THE DEVELOPMENT OF CORPORATE GOVERNANCE IN CHINA

Z. Jun Lin
Ming Liu
Xu Zhang
Department of Accountancy & Law
Hong Kong Baptist University
Hong Kong

Abstract

This paper delineates the development of corporate governance in China in the course of the recent market-oriented economic reforms. The four-stage evolutionary progresses of corporate governance practices in the country are outlined, while the main deficiencies in the existing governance practices of the Chinese companies are analyzed. In addition, the most recent efforts made by the Chinese government in order to promote capital market reforms and improve corporate governance practices are described. It is argued that a series of corporate governance practices originating in western countries have been gradually adopted or experimented in China although the actual effects of their implementation in practice remains to be seen.

Keywords: Corporate governance, Chinese economic reforms, enterprise reform, Chinese corporations

Introduction

The importance of corporate governance derives from the separation of ownership and management in large organization. There is a need to establish appropriate control and monitoring procedures to ensure management can effectively utilize the entrusted resources to add values for business owners (Karpoff et al. 1996; Bhagat and Black 1999; Claessens et al. 2000). The owners (investors) do not directly participate in the daily operations as management is involved in the planning and control of business activities. Owing to divergence in the interests of owners and managers, management may pursue self-welfare at the expense of owners. Conflict of interest causes agency costs to be borne by different parties. In order to minimize agency costs, a set of control mechanisms or procedures is set up to bind the behaviors of owners (principal) and management (agent). These mechanisms are an important part of good corporate governance (Eisenhardt 1989; Bushman and Smith 2001).
Since business firms have many stakeholders there are varied kinds of principal-agent relations, e.g., between owners and management, controlling (large) shareholders and minority shareholders, creditors and owners, regulatory bodies and business firms, etc. A primary objective of corporate governance (CG) is thus to monitor the behaviors of different interested parties and to reduce the agency costs associated with these varied principal-agent relations (Karpoff et al. 1996; Lashgari 2004; Marnet 2005). Thus corporate governance can be defined as “a set of mechanisms, both industrial and market-based, that induce the self-interested controllers of a company to make decisions that maximize the value of the company to its owners” (Denis and McConnell 2003). More specifically speaking, corporate governance is the set of institutional mechanisms that maintain an appropriate balance between the rights of shareholders and the needs of the board of directors (BoD) and management to direct and manage a firm’s affairs (TIAA-CREF 2004).

Many studies have demonstrated that corporate governance is positively associated with the efficiency and effectiveness of business operations and capital market performance (Morck et al. 1988; La Porta et al. 2002; Joh 2003). People generally believe that good corporate governance increases a firm’s market valuation. McKinsey conducted a series of surveys with institutional investors and private equity investors in the context of emerging markets and reported that 80% of these investors were willing to pay a premium to well governed firms (McKinsey & Company, 1999-2002). In addition, Black (2001) and Joh (2003) both found a positive correlation between performance measures and levels of governance. Sound corporate governance increases a firm’s value and attracts the trust and investment of capital market participants (Gompers et al. 2003; Steen 2005; Pagano and Volpin 2005). Consequently, more and more institutions, researchers and practitioners in both developed and developing countries are devoting more attention to corporate governance principles and have proposed various approaches to raise the standards of corporate governance (Denis and McConnell 2003; Bai et al. 2004; Ugeux 2004; Jirapornet et al. 2005).

Due to significant differences in social, economic, legal and cultural systems from those in developed western countries, where the modern corporation evolved, business systems and governance practices in China have distinct characteristics. Although the differences between Chinese and Western economies have lessened in recent years, corporate governance practices in China remain relatively unsophisticated. This paper illustrates the evolution of these practices at the present time.

The remainder of the paper is divided into five further sections. Four stages in the development of corporate governance in Chinese businesses is introduced in the
next section, followed by an analysis of the major deficiencies or problems inherent in the governance practices in Chinese companies. The next section illustrates the most recent corporate governance reforms implemented by the Chinese government. Finally a brief section ends the paper.

Evolution of Corporate Governance in China

Following the founding of the People’s Republic in 1949, the Chinese government adopted the public (state) ownership of all production means and the formal-Soviet-style planned economy. All enterprises were considered as being owned by the people and the state (through government authorities at different levels) directly ran enterprises with centralized planning and control. Business enterprises were treated as the basic producing units for implementing national economic plans. Business managers were directly appointed by government authorities in charge at different levels. Under the Socialist doctrine, production workers were regarded as owners of the means of productions having the same interests as the state, although business managers and workers did not directly share the ownership rights and benefits.

Under the centralized system, all capital was provided by the state. Businesses had little economic independence and management had almost no decision-making rights in terms of production or operations. Profits earned by the enterprises belonged to the state’s public finance department. There were no commodity capital and capital markets and business operations were not subject to market pressures, so long as enterprises fulfilled the production and sales plans laid down by government. Obviously, Chinese such state businesses were not run like modern enterprises during this period. As a result the governance mechanisms in the state-run businesses were substituted by hierarchic and bureaucratic administrations. Under highly centralized governmental controls, the importance of corporate governance was ignored before the 1980s.

State ownership and the planned economy over more than 30 years was perceived as resulting in production inefficiencies and economic stagnation in China, forcing the Chinese government to introduce market-oriented economic reforms in the late 1970s. After more than two decades of economic reforms, significant changes were effected in Chinese economy. In particular, the original state-owned and state-run businesses have been restructured to become relatively independent business entities operating under an emerging market-oriented economic system. Thus corporate governance has gradually become an important issue for enterprise reform in China, and corporate governance practices have evolved gradually through four major development stages.
Initial Development (from the late 1970s to the mid 1980s)

A primary objective of the early economic reforms was to gradually adjust the relations between the state and the state-run businesses, aiming to increasing the autonomy of businesses and expanding the decision-making power of business managers. Confined, however, by orthodox Socialism doctrines, the government did not want to give up public (state) ownership and planned economic administration. All businesses remained state-owned and run by government authorities at various levels. However, certain reform measures on business governance were introduced in order to motivate business managers to raise production efficiency. For instance, the state, through various government departments, relaxed, to a certain extent, the centralized control of businesses and reduced direct intervention in business production and operations.

Businesses were required to be relatively independent operating entities with certain autonomy. Business managers were allowed to make some operating decisions in the light of their operating conditions. The government implemented a policy of ‘taxes instead of profit’ to invigorate enterprises, i.e., introducing income taxes to replace the formal practice of remitting all profits to the state, while businesses were allowed to retain a certain amount of after-tax profits for business expansion and employees’ benefits (including bonuses to managers and workers).

Such reform measures changed the relation between the state, as owners, and businesses. They also induced business managers to exercise greater power in decision-making. As a result, the importance of effective corporate governance began to be recognized and some efforts to set up governance mechanisms were made to constrain managers’ behaviors, to reduce the potential agency costs. For instance, all businesses were required to establish a managing committee consisting of party workers and employee representatives, to assist and monitor business managers (factory directors) in making decisions on importance issues. Nonetheless, as businesses remained directly owned and controlled by the state, and emerging commodity markets were relatively insignificant, the mechanisms of corporate governance similar to those found in modern western market economies could not function well in China during this period Gelb et al. 1993; Groves et al. 1994; Li 1997)

Contracted Responsibility and the Business Leasing System (in the mid 1980s)

Since the mid 1980s, Chinese economic reforms have been aimed raising the operating efficiency and effectiveness of business entities. The government introduced the ‘Contracted responsibility system’ or the leasing of SOEs, e.g.,
allowing business management and workers to lease the SOEs from the government. This allowed SOEs to have relatively independent operations, as long as they succeeded in paying the authorities in charge of the agreed-upon amount of profits and taxes (the contracted responsibilities).

The rationale behind the contracted responsibility system was to maintain state-ownership while providing individuals economic incentives. Under the contracted responsibility system, state-ownership was reflected by the collection of profits or taxes. Business managers (the leasees) were, in return, given discretion in running businesses and residual rewards from the business after the deduction of the agreed “rental” and taxes, payable to the government. The system was designed to encourage business managers to make greater efforts to increase business productivity and effectiveness. However, the system created significant agency costs, as business managers pursued short-term behaviors such as income manipulation. For example managers might seek exorbitant personal returns by maximizing current period income at the expense of future development of businesses, infringing upon the state’s (and the people’s) long-term interests.

Instances of dysfunctional behaviour resulting from the business leasing system included managers running down the production facilities by deferring necessary maintenance expenditures or R & D spending in current period, and manipulating income to maximize payouts. The ability to control disclosure by management made it hard to monitor behaviour, as managers tended to be left alone so long as they could pay their rentals and taxes. As a result of a lack of governance mechanism whose effective procedures the state could not find, the contracted responsibility/business leasing system was not successful and officially abandoned by the government in the late 1980s (Xu 2000).

**Business Restructuring with Incorporation in the 1990s**

As the pace of economic reform accelerated, the problems of SOEs governance were exacerbated. The effect of a system in which the state acted as the owner, administrator and regulator of business, was that any number of government authorities could, and frequently did, intervene in the operations of SOEs. This led to poor operating results. In addition, the management of SOEs was delegated to appointees of government authorities who were often judged in terms of their political, rather than economic, performance. Business managers did not bear the risks or losses of businesses though they might perform poorly. Under such kind of governance structures, conflicts of interest between the state and enterprises, or between government officials and business managers, were inevitable. According to the government’s statistics, at the beginning of 1990s, more than two-third of SOEs made losses (Qian 1996; Lin 2001).
In order to solve this problem, the Chinese government launched a business restructuring movement in the early 1990s, by incorporating the original SOEs, i.e., forming limited liability companies in order to make SOEs independent enterprises. Also, the government introduced another reform to separate the governmental and business administration functions by setting up the State Administration of State-Owned Assets (SASA) and industrialized administrative companies of state-owned assets in the mid 1990s. It was anticipated that the SASA and industrialized holding companies would better represent the state’s interests, as the owner of SOEs. Thereafter, state and other governmental authorities would no longer participate in business operations, while the newly incorporated enterprises were required to increase value for their owners. The Chinese government reopened two share markets in Shanghai (SHSE) and Shenzhen (SZSE) in 1990 and 1991, respectively, to facilitate the conversion of SOEs into share-capital based companies (Sun and Wilson 2003). In addition, the government enacted and implemented the first *Company Law* in China in 1993 to provide legal support for the incorporation process.

With the establishment of limited liability companies, there was a substantial change in the ownerships structure of business enterprises. There was a clearer separation of ownership and management, with demands for a large number of professional managers to take up additional administration functions. Corporate governance became a more evident critical issue and it was necessary to establish a set of corporate governance mechanisms compatible with the new incorporated enterprises.

The Chinese government drew on the experience of corporations in the western countries since the mid 1990s. For instance, the *Company Law* states that a company must set up three-tier corporate governing bodies with a balance between the powers of shareholders, Boards of Directors (BoD) and other levels of management. Shareholders appoint BoD members to direct and monitor more junior management and business operations, while the appointment, evaluation and dismissal of management officers is conducted by the BoD on behalf of shareholders. The *Company Law* also requires Chinese companies to set up a Supervisory Board (SB) with membership drawn from representatives of the SASA, relevant government authorities and well as internal employees. Although a SB does not participate in a company’s operational decision making, it exercises supervision over the work of the BoD, the performance of management and the business’ financial affairs (Shi and Weisert 2002). Such a German-styled, multi-tier Board system has become the backbone of corporate governance in most Chinese companies since the mid 1990s.

The Chinese government further promoted the public listing of share-capital companies and the development of capital market in the 1990s. A large number
of SOEs went public after converting the original SOEs into companies to be listed, both in China and abroad. By the end of 2001, about 1200 companies were listed in the SHSE and SESE while more than 100 Chinese companies were listed in Hong Kong (H-share), New York, London and other overseas capital markets (Sun and Wilson 2003; Bai et al. 2004).

As a result of the reforms of the 1990s, stakeholders in listed companies are more than just the state and business management, and include many other public investors, both institutional and individual. There are different contractual relations among the various interested parties and management is more complicated than in the era of state-owned companies. It is now quite natural to demand corporate governance structures with higher standards. The Chinese market regulators, the China Securities Regulation Commission (CSRC) in particular, have set out more detailed regulations on the accountability, transparency and information disclosure required of listed companies. In particular, listed companies are required to publish financial statements regularly and on a timely basis and they must be audited by authorized Chinese CPAs in order to ensure their quality.

**Standardization of Corporate Governance Practices (since 2000)**

Following the exposures of several corporate scandals in the western countries, including Enron, WorldCom, and Xerox in the early 2000s, governments, market regulators, and public investors in many countries have paid increasing attention to corporate governance and efforts have been made to improve the standards of good corporate governance practices (Shi and Weisert 2002; Ugeux 2004; Steen 2005; Pagano and Volpin 2005). During the same period, corporate scandals were also uncovered in the Chinese stock market. Fraud has resulted in substantial losses to Chinese investors, reducing the confidence of investors and causing a significant outflow of capital from share markets and a consequent reduction in value. This prompted the Chinese government to place more emphasize on market reform and strengthen the governance practices of listed companies. New rules or practices were introduced since the early 2000s, aimed at standardizing and improving corporate governance practices for Chinese companies. The major changes include:

*Introduction of an Independent Directors’ System*

Almost all Chinese companies have set up SBs in accordance with the requirement of the *Company Law*, but the prescribed SB functions of exercising supervision over the performance BoDs and management does not work well in practice. In consequence, the CSRC has introduced the Anglo-Saxon style indirect (nonexecutive) director system to Chinese listed companies, in order to strengthen the monitoring role of BoD on management performance and business operations.
Under a “Guideline on the establishing Independent Director System in the Listed Companies” issued in August 2001, all listed companies are required to appoint independent directors, with these being at least one-third of the BoD membership by June 30, 2003. Independent directors are authorized to review and express independent opinions on significant related-party transactions, the nomination of directors and the appointment and dismissal of senior management officers, before these matters are submitted to BoD for discussion. Independent directors also review the determination of compensation or remuneration of directors and senior management officers (CSRC 2001). According to a recent study almost all Chinese listed companies have appointed independent directors to conform to CSRC requirements (Lin 2005).

**Adoption of Best Corporate Governance Practices**

The CSRC issued “Standards on Corporate Governance for the Publicly Listed Companies” in 2002, which was prepared with reference to the codes of best corporate governance practices in the UK and US. The new Standards lay down a series of requirements on the right of shareholders, procedures at shareholders’ meetings, related party-transactions, the behaviour of controlling shareholders, the independence, nomination and appointment of directors, obligations of directors, composition and responsibilities of the BoD, procedures of BoD meetings, the independent director system, composition, working procedures and responsibilities of the SB, performance assessment for directors, SB members, and senior management officers, the appointment of, and incentive for senior management officers, transparency and information disclosure, and so on. At present the Standards have been adopted by most listed companies.

Some of the recommended corporate governance practices include (CSRC 2002):

a. A listed company must be independent of its parent companies or controlling shareholders with respect to manpower, financing and resources;
b. The position of chairman of the BoD and the CEO of a listed company may not be taken by senior officers of parent companies;
c. Special arrangements must be made if one person is to hold both the position of Board chairman (president) and CEO, or the positions must be occupied by different people;
d. Related party-transactions must follow the arm’s length principle – the transactions should be based on relevant market prices and should be reviewed and endorsed by independent directors, while BoD members should not vote on matters concerning transactions with which they are related;
e. Listed companies are not allowed to undertake loan guarantees for their controlling parents and other related parties;
f. The nomination of directors must be reviewed and endorsed by independent directors and appointed by a voting system in the annual general meeting (AGM);

g. A strategic development committee, nomination and remuneration committee, and audit committee should be set up under the BoD with independent directors serving either as the majority of the members or as the convener of those special committees, and at least one member of the audit committee should be an independent director who is an ‘accounting expert’; and,

h. Listed companies should publicly disclose information about the corporate governance procedures and performance.

**Improvement of the Quality of Information Disclosure**

Chinese market regulators now stress the importance of corporate transparency and the quality of information disclosure by the listed companies. Since 2001, the CSRC and the two stock exchanges have issued regulations on the content and quality of the annual financial reports and other disclosures to be released by listed companies (Lin 2005). Under these regulations, the Chairperson and CFO (or director of the accounting department) are required to certify the truthfulness and completeness of the financial data disclosed to the market. All listed companies must release their audited annual financial statements within 4 months after the fiscal year end, in order to ensure timeliness of the financial reports. For significant transactions or events that may have an impact on the movement of stock prices, reports should be submitted to the CSRS and the stock exchanges, and otherwise publicly disclosed, within five working days. Following the implementation of **Standards on Corporate Governance** in 2002, listed companies are now required to annually disclose information about existing procedures of corporate governance, such as the composition or membership of the BoD and SB, the working status and performance assessment of the BoD and SB, the performance of independent directors, the composition and work of the special committees under the BoD, and the plans or procedures that will be adopted to improve corporate governance practices, etc.

In order to ensure the quality of information disclosure, the CSRC and other regulatory authorities have also enacted regulations to strengthen supervision and policing over the behavior of professional market intermediaries such as securities and futures dealing companies, law firms, CPA firms and property assessors or asset appraisal firms. Investigations and penalties (e.g., fines, suspension of practicing licenses or revocation of professional certificates) against rule-violations have been increased. In general, there has been a considerable improvement in the quantity and quality of information disclosures by Chinese listed companies in recent years.
Major Deficiencies of Corporate Governance in China

Despite the reforms described in the last section, there are some weaknesses in corporate governance practices in Chinese companies, owing to the constraints of the former centralized business administrative system and imperfections in the capital markets of China. Major deficiencies inherent in the corporate governance practices in Chinese companies include the following:

**Absence of a “Real” Owner and Heavy Agency Costs**

Although a large number of SOEs have been incorporated, the state remains the major owner or shareholder of Chinese companies. Even though the government has set up SASA and some industrialized holding companies of state-owned properties to exercise *de facto* ownership rights over the state’s equity shares in the incorporated entities, the officials in SASA and other industrialized holding companies are essentially the second-order agents instead of real owners of the state interest in business enterprises. They do not take responsibility for the results of business operations, including the losses these may incur. In fact, officials in government authorities may pursue their own welfare (such as job promotions or increases in salaries and other benefits) at the expense of the interests of the state. “Owner absence” inevitably leads to two-tier, principal-agent relations in Chinese companies: one between the state (as principals) and the officials of SASA and other industrialized holding companies of state-owned properties (as agents); and another between the government officials (as principals) in charge and business management (as agents). These dual principal-agent relations have quite often resulted in significant agency costs (including moral hazard problems) due to the absence of a real, identifiable owner of state-owned properties. In particular, with bureaucracy and corruption, government officials have frequently surrendered the supervision rights of ownership over business operations in exchange for perquisites from business management (Xu et al. 2005).

**Monopolist Controlling Shareholding and ‘Tunneling Behaviors’**

Research has found that majority shareholders may try to maximize self-interest through ‘tunneling’ or benefit transfers, expropriating the interests of other minority shareholders and related parties (La Porta et al. 1999, 2002; Johnson et al. 2000). Such “tunneling behavior” is extreme in China due to the unique equity structure of Chinese listed companies. At present there are three sources of equity capital for most listed companies in China: state-shares, representing the state’s interest in a listed company, legal-entity shares, being the equity held by other SOEs or social units and public shares, held by both institutional and individual investors. State shares account for a significantly large proportion of the total equity. Under the current ‘split-share system,’ only public shares are tradable in the market.
State-shares and legal entity-shares are not tradable at present, so there is little motivation for controlling large shareholders to care about changes in the share price of listed companies. Controlling shareholders have frequently intervened in the operations of the listed firms to benefit parent companies, using the listed firms to guarantee loans for related entities, and exposing the listed firms to unnecessary financial and operating risks. In fact, the controlling shareholders of many listed companies, who are mainly government agencies or parent SOEs, are often motivated only to raise funds in the stock market. Benefit transfers through the misappropriation of funds or related-party transactions infringe upon the interests of shareholders and public investors. Controlling shareholders have a monopolist’s position so they can control or dominate the nomination and appointment of directors and senior management, excluding other shareholders from participation in making operating decisions. The monopolist position of controlling large shareholders not only facilitates tunneling behavior but also frees listed companies and senior management from the supervision of minority shareholders and other interested parties.

Dysfunction of Internal Supervision Mechanisms

Although Chinese companies have set up SBs in order to monitor the performance of BoDs, management and business financial affairs under the requirements of the Company Law, SBs are more “decorative” than functional in reality. This is mainly due to the fact that the composition of an SB is subject to the dominant influences of controlling shareholders (e.g., government agencies or the parent SOEs). Currently, most SB members are the representatives of controlling shareholders (e.g., government officials in SASA and the industrialized holding companies of the state-owned properties), party committees and employees’ unions. Many SB members are insiders and they share direct or indirect interests with large shareholders or senior management. Furthermore, most SB members lack knowledge and expertise in law, accounting and business administration, and they can hardly exercise effective supervision or monitoring (Xiao et al. 2004). Although the CSRC introduced the independent director system in order to strengthen the BoD’s supervision over management performance and business financial affairs, the system does not function well at present. Although most Chinese listed companies have now appointed at least one-third of their directors to BoD as “independent”, most are academics or social celebrities who have little experience in actual business operations and management processes.

Many independent directors are willing to spend little time and effort in investigating business operations and monitoring management performance, owing to a fairly low level of compensation. Most are nominated by senior management and are reluctant to be adversarial, risking loss of reappointment and remuneration.
Therefore, most independent directors cannot exercise effective monitoring over management performance and business financial affairs. It is unsurprising that many companies have treated independent directors as mere “flower vases” to lift the image of corporate governance, while the effectiveness of their supervisory role is doubtful.

Coexistence of SB and independent director system may have further obstructed the internal supervision mechanisms in Chinese companies because of overlap in the prescribed functions or roles of SB and independent directors. The dual-supervision system results in not only a turf war or tension between SB members and independent directors, but also the resistance from management to the duplicated or redundant supervision functions. In fact the potential conflicts of interest between SB members and independent directors often cause ineffectiveness or failure in the internal supervision mechanism. Although the motivation behind the dual-supervision mechanism is admirable, the actual operation of mixing up the two-board (Continental-law system) and unit-board (Common-law system) in corporate governance structure may not necessarily be desirable.

Weak Enforcement of Market Regulations

Market regulation and surveillance system remain under-developed in China. There is a severe shortage in both market regulation and enforcement manpower. The enforcement of many business laws and regulations is far from satisfactory and the “soft-binding” phenomenon prevails in China. Therefore, many regulation violations are not investigated and disciplined. The regulatory authorities’ surveillance or monitoring of serious misstatements and the manipulation of stock prices is less than satisfactory at present. Fraudulent reports and misleading information disclosures are not uncommon and insider trading is frequent in the market. Weak regulation and serious corporate misconduct has brought about losses to investors and hampered market confidence. A relatively weak regulatory surveillance system has led to wide spread rules violations and corporate scandals. Corporate governance depends upon enforcement as well as legislation. Corporate governance practices will remain substandard in an environment with a weak market regulation system (Lashgari 2004).

New Efforts Toward Corporate Governance Reform

The Chinese government has recognized the existence of problems in corporate governance and is introducing more reform measures. The main reforms of the most recent period are as follows:
Promoting the Sustainable Development of Capital Markets

The State Council issued “Opinions on Promoting Capital Market Reforms and Sustainable Growth” in January 2004, in order to provide an authoritative guideline for the consolidation and development of capital markets in China. The Opinions addressed several key policy issues on how to enhance the quality of listed company governance and to standardize operations in capital market. Particularly, it stresses that all listed companies should establish ‘modern enterprise systems’ to achieve a balanced power structure among executive and supervisory units, enhance the accountability of directors and senior management officers, further regulate the behavior of controlling shareholders and enhance the effective functioning of the independent director system.

Thus, controlling shareholders can be held liable for misconduct that encroaches upon the interests of listed companies, minority shareholders and other interested parties. The Opinions states that emphasis should be placed upon the obligations of individuals who are responsible for financial reports and other information disclosures, to ensure the truthfulness, accuracy, completeness and timeliness of disclosed information. Mandatory suspension of the rights and privileges to issue new securities or delist stocks will be imposed on those listed companies that do not disclose information in compliance with the required procedures. In addition, listed companies are allowed to establish incentive schemes for senior management. Accordingly, the CSRC has issued new rules on how to improve corporate governance in listed companies, such as standardized procedures for dealing with the relations among investors (shareholders), the BoD, and business management; the implementation of qualification procedure and training of independent directors, the regular assessment of the work of independent directors; and establishment of stock options or other incentive schemes to motivate management to improve corporate governance and business operating effectiveness.

Protecting the Interests of Public Investors

In light of the State Council’s Opinions, the CSRC introduced “Rules on Protection of the Legitimate Rights and Interest of the Holders of Publicly-tradable Shares” in late 2004. The new Rules imposed several specific measures in order to curb tunneling behavior.

For instance, a voting system involving minority holders of publicly tradable shares is required. Significant business transactions, such as issuing new securities, assets swaps with significant amounts (over 20% of total audited book values) or business restructuring, debt repayments, the conversion of securities and overseas listing of subsidiaries, must gain the prior approval of public investors holding more than half of the total tradable shares, before being tabled to the AGM of shareholders.
Listed companies must establish and maintain good investor relations. For example, a listed company should establish a sound working system of investor relations and the company secretary should be responsible for maintaining a good relationship with investors. Various means of communications with investors, such as setting up consulting “hotlines”, website assess and regular press briefings, etc. are required for listed companies to provide timely feedback to inquiries from public investors. The Rules also encourage listed companies to distribute profits and adopt positive dividend policies to prevent tunneling behavior of controlling shareholders through related-party transactions and or profit transfers through transfer pricing. Thus profit distribution and dividend policy must be addressed explicitly in corporate charters. The BoD must issue an explanatory note if no profit distribution or cash dividend payout is to be made in the period, while decisions to not distribute profit must also be assessed by independent directors. Furthermore, listed companies are not allowed to issue new shares or convertible securities to the public if no profit distribution or cash dividend has been made in the most recent three years (Lin 2005).

**Strengthening Supervision Over Controlling Shareholders and Senior Management**

The CSRC issued further new rules in 2004 and 2005 in order to prevent majority shareholders from encroaching upon the interests of listed companies and other shareholders. If controlling shareholders or parent companies, for instance, engage in tunneling funds from a listed company, refunds or repayment of the funds must be made, firstly using the cash dividends to which they are entitled. The CSRC further requires that the listed companies should not provide loan guarantees for controlling shareholders or other related parties, and illegitimate loan guarantees must be rescinded by the end of 2006. The CSRC will not accept applications for new share issues or other security sales from companies being investigated for misuse of funds.

The CSRC and the two stock exchanges have also strengthened their monitoring of the behavior of senior management officers. The names of those senior management officers who have committed dishonest acts will be kept in ‘black-books’ by market regulatory authorities and the stock exchanges, and disclosed to the public. Those directors and senior management officers who have committed serious rule-violations will be banned from the market and be made legally liable for losses suffered by listed companies and public shareholders. Any person who has been debarred by market regulatory authorities for less than 2 years is not allowed to be reappointed to a senior management position. Implementation of these new rules should help to enhance the honesty and accountability of directors, supervisors and senior management officers and promote good corporate governance in Chinese companies.
‘All-Circulation’ Reform

A root cause of most corporate governance problems in Chinese companies is derived from the split-share system, which divides shares into non-tradable state-shares and legal entity shares and tradable public shares. Non-circulation of the dominant portion of the state-owned shares induces dysfunctional behavior among controlling shareholders that encroaches upon the interests of other shareholders. To solve this problem, the Chinese government introduced the so-called ‘all-circulation’ reform in late 2005 aimed at speeding up the development of capital markets and improving corporate governance.

A main task of the most recently introduced reforms is to allow trading of formerly not-tradable shares, with certain conditions. The circulation of shares exposes controlling shareholders to market discipline. Since only public investors holding tradable shares bore risks before the ‘all-circulation’ reforms, the holders of formerly not-tradable shares (i.e., the state-shares and legal-entity shares) are required to compensate public shareholders in consideration for allowing the circulation of non-tradable shares in the market. Therefore, bargaining to reach parity between the two sides is required to set the conditions for an ‘all circulation’ market, which could involve issuing new shares to public shareholders at discounts or paying premiums for shares held by public investors. Implementation of the ‘all-circulation’ reforms will have a significant impact on the relationships between the various interested parties of a listed company and all shareholders will share risks on an equal basis.

Concluding Remarks

Corporate governance practices have evolved at a relatively slow pace in China. Under the former public ownership, centralized planning economy, all businesses were state-owned and state-run after the communist party took power in 1949. The mechanisms of corporate governance derived from free market economies were absent until the Chinese government launched economic reforms in the early 1980s. In line with market-oriented economic reforms, the government restructured ailing SOEs and abandoned the state-run business administration system by separating the ownership and management of businesses. By these changes, enterprises were required to be relatively independent business entities, exposed to market pressures. Later, in the 1990s, many SOEs were incorporated to become limited-liability companies or publicly listed companies. As a result, the Chinese government started to pay attention to the issues of corporate governance, in order to balance the divergent interests of various parties and enhance the operating efficiency and effectiveness of Chinese companies.
Significant progresses in corporate governance can be witnessed in China in the last two decades. Abreast of the development of market-oriented economy, the modern enterprise system is taking shape. Thus many corporate governance practices stemming from Western countries have been introduced, including the separation of ownership and management; the establishment of shareholders’ meetings, Boards of Directors and supervisory boards for directing and monitoring managerial performance; restrictions on related-party transactions; minority shareholder protection; better corporate transparency, increasing the quality and timeliness of corporate reports and information disclosure; a strengthening of market regulation and surveillance, standardization of market intermediary services and improvements in investor relations; and the ‘all-circulation’ reforms. The effect of the implementation and enforcement of the new regulations or measures remains to be observed in practice. However, despite some remaining deficiencies, the changes can only positively contribute to the advancement of corporate governance practices in China, in terms of prevailing international standards or norms, and they should lift investor confidence and promote the productivity and effectiveness of Chinese companies.

One of the critical problems in corporate governance practices in China is the ‘absence of owner’ which resulted from the years of state control of the means of production and produced significant agency costs. Although many SOEs have now been incorporated through business restructuring, the state remains the main owner of Chinese companies. Even though ownership rights have been delegated to SASA and industrialized holding companies of state-owned properties, government officials are unlikely to be held ultimately responsible the survival of business enterprises. As such, as representatives of state-owned properties, they will continue to exercise the rights of resource allocation and control without bearing the risks associated with property rights. Thus the incentive remains for them to pursue their self-interests by encroaching upon the interests of the enterprise and other related parties. Although there has been a significant change in the corporate governance structure of Chinese companies, the potential conflicts of interest among various parties stemming from the problem of ‘absence of owner’ have yet to be completely resolved. This may hamper the future development of corporate governance in China.

The evolution of corporate governance practices depends upon the development of the Chinese economy. Following the growth of a market-oriented economy, the modern, western-style enterprise system has become increasingly important in the Chinese economy emphasizing the need for good corporate governance. Although the advance of corporate governance has been slow, the government continues to push capital market reform and enterprise restructuring and to adopt the best governance experience from western countries. It should also be noticed
that there are substantial differences in the economic, social, legal and cultural systems in China and the West. A simple transplant of western corporate governance practices to Chinese companies may not work. Adaptation or innovation of corporate governance, contextual to Chinese business environment is necessary. Further improvement of corporate governance practices will rely upon a sound market regulatory and monitoring environment in China. Much could be still done to strengthen the legal system and the extent of market surveillance over the performance of the senior management in large corporations, in order to reach better corporate governance standards.

References


____________ (2002). *Standards on Corporate Governance for the Publicly Listed Companies*. Beijing, China [printed in Chinese].


