therefore, it makes more sense to give new companies
a fresh start, to encourage signaling of good corporate governance, lower agency costs, and a

133 See Felice B. Friedman and Claire Grose, Promoting Access to Primary Equity Markets: A Legal and Regulatory Approach,
commitment to protecting minority shareholders. Compared to SOEs, entrepreneurs in non-state-owned enterprises have much stronger incentives to bond themselves for two reasons: first of all, non-state-owned enterprises often do not have one kind of agency problem that plagues SOEs: the agency cost associated with state as owner/master and entrepreneurs as managers/agent. In middle sized non-state-owned enterprises, managers are almost always the owners of the enterprises themselves. As such, if managers in non-state-owned enterprises decide to voluntarily bond themselves, they can enjoy the “bonding premium.” As discussed in Section IV above, this is not the case for SOEs, where the state enjoys the “bonding premium” while the managers bear the “bonding costs.”

The other important reason for non-state-owned enterprises’ stronger desire to bond themselves in exchange for better access to an equity market is simply because they have less access to debt markets. A survey conducted by the International Monetary Fund (IMF) revealed that at the end of 1999, the private sector accounted for only 1 percent of bank lending. The same survey also showed that about 80 percent of the non-state-owned enterprises considered their lack of access to finance to be a serious constraint.

Chinese companies with the best corporate governance are probably those non-state-owned enterprises that went public in the United States. By the end of 2005, there were at least 23 venture capital backed Chinese companies listed on NASDAQ, including Sina, Neteast, Baidu, and Vimicro. Most of them have decent corporate governance and

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135 Id.
136 Wei Zhang et al., *Venture Capital and the Financing of China’s New Technology Firms*, INSEAD Faculty & Research
dispersed ownership according to the U.S. standard. Their path of going public is closely following the Silicon Valley model. Most of them started with a group of entrepreneurs, funded by venture capital money from Silicon Valley, California. Venture capitalists not only brought money, they also “pushed owners and managers in these firms to put mechanisms in place that support good corporate governance and professional management.” As a result, in their early years, these non-state enterprises have already learned how to bond themselves by having their board and purses controlled by venture capitalists. When these companies became ready to go public, protecting shareholders’ interests and playing the game according to the rules has already become part of their corporate structure and culture. The legal and policy constraints that stop the development of a robust venture capital market in China is the topic of another paper, but the point here is that if the non-state enterprises’ development from start-ups to middle-size companies follows the path of balancing interests between shareholders and managers, a capital market that consists of these private enterprises will be mostly free from the path dependency problems that deeply limit SOEs already on the stock market.

3. The Self-Enforcing Model of Corporate Law

The “self-enforcing model of corporate law” is a paradigm Professors Bernard Black and Reinier Kraakman proposed to meet the needs of Russia to draft its new corporate law during Russia’s transition to a market economy. Russia is described as a typical emerging


137 Id.

capitalist economy, with “insider-controlled companies, malfunctioning courts, weak and sometimes corrupt regulators, and poorly developed capital markets.” The idea is to take these weaknesses as given, and then focus on private enforcement and self-compliance. The central features of this “self-enforcing model of corporate law” are:

(i) Enforcement, as much as possible, through actions by direct participants in the corporate enterprise (shareholders, directors, and managers), rather than indirect participants (judges, regulators, legal and accounting professionals, and the financial press).
(ii) Greater protection of outside shareholders than is common in developed economies.…
(iii) Reliance on procedural protections—such as transaction approval by independent directors, independent shareholders, or both—rather than on flat prohibitions of suspect categories of transactions.…
(iv) Whenever possible, use of bright-line rules, rather than standards, to define proper and improper behavior.…
(v) Strong legal remedies on paper, to compensate for the low probability that sanctions will be applied in fact.…

Unfortunately, experimenting with this model in Russia has been unsuccessful.

Black, Kraakman, and Anna Tarassova wrote an article, *Russian Privatization and Corporate Governance: What Went Wrong?*, four years after the Russian corporate law reform, suggesting that law enforcement is crucial, and that no perfect law can remedy the lack of decent law enforcement.

China’s situation is probably different from that of Russia. In Russia, as the result of mass privatization and “shock therapy,” the majority of the entrepreneurs after privatization do not have the incentives necessary to improve the corporate governance of newly privatized companies as they already have control of the company, and their next step is to strip the public

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139 Id. at 1915.
140 Id. at 1912.
companies’ asset and move them overseas. Fortunately, this is not quite the case in China. Private enterprises still have strong incentives to get investments from investors as cheaply as possible even if it means entrepreneurs have to bond themselves with good corporate governance.\textsuperscript{142} Thus, a self-enforcing model of corporate law may make more sense in China than in Russia.

On October 27, 2005, the Standing Committee of China’s National People’s Congress amended its Company Law. The amendments, to a great degree, modernized the Company Law. The new Company Law recognizes shareholders’ rights to bring derivative suits (Article 152), prescribes mandatory dividends and recognizes shareholders’ rights to appraisal (Article 75), regulates interested transactions (Article 125), recognizes cumulative voting, empowers 10% of shareholders to call a special meeting, defines the role of independent and non-executive director, liberalizes the corporate forms, changes many rules regarding internal governance from mandatory rules to default rules, lowers the incorporation capital requirement threshold, and expands forms of capital contribution. These are all good advances but the reform should continue. Major changes should be made to further liberalize the corporation capitalization restrictions\textsuperscript{143} and to provide tax benefits to certain business entities\textsuperscript{144} so as to foster a venture capital industry. Companies should be encouraged to amend their charters and

\textsuperscript{142} See Elise S. Brezis & Adi Schnytzer, \textit{Why are the Transition Paths in China and Eastern Europe Different? A Political Economy Perspective}, 11 \textit{Economics of Transition} 13, 13-20 (2003). (Transition in China and Eastern Europe was implemented in very different ways: Eastern Europe has chosen “Embezzlement for a rainy day,” while China has chosen “Market-Leninist.”)

\textsuperscript{143} Chinese Company Law generally follows the German model where a company must register the amount of its capital with the government agency. See Article 26, the Company Law of China (2005 Amendment). Under U.S. corporate law, whether in the states of Delaware, California or New York, the corporation’s charter authorizes the number of shares that the company can issue in the future, but the price for each share and when it will be sold is determined entirely by the corporation.

\textsuperscript{144} A company cannot avoid double taxation while maintaining limited liability under current Chinese law. There is no arrangement equivalent to the limited liability company, limited liability partner, or S corporation in China.
by-laws to signal to investors their commitment to protect shareholders’ interests.

VI. CONCLUSIONS

This paper deals with the relationship between effective law enforcement and the protection of minority shareholders. We start by agreeing that the protection of minority shareholders is crucial to developing a strong capital market in which investors are willing to buy shares of companies without fearing that their interests will be stripped by the controllers of companies. However, the relationship between law enforcement and protection of minority shareholders is more complicated. Legal institutions are not the only institutions and mechanisms that can protect minority shareholders, probably not even the most important ones in the context of Chinese listed companies. In principle, when the formal legal enforcement is weak, to lure investment, entrepreneurs have incentives to develop functional alternative institutions to ensure minority shareholders’ interests are protected. Thus, entrepreneurs may voluntarily “bond” themselves. China’s experience has provided several examples of companies initiating bonding and investors responding positively. Among various bonding mechanisms, diversifying the ownership structure and listing the companies on exchanges with higher disclosure standards are so far the most effective.

The difficulties of improving corporate governance in China are probably not mainly a question of improving the quality of legal enforcement. Instead, the challenge of improving corporate governance in China is how to encourage and facilitate bonding practices. If the only problem is weak enforcement, parties can find functional alternatives to weak legal
enforcement and reduce agency cost significantly. Entrepreneurs can bond themselves, internal corporate structures can be built up to ensure compliance, and parties may not need to rely upon the Chinese government to enforce their rights.

Three polices are proposed in this article to improve corporate governance with the common theme of facilitating voluntary bonding practice. First, companies who are willing to bond themselves and improve their corporate governance should be encouraged to cross-list their stock overseas and voluntarily subject themselves to higher disclosure standards and more stringent legal liability. Second, China should facilitate competition between exchanges within its jurisdiction and allow more non-state-owned enterprises to go public. And finally, the corporate law in China should follow the self-enforcing model, where private enforcement is emphasized and encouraged.