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China's Corporate Governance: Emerging Issues and Problems

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Abstract

As China approaches economic superpower status, its need to achieve considerably higher standards of corporate governance is becoming paramount. Despite impressive recent advances in its capital and stock exchange markets, the on-going overhang of state ownership in its former state-owned enterprises, together with an unwieldy and ineffective dual board governance system, has left China facing major corporate governance problems that will deter the private investment necessary for its continued growth. This paper illustrates these problems, and suggests possible reforms that will provide the foundation for the efficient further development of China's capital markets that is needed to help China become a major economic superpower.

Introduction

China is deemed to become an economic superpower during the twenty-first century. Economic indicators show that China has 1.3 billion people (20 per cent of the world's population), a land area of 9.36 million square kilometres (the third largest country behind Russia and Canada) and a gross domestic product of US$2.6 trillion (fourth in the world behind the USA, Japan and Germany), with 11 per cent GDP growth in 2006.

China's capital markets include two securities exchanges: one in Shanghai and one in Shenzhen. In 1992 there were only 50 listed

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companies in China, but in recent years China has experienced enormous changes in its capital markets. Consistent with the progressive opening up of its financial markets, its securities markets have become some of the most active markets in the world. By 2007 there were nearly 1,500 companies listed on the Shanghai Stock Exchange and the Shenzhen Stock Exchange, with a market capitalization of around RMB32.7 trillion. This is the fourth highest in the world, after the US, Japanese and British markets.[1]

Since early 2001 the corporate financial scandals involving listed companies in China (for example, Guanxia Industry Co. Ltd, Macat Optics and Electronics Co. Ltd, Sanjiu Pharmaceutical Co. Ltd and Lantian Co. Ltd) prompted policymakers, regulators and officials at the China Securities Regulatory Commission and the State Economic and Trade Commission to make corporate governance a priority issue for their agenda in 2002. The government came under increasing public pressure to improve its policy towards corporate governance structures. Additionally and importantly, according to the WTO entry agreement, China should be committed to capital market liberalization and corporate reform, in particular with respect to state-owned enterprises. An effective and efficient China corporate governance system must coincide with international standards, allowing both domestic companies and foreign companies to enjoy free market competition within a fair economic and policy environment.

Why does China need corporate governance?

A brief history of China's capital markets

China's securities markets have experienced many ups and downs in the last 50 years. The past six decades of the history of China's capital markets since 1949 can be divided into three phases: temporary trials to denials (1949–1956); full denials (1957–1980); and restoration to full development (1981–present).

In June 1949 the re-established Tianjin Stock Exchange marked the start of the Chinese securities market under the communist regime. In 1956, after the completion of the socialist transformation from a capitalist industry system, traditional socialist theories and

[1] Paul Pacter, 'An "Accounting Revolution" is Brewing in China', *Financial Executive*, Vol. 23, No.10 (2007), pp. 14–17.

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the centrally planned economic system began to deny and reject the existence of a stock market. In 1957, the socialist planned economic system replaced the transitional economic and Chinese securities markets, and their financial ideas largely disappeared for the next 25 years.

After the Third Plenum of the 11th Communist Party of China Central Committee's adoption of economic reforms, and Deng's Open-Door policy in 1978, China restarted its financial markets in order to drive its economic reforms. The Government issued its first treasury bonds in 1981 to finance its budget deficit. Soon after, many state-owned enterprises issued financial and construction bonds to solve funding shortages, with these funds being urgently needed for the economic reconstruction of the country.[2] For example, The China International and Investment Corporation 'privately' floated JPY10 billion in the Tokyo capital market. In January 1984 the Bank of China issued JPY20 billion worth of public bonds that were given an AAA rating by a Japanese credit rating institution.

The first Chinese company to issue public share certificates (A-shares)[3] was a joint investment company in Baoan County, Shenzhen in 1983. In July 1984, the first joint-stock company, the Beijing Tianqiao Departmental Store Company, issued shares to the public. In November 1984, the Shanghai Feiyue Hi-Fi Corporation floated 10,000 shares at RMB50 each. Both these issues were handled by a trust and investment company that was a unit of the Shanghai Branch of the People's Bank of China. Two months later, the Yanzhong Realty Company floated 100,000 shares to the public. On 30 November 1990 the Shanghai Vacuum Electronic Devices Co. Ltd became the first Chinese company to issue B-shares.[4]

Secondary markets were established and developed in 'securities trading centres' across the country in major provincial cities such as Guangzhou, Changzhou, Wuhan, Harbin and Dalian under Central Government supervision. In April 1990, Central Government

[2] Lay Hong Tan, 'The Legal and Regulatory Framework of Securities Markets in the PRC', *Working Paper* (Singapore: Nanyang Technological University, 1999).

[3] A-shares are common stock issued by mainland Chinese companies, subscribed and traded in Chinese currency, the RMB, listed on the mainland stock exchanges, and are reserved for trading by Chinese citizens.

[4] B-shares (also known as RMB special shares) are foreign-invested shares issued domestically by mainland Chinese companies. They are subscribed to and traded in foreign currencies (traded in US dollars in SHSE and in Hong Kong dollars in SZSE), and listed on the mainland stock exchanges.

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approved these trading centres, and provincial officials started designing their own exchanges and applying to Beijing for permission to open them. This idea was supported by legislators in the National People's Congress.[5] By the end of 1992 there were about 5,000 securities trading centres, spawning the growth of approximately 70 specialized securities companies and 1,000 institutions with securities operations. In 1989, the State Council decided to establish two stock exchanges to allow state-owned enterprises to raise external equity capital from the public. The Shanghai Stock Exchange was the first which opened on 26 November 1990, trading eight kinds of stock with a market value of RMB1 billion. The second, the Shenzhen Stock Exchange, was inaugurated on 3 July 1991 with five listed companies.[6]

Behind these impressive statistics, Paul Pacter points out that the major characteristics of China's capital markets are:

- A minority of shares are actually publicly tradeable.
- The majority of shares are still held by the state.
- Levels of institutional investment are low relative to Western securities markets.
- Only a small minority of the listed companies are audited by international auditing firms.[7]

The challenges after the WTO accession

At the same time as the stock markets were growing, China had been undertaking rapid reform of its corporations. Laws and regulations were established to allow stock-holding companies. The large state-owned enterprises and financial institutions were transformed into such companies. China faced new dynamics following the WTO accession on 11 December 2001. This accession brought in unprecedented international competition, and made the reform of China's financial markets and corporate governance even more urgent.

[5] Stephen Green, *China's Stock Market* (New York: Economist Intelligence Unit, 2003).

[6] Hung-Gay Fung and Wai Kin Leung, 'Chinese Financial Liberalization: Implications for Corporate Governance', *Chinese Economy*, Vol. 34, No. 1 (2001), pp. 5–14.

[7] Paul Pacter, 'An "Accounting Revolution" is Brewing in China', pp. 14–17.

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The WTO accession was not only expected to promote the sustained and healthy development of China's economy, but was also expected to have a positive effect on the long-term development of China's legal system. Randall Peerenboom suggests that reformers will be able to take advantage of the WTO accession for further legal reforms in China, including institutional reforms such as foreign investment policies.[8] The WTO accession created a vital milestone which enabled China to enter a new phase of opening up and it offered an opportunity of historic significance for the long-term development of its securities markets. Jonathan Reuvid summarizes three great challenges that the WTO accession has brought:

- The entry of foreign securities institutions will generate new tasks for China's securities regulation and supervision regimes. International political and economic factors will have an increased impact on China's financial markets, which will consequently increase the level of difficulty in regulating and supervising the securities markets and in handling any possible crises that may emerge.
- The second challenge results from the great gap that has existed between Chinese securities institutions and their foreign counterparts in terms of the size of capital requirements, level of corporate governance and risk control. Although foreign securities institutions can only enter China's securities market in the form of joint ventures at present, their direct entry into the securities market will inevitably become a reality with the acceleration of the opening up process. If domestic securities institutions are not able to mature quickly, they will eventually be eliminated from the market.
- Domestic listed companies will be subject to the law of the market when competing with international giants on the same stage. China's securities markets need to converge with international practices, which will require major reforms in order to improve market transparency and to crack down on illegal conduct.[9]

[8] Randall Peerenboom, 'Globalization, Path Dependency and the Limits of Law: Administrative Law Reform and Rule of Law in the People's Republic of China', *Berkeley Journal of International Law*, Vol. 19, No.2 (2001), pp. 161–264.

[9] Jonathan Reuvid, 'Banking, Foreign Exchange Transactions and Corporate Finance: China's Securities Market', in *Doing Business with China* (London: GMB Publishing: 2005), p. 273.

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The high concentration of state ownership is a major problem in shareholding restructuring for most state-owned enterprises in China, as non-state investors usually have only a limited shareholding in them. Consequently, monitoring of the performance of state-owned enterprises by non-state shareholders has not improved as much as was initially expected under the process of economic reform. Hence, the accountability issue of management remains unresolved and progress in corporate reform is slow.[10]

However, there have been some significant achievements in the Chinese securities market that can be summarized as follows:

- It has become a basic means for allocating economic resources.[11] Its growth in the last sixteen years has largely caught up with developments in the last 100 years in mature market economies such as the UK and the USA.
- The fast growth of the Chinese securities market has fostered and enhanced the notion of risk-bearing investments in the economy. Based on the China Securities Regulatory Commission's statistics, by 2005 70 million investor accounts had been opened across the country, and roughly 200–300 million Chinese people, directly or indirectly, had invested in and were affected by the stock market.
- The fast growth of the Chinese securities market and the WTO accession have accelerated the rate at which listed companies have established and improved their corporate governance.[12]
- Finally, intensive and extensive Chinese securities market reforms have resulted in an improved regulatory system and a market-oriented appraisal system for initial public offerings, as well as an expanded capital supply to the market.[13]

As China's economy takes off, the role of the securities market will become much more important in the growth of the economy. However, although the rapid development of the securities market has been impressive, it is still a newly developing market. Thus, there is a long

[10] Tyler T. Yu, Miranda M. Zhang and Shao-Zhou Qi, 'Government Intervention and Market Distortion: The Case of the Chinese Stock Market', *Journal of American Academy of Business*, Vol. 6, No. 2 (2005), pp. 32–36.

[11] Ibid., p. 33.

[12] Ibid., pp. 34–35; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', *Working Paper* (Singapore: Nanyang Technological University, 2004).

[13] Katharina Pistor and Chenggang Xu, 'Governing Stock Markets in Transition Economies: Lessons from China', *American Law and Economics Review*, Vol. 7, No.1 (2005), pp. 184–210.

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road ahead before this market will be mature and stable. Li Rongrong, Head of the State-owned Assets and Administration Commission, has acknowledged that there is still a huge gap between Chinese commercial giants and the world's leading multinational companies in terms of their scale or efficiency of corporate management, or the strength of their profits and innovative capability, or in terms of their internationalization.[14]

What corporate governance system should China adopt?

The legal framework for China's corporate governance

The aim of the Chinese Government was to establish a socialist market-oriented economy, prior to becoming part of the WTO, in order to improve and protect shareholders' rights, insulate companies' boards from inappropriate influences, and reduce information asymmetry.[15] Thus, corporate governance became a pressing issue to enhance Chinese enterprises' competitive advantage and to eliminate unacceptable practices. Although more than 300 laws and directives concerning the securities and futures markets have been issued since the establishment of the China Securities Regulatory Commission in 1992, in practice the state still owns large shareholdings in many companies, minority shareholders' rights are sometimes ignored and Chinese companies are liable to have influence exerted over them from a number of different sources. With the objectives of developing a prosperous socialist market-oriented economy and attracting more foreign institutional investors, the government realized that there is a need to create a corporate governance system that protects minority shareholders' rights and encourages confidence in the corporate structure and operations, and that companies need to provide accurate and timely information.[16]

In China, corporate governance developments involve a number of regulatory bodies, including the China Securities Regulatory Commission, the Ministry of Finance, the Economic and Trade

[14] People's Daily 16 June 2003, available at http://www.china.org.cn/english/NM-e/67078.htm [accessed 23 February 2010].

[15] Christine A. Mallin, *Corporate Governance* (Oxford: Oxford University Press, 2007).

[16] Ibid.

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Commission and the People's Bank of China, which is essentially the Central Bank of China.

The key legal framework for corporate governance in China consists of *The Company Law* promulgated in December 1993 and revised in 2005, *The Securities Law* promulgated in December 1998 and revised in 2005, and *The Code of Corporate Governance for Listed Companies in China* (*The Code*) issued by the China Securities Regulatory Commission and the Economic and Trade Commission in January 2002. *The Code* is applicable to all listed companies in China, and is the major measuring standard for evaluating whether a listed company has good corporate governance or not. All listed companies are required to act in the spirit of *The Code* in their efforts to improve corporate governance. With the objective of eliminating the dominant managerial powers of the boards of directors in China's listed companies, the China Securities Regulatory Commission issued *The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* (*The Independent Directors Guidelines*) in August 2001, mandating that by 30 June 2003, at least one-third of board members shall be independent directors.

The legal hierarchy framework is presented in Table 1. At the top level of the hierarchy is legislation enacted by China's highest legislative authority, the National People's Congress, which comprises *The Accounting Law*, *The Company Law* and *The Securities Law*. The China Securities Regulatory Commission, on the second level, is responsible for the regulation of securities markets and acts in a dominant role to issue regulations such as *The Independent Directors Guidelines* and *The Code*. The Shanghai Stock Exchange and Shenzhen Stock Exchange, on the third level, are responsible for issuing listing rules and guidelines, and for monitoring listed companies in accordance with these rules.

The Company Law, which was enacted in 1993 and became effective in July 1994, established the basic legislative provisions and improved corporate governance in China. It was the first attempt to create limited liability companies without regard to the nature of ownership, as part of a modern economic system. With China's accession to the WTO, corporate governance moved to the centre stage of China's economic reform.[17] The Fourth Plenum of the Communist Party of China's 15th Central Committee held in September 1999 adopted a decision that identified corporate governance as the core of the modern enterprise system.

[17] James V. Feinerman, 'New Hope for Corporate Governance in China?', *China Quarterly*, No. 191 (2007), pp. 590–612.

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TABLE 1
The Legal Framework for Corporate Governance in China

Authorities	Legislation Regulation	Effective Date
National People's Congress	*The Accounting Law*	1 May 1985 (Revised in 1993, 1999)
	The Company Law	29 December 1994 (Revised in 1999, 2005)
	The Securities Law	1 July 1999 (Revised in 2005)
CSRC SETC	*The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies*	August 2001
	The Code of Corporate Governance for Listed Companies in China	January 2002
SHSE SZSE	*The Guidelines on Information Disclosure for the Listed Companies*	Since 1990
	The Listing Rules of SHSE *The Listing Rules of SZSE*	Since 1991
	The Share Trading Rules of SHSE and SZSE	December 2001

Key: SHSE = Shanghai Stock Exchange, SZSE = Shenzhen Stock Exchange, CSRC = China Securities Regulatory Commission, SETC = Economic and Trade Commission.

According to *The Company Law*, the basic organizational structure of a limited liability company consists of three tiers of control. The first tier is the shareholders' meeting. In China this is known as 'the organ of power of the corporation' as it assumes supreme sovereignty in corporate governance. By statute, shareholders have the power to call meetings, elect and replace directors and supervisors, and approve their reports. They are also conferred with the right to examine corporate financial accounts, decide whether to issue additional shares and make decisions regarding corporate mergers, dissolution and liquidation. However, several problems stem from these shareholders' powers. First, if shareholders deny the decisions of the board of directors and exercise powers purportedly reserved exclusively to the board, this will result in power struggles between the two parties.[18] Second, the shareholders' meeting in reality is often

[18] Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now', *Working Paper 407* (Chicago: William Davidson Institute, University of Michigan Business School, 2001).

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simply a rubber stamp for the wishes of the majority shareholders, and provides little protection for minority shareholders.[19] Finally, although shareholders are allowed to file a lawsuit individually or jointly with other shareholders against directors or senior managers, class action is excluded as a permitted method due to the courts' lack of experience or resources to deal with thousands of shareholders in such actions.[20]

The second tier is the board of directors. The boards of directors of Chinese listed companies have the usual breadth of managerial powers comparable to their Western counterparts. Essentially, the board of directors is the critical link between ownership and corporate governance. Majority ownership of shares in listed companies is held by the State since most listed companies come from restructured state-owned enterprises. This dominance of state ownership implies that the government exerts control over managerial appointments and incentives.[21] In addition, the chairman of the board of directors and the CEO are often combined in China. It may be argued that this CEO duality offers clear direction by a single leadership and a concomitantly faster response to external events. But the CEO duality also results in a high possibility of the board of directors being controlled by 'insiders', thus resulting in ineffective board control and weak independence.[22] In order to bring independence to corporate structure, *The Company Law* requires that all listed companies have independent directors. Since 2003 *The Independent Directors Guidelines* further mandates that the boards of listed companies should comprise at least one-third independent directors.

The third tier is the supervisory board. The major responsibility of a supervisory board is to oversee the corporate board of directors. *The Company Law* (Article 52) places several requirements on the composition and operation of the supervisory board: it shall comprise at least three members; members shall include representatives of shareholders and an appropriate percentage of representatives of the

[19] Ibid., p. 21.

[20] H. C. Liu and Z. L. Ren, 'Halfway to Effective Shareholder Protection', *China Law and Practice*, (March 2003), pp. 29–32.

[21] Qiang Qu, 'Corporate Governance and State-Owned Shares in China Listed Companies', *Journal of Asian Economics*, Vol. 14, No. 5 (2003), pp. 771–783.

[22] Martin J. Conyon and Simon I. Peck, 'Board Control, Remuneration Committees, and Top Management Compensation', *Academy of Management Journal*, Vol. 41, No.2 (1998), pp. 146–157; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', *Journal of Accounting and Corporate Governance*, Vol. 1, No.1 (2004), pp. 1–23.

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firm's employees; the proportion of representatives of employees shall account for not less than one-third of all members; representatives of employees who serve as members of the supervisory board shall be democratically elected through the meeting of representatives of the firm's employees, shareholders' meeting or by other means; the supervisory board shall have one chairman, and may have a deputy chairman; and the chairman and deputy chairman shall be elected by more than half of all the members of the supervisory board. Due to the independent nature of the supervisory board, no directors or senior managers may concurrently act as a member.

The duties and responsibilities of a supervisory board have been clarified by *The Code* (paragraphs 59–63): supervising corporate finance, assessing the legitimacy of directors', managers' and other senior managers' performance of duties; protecting the firm's and the shareholders' legal rights and interests; having the right to investigate the operating status of the firm, and having the corresponding obligation of confidentiality; receiving necessary corporate information and assistance from management in order to satisfy the supervisors' rights to be informed about the company's matters; preparing and presenting a report of the supervisory board as an important basis for performance assessment of directors, managers and other senior management personnel; and reporting as a supervisory board, if necessary, directly to securities regulatory authorities and other related authorities. The supervisory board and the board of directors are legally on the same hierarchical level, and so the former has no power to dismiss the management nor does it have the power to report to the shareholders' meeting on the performance of the company and management.

Analyses of Anglo-American and German-Japanese models

Models of corporate governance can be divided into two major categories: the Anglo-American model and the German-Japanese model.[23] In the Anglo-American model, the corporate concept is based

[23] On Kit Tam, 'Models of Corporate Governance for Chinese Companies', *Corporate Governance: An International Review*, Vol. 8, No. 1 (2000), pp. 52–64; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', *Journal of Business Ethics*, Vol. 37, No. 3 (2002), pp. 303–320; Lucian Cernat, 'The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or still the Century of

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on the fiduciary relationship between shareholders and managers.[24] It is characterized by a clear separation between management control and shareholder ownership. Thus, it is also called the outside system of corporate governance.[25] Based on the concept of market capital, the Anglo-American system is founded on the belief that self-interest and decentralized markets can function in a self-regulating and balanced manner.[26]

In contrast to the Anglo-American system, the German-Japanese model considers not only the interests of shareholders but also the interests of other relevant stakeholders such as society and the community.[27] It is often believed that the special positions of financial institutions as shareholders and creditors can equip them with better information regarding companies and their financial conditions, thereby leading to more efficient monitoring and lending.[28] In general, the German-Japanese model is founded on three main characteristics.

The first characteristic is the role of financial institutions. The German-Japanese model does not have an active market for corporate control. Instead, financial institutions play a central role as corporate governance monitors. The most prominent group of stakeholders in German companies are the banks. In Germany individuals have no hostility towards banks, and companies always raise funds from banks rather than from the public sector. Other than their role as creditors, banks hold large stakes in numerous public companies and often have

Diversity?', *Journal of European Public Policy*, Vol. 11, No. 1 (2004), pp. 147–166; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects'; Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', *Journal of Corporate Law Studies*, Vol. 7, No. 1 (2007), pp. 143–183; M. Goergen, 'What Do We Know About Different Systems of Corporate Governance?', *Journal of Corporate Law Studies*, Vol.7, No.1 (2007), pp. 1–15.

[24] Lucian Cernat, 'The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or still the Century of Diversity?', pp. 147–166.

[25] J. Cook and S. Deakin, *Stakeholding and Corporate Governance: Theory and Evidence on Economic Performance* (Cambridge: ESRC Centre for Business Research, University of Cambridge, 1999); Lucian Cernat, 'The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or still the Century of Diversity?', pp. 147–166.

[26] Lucian Cernat, 'The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or still the Century of Diversity?', pp. 147–166.

[27] Ibid., pp. 153–154.

[28] Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', p. 4.

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board representation.[29] Thus, the banks are able to exercise their influence not only by direct ownership of equity but also through their holding of proxy votes.[30] In Japan, the special relationship between the main banks and large companies forms the core of the main banking system. Within this close relationship, banks take part in corporate governance. The main banks not only intervene to rescue companies in financial distress but also monitor governance.[31]

The second characteristic is the model's highly concentrated ownership structure. The banks' substantial holdings of equity means that ownership structure of German companies is highly concentrated compared with American companies.[32] In addition, Germany's lack of both an equity-owning culture and an entrepreneurial culture further result in a weak and illiquid stock market.[33] In Japan, corporate equity ownership structure is very stable and entails the holding of equity for long periods, without engaging in active trading of shares.[34]

The third characteristic is the two-tier board system. A unique feature of the German–Japanese model is the existence of a mandatory two-tier board system that separates the management board from the supervisory board. The management board is responsible for managing the enterprise and the supervisory board appoints, supervises and advises the members of the management board. To ensure independence, the two boards have absolutely separate functions and the supervisory board cannot undertake any managerial duties.

Much of the criticism of the German model has been directed at the supervisory board. These include insufficient provisions regarding its roles and responsibilities, inadequate management performance reviews,[35] and opaque disclosure in terms of representatives

[29] E. Boehmer, *Who Controls Germany?* (Berlin: Humboldt University, 1998), pp. 19–20.

[30] Robert E. Benfield, 'Curing American Managerial Myopia: Can the German System of Corporate Governance Help?', *Loyola of Los Angeles International and Comparative Law Journal*, Vol. 17, No. 3 (1995), pp. 615–647.

[31] Masahiko Aoki, 'Toward an Economic Model of the Japanese Firm', *Journal of Economic Literature*, Vol. 28, No. 1 (1990), pp. 1–27.

[32] Robert E. Benfield, 'Curing American Managerial Myopia: Can the German System of Corporate Governance Help?', pp. 615–647.

[33] Mark J. Roe, 'German Codetermination and German Securities Markets', *Columbia Business Law Review*, Vol. 1, No. 1 (1998), pp. 167–183.

[34] Paul Sheard, 'The Economics of Interlocking Shareholding in Japan', *Ricerche Economiche*, Vol. 45, No. 2/3 (1991), pp. 421–448.

[35] Mark J. Roe, 'German Codetermination and German Securities Markets', pp. 167–183.

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appointment by the banks. The criticism of the Japanese model has been directed at the main bank system, such as unsatisfactory main bank performance and service,[36] potential collusive exercise of oligopolistic market power by the large banks,[37] and purely ceremonial roles for the board of directors and the general shareholders' meeting.[38]

In contrast, the Anglo-American model possesses three major characteristics that distinguish it from the German-Japanese model. The first characteristic is the nature of its separation of ownership from control. In the early twentieth century, Adolf Berle and Gardiner Means[39] identified the separation of ownership from control in American companies. Since then, the rapid growth of American industries has prompted the sourcing of capital funds from widely diverse investors. Such diversified investments have created a class of passive investors who lack the ability, information and incentive to actively monitor the companies they invest in.[40]

The second characteristic is its one-tier board system. With a primary objective of reducing agency costs, the mechanism of a mandatory unitary board structure was introduced to restrain managerial power to ensure that shareholders' interests are maximized.[41] The structure of corporate governance in common law countries (for example, the USA and the UK) consists of three organs: shareholders' meetings, a board of directors (or corporate board) and management. The laws provide that the board shall oversee or monitor the management of the company on behalf of the shareholders. Thus, independent and fair supervision is a vital component of this system. In view of the conflicting roles of the board, it is common practice in American and British companies to appoint a majority of independent directors to the board because it is assumed that they are in a better

[36] Yishay Yafeh, 'Corporate Governance in Japan: Past Performance and Future Prospects', *Oxford Review of Economic Policy*, Vol. 16, No. 2 (2000), pp. 74–84.

[37] Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects'.

[38] M. L. Gerlach, *Alliance Capitalism—The Social Organization of Japanese Business* (Berkeley: University of California Press, 1992), pp. 103–159.

[39] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New Brunswick: Transaction Publishers, 1932), p. 250.

[40] Robert E. Benfield, 'Curing American Managerial Myopia: Can the German System of Corporate Governance Help?', pp. 615–647.

[41] Ibid., p. 623; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', p. 3.

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position to monitor management independently than are executive directors.

The third characteristic is the role of shareholders. Theoretically, shareholders may rely on the courts to ensure that directors fulfil their role as managerial monitors.[42]

However, there are some inherent drawbacks that limit this system's effectiveness in minimizing agency costs. For example, the board may be passive in fulfilling its fiduciary duties, and may not be able to monitor management independently; the market for corporate control does not protect shareholders from incompetent management; and the securities market often does not reflect the true long-term value of the company.

China has adopted the two-tier board structure consisting of a board of directors and a supervisory board.[43] The feature of the coexistence of a supervisory board and a board of independent directors demonstrates an important characteristic of China's economic and corporate reform, namely its cultural and philosophical approach of 'crossing the river by touching stones' (*mozhe shitou guohe*). This is because China's policymakers and regulators were eager to learn from, and introduce, proven foreign experience, but were unsure which system would be more suitable for China. It is for this reason that we observe both the supervisory board from the German-Japanese model and independent directors from the Anglo-American model being brought into China's corporate governance system.[44] However, unlike the German structure of the supervisory board, the Chinese board does not have the right to appoint and dismiss executive board directors. More importantly, insufficient resources and no really effective enforcement mechanisms are provided to facilitate the monitoring function of the

[42] Yuwa Wei, 'An Overview of Corporate Governance in China', *Syracuse Journal of International Law and Commerce*, Vol. 30, No. 1 (2003), pp. 23–48.

[43] Lay Hong Tan, 'Corporate Law Reform in the People's Republic of China', *Australian Journal of Corporate Law*, Vol.10, No.3 (1999), pp. 1–30; Guy S. Liu and Pei Sun, 'State-Dominated Corporate Governance System in Transition: The Case of China', in Christine A. Mallin (ed.). *Handbook on International Corporate Governance* (Cheltenham, UK: Edward Elgar Publishing: 2006), pp. 109–129.

[44] Peter H. Nolan also submits that China's political leaders and policymakers faced the challenges of globalization, transition and development. There are no textbooks to guide China along this path simply because no country has ever faced such a set of challenges. Under such circumstances China's leaders may be willing to learn the lessons from the country's own past and from other countries, and build its own best pathway. Peter H. Nolan, 'China at the crossroads', *Journal of Chinese Economic and Business Studies*, Vol.3, No.1 (2005), p. 1.

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supervisory board.[45] Also, in contrast with the Anglo-American system, there is no majority control by independent directors on the board of directors in Chinese listed companies.

In summary, the Anglo-American and the German-Japanese systems of corporate governance put their priorities in different areas. They each have their own merits and flaws. The Anglo-American model is viewed as a vehicle that allows companies to pursue aggressive competition by means of cost advantages and radical innovation. However, the German-Japanese model is a mechanism to encourage companies to compete through enhanced quality and gradual innovation. On Kit Tam presented an exhaustive comparison of the two stylized models and Chinese corporate governance arrangements and concluded that the merits of the Anglo-American and the German-Japanese systems did not dominate, either separately or jointly, in the Chinese model.[46] However, experience over the past ten years in China has shown a trend of convergence among these patterns, despite differences remaining in many other aspects.[47] As of 2009, the formation/selection of a corporate governance model suitable to the Chinese situation remains to be further refined.

Key issues surrounding China's corporate governance

It is commonly agreed that the 1997 Asian financial crisis was largely the result of ineffective corporate governance which, in China, had allowed the relatively recently privatized and listed companies to engage in the accounting practices of deferring reported losses and transferring assets out of the company to the disadvantage of minority shareholders and creditors. Thus, over the last several years, China's regulations have actively reviewed and improved corporate governance and transparency. However, problems remain in the Chinese corporate governance system, such as opaque related-party

[45] Guy S. Liu and Pei Sun, 'State-Dominated Corporate Governance System in Transition: The Case of China', pp. 109–129.

[46] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320.

[47] Simon S. M. Ho, 'Corporate Governance in China', *Working Paper* (Hong Kong: Hong Kong Baptist University, 2003).

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transactions,[48] weak supervisory boards,[49] weak independence of the boards of directors,[50] and a highly concentrated ownership structure.[51]

Opaque related-party transactions. In Chinese companies, majority shareholders are typically very strong and individual minority shareholders are extremely weak and are unable to counter the influence of the majority/controlling shareholders. Related-party transactions between controlling shareholders are often detrimental to minority shareholders, who are often regarded as speculators

[48] Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Shenshi Mei, 'The Corporate Governance of Listed Companies in China: Some Problems and Solutions', in Roman Tomasic (ed.). *Corporate Governance: Challenges for China* (Beijing: Law Press: 2005), pp. 422–437; Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183; Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', *Corporate Board: Role, Duties and Composition*, Vol. 4, No.1 (2008), pp. 37–49.

[49] Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now'; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects'; Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183; Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', *Compliance and Regulatory Journal*, Vol. 3, No.3 (2007), pp. 47–55; Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp.37–49.

[50] Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now', pp. 28–30; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', pp. 11–12; Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183; James V. Feinerman, 'New Hope for Corporate Governance in China?', pp. 590–612.

[51] Laura M. Cha, 'The Future of China's Capital Markets and the Role of Corporate Governance', paper presented at the Luncheon Speech at China Business Summit, 18 April 2001, Beijing; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Yuwa Wei, 'An Overview of Corporate Governance in China', pp. 23–48; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Shenshi Mei, 'The Corporate Governance of Listed Companies in China: Some Problems and Solutions', pp. 422–437; Guy S. Liu and Pei Sun, 'State-Dominated Corporate Governance System in Transition: The Case of China', pp. 109–129; James V. Feinerman, 'New Hope for Corporate Governance in China?', pp. 590–612.

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expecting to gain a 'free ride' on the firm's performance.[52] Thus, China's corporate governance is potentially relatively ineffective in its protection of minority shareholders' rights.[53]

Shenshi Mei submits that more and more Chinese listed companies have been 'hollowed' out by controlling shareholders due to unclear related-party transactions and expropriation of the interests that belong to minority shareholders.[54] The opaque disclosure of related-party relationships and transactions has also given many listed companies and their controlling shareholders incentives to engage in potentially harmful practices like earnings management, tunnelling and loan guarantees.[55]

One important aspect of protecting minority shareholders' rights is to disclose more information about related-party relationships and transactions.[56] Whilst good board governance would demand that both the corporate board and the supervisory board strongly monitor and support related-party disclosures by the company, such disclosures can be sensitive to those board members who directly or indirectly enter business transactions and relationships with the company.

Thomas W. Lin argues that *The Company Law*, *The Securities Law* and *The Criminal Law* are inclined to neglect civil liability and compensation, and have not provided a procedure and specific clauses for enforceable civil actions.[57] In addition, there is no provision for class action lawsuits under Chinese law and it is very cumbersome

[52] Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23.

[53] Laura M. Cha, 'The Future of China's Capital Markets and the Role of Corporate Governance', pp. 1–2; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now', p. 15; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Shenshi Mei, 'The Corporate Governance of Listed Companies in China: Some Problems and Solutions', pp. 422–437; Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

[54] Shenshi Mei, 'The Corporate Governance of Listed Companies in China: Some Problems and Solutions', pp. 422–437.

[55] Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

[56] Ibid., p. 37.

[57] Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23.

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for an individual shareholder to sue listed companies for fraud.[58] In this situation, it is no surprise that a series of corporate scandals were exposed in 2001. These scandals have helped fuel the drive for corporate governance reforms and led to the formulation of *The Code*, which, as mentioned above, became effective in January 2002.

The Code states three requirements for related-party transactions. First, written agreements shall be entered into for related-party transactions between a listed company and its connected parties. Such agreements shall observe the principles of equality, voluntariness and fair value of compensation. Second, efficient measures shall be adopted by a listed company to prevent its connected parties from interfering with the operation of the firm and damaging the firm's interests by monopolizing purchase or sales channels. Therefore, the company shall fully disclose the basis for pricing for related-party transactions. Third, the firm shall adopt efficient measures to prevent its shareholders and their affiliates from misappropriating or transferring the capital, assets or other resources of the firm through various means. On top of these requirements, the Chinese Accounting Standard for Business Enterprises, *ASBE 36*, prescribes requirements concerning related-party relationships and transactions disclosures.[59]

Weak supervisory board. The supervisory board in China has played no effective governance role[60] because its effectiveness is undermined by

[58] H. C. Liu and Z. L. Ren, 'Halfway to Effective Shareholder Protection', pp. 29–32.

[59] For example, according to Article 9, ABSE 36 with respect to related-party relationships, the following matters should be disclosed: (1) the nature or type of business entity, the name, the legal representative and the place of registration of the related enterprise, and its registered capital and changes therein; (2) the principal business of the related enterprise; (3) the proportions of shares or equity interest held and changes therein. According to Article 10, ABSE 36 on related-party transactions, the reporting entity should disclose information as follows: (1) the amounts of the transactions, or the appropriate proportions; (2) the amounts of outstanding items, or the appropriate proportions; (3) pricing policies, including those transactions where no amount or only nominal amounts have been charged.

[60] Laura M. Cha, 'The Future of China's Capital Markets and the Role of Corporate Governance', p. 2; Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now', pp. 6–8; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Chenxia Shi, 'Governance of State-Owned Enterprises in Post-WTO China', in Roman Tomasic (ed.). *Corporate Governance: Challenges for China* (Beijing: Law Press: 2005), pp. 385–421; Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', pp. 47–55; Yuan G. Shan

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its composition.[61] Under the Chinese system, the supervisory board is small in size and usually has members from labour unions, party members (political officers), leaders of the non-functional trade union, and close friends who are nominated by the board of directors and elected by shareholders.[62] Unlike the supervisory board in the German model of corporate governance, it has only a loosely defined monitoring role over the board of directors and managers,[63] and does not have strategic decision-making powers, nor does it have powers to appoint or dismiss the board of directors and management.[64] In reality, its members can be regarded merely as 'rubber stamp' directors.

The key problems of supervisory boards in China can be highlighted as follows. First, the executives not only appoint supervisors but also determine their compensation. Thus there is virtually no independence from management.[65] Second, the supervisors are not involved in the selection of directors and managers and have no means of disciplining them.[66] Third, due to the dominant role of corporate board directors and senior managers, many supervisory boards in China are treated as a 'censored watchdog', and are not allowed to speak against the management installed by the controlling shareholder or the government.[67] Fourth, the supervisory board has limited access to corporate information so it is impossible for it to make

and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

[61] Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', pp. 47–55.

[62] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Jay Dahya, Yusuf Karbhari, Jason Zezong Xiao and Mei Yang, 'The Usefulness of the Supervisory Board Report in China', *Corporate Governance: An International Review*, Vol. 11, No.4 (2003), pp. 308–321; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23.

[63] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320.

[64] Chenxia Shi, 'Governance of State-Owned Enterprises in Post-WTO China', pp. 385–421.

[65] Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', pp. 47–55.

[66] Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23.

[67] Jay Dahya, Yusuf Karbhari, Jason Zezong Xiao and Mei Yang, 'The Usefulness of the Supervisory Board Report in China', pp. 308–321; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

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informed decisions.[68] Last, almost all supervisors are insiders rather than outsiders who either work directly for, or have close connections with, the firm, its parent firm or its subsidiaries. They thus lack true independence.[69]

In short, it is widely recognized that the supervisory board system in China is a failure in terms of improving corporate governance.[70] Laura M. Cha, Vice Chairwoman of the China Securities Regulatory Commission, has offered the following conclusion:

> It is sometimes argued that more authority should then be given to the supervisory board, which sits on top of the boards of our listed companies. However, experience has shown that this system of supervision is not effective as it is often unclear whose interest is being represented by the supervisory board. In many cases, the supervisory board duplicates the authority of the board itself but without corresponding responsibilities. In fact, the presence of a supervisory board may give the illusion of certain checks and balances in the listed company when none existed.[71]

Weak independence of board of directors. China's corporate governance is characterized by weak independent boards of directors in listed companies.[72] The key problems of independence are related to the directors and managers of listed companies. Most directors are insiders or executive directors, and few companies have many

[68] Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', pp. 47–55.

[69] Jason Zezong Xiao, Jay Dahya and Zhijun Lin, 'A Grounded Theory Exposition of the Role of the Supervisory Board in China', *British Journal of Management*, Vol. 15, No.1 (2004), pp. 39–55; Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

[70] Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183; Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', pp. 47–55.

[71] Laura M. Cha, 'The Future of China's Capital Markets and the Role of Corporate Governance', p. 2.

[72] Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now', pp. 28–30; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 330–320; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', p. 12; Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183; James V. Feinerman, 'New Hope for Corporate Governance in China?', pp. 590–612; Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', pp. 47–55.

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independent directors. This results in insider control in most Chinese listed companies.[73]

In terms of the nature of independence, Lay Hong Tan and Jiangyu Wang submit that most independent directors in Chinese listed companies are appointed by the board members or majority/controlling shareholders.[74] Hence they owe their loyalty and patronage to their appointers. Additionally, within the Chinese network of *guanxi* the appointed independent directors are installed for the 'giving of face' (*gei mianzi*) to their patrons. The independent directors therefore will not act as objective and independent watchdogs, but rather will follow the controlling shareholders and their patrons in order to maintain their secured positions within this network.

The legal framework also generates problems that undermine the effectiveness of independent directors. Jiangyu Wang argues:

> The CSRC is certainly aware of the extensively reported problems of high-ownership concentration and key-person control in China's listed companies. Nevertheless, it still imposes no restrictions on the power of the controlling shareholders to nominate independent directors, and grants no special privilege to minority shareholders who are the major victims of the agency problems associated with the key-person control model.[75]

In August 2001, the China Securities Regulatory Commission overhauled insider-controlled board structures by issuing a regulation requiring each listed company to have at least one-third of the board as independent directors by June 2003.[76]

Additionally, since 2001, the China Securities Regulatory Commission has promulgated a series of provisions to confer

[73] James V. Feinerman, 'New Hope for Corporate Governance in China?', pp. 590–612.

[74] Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183.

[75] Jiangyu Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies', p. 53.

[76] Donald C. Clarke, 'Corporate Governance in China: An Overview', *China Economic Review*, Vol. 14, No.4 (2003), pp. 494–507; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects'; Lay Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy', pp. 143–183; James V. Feinerman, 'New Hope for Corporate Governance in China?', pp. 590–612.

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independent directors with special powers to assemble shareholders' meetings, recruit or dismiss accounting firms, invite independent auditors, offer independent financial reports from the perspective of their normal duties as board members,[77] and approve proposed related-party transactions before submission to the board of directors for discussion. It is hoped that independent directors will work more effectively in their duties and responsibilities, and that this will result in greater accountability, transparency and fairness.

Highly concentrated ownership structure. Peter Nolan points out that China has experienced difficulties in achieving the separation of government and enterprise that has been advocated for many years.[78] China's corporate governance is greatly affected by the highly concentrated ownership structure of Chinese companies.[79] The current situation in China is that the state is the major shareholder to be found in this highly concentrated ownership structure because of China's partial privatisation.[80] Currently only individual shares are traded on the securities markets. However, the fact that state shares and legal person shares are not traded on the securities markets means that more than 81.6 per cent of all listed companies were under the direct or indirect control of the state by the end of 2001,[81] and 60 per cent of the outstanding shares are excluded from the market.[82] Because of the high rate of savings and the very

[77] D. M. Zhang, 'New System to Improve Corporate Governance', *China Daily*, 24 August 2001.

[78] Peter Nolan, 'China and the Global Business Revolution', *Cambridge Journal of Economics*, Vol. 26, No.1 (2002), pp. 119–137.

[79] Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now', pp. 5–11; On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Yuwa Wei, 'An Overview of Corporate Governance in China', pp. 23–48; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23; Shenshi Mei, 'The Corporate Governance of Listed Companies in China: Some Problems and Solutions', pp. 422–437; Guy S. Liu and Pei Sun, 'State-Dominated Corporate Governance System in Transition: The Case of China', pp. 109–129; James V. Feinerman, 'New Hope for Corporate Governance in China?', pp. 590–612; Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

[80] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320.

[81] Guy S. Liu and Pei Sun, 'State-Dominated Corporate Governance System in Transition: The Case of China', pp. 109–129.

[82] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23.

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limited range of investment instruments available in China, minority shareholders are often regarded as 'free riders' in the securities market. From the beginning, minority shareholders exhibited a highly speculative tendency with very short investment horizons.[83] The highly concentrated ownership of the state and legal persons has reduced the liquidity of the secondary market and has become the main obstacle to the efficient operation of the market.[84]

Shenshi Mei argues that as almost all of China's listed companies are former and current state-owned enterprises and most managers are political appointees, the inevitable question must be about the level of political interference.[85] Although the state wants its companies to operate efficiently, state-owned enterprises are required to implement a wealth maximizing approach for the state, such as by maintaining the unemployment rate at certain levels, and manufacturing unprofitable products for political purposes, instead of the enterprises pursuing a solely profit-maximizing approach.

Yuan G. Shan and Dennis W. Taylor analyse the four key problems of China's corporate governance system as discussed above.[86] They argue that independent directors should be motivated to work in the best interests of shareholders in order to maintain their personal reputations, and to improve corporate disclosure, even in countries that have fewer incentives for transparency. They also argue that the supervisory board should demand high standards of professionalism from its members in order to effectively carry out its role of overseeing the performance of the board of directors and management, and to protect stakeholders' rights and interests. However, their empirical results reveal that the ratio of independent directors on the board of directors has a positive impact on the extent of related-party disclosure, whereas the credentials of supervisors on the supervisory board, in terms of their qualifications and experience, appear to have a negative effect on related-party disclosure, within this highly

[83] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320.

[84] Thomas W. Lin, 'Corporate Governance in China: Recent Developments, Key Problems, and Solutions', pp. 1–23.

[85] Shenshi Mei, 'The Corporate Governance of Listed Companies in China: Some Problems and Solutions', pp. 422–437.

[86] Yuan G. Shan and Dennis W. Taylor, 'Related-Party Disclosures in the Two-Tier Board System in China: Influences of Ownership Structure and Board Composition', pp. 37–49.

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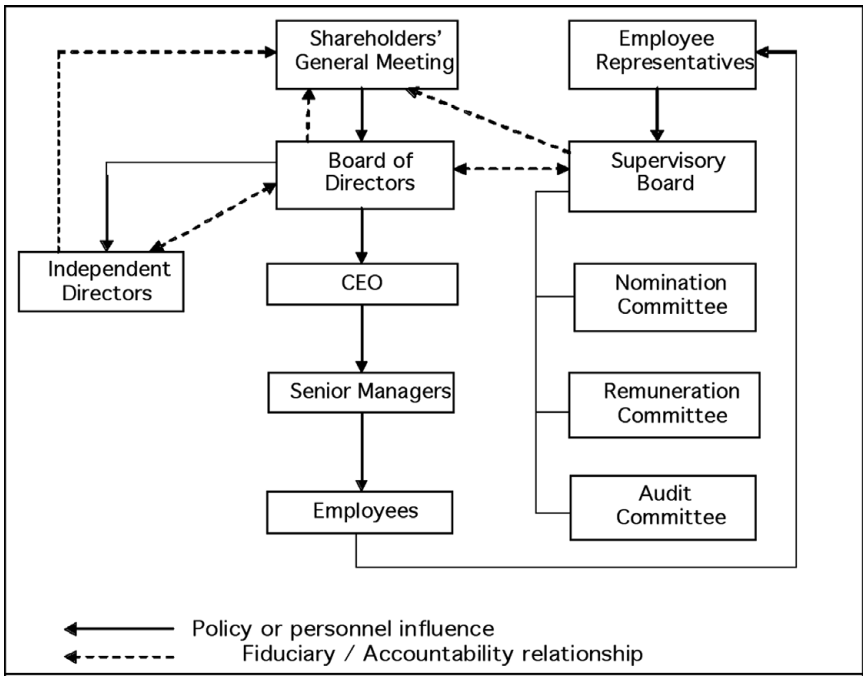


Figure 1. *Effect of key issues on China's corporate governance*

concentrated ownership boundary in China. These findings are simply illustrated in Figure 1.

Some suggested solutions for the observed corporate governance problems

Short-term legal improvement

From a legal perspective, it appears that the moves by the China Securities Regulatory Commission to require improved qualifications and experience of supervisors on supervisory boards of listed companies have not been sufficient to ensure that these boards properly fulfil their roles of independent oversight and public reporting on the performance of the corporate board and management, especially in the sensitive area of related-party transactions. There is a case, it seems, for giving specific externally derived authority to supervisory boards.

Such externally derived authority may emerge in the form of imminent revisions to the international accounting standard, *International Accounting Standard 24 Related Party Disclosures* (hereafter,

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IAS 24). In February 2007 the International Accounting Standards Board published an Exposure Draft of these proposed amendments that addressed disclosure requirements for state-controlled entities when they transact with similar entities, and also broadened the definition of a related party. The revised *IAS 24* should be issued late in 2009. If these revisions are adopted in *Accounting Standards for Business Enterprises 36* (hereafter, *ASBE 36*), the equivalent accounting standard in China, this would provide a strengthening of the source of external authority for supervisory boards through the appointment of professionally qualified supervisors, thereby boosting the comprehensiveness of related-party disclosures by Chinese listed companies.

As noted earlier, the effectiveness of a typical supervisory board in China is undermined by its composition, and Yuan G. Shan and Dennis W. Taylor have noted the existence of highly concentrated leadership in the hands of either the state or key controlling shareholders.[87] To overcome these problems, On Kit Tam, and Lay Hong Tan and Jiangyu Wang, have proposed a new model of corporate governance as shown in Figure 2.[88] Under this new model, new relationships and roles for the board of directors and the supervisory board are established. The independence and autonomy of the board of directors should be established and the present strong levels of intervention by the Party/Government should be eliminated. The election of directors and the appointment of the CEO should comply with the existing set of principles and rules, such as *The Company Law*, *The Securities Law*, *The Code* and other directives and regulations promulgated by the China Securities Regulatory Commission. In order to confer effective power and ensure an active corporate governance role for supervisors, a redistribution of the structure of employees between the board of directors and the supervisory board is needed to more effectively rebalance the responsibilities of the supervisory board.

With respect to the independence of supervisory boards in the new model, the proportion of insiders is proposed to be kept below 20 per cent in order to avoid the presence of a majority of insiders, and it is recommended that a set of functional committees (nomination, remuneration and audit committees) should be established to remove

[87] Ibid., p. 48.

[88] On Kit Tam, 'Ethical Issues in the Evolution of Corporate Governance in China', pp. 303–320; Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', p. 19.

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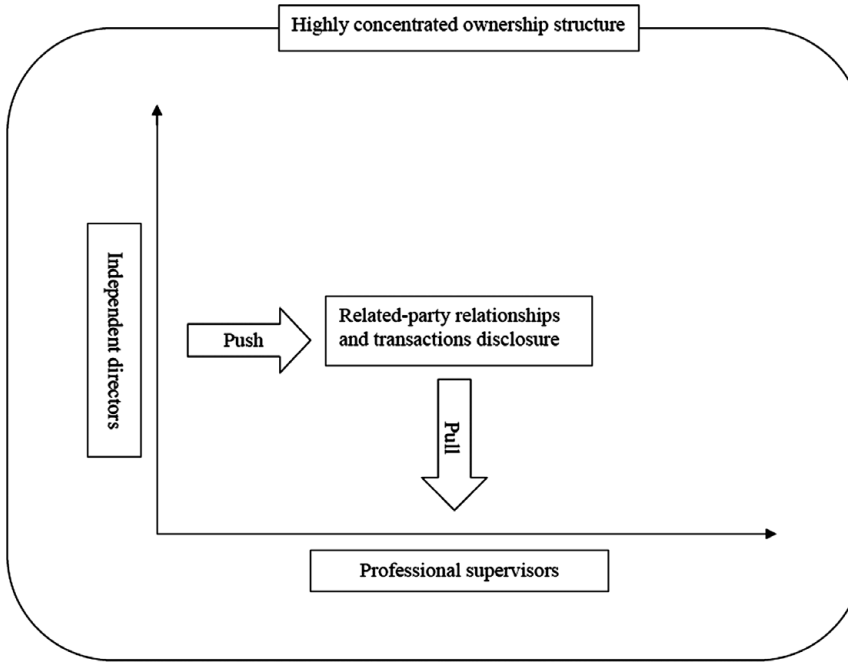


Figure 2. *A new model for China's corporate governance*
Source: Lay Hong Tan and Jiangyu Wang, 'Proposing a Model of Corporate Governance for China's Listed Companies: Problems and Prospects', revised figure based on On Kit Tam, 'Models of Corporate Governance for Chinese Companies', p. 61.

some of the grounds on which insider control has been built. Other than these innovations, changes should be made to *The Company Law* and *The Code*. The supervisory board should be given greater power to hire and remove directors. This authority will improve the supervisory board's status within and outside the company. Moreover, *The Company Law* should prescribe legal responsibilities for the supervisory board so that supervisors will be statutorily obliged to undertake their duties diligently. On the other hand, *The Company Law* should clarify an obligation of the board of directors to provide supervisors with timely information regarding the firm so that the supervisory board can effectively exercise its monitoring function.

Macro level reforms in China's capital market

On the macro level, the economic reforms in China since 1978 have aimed to transform the centrally planned economy into a

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market-oriented economy, and have now come to the stage of reforming and reconstructing China's enterprises. The ownership structure in state-owned enterprises differs from that of a modern firm due to a lack of external ownership. Theoretically, the owner of a state-owned enterprise is the state, or 'the people as a whole'. In fact, there is no such ownership that can physically appear to monitor the firm's management and performance. Practically, ownership rights in a state-owned enterprise are exercised by administrative departments at different levels of government. Therefore, state ownership can be regarded as an absence of direct ownership and operating through the powers of control and supervision.[89]

Chinese policymakers and regulators recognize that this issue has become an obstacle to state-owned enterprises reform. In September 1999, the Fourth Plenum of the 15th Communist Party of China Central Committee defined the major objectives and guiding principles for the reform and development of state-owned enterprises up until 2010 as follows:

- To complete strategic readjustment and restructuring to bring into being a more rational layout and structure of the national economy.
- To establish a well-functioning modern corporate system to improve economic performance.
- To promote scientific and technological development, market competition and risk management.
- To make the state-run economy play a better, less dominant role in the operation of the national economy.

The guidelines imply the continuation of state-owned enterprises as the non-dominant form of corporation, the strategic readjustment of the state economy and the restructuring of state-owned enterprises, the establishment of a modern corporate system, and the fostering of competitive mechanisms. This shows the government's determination to introduce a diversified ownership structure to state-owned enterprises and to encourage market competition. However, such positive expectations can only be realized under an effective corporate governance system.

A rational model of corporate governance can generate better economic efficiency and reduce unnecessary economic costs. China's policymakers and regulators should continue to search for an advanced

[89] Yuwa Wei, 'An Overview of Corporate Governance in China', pp. 23–48.

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and workable corporate governance system for existing and future enterprises, and to physically build up such a system within the Chinese legal framework.

Conclusion

Effective corporate governance is crucial to China's development. It involves many issues and has profound policy and practical implications. China's current dual board system of corporate governance has not been effective in improving the performance and accountability of listed Chinese corporations. A far more independent and rigorous set of checks on management is needed. In the process of transition from a centrally planned economy to a market-oriented economy, China has at least embraced the concept of corporate governance and its underlying principles. However, serious deficiencies may be observed in the current system, such that corporate governance problems arising from China's transitional emerging economy have arisen to engage the attention of policymakers, regulators and corporate players.

The development of China's capital market is, to a large extent, determined by the quality of its listed companies, which is closely linked with the efficiency and effectiveness of corporate governance. Further studies of international experience in corporate governance need to be conducted so that China can follow new developments and improve existing practices, and devise the best system of corporate governance to facilitate the efficient development of its growing capital markets. Such a strengthening of corporate governance will play a vital role in ensuring that China's economic reforms lead to it becoming a major international economic superpower.

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