International corporate governance developments: the path for China

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Abstract

China’s WTO entry in 2001 accelerated its integration with the world economy and exposed Chinese companies to international competition. As globalization gains momentum, national corporate governance systems come under greater scrutiny. This article discusses three generic corporate governance models and the 2004 OECD Corporate Governance Principles and their possible application to China. To investigate the possibility of China’s convergence or divergence from international corporate governance models and principles, it delves into the evolution of governance of Chinese listed companies that are transformed from State-Owned Enterprises (SOEs) and examines current major corporate governance issues in listed companies. The correlation of the historical development of governance of SOEs and persistent governance issues reveals that the governance of SOEs and listed companies bears the mark of China’s political economy, defining their path dependency. The article argues that China needs to develop a corporate governance regime that best suits Chinese companies even if this is partially divergent from international corporate governance best practices.

Introduction

Much attention has been paid to corporate governance issues following the recent wave of corporate collapses. The corporate scandals of Enron, WorldCom in the US, HIH, OneTel in Australia and Parmalat in Italy have shown that corporate governance is not only a problem for emerging market economies but also for developed economies (Rhoads, 2004). It has become a global issue. To improve the quality of governance of companies, international organisations such as OECD have developed corporate governance guidelines that aim to provide broad guidance across jurisdictions and promote best practice in corporate governance. National governments have also tightened up the regulation of the corporate world by formulating new laws that are responsive to the governance problems exposed in recent corporate scandals. Stock Exchanges such as NYSE, NASDAQ and ASX have revised their listing rules to impose higher governance standards for listed companies.

As economic globalisation empowers companies operating internationally, corporate governance has increasingly extended from national to international dimensions. It has been suggested that the best practice of the international corporate governance models can improve corporate governance of nation states. Consequently there have been debates on the possible influence of globalisation on the development of corporate governance of nation states.

One view is that the corporate governance of different countries will eventually converge by adopting a set of tested international best practices of corporate
governance. The other is that corporate governance will become further divergent due to different countries’ engrained social, economic, cultural and political conditions (Bebchuk et al, 1999).

This article looks at the current corporate governance models and recent development of international principles on corporate governance. It specifically analyses the governance problems in China’s state-owned enterprises and listed companies and examines the path of the future development of corporate governance in China: will it converge with, or diverge from, the international corporate governance models?

I argue that neither full convergence nor complete divergence will be the path ahead. As the social governance of nation states varies significantly, the development of corporate governance of nation states will bear their own historical mark. However, a pragmatic approach towards optimising their own corporate governance practices might lead to hybrid models of combining selective international and local practices being adopted by many countries.

**Current Corporate Governance Models**

Corporate governance practices vary from country to country. Different types of companies adopt different governance regimes. But companies possess common attributes such as legal personality, limited liability and eternal existence (Parkinson et al, 2000). Likewise, corporate governance in different countries experiences common governance problems, for example, abuse of power by directors and weak accountability mechanisms.

While it is difficult to categorise all corporate governance models, based on similarity of market conditions, corporate organisational structures or management styles, some generic corporate governance models may be identified. Ho has summarised the three chief corporate governance models that have been developed worldwide so far, as follows (Ho, 2002):

1. Anglo-American Model (Market-Oriented and External Control Model)
   - Widely dispersed and actively traded ownership;
   - Separation of ownership and control;
   - Arms-length business activities;
   - A single-tier company board representing shareholders as the centre of governance;
   - A mature stock market;
   - High level of transparency of the company and the market;
   - Intermediate agencies play an important role;
   - Stronger shareholders’ rights and better protection of minority shareholders; and,
   - A competitive corporate control market (Ho, 2002).

2. German – Japanese Model (Network-Oriented and Institutional Control model)
   - More concentrated ownership;
   - Cross-shareholding and external monitoring by banks and financial institutions;
   - Two-tier board structure;
• Mainly bank-centred debt financing;
• More collective decisions;
• Weak public disclosures and legal protection for investors; and,
• An inactive corporate control market (Ho, 2002).

3. Family Control Model. This model has been mainly practised in Asia.
• Concentrated ownership and control;
• Concurrent position-holding of directors and senior executives by family members;
• Relationship-based business activities;
• Collective decisions by a single-tier board;
• High efficiency and loyalty to the family business;
• Weak transparency of company information;
• Company’s borrowing power relies on owners’ reputation; and,
• Strong protection of inside shareholders interest and weak protection for minority investors (Ho, 2002).

The Anglo American model is a more market-oriented system. It is based on developed capital and securities markets, and a set of sophisticated market systems. Takeovers and the market for corporate control are two external monitoring mechanisms over the management (see Ho, 2002). Information disclosure is relatively transparent.

The German-Japanese model, on the other hand, due to weak capital and securities markets, is more oriented towards enterprise organisation and bank influence (Theodar, 1998). Institutional investors play a significant role in corporate governance and the stakeholder approach is evident in collective decision-making.

The family model is characterised by concentration of ownership and management power in family members and a weak disclosure system. As opposed to the arms-length business practices adopted in Anglo-American model, the business practices of the (predominantly Asian) family model largely depend on social connections and relationships.

The difference between these models is undoubtedly related to substantial differences in financial structures, in particular the prevalence of securities financing in Common law countries and the predominant role of the banking system in Civil law countries.

Moreover, different traditions of law and regulatory regimes also contributed to the shaping of their respective corporate governance models. Path dependency seems also at work. Path dependency means that a country’s pattern of corporate governance at any point in time depends partly on its earlier patterns (Bebchuk et al, 1999). Consequently, different systems of countries “might persist at later points in time even if their economies have otherwise become quite similar“(Bebchuk et al, 1999).

Because the Anglo American model has been proven largely effective, there is a growing trend of adopting US corporate governance structures as countries strive to get access to the international capital market and increase their economic competitiveness and power. They hope that the long march to economic prosperity
may be shortened by selecting capital market-preferred governance structures. This is somewhat delusional in that recent corporate failures and scandals in corporate America show that this model has its own problems. And if there are problems arising from US model in its home country where there is supportive infrastructure for its effective use, there are likely to be far more problems encountered by countries adopting this model without similar economic and legal infrastructure. For instance, Japan’s corporate governance has traditionally been characterised by the dominance of major banks. Plagued by poor economic performance in the past decade, Japan reformed its corporate governance systems in 2002. Japanese companies since 2003 have the option to choose either Anglo-American corporate governance structure (board of directors and committee structure) or their traditional structure (Gilson and Milhaupt, 2004). The option was the “product of compromise, not overwhelming consensus on (or empirical support for) the advisability of moving toward US corporate governance model” (Gilson and Milhaupt, 2004). Thus “members of a Keiretsu get something from Keiretsu structure that is easy to accomplish under the traditional corporate governance structure but may be more difficult to achieve through alliances under US and UK governance” (Gilson and Milhaupt, 2004). The path dependency of corporate governance can be further evidenced by the family model in Asia. Hong Kong, for example, has a well developed capital market, but family companies have not adopted a market-oriented governance approach, preferring instead to stick to traditional governance styles.

It is true that ‘all societies confront similar basic issues or problems when they come to regulate human activity’ (Licht et al, 2001), but differences in culture, law, custom, norm and organisational structure often dictates different ways to address them. In particular, the political economy of a given country has a significant impact on its corporate governance structures and practices and how these issues might be tackled (Roe, 2003). Globalisation of capital markets and companies perhaps has brought about the harmonisation of regulatory systems to a certain extent, but its capacity to change the pattern of governance in these models is yet to be seen.

The globalisation of business activities of corporations and the resulting need for international regulation for such activities has contributed to some global consensus on certain principles of good corporate governance developed by some national and international organizations. For example, the OECD and the World Bank principles were designed to apply across a broad range of legal, political and economic environments (Dallas et al, 2002).

**Corporate Governance Principles**

The OECD released its Principles on Corporate Governance in 1999. In view of recent corporate collapses, the OECD has since stepped up efforts to improve corporate governance through revision of the Principles (Rhoads, 2004). The revised version was released in May 2004. The revision concerns not only corporate management but also ‘confidence-building measures’ to restore investors and public confidence in corporate governance (Rhoads, 2004).

According to the revised Principles, the core principles of corporate governance practices that are relevant across a range of jurisdictions include fairness,
transparency, accountability and responsibility. The OECD has also refined the goals of corporate governance in the revision. The Principles are intended to:

[a]ssist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investor, corporations, and other parties that have a role in the process of developing good corporate governance.

The OECD has also stated that:

Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently (OECD Principles, 2004).

The governance problems of the board and issues surrounding directors’ abuse of power and accountability, which have long been a concern but which have been sharply exposed in the recent corporate debacles, have prompted the OECD to strengthen the role of the board and enhance the accountability of directors. The revised principles thus state that the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board’s accountability and loyalty to the company and the shareholders (OECD Principles, 2004). The fiduciary duty of the board is a key condition which should govern all their actions (Annotations to OECD Principles, 2004).

According to the revised principles, the responsibilities of the board include the following (Part Five of OECD Principles, 2004):

1. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
2. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
3. The board should apply high ethical standards. It should take into account the interests of stakeholders.
4. The board should fulfill certain key functions.
5. The board should be able to exercise objective judgment on corporate affairs independent from management, controlling shareholders and others in a special position to influence the company.
6. In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

It is clear that the revised principles aim to strengthen the responsibility of the board and consequently imposed more strict duties on directors, which keep in pace with the post-Enron tightening up of national regulations and listing rules on corporate governance and accountability.
It can also be observed that while these principles are applicable to companies belonging to three generic corporate governance models discussed above, the scope of application is wider for US and UK companies than for German and Asian companies. The Principles promote market-oriented systems and enhanced disclosure regimes, things to which US and UK companies are naturally receptive. Their effects on companies of different governance models, however, inevitably vary. Thus while there is no doubt that international principles are instrumental to promoting and improving corporate governance globally, their ability to bring different governance models to an international best practice model remains to be seen. China is a good example of this, as the balance of this article seeks to show.

Corporate Governance in China

An Overview

After more than 20 years of economic reform and outstanding economic growth in the past decade — with GDP growth remaining above 7½ per cent in recent years — China has maintained its strong momentum and continued its rapid integration into the global economy (IMF, 2003). China’s admission to the World Trade Organization in 2001 ‘marks its participation in economic globalisation at a higher level and with a wider scope. It indicates a greater and deeper involvement of China companies in global markets in terms of cooperation and competition’ (Chen, 2003). ‘To meet these new challenges, Chinese enterprises have been speeding up reforms, increasing productivity and efficiency, instituting more standardized forms of governance and management, and generally improving their overall quality’ (Chen, 2003). In 2002, China was ranked sixth in the world in terms of total economic output and seventh in terms of the volume of foreign trade (Chen, 2003).

CSFB, a leading global investment banking and financial services firm, has estimated that China’s GDP has grown by 8.8 per cent in 2003, up from 8 per cent in 2002, but will return to 8 per cent in 2004. According to the Ministry of Commerce, China’s 2003 foreign direct investment (FDI) inflows amounted to US$53.5 billion in paid-in terms. According to the United Nations Conference on Trade and Development (UNCTAD), China shared 8 per cent of US$653 billion global FDI flows in 2003. It is anticipated that the inflow of foreign capital will have a transformative role in developing high quality Chinese companies and improving corporate governance.

The growth of China’s capital market over the past decade has been rapid. It has grown to be the third largest in Asia, after Japan and Hong Kong, in terms of market capitalization (Cheng, 2004). The total market capitalization at the end of March 2001 was RMB 5 trillion with over 60 million stock holder accounts (Cha, 2001). Total capitalization reached US$510 billion in 2003. As of April 2003, 1,219 companies have been listed in Shanghai and Shenzhen exchanges (Hu, 2002). In addition, 78 companies have been listed in Hong Kong, New York and London (Hu, 2002). There were some big initial public offerings, for example, China Life Insurance raised US$3 billion in a dual Hong Kong and New York listing which was the biggest global offering in 2003 (Ai 2004). Due to fast market expansion, tightened capital supply, growing potential of a near-term interest rate, and a slew of fund embezzlement scandals that have eroded investor confidence in the past two years, the overall
capitalization of A shares and B shares dropped to RMB 4.47 trillion (Us$539.8 billion) in May 2004 (Sun, 2004).

Like the rest of the world, corporate governance has become a hot topic in China. Governance problems in SOEs, banks and listed companies have been reflected in cases involving fraud, corruption, insider control and mismanagement. The improvement of corporate governance has thus ranked highly on China Securities Regulatory Commission (CSRC)’s agenda. Progress has however been slow because of institutional obstacles embedded in the current governance system.

As the majority of listed companies in China are largely corporatised SOEs, the governance problems of SOEs and listed entities can be better understood by examining systemically with an historical approach. I will first look at the evolution of governance of SOEs and governance issues of listed companies, and then evaluate initiatives taken by CSRC to improve corporate governance of listed companies and assess the prospect of convergence of China’s corporate governance practices with the international models.

**Governance of State-owned Enterprises**

The development of SOEs in China has experienced four major stages as a result of the state’s strategic economic and legal policy shifts in the course of the reform. These include greater autonomy for managers, management contracting, corporatisation and ownership diversification.

**1949-1966**

From 1949 to 1966, SOEs largely operated under the centrally-planned economy. After the founding of the PRC, state and public enterprises were managed by factory management committees (gongchang guanli wenyuanhui) chaired by a factory director and management staff and employee representatives. A workers’ congress was also set up in large SOEs to advise and monitor the factory management committee. The relevant authorities assumed a supervisory role over the committee. This arrangement was abandoned after the state, following the former Soviet Union’s practice, launched the first Five Year Plan to carry out socialist transformation whereby private capital was largely assimilated into public ownership to realise the fundamental principle of socialism: public ownership of the means of production (Gao and Yang, 1999). Hence the state restructured industrial enterprises into SOEs based on a Soviet management model of command planning.

Under this model, the government played a central role in both external supervision and internal governance of the state industrial enterprises (Yuan, 2002). SOEs were not independent commercial entities. Rather, according to socialist ideology, they were owned by the people as a whole and used as tools by the government and relevant authorities to carry out economic plans and industrial outputs. SOEs had little decision-making power as regards business management. They were virtually treated as a branch of the government and run by the relevant government departments in charge of their supervision. The governance of enterprises was indistinguishable from the general governance system of the state. ‘Unified leadership
and hierarchical governance are the government’s principles for running state industrial enterprise’.\textsuperscript{20}

In short, the governance of state-run enterprises from 1949 to 1966 was largely politically controlled. The development of state-run enterprises was interrupted by the political campaigns of ‘Three Antis’ (San Fan),\textsuperscript{21} ‘Five Antis’ (Wu Fan)\textsuperscript{22} and the ‘Great Leap Forward’ (Da Yue Jing)\textsuperscript{23} in the 1950s and early 1960s and was totally halted in 1966 by the Cultural Revolution (Riskin, 1987).

1978-1984

The year 1978 became the turning point in the development of SOEs as the government adopted policies that encouraged greater autonomy for SOEs and granted more decision-making power to their management teams, in line with the overall package of economic reform and opening up.\textsuperscript{24} A trial was conducted in response to this policy in October 1978 and the total number of pilot enterprises reached 4200 nationwide by the end of the 1979 (Gao and Yang, 1999). The State Council adopted a set of measures to guide the expansion of SOE autonomy\textsuperscript{25} and profit-sharing schemes.\textsuperscript{26} In 1981, the government pushed for an economic accountability system giving more autonomous power to enterprises to allow them to become independent economic units bearing responsibility for their profits and losses.\textsuperscript{27} A series of regulations on SOEs were also enacted by the State Council.\textsuperscript{28}

Despite efforts to expand the autonomy of the enterprises, SOE vulnerability to government control was still evident in these regulations. For example, SOEs were under the leadership of the relevant authorities in carrying out their business operations and production,\textsuperscript{29} and the managers were appointed and dismissed by the relevant authorities.\textsuperscript{30} The performance of SOE directors was not determined by financial results of the enterprises but by their ability to carry out the plan set down by the government (Schipani and Liu, 2002).

However, attempts were made to reduce the undue influence of the party committee in the SOEs’ daily management by empowering directors to decide on matters relating to an enterprise’s operation and production.\textsuperscript{31} The workers’ congress, endorsed by the principle of ‘democratic management’,\textsuperscript{32} was also granted the right to participate, discuss and make decisions on important matters relating to SOEs.\textsuperscript{33} But the boundaries of powers and responsibilities belonging to the state, the party committee, the management and the workers’ congress were not clearly defined (Wang and Cui, 1984).

Thus, despite all these policy developments, some scholars argued that the policies adopted for the SOEs from 1978 to 1984 were not fundamentally different from those of the 1950s and early 1960s (Lee, 1987). State ownership was unmistakably regarded as the only means for safeguarding state property owned by the whole people (Schipani and Liu, 2002). The state and the party committee continued to control the decision-making power of SOEs (Zheng, 1988).

1984 to 1992
A significant change took place in 1984 when the Decision on the Reform of the Economic System further pushed for dramatic economic and SOE reforms. The SOEs were to become legal persons that enjoyed full management power and assume full responsibility for their profits and losses. The reform also aimed at separating government administration from enterprise operation and establishing a factory director responsibility system. The Decision recognized the problems of the state’s excessive control over enterprises and attempted to confine the state’s role to macroeconomic administration. A series of laws and regulations based on the principles of the Decision were enacted in the following years. Legal person status was granted to enterprises that met the legal requirements set down by the law. Thus SOEs now had the rights to possess, use and dispose of enterprise property that the state had authorised them to operate and manage. Based on the principle of separating ownership from managerial power, SOEs were to operate and manage enterprise property with the authorisation of the state. As a result, enterprises gradually gained more autonomy in managing their own affairs, which were largely executed by the factory director.

Factory directors were also assisted by an advisory body — the management committee. The power of the workers was also strengthened and they were given representation in the management committee. In this sense workers’ congresses in SOEs were said to be similar to worker cooperatives in the West. The management committee resembled co-determination in German companies that were defined by social democratic ideas. But relevant authorities still retained residual power in important decision-making, such as issuing unified mandatory plans, appointing and approving the appointment of the factory director and management.

The 1988 Enterprise Law prohibited the state and its organs from encroaching on the autonomy of SOEs in organising production and managing business. Later, legal remedies were available to SOEs for undue interference by the state organs with their operational rights. The role of the Party Committee in the enterprises was also significantly reduced by regulations to ensure factory directors’ independent exercise of managerial autonomy. However, the separation of government administration and enterprise management has not been achieved because of poor implementation of these policies and regulations.

One important development during this period was that the priority of SOE reform was given to the establishment of a management system of SOEs. Based on the principle of separating ownership from management, a contracting system was adopted to govern the relationship between the state, SOEs and factory directors, thereby transforming the operation system of SOEs. This contracting system was devised to improve performance where privatisation was not feasible or desirable. Most of these enterprises were often the largest and most valuable or problematic monopolies in infrastructure, mining, petroleum and heavy industry.

Under the contracting system, a government agency and a SOE are the two parties to the contract. The SOE is represented by its CEO (zong jing li) who is selected
through a competitive process and is responsible for the management of the SOE.\textsuperscript{52} State controls over the management of the SOEs were thus loosened and state revenue was increased (Schipani and Liu, 2002). However, there were inherent problems with this contracting system:

1. It resulted in enterprises pursuing short-term gains (Shi et al, 2001:103).
2. There were technical difficulties in calculating and fixing the minimum amount of profit SOEs must pay to the state when signing the contract (Shi et al, 2001:4).
3. Although the contract required SOEs to pay their due to the state, SOEs were practically unable to pay if they sustained losses (Shi et al, 2001:4).
4. When SOEs make profits, the share of profit they retained was not used for further development of the enterprises (Shi et al, 2001:4). In fact, there were cases of appropriation and embezzlement of state assets for personal use (Shi et al, 2001:4).
5. It could not resolve the fundamental problem of the mingling of government administration and enterprise management (Shi et al, 2001:101).

In short, the contracting system initially improved the productivity of SOEs and increased revenue, but it failed to promote the reform of SOEs in a structural and sustainable way.

According to a study by the World Bank, contracting theory suggests that for contracting enterprises to improve performance they must:

1. Reduce the information advantage that managers enjoy over their owners;
2. Motivate managers to achieve the contract’s targets through rewards or punishments; and
3. Convince managers that government promises contained in the contract (for example, to pay bonuses or apply punishments) are credible (Shirley, 2000).

The contracting system of SOEs in China failed on all three counts. The contracting system came to its demise in 1994 when the SOEs were required by the government not to renew contracts (Shi et al, 2001:4).

The development and reform of SOEs from 1984 to 1992 was generally progressive both at the macro and micro levels. At the macro level, the dissolution of the command economic system resulted in more autonomy for enterprises. At the micro level, the governance of SOEs featured power sharing between the Party committee, the director and the workers’ congress, with the power centre gradually shifting from the Party committee to the factory director.

It can be observed that the reform has proceeded with a cluster of experiments. This gradual approach was based on a consensus that the reform of state enterprises should ‘advance in stable conditions’ (wen zhong qiu jing) as state enterprises still account for a significant percentage of the state economy and play an important role in China’s social life. But these experiments did not bring about the fundamental change in the form of the separation of government administration and enterprise management that is critical to the reform of SOEs.
1993 Onwards

The need for a structural and systemic change to SOE reform\textsuperscript{53} heralded the establishment of a ‘modern enterprise system’.\textsuperscript{54} As part of the general objectives of economic reform, the goals of the reform of SOEs were set down by the government at the third plenary session of 14\textsuperscript{th} Party Congress in 1993, as follows:

- Separate state-ownership from business management;
- Clearly delineate the ownership and control of SOEs;
- Align the interests of shareholders and management and other stakeholders;
- Protect the interests of creditors; and
- Establish a scientific and efficient management system to maximize the company’s value.\textsuperscript{55}

The modern enterprise system is considered to be embodied in a company system and, accordingly, a process of corporatisation of SOEs was put into motion following this Decision. Under the 1993 Company law, SOEs could be restructured into three types of companies: wholly state-owned companies, limited liability companies and joint stock limited companies.

The State Council selected one hundred large and medium sized state enterprises to conduct a pilot program of establishing a modern enterprise system in 1995 (Shanghai Stock Exchange, 2003:5). About 5,800 state industrial enterprises were corporatised by the end of 1996 (He, 1998). In 1997 the State Statistic Bureau Enterprise Investigation team conducted a survey of 2,343 pilot enterprises. The results showed that a majority of enterprises had adopted the corporate system in different forms (He, 1998). Five hundred and forty pilot enterprises were transformed to joint stock limited companies while 540 pilot enterprises were transformed to limited liability companies (He, 1998). Both account for 46 per cent of total pilot enterprises (He, 1998). Nine hundred and nine pilot enterprises were transformed to wholly state-owned companies, accounting for 39 per cent of the total (He, 1998).

In 1997, nearly 40 percent of China’s 16,000 large and medium sized SOEs reported deficits (People’s Daily, 2001). At the end of the year, the Chinese government set a goal for these enterprises to make a profit and establish a modern corporate system within three years (People’s Daily, 2001). By the end of 2000, two-thirds of the large and medium sized SOEs had started to make a profit and 80 percent of them had built up a better corporate system (People’s Daily, 2001).

The restructuring of the economy through mergers and acquisitions of once state-monopolized sectors over the past few years also brought SOEs under pressure to reform and boost efficiency (People’s Daily, 2001). The new ownership system now sets the guidelines for a shareholding system as the major form of public ownership.

Foreign investors are, however, currently concerned with sound governance of enterprises in China, including listed companies (People’s Daily, 2001). As foreign companies and non SOEs have been involved in 83 per cent of the property right transfers by SOEs directly under the central government since March 2004, the Chinese government plans to create a better environment for large foreign companies to participate in the merger, acquisition and restructuring of its SOEs by further formulating and improving related laws and regulations to provide legal protection for
foreign investors. \(^5^6\) China will also speed up shifting SOEs to joint stock companies in 2004, so they can be listed at home and abroad (People’s Daily, 2001). By the end of May 2003, the number of listed companies that have non-tradable foreign legal person shares reached 84, of which 52 are listed in Shanghai and 32 are listed in Shenzhen. The participation of foreign investors is expected to help promote the development of the merger and acquisition market in China (Shanghai Stock Exchange, 2003:13).

The 16\(^{th}\) National People’s Congress emphasised the new direction for reform of state asset management. It decided that:

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\text{[t]he State shall promulgate laws and regulations, set up a state asset management system under which the central and local governments represent the state in carrying out their responsibilities as asset contributors and enjoying ownership rights. Such a system shall also balance the rights, duties and responsibilities of the governments as asset contributors and coordinate the management of the assets, personnel and business affairs (Shanghai Stock Exchange, 2003:6).}\
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It further stated that:

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\text{[t]he central government represents the state in carrying out its responsibilities as a contributor of State assets concerning economic lifeline, national security, infrastructure and pivotal natural resources while the local governments represent the state as contributors for other non-essential state assets (Shanghai Stock Exchange, 2003:6).}\
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Both central government and local governments are therefore required to set up state asset management agencies (Shanghai Stock Exchange, 2003:6). Hence the central State Asset Regulatory Commission (SARC) was set up in 2003. It is now directly supervising 189 of the biggest and centralised SOEs as the representative of the state in these enterprises, leaving the rest to the mandate of local state asset watchdogs (People’s Daily, 2001). The role of SARC is to act as a responsible investor of SOEs in accordance with laws (People’s Daily, 2001). Its major task in 2004 is to push forward the reform of SOE corporate governance and urge promising SOEs to list on domestic and overseas stock exchanges (People’s Daily, 2001). One proposal is that managers of the 189 SOEs will receive a pay package based on performance (People’s Daily, 2001).

As the state or state-owned entities are controlling shareholders in the listed companies that were restructured from the SOEs, these companies inherited the traditional operating and management culture and system of the former SOEs (Shi et al, 2001:103). Although they acquired company form after the corporatisation, the governance of these listed companies still presents complex and sometimes intractable problems as they carry with them the historical and political burden of the path that led to their creation: a socialist economy in transition from planning to market. \(^5^7\)
Major Corporate Governance Issues in Listed Companies

Excessive State Ownership in Listed Companies and Government’s Role in Corporate Governance

Listing on the stock exchange does not necessarily improve corporate governance for transformed SOEs in China as it still could not resolve the long standing problem of separating state administration from enterprise management. Berle and Means laid the foundation stone for the modern corporate governance in the 1930s by identifying ‘separation of ownership from control’ as the key (Berle and Means, 1932). However, in Chinese listed companies two critical ‘separation’ issues have not been finalised: the separation of state ownership from control; and the separation of the state’s role as an administrator from its role as a shareholder.

The state is the controlling shareholder of most listed companies (Tevev et al, 2002). The shareholding structure of listed companies is comprised of state shares, legal person shares and individual shares. State shares are held by central and local governments. They are represented by central and local financial institutions, state asset management companies or investment companies (Tevev et al, 2002:75). The legal person shares are held by domestic institutions such as industrial enterprises, securities companies, trust and investment companies, various foundations and funds, banks, construction companies, transportation and power companies, research institutes and other legal persons (Tevev et al, 2002:75). The state shares and legal person shares are not tradable in the stock exchanges which hampers the formation of external monitoring mechanisms such as the market for corporate control.

Because of the concentration of state ownership, the state, as a controlling shareholder has unmatched power to dominate shareholders’ meetings, the board and the management. The first separation of state power from enterprise management is thus illusory. Moreover, the state is an abstract form: it needs to play its role as a controlling shareholder through agents. The directors and managers of listed companies are therefore largely political appointees whose job is to safeguard state assets, but without adequate supervision they may well pursue personal interests. Information asymmetry thus has become an issue, the result of which is adverse selection and moral hazard.58

It has been widely acknowledged that state ownership should be reduced to improve the quality of governance of listed companies, as the reduction of state ownership means reduction of its dominant role in the governance of listed companies.

There is much rhetoric about reducing state ownership and there have been attempts to sell state shares, not only to balance the ownership structure of listed companies, but also to fund the social security system. Political concern for social stability and an engrained risk averse approach have, however, halted the state’s share reduction strategy.59 The suspension of state share sales and the CSRC’s tight control on new listings indicates that the state’s influence over the stock market is still strong and it wants the market to function as an allocator of capital in ways that it prefers – and controls (Dolven, 2002).
The governance problem associated with excessive state ownership of listed companies has also been complicated by the multiple roles played by the state. The state is a key figure in corporate governance, both as drafter and enforcer of regulations and rules, and as a controlling shareholder in many listed companies (Shanghai Stock Exchange, 2003:4).

The overlap and conflict of being referee and player, combined with the inefficiency caused by pursuing political objective instead of taking responsibility as a shareholder, are the apparent negative influences on governance qualities. In order to minimize these influences and improve efficiency of state-owned enterprises, China is constantly exploring new paths of its state asset management by trial and error. (Shanghai Stock Exchange, 2003:4).

The separation of state’s role as the administrator from its role as a shareholder is a daunting task, as it depends on broad political, cultural and market conditions and deeper structural reform of SOEs. Although some measures have been taken to address this, path dependency may influence the extent to which the State’s administrative role can be separated from its role as a shareholder. Indeed, a complete separation may not occur. Because of institutional and systemic constraints on two ‘separations’, there is a pessimistic view that the separation of ownership and control (as a result of corporatisation of SOEs) has failed to produce greater efficiency and is not necessarily an appropriate structure for Chinese companies (Fang, 1995). I prefer the view that the transformation is a process and that this process takes time (Gao, 1995).

**Absence of Ownership and Insider Control**

According to agency theory, the agents of corporations act on behalf of principals in accordance with their contractual obligations (Eisenhardt, 1989). Hence theoretically the state is the principal, and the relevant government authorities and directors and managers appointed by them are agents. But one key element is missing: there is no contractual relationship between them. Furthermore, as they represent the state ownership which is abstract in itself, they can be seen as principals themselves. In this sense they are both principals and agents, as they combine residual ownership and management authority in themselves. Their conduct cannot be disciplined by revision of contracts, as would otherwise be the case in an agency relationship.

Moreover, the board members of listed companies are mainly former senior managers of pre-transformed state-enterprises. Directors and managers are usually closely linked with the controlling shareholders of listed companies. This has given rise to the serious problem of insider control. Because of lack of effective monitoring mechanism, the insiders including the controlling shareholder (and its agent) and the directors and managers pursue their own interests rather then the interests of the company. This may include:

- Transferring and misappropriating companies’ assets through unfair related party transactions;
- Engaging in self-dealing for personal gains;
- Presenting false accounting records to the regulatory body and investors and using inside information for personal gains; and
Developing personal connections by using company resources (Shanghai Stock Exchange, 2003:29).

According to a 1998 empirical study by He Jun, there are 83 companies whose insider control ratio (the total number of board divided by the number of insider directors) is 100 per cent, accounting for 20.4 per cent of the sample in total (He, 1998). There were 78.2 per cent of companies with an insider control ratio of 50 per cent (He, 1998).

In addition, some listed companies are spin-offs of SOEs. In reality, the two entities are often not separate in terms of personnel, assets and financial affairs. Some listed companies have been effectively reduced to ‘ATMs’ for the controlling parent company. Diversion of capital of listed companies by the controlling shareholder for various purposes is also common, mostly through the form of large loans.

*Weak Directors’ Duties and Accountability System*

Directors’ duties and their accountability are essential to an effective corporate governance system. Current Chinese company law contains insufficient provisions on directors’ duties and no effective accountability system. History seems to have a role in this.

The historical development of Chinese corporate law and legislation has shown that the elaboration of directors’ duties in both the literature and legislation, at any given time, is limited. Directors’ duties in pre-1949 Chinese company laws were mainly transplanted from Western Law and Japanese Commercial Code. The 1904 Company Law was modelled on 1856 British Joint Stock Companies Act, 1862 Companies Act and 1899 Japanese Commercial Law (Lai, 1977:9). About three-fifths of the articles were grafted from Japanese law while about two-fifths were transplanted from British law (Lai, 1977:9). The 1914 amendments were modelled on Japanese Commercial Code.

The rationale of directors’ duties in these Laws was largely derived from Japanese law. Strictly speaking, there was no indigenous theory on directors’ duties that had been systemically, consistently and coherently established. Most literature on directors’ duties are interpretations of Western corporate law theories and legislations. There are, for example, no dedicated sections on directors’ duties in the pre-1949 company Laws. Provisions concerning the board, directors, directors’ duties and powers are provided only briefly in just one short section, and are characteristically succinct and prescriptive.

The 1994 Company Law inherited the same features. There were some provisions dealing with directors’ duties in the current company law but, typically, they carry broad and generalised meanings that sound hollow when it comes to application and enforcement. Directors are required not to use their position for personal gain; not to disclose company secrets; not to misappropriate company assets; and not to engage in self-dealing, but there is no effective mechanism to hold them accountable if they breach these duties. As they are defined in general and broad terms, a breach of duty has proven to be difficult to establish. It is therefore hard to make errant directors accountable. Lack of accountability results in abuses of directors’ powers that, again,
always involve directors pursuing personal interests at the expanse of the company’s interests.

There are two main responses possible. One is to impose tough external monitoring and regulatory mechanisms. The other is to impose directors’ duties to constrain and prevent abuses in the first place. While external supervision is necessary, directors’ duties play a larger role in preventing corporate misconduct and improving corporate governance in the long run. This is because although the power of a director can be demonstrated by exercising decision-making power collectively with other board members, his or her duties and responsibilities can only be born individually. If duties and responsibilities were to be borne collectively by the directors, this would lead to a situation where nobody could be held accountable for anything. In the Common Law system, directors owe fiduciary duties to their companies and their fiduciary duties can only be borne individually. But in China, lack of a fiduciary culture and the existence, instead, of non-fiduciary duties, plus ineffective monitoring mechanisms and insufficient civil penalty provisions, have all contributed to the failure to hold accountable individual directors who engage in corporate misconduct or misuse their position.

Ineffective Supervision

China has adopted a two-tier system for the internal governance of companies. The supervisory board assumes a monitoring role in the listed companies, but has consistently failed to perform that role effectively. Unlike the German system where the supervisory board is involved in decisions of fundamental importance to the company and has the power to appoint and dismiss management Board members, the Chinese counterpart does not have strategic decision-making power, and has no power to appoint or dismiss the board of directors and management. Their starting position is thus weak (Xie et al, 2001:176). Moreover, members of the supervisory board, who are nominated by the board of directors and elected by shareholders, can, in reality, only retain their position by ‘rubber stamping’ directors’ actions. They therefore normally do not risk challenging the management (Xia, 1999). Supervision by the employee members is even more ineffective, since the employees depend on management for their job security, welfare and promotions.

To improve the supervision quality and corporate governance, CSRC introduced independent director system to listed companies. It issued Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies in 2001. Since then there have been a flurry of appointments of independent directors by listed companies. Independent directors refer to directors who hold no other posts in the company, and who have no relationship with the company and its majority shareholders and are thus able to make objective judgments independently. But the independence of independent directors and effectiveness of their supervision role are also in question (Clarke, 2003). As they are the minority on the board, and largely nominated by controlling shareholders, their independence is only nominal. They are, in reality, powerless to protect minority shareholders’ interests from depredations of controlling shareholders and management (Economic Daily, 2001). Further, the functions of the supervisory board and independent directors largely overlap which also raises the question of efficient use of resources.
Lack of Effective Protection for Minority Shareholders

Due to the ownership structure of listed companies and the dominant status of controlling shareholders, the minority shareholders’ interests are inadequately protected. Controlling shareholders use their controlling power to exploit minority shareholders by various means, such as price manipulation in transactions with controlled entities (Clarke, 2003). There are also no effective remedies for minority shareholders, such as a shareholders’ derivative action. Apart from inadequate provisions in law, this partly results from the political reluctance of government and judiciary to allow shareholder lawsuits, particularly class actions, for fear of social trouble (Lawrence, 2002).

Although the state has stressed the importance of protecting minority shareholders in the listed companies, it may itself be guilty of exploration of interests of minority shareholders when it is in many cases the controlling shareholder (Clarke, 2003). Because of the current ownership structure of listed companies, one meaningful legal protection for minority shareholders would be to impose constraints on the state’s ability, as the controlling shareholder, to do those things that a normal controlling shareholder will do to retain controlling ownership and power (Clarke, 2003). This problem may, however, only be disentangled after the further reform of the ownership structure of the listed companies.

It is proposed that the controlling shareholders be made subject to a duty of care and good faith to both the company and to other shareholders (minority shareholders) (Shanghai Stock Exchange, 2003:47). Unless this duty is clearly written in Law, and there is an effective enforcement system in place, minority shareholders’ interests will still be at the mercy of the controlling shareholders.

The Regulatory Framework for Corporate Governance of Listed Companies

Increasingly, the regulatory body with authority over Chinese listed companies, the China Securities Regulatory Committee (CSRC), has taken initiatives to introduce some best practices in international corporate governance to Chinese companies. A number of regulations concerning corporate governance have been produced. Recent important Laws and regulations include:

- 1994 Company Law (promulgated by the National People’s Congress);\(^{66}\)
- 1994 Special Regulations concerning Floating and Listing of Shares Overseas by Joint Stock Limited Companies (enacted by the State Council);
- 1994 Essential Clauses in Articles of Association of Companies Listed Overseas. (issued by CSRC and State Restructuring Commission);\(^{67}\)
- 1997 Guidelines on Constitution of Listed Companies (issued by CSRC);
- 2001 Code of Corporate Governance for Listed Companies (issued by CSRC and State Economic and Trade Commission (SETC));
- 2001 Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies (issued by CSRC and SETC);\(^{68}\)
• 2001 Shanghai Stock Exchange Guidelines on Corporate Governance (issued by Shanghai Stock Exchange).
• 2002 Circular on Conducting Review of Listed Companies in Building-up Modern Enterprise System (issued by CSRC and SETC); and,

The 1993 Company Law provides inadequate provisions on corporate governance which were amended in 1999 and is now under a second review. The Code of Corporate Governance for Listed Companies is, in principle, supplementary to this Law but it, in fact, acts as the major guidance for the listed companies. The Code was largely drawn from 1999 OECD Corporate Governance Principles. The CSRC believes that improved corporate governance aligned with international standards will ensure the confidence of investors to invest in Chinese companies (Cha, 2001).

The Code includes following sections: 1, Shareholders and Shareholders’ Meetings; 2, Listed Company and its Controlling Shareholders; 3, Directors and Board of Directors; 4, The Supervisory Board; 5, Performance Assessments and Incentive and Disciplinary Systems; 6, Stakeholders; 7, Information Disclosure and Transparency; 8, Supplementary Articles. The Code is responsive to the governance problems of the listed companies and provides relatively detailed provisions dealing with major areas of relevance. Some of these are now considered in turn.

**Major Provisions on Controlling Shareholders**

The principle of ‘take the first step to restructure or reorganise companies and then take the second step to get them listed in the Stock Exchanges’ should be observed by controlling shareholders in their attempts to restructure and reorganise companies that are intended to be listed; and a balanced shareholding structure should be formed (art 15).

To get restructured or reorganised companies listed, the controlling shareholders must separate non-operational assets of such companies from operational assets and sever companies’ social welfare functions (art 16). The controlling shareholders are also required to support listed entities reform in labour, personnel and distribution systems; and in transforming operational and managerial mechanisms (art 18). The controlling shareholders nominate candidates for directors and supervisors (art 20) and they also have a role in management selection processes (art 18).

The controlling shareholders owe a duty of good faith to their companies and other shareholders. They are barred from taking advantage of their privileged position to gain personal benefits (art 19). Listed entities’ businesses must be independent from the controlling shareholders’ own business (art 27). Controlling shareholders and their subsidiaries are also required not to be in competition with listed entities by avoiding engaging in the same or similar business as those conducted by listed entities (art 27).

**Major Provisions on Directors’ Duties and the Board**

Directors are required to faithfully, honestly and diligently perform their duties for the best interests of the company and all the shareholders (art 33). They need to ensure
adequate time and energy for the performance of their duties (art 33). The board of
directors shall be made accountable to shareholders (art 42). They shall treat all
shareholders on an equal basis and take into account the interests of stakeholders (art
43). If resolutions of board of directors violate laws or regulations or the company
constitution and result in losses to the companies, directors shall be liable for
compensation, except for those who object to the resolution and have that objection
recorded in the minutes (art 38).

Such compensation cannot be covered by the insurance purchased for their liability
cover by the companies (art 39). The directors shall possess adequate knowledge,
skills and qualities to perform their duties (art 41). Clear principles and rules shall be
stated in the constitution as to the delegation of part of the board of directors' powers
to the chairperson of the board while the board is not in session (art 33). Matters that
are of material interests to the companies shall be submitted to the board of directors
for collective decisions (art 33).

Listed companies’ board of directors may set up sub-committees. These
sub-committees may include a strategic decision-making committee; 70 an audit
committee; 71 a nomination committee; 72 a remuneration and appraisal committee; 73
and other special committees as approved by the shareholders’ meeting (art 52). The
majority members of the audit committee, nomination committee and remuneration
and appraisal committee should be independent directors and these committees should
be chaired by an independent director (art 52). With regard to the Audit Committee,
at least one independent director of the committee should be an accounting professional
(art 52). Each committee is accountable to the board of directors and all proposals
made by each committee should be subjected to the review and approval by the board
(art 58). These committees may solicit professional advice, the costs of which are to
be paid by the company (art 57).

Major Provisions on Independent Directors

Independent directors are required to be introduced to the board of directors in
accordance with relevant regulations. Independent directors should perform their
duties truly independently by keeping the influence of companies and major
shareholders at bay (art 49). The independent directors owe a duty of good faith and a
duty of due diligence to the companies and shareholders. They should perform their
duties independently and in a manner that does not subject themselves to the influence
of major shareholders, actual controllers or other persons and entities who have vested
interests in the companies (art 50).

CSRC also released the Guidelines for Introducing Independent Directors to the
Board of Directors of Listed Companies in 2001 and set 30 June 2003 as a deadline
by which at least one third of the board of listed companies must be independent
directors. This reflects the CSRC’s determination to improve the supervision and
governance qualities of listed companies.
The Code emphasised the fair treatment of all shareholders particularly the minority shareholders and states that listed companies shall establish a corporate governance structure sufficient for ensuring the full exercise of shareholders’ rights (art 1). Listed companies are required to provide the necessary means to ensure the legal rights of stakeholders. Stakeholders could seek redress if their rights are violated. Listed companies should provide relevant financial information to stakeholders and solicit constructive feedback on important decisions regarding employees’ interests (art 83 and 84). Listed companies, while maintaining the company’s development and maximizing the shareholders’ interests, should also take into consideration their social responsibility such as welfare, environmental protection and community interests (art 86). Under the ‘one share, one vote’ voting system, minority shareholders do not have incentive and power to monitor the management of companies.

Some of the better principles and the provisions of the Code are practices introduced from both the US (independent directors and board subcommittees) and German (stakeholder approach) systems. Others have been developed from China’s own enterprise governance experience: the code is a hybrid product. Some of these provisions, however, carry no concrete meaning and pose enforcement issues — a persistent problem in Chinese legislation and regulations. For example, controlling shareholders owe a duty of care and good faith to the listed company and other shareholders, but what constitutes a duty of care and good faith to the company, and to other shareholders? What are the consequences for breach of such a duty? How can the liability of controlling shareholders for breach such a duty be enforced?

Moreover, due to lack of a fiduciary culture in China, the effect of imposing such a duty on controlling shareholders to improve corporate governance is not evident. In relation to directors’ duties and the board, the Code prescribes a list of duties and responsibilities of directors in articles 33-37 but in general and broad terms. Weak directors’ duties and accountability has been a major issue in Chinese corporate governance, but the Code does not address this issue in a significant way. Independent directors are required to carry out their duties independently and not to be influenced by controlling shareholders and other related parties of listed companies, but there are no provisions on how to achieve their independence or what mechanisms can be used to counter the undue influence of controlling shareholders.

With regard to shareholders and stakeholders, the Code is progressive in that it embraces a very broad stakeholder approach requiring listed companies not only act in the best interests of companies and shareholders but also to take into account the welfare, environmental protection, the public interests of the community in which they locate and generally assume social responsibility. But how the interests of shareholders and other stakeholders are to be balanced, and how the interests of the stakeholders are to be advanced, are not well defined.

In short, the Code has filled many gaps in the Company Law, but there also remains significant room for improvement. Furthermore, legal implementation and enforcement have long been a difficult issue in China. The poor implementation of CSRC’s regulations, rules and the Code means the improvement of corporate governance is probably only ‘skin deep’.
This can be attributed to a lack of resources and a lack of independent enforcement authority of CSRC, but the major reasons are systemic. Listed companies still report to relevant government departments which each exert considerable influence over company management. The CSRC is reluctant to discipline companies whose major shareholders are powerful government departments. Despite this, the CSRC, jointly with other government departments, launched a major campaign in 2001 in a bid to rein in listed companies.

**The CSRC Campaign on the Corporate Governance and Enforcement**

2001 was named the ‘year of corporate governance’ by CSRC in its bid to resolve the outstanding governance problems of listed companies (Financial Times, 2002).

Specifically, the CSRC aimed to formulate some concrete measures to eradicate bad corporate practices and enhance the overall quality of corporate governance of listed companies through this intensive campaign. The ‘regulation storm’ campaign started from August 2001. Multi-departmental coordination and multi-facetted regulations were effective in conducting the review of corporate governance practices of listed companies and investigating the wrongdoers.

Preliminary statistics indicated that about 50 listed companies received an inspection, warning, criticism and fine from CSRC, SETC and other regulatory bodies (Financial Times, 2002). These included the following:

1. The chairman of the board of directors of Shenhua Share-controlling company, Yang Rong, dubbed by Forbes the third richest man in the country, faces arrest on charges of economic crime.
2. Lao Derong of Shen Energy A company has been stripped of his chairmanship and directorship.
3. The honorary chairman of the National Power company has gone missing.
4. The chairman of the Triple Nine Pharmaceutical company has been given a warning.
5. The former chairman of Yu Tong Civil Bus company, Lu Farao, and its chief executive and chief financial officer, Tang Yuxiang have received warnings and fines.
6. The former chairman of the ST Oceanic company, Wu Wu, and its former deputy chairman, Chen Shaoxi have been prosecuted by Si Min district People’s Procuratorate of Xiamen city (Financial Times, 2002).

The campaign to strengthen corporate governance of listed companies is also driven by the state leaders’ emphasis on the topic. President Jiang Zemin instructed at the Central Economic Work Meeting in 2001 that “listed companies should lead the first step in the building-up of modern enterprise system”. Premier Zhu Rongji in his State Council Work Report at the fifth Session of Ninth National Congress in 2002 also indicated that ‘a review of the developments of listed companies in building-up modern enterprise system should be given priority this year. The existing problems should be examined and tackled’.
Conclusion

The peculiarities of the social governance fabric of a particular country can make harmonisation with other, foreign governance systems difficult. This article has sought to show that Chinese social traditions and legal culture are very different from those of the Western countries where contemporary ideas of corporate governance developed. In particular, development of state-owned enterprises, the emergence of corporations and the coming into existence of laws governing corporations have thus taken a path that is distinct from that of most other countries.

This path of reforming SOEs in China can be viewed as comprising four major stages: greater autonomy for managers; management contracting; corporatisation; and ownership diversification. The governance of SOEs has its periodic features as a result of the state’s strategic economic and legal policy shifts in the course of the reform. But throughout, the state has always played a significant role in enterprise operation and management. The SOEs operated according to a state production plan and then governance was mainly about setting up linkage between state policy and factory production. They were used as sites of general welfare production, not a site of narrow private wealth production. They did not concern themselves with markets or particular shareholders. Experimental reforms to improve the efficiency of SOEs were conducted from government’s perspective of economic policy not from the market perspective, unlike the case in the US and Australia. The governance of SOEs and listed companies thus bears the mark of China’s political economy and this defines their path dependency.

Hence none of the three generic corporate governance models described earlier is suitable for Chinese companies. China has not yet developed a solid infrastructure, for example, a well-developed capital market, a market for corporate control, or an effective internal corporate control system that would allow the Anglo American model to work on its soil. Although China has traditionally been a civil law country, the major presence of the German model of corporate governance in China is the two-tier board structure. Such a structure has proven to be a successful regime for German companies, but it is not effective in China because the supervisory board does not have real supervisory power. In addition, the Chinese securities and capital markets are even weaker than in Germany and Japan. And institutional investors such as banks currently do not play an important role in corporate governance. The Family model of corporate governance was used in China before the Communist Party came into power. It has re-emerged since the launch of China’s reform program in 1980s. Currently, however, the number of listed companies that are privately owned and whose governance system resembles the family model is tiny.

It is easy to appear to converge with international models in written laws and rules, but the prospects of Chinese corporate culture and practices being fully compatible with those models are small, at best. CSRC has introduced some US corporate governance systems in areas such as auditing, board subcommittees and independent directors in recent years but they have little noticeable effect on the governance of listed companies so far. Moreover, both regulators and companies have limited experience with good governance given company law was enacted only ten years ago and most companies had limited exposure to the international markets.
China’s entry to WTO in 2001 resulted in both challenges and opportunities for Chinese companies, and the new draft of the revised Company Law (now for consultation) has a focus on the governance of listed companies and treatment of SOEs (Chen, 2004). It is anticipated that the revised Company Law will ultimately tackle the current major governance issue of listed companies and lay a foundation for formulating an effective corporate governance model, but will do so in a way that does not necessarily track international models. China needs to develop its own corporate governance model and supplementary corporate governance mechanisms that best suit the complex and changing nature of Chinese companies. The roadmap for the trajectory of corporate governance reform in China and the production of a model will no doubt take time to draw. The process will be evolutionary not revolutionary.

Notes:

1 The author wish to thank emeritus Professor Harry Glasbeek and Professor Tim Lindsey for their comments on the draft.

2 LLB (NUPL), LLM (CASS), Ph.D candidate at the Law School, University of Melbourne and Assistant Lecturer, Department of Business Law and Taxation, Monash University, Australia.


6 These points are contained in both the 1999 and 2004 version of the OECD Principles. Also see Dallas, George and Bradley, Nick (2002), “Calibrating Corporate Governance”, Corporate Governance International, Vol. 5 issue 1, p48.

7 See Preamble of OECD Principles of Corporate Governance, draft revision, January 2004. available at: http://www.oecd.org/dataoecd/19/29/23888981.pdf. In comparison, the goals of 1999 OECD Principles state as: “The principles are non-binding and will not give detailed prescriptions for national legislation but rather are intended to serve as a reference point for countries’ efforts to evaluate and improve their own legal, institutional and regulatory frameworks and will be applied by countries in accordance with their own circumstances. While primarily aimed at governments, the Principles will also provide guidance for stock exchanges, investors, private corporations revised s and national commissions on corporate governance as they elaborate best practices, listing requirements and codes of conduct.” See OECD Ad Hoc Task Force on Corporate Governance, “OECD principles of Corporate Governance”, Directorate for Financial, Fiscal and Enterprise Affairs, available at: http://www.oecd.org/daf/governance/principles.htm.
See Part Five of OECD Principles, 2004. The key functions of the board are: 1, Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures; 2, Monitoring the effectiveness of the company’s governance practices and making changes as needed; 3, Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning; 4, Aligning key executive and board remuneration with the longer term interests of the company; 5, Ensuring a formal and transparent board nomination and election process; 6, Monitoring and managing potential conflicts of interests of management, board members and shareholders, including misuse of corporate assets and abuse in related party transaction; 7, Ensuring the integrity of the company’s accounting and financial reporting systems, including th independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards; 8, Overseeing the process of disclosure and communications.


For example, Monkey King and Yinchuan guangxia were two notorious cases involving serious corporate misconduct. See Financial Times (2002), “Corporate Governance Measures on Noncompliance Issues of Companies as the discipline of Securities Market Enters the Final Stage” [gong si zhi li zhong chuang wei gui gong si, gu shi jian guan jin ru shou gong jie duan”], Financial Times [Can Jin Shi Bao], 25 October 2002.


See the Decree on Establishment of Factory Management Committee in State-operated and Public-operated Factories, above n13.

Also referred to as higher authorities, including state departments, ministries and other state authorized organs that are in charge of the supervision over enterprises in different industries.

Articles 6 of the Decree on Establishment of Factory Management Committee in State-operated and Public-operated Factories, above, n47

Namely, transforming private enterprises into public and private jointly operated industrial enterprises.

To facilitate the transformation, the State Council enacted Provisional Regulations on Public-private Jointly Operated Industrial Enterprises (Gong si he ying gong yeqi ye zhan xing tiao li) on 2 September 1954.


According to article 10 of the Draft Regulation on State Industrial Enterprises (Guo ying gong ye qi ye gong zuo tiao li cao an), issued by the Central Committee on 16 September 1961, SOEs’ monthly production plans need to be approved by relevant authorities.

Item 1 of article 4 of the Draft Regulation on State Industrial Enterprises, above n 20.

The “Three Anti” (san fan) was directed against the evils of corruption, waste, and bureaucratism, and aimed to eliminate incompetent and politically unreliable officials and bring about an efficient, disciplined, and responsive bureaucratic system.

The “Five Anti” (wu fan) aimed at eliminating recalcitrant and corrupt businessmen and industrialists, who were in effect the targets of the Party’s condemnation of “tax evasion, bribery, cheating in government contracts, thefts of economic intelligence, and stealing of state assets”.

To hasten the pace at which China was approaching communism.


The State Council, Several Measures Concerning the Expansion of the Operation and Management Autonomy of State-run Industrial Enterprises (Guan yu huoda guo ying gong ye qi ye jing ying guan li zi zhu quan de ruo gan gui ding), issued on 13 July 1979.

The State Council, Measures Concerning the Profit Retention by State Industrial Enterprises (Guang yu guo ying qi ye shi xing li run liu cheng de gui ding), issued on 22 January 1980.
According to the article 44 of the 1988 Law on Industrial Enterprises Owned by the Whole People and article 7 of the 1986 Law on Industrial Enterprises Owned by the Whole People, the workers’ congress has the power to decide on the appointment and dismissal of directors, subject to approval by the relevant authorities.
he other is that directors usually do not need to be in company offices. Executives ought to submit matters to the board to make decisions. The chief executives in accordance to relevant rules. Should any significant matters arise, the chief executive may make decisions on the spot. Also, the board may be unable to monitor the management ‘on the spot’. One case the management holds some private information unknown to the board (including their ability to run the company) which may result in unqualified management being chosen by the board; The other is moral hazard, in which case the management act opportunistically by overtly agreeing to but covertly opposing the board’s decisions while the board is unable to monitor management ‘on the spot’. Also see Michael C. Jensen (2000), “Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems”, A theory of the Firm: Governance, residual Claims and Organizational Forms, Harvard University Press.

50 According to article 11 of the 1986 Regulations Concerning the Work of Directors of Industrial Enterprises owned by the Whole People, worker representatives can account for one third of the management committee.

51 Article 55 of the 1988 Law on Industrial Enterprises Owned by the Whole People, above n 39.

52 Article 14 of Provisional Regulations concerning Contracting Management System in the State-owned Enterprises, enacted by the State Council on February 27, 1988. According to this article, by employing the contracting system, the minimum amount of profit SOEs have to pay to the State is locked and SOEs are liable for paying that fixed amount regardless of whether they have made a profit or not. SOEs are entitled to keep the remaining profit after turning the fixed profit over to the State.

53 Article 26, 27, 28 and 30 of Provisional Regulations concerning Contracting Management System in the State-owned Enterprises.

54 The “Decision on Many Issues Concerning the Establishment of a Socialist Economic System” passed at the third plenary session of the 14th Central Committee of the Communist Party on November 1993.

55 In China’s context, particularly in the context of transformation of SOEs, “Modern Enterprises” refers chiefly to the modern corporations including listed companies.

56 “The working conference on piloting modern enterprise system nationwide” held by the State Council in November 1994 ushered in the initiation of the pilot program of establishing a modern enterprise system.

57 China also promulgated regulations on the takeover of SOEs.

58 Li Jianmin (1999), “Empirical study of Chinese enterprise governance since corporatisation process” [Gong si hua gai zao yi lei wo guo qi ye zhi li jie gou de shi zhen fen xi], Journal of Reform, Gai ge, issue 4, p 34. A recent survey by the Shanghai Stock Exchange showed that the current market economy still reflects many features of the old planned economy, for instance, the multiple roles of government in corporate governance. See Shanghai Stock Exchange, Executive Summary “The Transformation of Corporate Governance in China” in Corporate Governance Report 2003.

59 Theoretically, information asymmetry is reflected in two cases. One is adverse selection, in which case the management holds some private information unknown to the board (including their ability to run the company) which may result in unqualified management being chosen by the board; The other is moral hazard, in which case the management act opportunistically by overtly agreeing to but covertly opposing the board’s decisions while the board is unable to monitor management ‘on the spot’. Also see Michael C. Jensen (2000), “Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems”, A theory of the Firm: Governance, residual Claims and Organizational Forms, Harvard University Press.

60 “In late June 2002, more than a year after authorities unveiled a plan to raise much-needed money for the country’s social-security fund by selling some state shares, the State Council admitted failure and scrapped the sales. Only a tiny portion of the sales had actually happened, but the threat that more might come had sent shanghai’s A-share market, which consists of renminbi-denominated shares restricted to domestic investors, into a 35% tailspin between May and October in 2001”. See Ben Dolven (2002), “Capital Drought”, Far Eastern Economic Review, July 11, 2002, p30.

61 As discussed from page 7 to page 14 of this article, the governance of SOEs and listed companies is gradually changing from administratively controlled to market driven.

62 For example, the article 67 of section 4 of the Company Law states that, the board has the power of decision-making over company business, the ordinary affairs of the company should be handled by chief executives in accordance to relevant rules. Should any significant matters arise, the chief executives ought to submit matters to the board to make decisions and implement board decisions. The directors usually do not need to be in company offices.

63 See articles 59, 60, 61, 62, and 123 of the Company Law.
Articles 61, 63, 118 and 214 of the Company Law impose civil liability on directors but the law is silent about the enforcement of directors’ civil liability.

5.1.1 and 5.1.2 of German Corporate Governance Code 2003.


The corporate governance structures of Chinese companies are set down in the Company Law, albeit in abundantly general terms. It adopted some features of corporate laws in both Civil Law countries and Common Law countries. It can be said a hybrid of Western models and some elements of Chinese inventions characterised by Chinese tradition and socialist market economy the country currently pursues. The Law set down the organisational structure of companies and powers and responsibilities of three corporate organs. They are shareholders’ meeting, the board of directors and the supervisory board. No further specific provisions on corporate governance are provided.

The Essential Clauses are supplementary to the 1993 Company Law’s provisions on Joint Stock Limited Companies. It states that foreign investors can participate in the special category shareholders’ meeting to ensure their interests and it also allows foreign-listed companies to employ outside independent director system if they need to.

It was widely perceived that the supervisory board, due to structural problem, has not been effective in monitoring directors and officers, but strong and independent supervision is needed to enhance corporate performance. CSRC grafted US independent director system to China.

It was mainly aimed to straighten up complex relationship between listed companies and their controlling shareholders, this is because controlling shareholders of listed companies have exerted undue influence over company’s governance and thus has become a major issue in corporate governance of listed companies.

According to article 53 of the Code, The main functions of the Strategic Decision-making Committee are to conduct research and make recommendations on the long-term strategic development plans and major investment decisions of the company.

According to article 54 of the Code, the main functions of the Audit Committee are: (1) recommend employment or replacement of companies’ external auditors; (2) review internal auditing system and the implementation of the system; (3) monitor companies internal and external auditors and their interactions; (4) inspect companies’ financial information and its disclosure; and (5) monitor companies’ internal control system.

According to article 55 of the Code, the main functions of the nomination committee are: (1) formulate standards and procedures for the election of directors; (2) conduct extensive search for qualified candidates for directorship and management; and (3) evaluate qualities of candidates for directorship and management and make recommendations.

According to article 55 of the Code, the main functions of the remuneration and appraisal committee are: (1) set up appraisal standard for the performance of directors and management and conduct appraisal and make recommendations; (2) review remuneration policies and packages for directors and senior management.

According to the Code, stakeholders of listed companies include banks and other creditors, employees, consumers, suppliers, the community and other stakeholders.

For example, CSRC, SETC, Shanghai Stock Exchange, Shenzhen Stock Exchange, Ministry of Finance.