Corporate Governance for Listed Companies in China: An Agenda for the Crisis?

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Abstract

The importance of corporate governance (CG) has been highlighted by the current global crisis. Shortcomings of CG mechanisms have been contributing to a large extent to the current crisis and issues of transparency, accountability and incentive mechanisms consistent with long term sustainable growth will be crucial in rebuilding market confidence internationally. Facing rapid export-led globalization, the Chinese state has realized that CG provides an effective framework to promote transparency in economic affairs, strengthen confidence among market players and that it can act as a safeguard against mismanagement and corruption. Although CG in China has improved substantially over the last few years, many problems remain. These include, among others, weak board systems, inadequate incentive mechanisms for management, insufficient checks and balances, inefficient information disclosure and a weak external governance structure. As China has gradually transformed into an economic superpower with a far-reaching influence on the global economy, changes in the Chinese CG system might be relevant for the world economy as a whole. This paper provides a survey and an analysis of the current CG system for listed companies in China and offers some suggestions for improvement to make the current set of regulations more efficient.

Keywords: Corporate Governance, China, Ownership, Share merger reform, Stock Market

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1. Introduction

The importance of *corporate governance* (CG) has been evident for quite some time. Even more so this is emphasized by the current global crisis. Shortcomings of CG mechanisms have been contributing to a large extent to the current crisis and issues of transparency, accountability and incentive mechanisms that are consistent with long term sustainable growth will be crucial in rebuilding market confidence internationally. In the last three decades, China has gradually transformed into an economic superpower with a far-reaching influence on the global economy. Facing rapid export-led economic development, the Chinese state has realized that CG provides an effective framework to promote transparency in economic affairs, strengthen confidence among market players and that it can act as a safeguard against mismanagement and corruption.

Though CG has improved substantially over the last few years, many problems remain. Until 2004, around 65% of the shares in listed companies were non-tradable, either owned by the state or by a legal person. This setting was also seen as one of the fundamental weaknesses of the Chinese CG system, by which the government maintained a major controlling interest in listed companies to protect them from private or foreign ownership. At the same time, this structure was accountable for the highly speculative stock market and almost non-existence of merger and acquisition activity. However, after several failed attempts, the Chinese government initiated the “split share structure reform” in 2005, which ensured that all non-tradable shares were converted into tradable A-shares. The reform was expected to substantially improve CG structures, and this paper evaluates the current CG standards of listed companies in China.

This paper surveys and analyses the CG system for listed companies in China implying some suggestions for improvement to make the current set of regulations more efficient. The paper is organized as follows: The next section discusses the general notion of CG. Section 3 investigates the evolution of CG in China and describes the economic reforms of State Owned Enterprises that took place in China between 1979 and today. Section 4 analyses the process and the consequences of the split-share reform (from 2005 until now) with regard to CG of companies that have implemented this structural change, including a description of the Chinese CG model and the underlying legal framework. Major problems with the current Chinese CG system are identified and analyzed in Section 5. These include, among others, concentration of ownership and control, weak board systems, inadequate incentive mechanisms for management, insufficient checks and balances, inefficient information disclosure and a weak external governance structure. Section 6 proposes some solutions to make the current set of regulations more efficient, such as the strengthening of the function of the general shareholder-meeting, clarification of the role of the board, more stringent internal controls and more efficient external control mechanisms. Finally, some conclusions are provided.

2. Definition of Corporate Governance

The Chinese CG definitions are based on the Organization for Economic Co-Operation and Development (OECD) Principles of CG, first published in 1999, which define CG as a system providing “the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good CG should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently” (OECD 1999, p.2).

Problems of CG arise from the separation of ownership and control, which leads to principal-agent situations between owners (principals) and managers (agents) in a corporation (Jensen and Meckling, 1976). Relationships between outside investors and managers of a company can be characterized by incentive incompatibility and information asymmetry (vertical exploitation).[1] When shareholders pass over decision rights to the management, they suffer a loss of effective control over the managers’ behavior. To restrict the self-serving and opportunistic behavior of managers and to ensure that managerial decisions are based on the shareholders’ best interests, many reporting and governance mechanisms have been developed and adopted by enterprises today. In this way, most governance processes deal with issues like performance measures, delegation of power and accountability. Thus, CG can be viewed as a structure to direct, administer and control a corporation as well as a method to align the incentives for managers with those of shareholders to reduce agency costs and the costs of information asymmetry.

Globally, mainly two CG models are in practice. One is the shareholder value model common in Anglo-American countries. It can be characterized by a relatively decentralized distribution of shares, few industrial cross holdings and an active market for hostile takeovers. This model can also be seen as a market-oriented model, as shareholders directly sanction unsatisfactory performances of the enterprises by selling shares. The main goal of this type of CG is to increase corporate value for the shareholders’ benefit. In this case, the law and courts protect the interests of other stakeholders (e.g. laborers, suppliers and business partners). The main costs in this mod-

[1] The agency problem can be divided into two main cases according to how the controlling party exploits the other one: the horizontal case, where the major shareholder exploits the minority shareholder, and the vertical one, where all stockholders of a company can be exploited by the management.

el occur owing to monitoring the management of a corporation, where conflicts of interest may arise since shareholders are controlling managers (cf. the principal-agent problem).

The second model is the codetermination model, which is popular in Continental Europe and Japan. This CG system with industrial cross share holdings and few hostile takeovers as characteristics stresses a more network-oriented approach. Here political goals like job protection and work safety play a predominant role. Core investors as financial institutions with significant stakes in a corporation monitor and control the management. The background of this model is the emphasis on participation theory, according to which codetermination can enhance the loyalty and motivation of employees. According to this model, employees are represented in the Supervisory Board. This is actually also the central problem of this model. Employees within the Supervisory Board inevitably lead to non-linear principal-agent situations (conflicts of interests) between the employees' representatives, who tend to lobby for job security, high wages and protection of insiders, and other Supervisory Board members, who may represent shareholder interests or the interests of creditors (banks, asset managers or even hedge funds). Aligning and solving the resulting conflicts of interest can lead to high transaction costs.

In comparison, both models put their priorities in different areas, and have their own distinctive advantages and disadvantages. The shareholder value model is seen as one that drives companies to compete more aggressively through cost advantage and radical innovation, whereas the codetermination model is considered to encourage corporations to compete more through enhanced quality and gradual innovation.

3. The Evolution of CG in China

The development of CG in China is closely related to its economic reforms (Fulin 2004, Voß and Xia, 2006). Hence, an understanding of the historic development of State Owned Enterprises (SOE) is essential in order to identify the origin of the current inefficiencies of CG in China. After 1978, Deng Xiaoping initiated many reforms with the purpose to promote China's economy and catch up with the living standards of the western societies ("open door policy"). Since then, China has undergone a rapid change resulting in efficiency gains leading to a more than tenfold increase in GDP. Whereas in 1978 China had a GDP of USD 147,4 billion, by 2008 the GDP had risen to USD 4.4216 trillion with an annual average growth rate of 9%[2] (Xinhua Online 2009), and China had become the second largest economy in the world after the US[3] (CIA, 2008). Despite the global financial crisis, the forecast for China's real GDP growth remains impressive with around 8% (Xinhua Online 2009).

Before the transformation period, China was a centralized and planned economy where the majority of enterprises were state owned and controlled. All decision rights were with the state with no existing incentive- and CG system. The government was the sole investor, which managed and controlled enterprises in every aspect.

3.1 Reform of State Owned Enterprises

From December 1978, China has implemented a series of changes regarding the organizational and managerial structure of SOEs. In contrast to the shock therapy applied by some post-communist countries of Eastern Europe, the former Soviet Union and Latin America, China has implemented its reforms in a controlled and gradual, progressive way. The Chinese government has pursued a dual-track resource allocation system, which enabled it to keep its significant role while markets for free resource allocation developed much more gradually. Instead of directly privatizing SOEs, China has approached its reform by different measures, e.g., by increasing the autonomy of executives and introducing financial incentives as well as performance contracts. While from the micro-perspective, these efforts aimed at transforming inefficient and unprofitable SOEs into modern corporations, from the macro perspective, the reforms were intended to move the country towards a market-oriented economy by eliminating the prevailing economic imbalances of the command economy. Generally, the reform of SOEs in China can be divided into three consecutive phases.

During the first phase, from 1979 to 1991, the Chinese government increased the decision-making power of SOEs. The government believed that the origin of the problems of SOEs was the lack of independence of SOE managers and that their performance was unrelated to any reward system. Therefore, the Chinese government first put their efforts in restructuring SOEs by consolidating their property rights on the municipal government

[2] Since 2001, this was the lowest growth rate, when GDP was recorded as 8.3% (Xinhua 2009).

[3] Measured on purchasing power parity (PPP).

level. Only SOEs referred to as natural monopolies or as strategically important to the national economy (e.g. oil fields, coal mines, arms industry) remained under the control of the central government, while their structural affiliations were consolidated either in their respective industrial ministries or in one of the several newly created national holding companies or conglomerates (e.g. National Coal and North Industries). Reform initiatives to increase the autonomy of SOEs and ease the interdependence of the enterprises and the state included the Employee Bonus System and the Contract Responsibility System (CRS). Contrary to the government's intentions, the Employee Bonus System had the opposite effect, as it was asymmetrical by its very nature. It was a one-sided reward system, since it was politically not possible to sanction (by reducing or removing bonuses) enterprises and individual staff members for bad performance. The main goal of the CRS was to make SOEs responsible for their own losses and profits, hence this system granted more flexibility to enterprises concerning operations and production, and it was expected to reduce bureaucratic intervention by the state. However, the CRS led to undesired results like corruption and opportunistic behavior between managements of enterprises and government authorities due to imbalanced control mechanisms and information asymmetries (Chen and Strange 2004; Schipani and Liu 2002).

The second phase falls between 1992 and 2000. In contrast to earlier management-oriented reforms, the Chinese government tried to implement an enterprise-oriented approach. Selected SOEs from different industries carried out a corporatization process according to the 1993 Company Law. Through the corporatization process, many SOEs, mostly the larger and better performing ones, were listed on the Shanghai and Shenzhen stock exchange, fulfilling the state goal of raising equity capital for SOEs and separating them from the government. The listing of reformed SOEs was perceived as necessary in order to gain more structural and organizational autonomy. The state hoped to improve the management of state assets and CG structures with the listing of reformed SOEs and with their new organizational form (Clarke 2003; Chen et al. 2004). In response to the Asian financial crisis, the 1998 Securities Law was released. It not only protects investors, as it gives them the possibility to sue companies for deliberately publishing misleading or false information, but also strengthens the regulatory authority of the China Securities Regulatory Commission (CSRC) to overlooking CG of listed companies. 1999 marked another important milestone for CG practices in China.[4] It was characterized by important decisions concerning the state sector, and identified CG as being at the heart of

[4] 4th plenum of the 15th congress held by the Chinese communist party: 22. September 1999

modern enterprise transformation. One of the driving factors calling for the reform was the declining fiscal revenues of the central government, which itself had increasing difficulties in cross-subsidizing non-profitable SOEs. According to the China Statistical Yearbook in 2004, the fiscal position of the central government deteriorated from a net surplus of RMB 1,0 billion in 1978 to a deficit of 174,4 billion RMB in 1999. Another driving force for the reform was China's effort to become a member of the WTO.

The third stage, from 2001 to 2005, is marked by China becoming a member of the WTO in 2001 and the implications of this membership for its economy. Since 2001, China, facing a deeper integration into the global economy, has also entered a new stage of economic reforms including lower trade barriers, which put further pressure on the Chinese government to improve legislation and law enforcement. One of the pre-concerted efforts to get into the WTO was the issuance of the "Code of Corporate Governance for Listed Companies in China" in January 2001 and the guidelines for introducing Independent Directors to the Board of Directors (BoD) for listed companies in August 2001, by the CSRC.

The fourth and last stage, from 2006 until now, is driven by legislative forces and the split share merger reform. In 2006, the 1998 Securities Law was amended, balancing shareholder rights between minority and majority shareholders. Furthermore, it required the installation of an investor protection fund with financing from investment banks. Another sign of the growing awareness of the importance of proper CG practices in China is the fact that serious measures are put into place to penalize companies which do not comply with CG regulations. The Shenzhen Stock Exchange, e.g., delisted or suspended 102 companies for failing to provide acceptable information transparency in 2006. Adding to the Chinese governments pressing endeavors to enforce the implementation of improved CG regulations, the global financial crisis from 2008 until now has revealed how shortcomings of CG can lead to severe damages to the economy as a whole.

Altogether, the reforms resulted in a sharp decrease in the total number of SOEs. Between 1997 and the end of 2001, the number of registered SOEs went down from 262,000 to 174,000, a decrease of 88,000. Of those, the local governments administered around 90%. The net profitability of SOEs more than tripled from 1.2% to 3.7%, whereas loss making SOEs were reduced from around 2/3 to around 1/2 of the overall number of SOEs. However, although profitability of SOEs had been increasing since 1998, over 51% of all SOEs were still loss making in 2001 (Financial

Yearbook of China 2002). As a result of the decentralization and corporatization of SOEs, non-profitable enterprises were cleared from the market and increased the net profitability of SOEs, while keeping the absolute number of profitable SOEs more or less constant. However, non-profitable firms still remain a great challenge for the Chinese government. To avoid social unrest and preserve national security, some of the loss making SOEs cannot exit the market freely. The global financial crisis reinforced China's restrictive monetary policy, when export-led growth suddenly subsided and millions of urban workers were laid off. However, learning form the success of the Keynsian policies applied through the Asian financial crisis and given the cushion of a large foreign exchange reserve, the Chinese government has embarked on a large expanding fiscal and monetary policy. In November 2008, China announced a 586 billion US$ stimulus package, about 13% of its GDP (spread over two years) to be invested in infrastructure and social welfare (Forbes, 2008; Times, 2009). At the same time, state banks replaced the formerly strong restrictive provision on loans by instructions to expand lending.

3.2 Listed Companies in China

The Chinese securities market started with the formal establishment of the Shanghai (in 1990) and Shenzhen (in 1991) stock exchanges and a new government body, the CSRC. The initiation went along with the corporatization process of SOEs, when they were partially privatized. Most of the SOEs were restructured to stock corporations according to the Company Law, which requires listed companies to be *Companies Limited by Shares* (CLS). The first listings on the stock exchange were some of these stock enterprises, which undertook Initial Public Offerings (IPOs). In the beginning of the securities market, state officials hoped it would support the reform process of SOEs leading towards a modern enterprise management system, transparency and efficiency.

During the corporatization process, it was believed that the listing of reformed SOEs would change the SOEs from exclusive state ownership into stock companies with diverse ownership structures. At least in theory, listed SOEs would become independent enterprises, regulated by the market. Contrary to this goal, the state only passed specific decision rights to the management of listed SOEs, leaving the ultimate decision right (e.g. disposal of assets, mergers and acquisitions and appointing CEO positions of listed SOEs) with the government (Chen et al. 2004). Facing the fear of losing control, the state allowed listed SOEs to issue freely tradable shares to individual minority investors only, and created various share categories and ownership rights. Shares were classified into three kinds: state shares, corporate or legal person shares, and individual shares. Generally, shares in China are classified as foreign (B-, H-, N-, L-, S-shares) and domestic (A-shares) shares by the holders' residency. H-, S-, L- and N-shares are issued by Chinese companies listed on stock markets outside mainland China.[5] H-shares are from companies listed in Hong Kong, S-shares in Singapore, L-shares in London and N-shares in New York.

Before the share reform, only freely tradable A-shares could be publicly traded, since they were split into tradable and non-tradable share (NTS) types. Non-tradable A-shares were those held by the state, legal persons or employees. Since the mid-1990s, the transfer of legal person status and state shares has been allowed and effected through irregularly scheduled auctions, private arrangements or over-the-counter transactions. Green and Black (2003) reveal in their analysis of 840 transactions at the Shenzhen stock market between 1994 and 2003 that the dominant sellers were state-controlled companies accounting for 32% of all trades in 2001 and 46% in 2002. Liu and Sun (2005) suggest that by the end of 2001, 81.6 % of all listed companies were under direct or indirect control of the state, with holdings of 48% of all shares on average. The ownership concentration in the hands of the state had not only reduced the liquidity of the secondary market (free float) but was also viewed as the origin and cause of many other inefficiencies (Lin 2004, Chen et al. 2004).

4. Split-Share Reform

The split share reform is testament to the efforts of the Chinese government to establish a proper Chinese capital market, eliminating the multiple-principle problem within state-controlled companies and building systemic pressure to improve CG on the firm level. The share reform can be seen as the only way for the government to resolve the inherent problems of the Chinese stock market and the business practices of listed companies. The share reform did not mark a fundamental turning point in the Chinese capital market, but was one of the fundamental factors in building a solid CG structure in a corporation.

[5] For further details on the share structure of listed companies in China see, e.g., Xu and Wang (1997).

In fact, since 1999, the Chinese government has acknowledged the deficits of the split-share structure and attempted in 1999 as well as in 2001 to introduce the privatization of NTSs. In 1999 they chose two pilot companies to sell their NTSs, but failed dramatically after the two companies lost 40% of their share price within 15 days. In 2001 the governments attempted for the second time to reform the share structure, but failed shortly after because of the prospect of an oversupply of shares as it planned an equal pricing system for tradable and non-tradable shares.

4.1 The Split-Share Reform and its Background

One of the major effects of NTSs was the suspension of an active corporate control market: owners of tradable shares were typically individual investors with a low shareholder ratio and limited interest as well as limited power to actively monitor the development of a company. According to Hua (2005), only 11% of the total public shareholders have actively taken part at the annual shareholders' general meeting. As a result, the state as the majority shareholder could exercise its decisive and controlling position without any interference from minority shareholders.

This peculiarity exemplifies the multiple-principle problem of the Chinese CG system before the share reform, where even though the government acts as the representative (Agent) of the people (Principal), nobody was defined as being de facto accountable for any risks or failures of the performance of a listed SOE, since it was represented through many different regulatory bodies, institutions, and ministries. The main priority of the state was "preserving and increasing the value of state properties," but it was not clear how it was possible to measure the value of state assets clearly. It could not be measured through book values alone, since they did not reflect the future profitability of an enterprise. Making matters worse from the viewpoint of clear CG structures, the business culture of China is mainly relationship-driven and builds on the idea of avoiding conflict, which inevitably leads to an emphasis on informality and discretion as opposed to delegation, transparency, clear accountability or open control.

Given the circumstances of a concentrated shareholding structure and the historical relationship between listed companies, state holding companies and governmental bodies, majority shareholders could easily undermine the interests of minority shareholders and use information asymmetries to their advantage. The findings of La Porta et al. (1999) unveil that ownership and control can be separated to exploit minority shareholders to the benefit of large shareholders. As in China it was impossible to sell NTSs, movements in share price did not matter to major shareholders. Additionally, the management and the BoD had access to key private information concerning stock prices before other investors, and, hence, could use insider financial information to their benefit. Documented abuse and collusion by the controlling shareholders included the use of listed companies as guarantors to get bank loans, sale of assets to listed companies at unfair prices commonly without an appraisal by independent evaluators and soft loans from listed companies on a long-term basis (Lin 2004, Hua 2005).

In this systemic institutional setting, it was very difficult to define who serves as the principal or agent and thus to define the right institutional set-up to solve the inherent incentive problems. Furthermore, commonly the government would select the companies for listing at the stock exchange. As Heilmann (2001) observed, companies were chosen according to political criteria rather than through market-oriented IPO processes. As a result, stock prices and investors' decisions in China were mostly not based on corporate performance but rather on the names of key institutional investors (Heilmann 2001, Mei et al. 2004). Given the small fraction of tradable shares and limited participation of institutional investors on floating shares, individual investors could easily gain large price effects. Consequently, the Chinese stock market has been characterized by drastic fluctuations, co-affected by government interference and market manipulation, and by the speculative behavior of small investors.

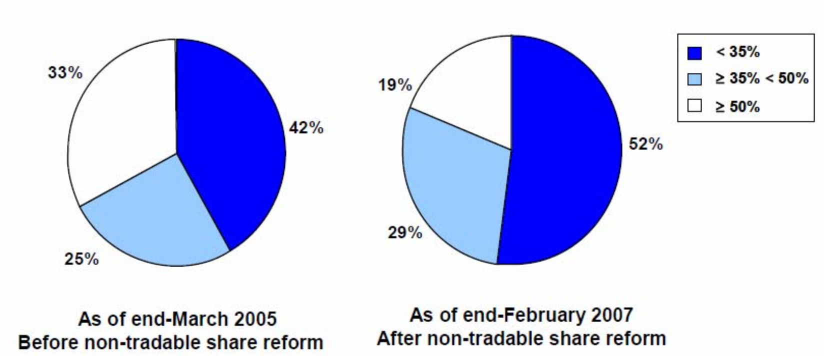
In April 2005 the state authorities announced the start of a new and improved pilot project with four selected stock corporations. The main difference between this reform and the former ones was that the interests of tradable shareholders were considered throughout and built into the pricing system. In order to prevent negative reactions of the market, like in the previous attempts, tradable share owners were given proper compensation[6] in order to balance the price discrepancy between tradable and non-tradable shares and the possible loss experienced by the tradable shareholder through the increase of overall available shares in the market.

Under the supervision of the CSRC, the reform was applied according to the principle: "pilot companies go first and others gradually follow up,"

[6] "Compensation" is defined as the price which non-tradable shareholders have to pay tradable shareholders for gaining the right to trade. Bonus shares is among the most frequent forms of compensation; other forms such as warrants, stock splits and cash were also possible.

and an official guideline called "Measures on the Administration of split-share structure reform of listed companies" was released on September 5, 2005 for the implementation. Despite the negative reaction of the market (which lost more than 4% after the official notice) the share reform continued in batches. First, four pilot companies were allowed to distribute their former NTSs among their existing stockholders. The execution of the reform was decentralized and each listed company had to come to an agreement about the compensation with their tradable shareholders. When at least two thirds of the tradable shareholders and two thirds of all shareholders reached a mutual consent about the compensation plan, as required by the CSRC, the reform was successfully implemented. After the successful share-merger of the first batch, the CSRC announced to extend the share merger reform to the whole market. The reaction of the market to this plan was positive and rose by 7%. The plan was to complete the reform by the end of 2006. Comparing the ownership structure of the majority shareholders for listed companies before and after the reform, the percentage in which the largest shareholder owns more than 50% has significantly decreased from 33% in March 2005 to 19% in February 2007 (see Fig. 1).

Figure 1: Distribution of majority ownership of shares for listed companies (Source: Namura Capital Market Review Vol. 10, No. 2)



At the same time, a series of measures was taken to stabilize the stock market. In order to regulate price volatility and the price pressure due to the severe expected supply of available shares on the market, the trading of shares was suspended around critical dates during the implementation of the reform. Another measure was a 12-month lock-up period for non-tradable shareholders, followed by an immediate restriction that within two years after this time frame, holders of more than 5% of the total shares outstanding were forbidden to trade more than 5% (10%) of the total shares outstanding within 12 (24) months. Moreover, controlling shareholders and the company were allowed to stabilize the market price through share repurchase (Beltratti & Bortolotti, 2006). After the completion of the reform at the beginning of 2007, however, the government still tightly holds its shares at listed companies.

4.2 The Chinese Corporate Governance System

The Chinese CG system can be described as a combination of the shareholder value model and the codetermination model. The Company Law requires listed companies to adopt a two-tier board system structure, consisting of a BoD and a Supervisory Board. It is in accordance with the German codetermination (Mitbestimmung) model, which allows labor representatives in the Supervisory Board and represents the influence of the continental co-determination model.

Generally, there are two kinds of shareholder meetings: regular general meetings (ordinary meetings) and interim meetings (extraordinary meetings). The general meeting is held once a year, approving and reviewing annual financial budgeting, plan of profit distribution and plan of loss recovery. An interim meeting has to be held if the following events occur: (1) it is requested by the Supervisory Board or by the BoD, (2) there is an insufficient number of directors to comply with the law and (3) the corporations' net accumulated losses exceed more than one-third of its total paid-up capital (Chen 2004). Intuitively, this institutional setting reflects the Chinese rationale, where shareholders are perceived as the ultimate source of authority, and have, compared to the US, a more powerful position than the BoD. Schipani and Liu (2002) conclude that the CG system and the superior position of the shareholders originate form the rationale of the political structure in China. They further argue that it was just a matter of course that the Chinese government extended their scheme of political governance regime into the business world and compare the shareholders' general meeting with the National People's Congress (NPC).

4.3 Legal Framework on Corporate Governance

Today there are many laws and regulations to evaluate good CG of listed enterprises, but the "Code of Corporate Governance for listed Companies in China" stands out as the most important assessment standard.[7] It was released by the CSRC and the former State Economic and Trade Commission in January 2001. Today, the former State Economic and Trade Commission is named the State-owned Assets Supervision and Administration Commission of the State Council. It is a ministerial unit in charge of supervising and administrating state owned holding stockholders of listed companies. The CSRC was established in 1992, and ranks directly under the State Council. It is the regulatory body for the securities market in China, viewed as the main body for CG.

All of China's laws and regulations are based on a constant adoption of the western law systems and corporate concepts. The Company Law (1993), e.g., approves two types of companies: stock corporation and limited liability companies. The board structure in China is similar to the German codetermination model, which allows labor representatives within the supervisory board. The Chinese code of CG is based on the *OECD Principles of Corporate Governance* and their suggested best practice (Hua 2005). In the preface, CSRC describes the scope of the Code as follows: "The code is the major measuring standard for evaluating whether a listed company has a good CG structure, and if major problems exist with the CG structure of a listed company, the securities supervision and regulation authorities may instruct the company to make corrections in accordance with the Code" (CSRC 2001, p.1).

Realizing the problem of concentrated ownership and minority shareholder protection, the government has reacted with the Regulation on Strengthening the Protection of Social Public Stockholder's Rights and Interests, released by the CSRC in December 2004. The Regulations mainly aim at strengthening the relationship between individual investors and the management and at reinforcing the supervision of listed companies. The Chinese government amended the Securities Law and Company Law to support the reforms on the financial market and CG. At the end of January 2006, strategic investors were allowed to buy shares in listed companies. It loosened the rule, where A-shares were limited to qualified investors with a minimum stake of 10% and a three-year lock-up time of holding the shares. In 2007, the Chinese financial regulatory bodies, including the CSRC, the China Insurance Regulatory Commission and the China Banking Regulatory Commission, enforced CG standards by imposing new regulations on more strict examinations and firm penalties in case of misconduct. As a consequence, listed companies in China accomplished three

[7] Full documentation available at CSRC (2001).

stages of CG: covering self-assessment of CG, seeking the opinion of the public and preparing an improvement plan.

5. Main Problems of the Chinese CG System

5.1 Concentration of Ownership and Control

Given the background of the problematic constellation of the state being the major shareholder in most listed companies, which led to the launch of the share-reform, the current situation of listed companies still reflects a multiple-principle agency problem. Due to the lock-up period of the share reform, most listed companies are at the moment still owned by the state. The annual report of 2007 by the Shanghai Stock Exchange shows that 65% of all listed companies are SOEs (Kang et al., 2008). This situation spurs rampant insider trading and tunneling assets from listed companies to the government, as the findings of Cheung et al. (2008) indicate. Related party transactions between listed companies in China and their state owners can result in serious expropriation of the corporations' minority shareholders. An evidence for this and for the strong relationship between major shareholders and the management of a listed company is the fact that over 9.2 billion yuan in funds at listed companies had been misappropriated by the end of 2006 in China (Jingu 2007).

5.2 Weak Board System

In general, the board plays a significant role in CG, as it is its responsibility among other duties to endorse the company's overall strategy and direction and to ensure accountability of the organization to the public as well as to its owners and the authorities (OECD 1999). The current two-tier board structure in China, however, where members of the Supervisory Board and the BoD are both appointed by shareholders and report to shareholders, does not seem to be efficient in fulfilling that role.

The BoD[8] has only a weak impact upon the decisions of a listed company. The problem starts at a very basic level already, namely, from the se-

[8] For detailed discussion on the role of the supervisory board and board of directors in Chinese listed companies see Dahya et al. (2003).

lection process of directors. According to a recent study conducted by Tong et al. (2009a), analyzing the top 100 listed companies in China based on market value, 77 out of 100 are still controlled by their five majority shareholders, most dominated by the government. As shareholders appoint the members of the board, they are directly controlled by the majority shareholders. As part of the government promotion system for state officials, often the general manager and the chairman of the board are appointed by the regional government (Jingu, 2007). Minority shareholders are additionally restricted by company regulations of minimum required shareholdings before they are entitled to nominate their candidates. 66% of the companies assessed by Tong et al (2009b) stipulate that only shareholders holding at least 1% of the shares are authorized to nominate candidates for independent directors. With this governance structure, the BoD is basically serving as the agent of majority shareholders. Shi and Weisert (2002) also report that many insiders of listed companies have won dominant positions on the Board of Supervisors and directors, placing cronies in board positions and reducing their function to a formal obligation.

Supervisory Boards are equally ineffective, with an only vaguely defined monitoring role over managers and BoD. Dahya et al. (2003) report that most shareholders simply do not know the function and role of the supervisory board. Compared to other countries practicing two-tier structures, the supervisory board in China does not appoint the members of the BoD and has no authority to dismiss management or board members. They are thus directly accountable to the majority shareholder, namely, the state. Consequently, supervisors are seen as subordinates of directors and senior executives, without involvement in the selection of managers and directors and without power to exert disciplinary action.

The CSRC has recognized this problem and reacted, after publishing the “Code of CG for listed Companies,” with a proposal concerning the composition of independent directors at listed companies. The Guidelines for Introducing Independent Directors to the BoD of Listed Companies require that all listed companies have at least two independent directors. One of them has to be a professional accountant, and altogether independent directors should represent in total one-third of the board composition by the end of June 2003. Independent directors are defined as people “who hold no posts in the company other than the position of director, and who maintain no relations with the listed company and its major shareholder that might prevent them from making objective judgment independently” (CSRC 2001). Theoretically, the guidelines had marked a major move to improve CG. However, in contrast to the regulations, Tong et al. (2009a) reports that the nomination of supervisors and directors for minority shareholders is almost impossible. Around 50% of the analyzed companies require at least an ownership of 3% of all shares in order to be eligible to nominate and consequently controlling the majority shareholder.

As Hua (2005) reports, most independent directors are scholars and professors, who have a lack of experience in enterprise management. He continues by suggesting that some members of the BoD, including independent directors, do not attend board meetings over a long period of time. Limited knowledge and time constraints complicate even more their function as independent directors. According to the IFC (2005), most board members have no clear understanding of their functions and responsibilities, as they generally lack basic knowledge of the decision making processes applied by corporate boards. This situation is worsened by the fact that the general manager and the chairman of the board are in some cases the same person, lowering even more the effectiveness to supervise the management of a corporation. This governance structure, which lacks a clear separation of management and ownership and a sound education of all stakeholders, results in an ineffective supervisory board and BoD, and impairs rather than upholds a sound level of CG. According to a survey of the Centre for Financial Market Integrity (2007) the Chinese two-tier model leads to high agency costs due to redundancy of functions, inefficiency and confusion in the governance structure.

5.3 Inefficient Information Disclosure

According to a speech of Zhengwu Ma at the OECD Second Policy Dialogue on CG in Beijing, disclosure of corporate information means “releasing the company’s financial and non-financial information completely, accurately, timely and openly to shareholders and stakeholders for the purpose of enhancing their participation and protecting their benefits” (Ma 2005).

All listed companies in China are required to publish audited annual reports, interim reports, quarterly reports and periodical reports signed by the BoD in a national publication authorized by the CSRC. Starting from 1999, the CSRC further suggests to listed companies to make their entire annual reports available on the Internet while publishing only summarized key information in physical publications. While adequate financial reporting is one of the primary responsibilities of the management and chief executives of a company, auditors are accountable for their audit reports. The CSRC sets the main duties of the audit committee (CSRC 2001). Nevertheless, Chinese Certified Public Accountant (CPA) corporations themselves have many problems. First, they lack sound supervision, and second, they are lagging behind international standards concerning management, qualifications and services. Due to a lack of training and education, many CPAs have not enough knowledge about international accounting standards and practices. Furthermore, most of them are not sufficient in their computer skills. In general, most information disclosed by listed companies today can be described as being inaccurate, packed, not timely, or incomplete (Lin 2004, Ma 2005). Additionally, IFC (2005) revealed that most reporting practices of listed companies are more focused on satisfying the requirements of governmental bodies rather than the needs of investors. Consequently, this situation raises the potential for falsification of financial information of listed companies.

5.4 Weak External Governance Structure

Mandatory CG rules require legislation, stock exchanges, courts and supervisory authorities. All of these are necessary to enforce and implement CG. In advanced economies, this set of regulatory framework is essential to solve the collective action problem arising through dispersed shareholder structures and to protect the rights of minority shareholders (Becht et al. 2002). Nevertheless, in China, it is questionable how effective legislation can really be in protecting minority shareholders. Furthermore, courts in China are relatively unfamiliar with CG rules and business frauds. In addition, they are governmental bodies, paid through the local governments that may limit their independence. As a result, courts are reluctant to deal with litigations involving large monetary values or politically powerful defendants. Clarke (2003) takes the Supreme People's Court 2003 as an example, where just few cases of securities-related claims were heard.

With lack of institutional investors and the broad geographical spread of individual investors with a low ratio of freely tradable shares and no incentives to actively supervise the management of a corporation, the questions remain who controls the monitor (state) and how it would be possible to solve the existing problem of collusion between management, board members and governmental institutions. The main control organ (CSRC) solely concentrates its efforts on the application of the Code of CG for Listed Companies in China, with on spot investigations. According to Hua (2005), director of CSRC, 100 on spot investigations were planned for 2005. This is against a background where external monitoring professional organizations as media and banks remain limited. In summary, there are three areas of weakness in the external governance structure: First, the market for enterprise control is immature due to information asymmetry, barriers in regulations, lack of professional executives and low free float of freely tradable shares. Second, the legal enforcement has been weak due to the lack of information transparency and the effects caused by the concentration of the shares in the hands of the state. Third, the insignificant and barely existing number of institutional investors and speculative individual investors in the freely tradable shares which thus merely play an insignificant role in improving CG practices.

6. Proposals to Improve the CG Efficiency

In order to solve or mitigate CG problems, a number of proposals can be made. They can be classified into proposals to improve CG directly, and proposals to establish fully functioning capital markets. With the current share reform, China is already on the way to morph its current and centralized ownership and control structures into more market-oriented, private and decentralized structures.

6.1 Proposals to improve CG on the corporate level

Strengthening minority shareholder rights and improving the role of the shareholder meeting (Hua 2005, CSRC 2004, Lin 2004, Schipani and Liu 2002): The Chinese government should put more effort in strengthening the mechanisms for minority shareholders to actively participate in the development of a listed company. This could be achieved through different measures: (1) put more pressure on listed companies to enhance their voting mechanisms; (2) increase the legal protection of minority shareholder rights; (3) redefine the role and relationship between governmental bodies and listed companies; (4) authorize minority shareholders to requests information from the management, BoD and supervisory board; and (5) enhance efforts to guide and educate minority shareholders about their rights.

Improving the role of the board: Given the fact that most people do not have a clear understanding of the role of the board (Hua 2005, Dahya et al. 2003), they need to be educated with respect to the role and function of the

BoD and the supervisory board in order to be effective. Directors and supervisory board members must also be clear about their responsibilities and rights, otherwise Chinese corporate boards will fail to function properly.

Improving information disclosure: According to Lin (2004), the CSRC could learn from the CG rules of the New York Stock Exchange and Sarbanes-Oxley Act. Under their requirements, listed companies are obliged, among others, to: (1) certify the comprehensibility and completeness of their information released to investors; (2) attest their compliance with CG codes; (3) publish a code of business conduct; (4) have an internal audit function and independent audit committee.

6.2 Proposals to improve the functioning of the domestic capital markets

Introduction of a domestic private institutional market: The Chinese government should seek to establish a private market for institutionalized investors. This could be created by establishing a market for private pension schemes as one example, but could also be created in order to further private ownership (e.g. make private investment in asset funds tax deductable and hence, funnel private capital into a fund industry). Currently this market is underdeveloped in China, partly owing to a historical emphasis on covering social tasks (and especially retirement) either through the government, the companies themselves or the family.

Institutional investors are more willing to invest on a long-term basis and therefore pay much more attention to the basic structures of listed companies and their CG mechanisms. Several studies have proven that the shareholder structure has an impact on the performance of enterprises. They have also shown that listed companies in China without a dominant state ownership outperform enterprises with dominant state ownership (Xu and Wang 1997, Bai et al. 2003, Wong et al. 2004).

Establishing a market for domestic institutional investors could address some of the problems: First, it would lead to more sophistication and more expressed market orientation with regard to allocation of private capital. Within a shorter period of time, market professionals would become a greater force in allocation of scarce capital. As a related side aspect, this could foster the development of a new industry, which in western market economies is an increasingly powerful counterweight to Governments and

Corporate in establishing, defining and demanding proper CG standards. Second, it would give the Government an exit opportunity for taking public companies private and allow for market solutions without unduly disturbing market prices in illiquid markets. Third, it could be considered a strategic market for the development of the Chinese market economy offering intelligent opportunity for growth and for opening up a wealth of further industries to develop on the back of such development (Brokers, Fund-Industry, Investment Banks, etc.)

Introducing more foreign investors: To the same end, efforts should be made by the government to increase the number of foreign institutional investors for freely tradable shares.

7. Conclusion and Outlook

This paper has argued that China has constantly moved starting in 1978 to implement a modern enterprise system and has achieved, driven by ideological government regulation coupled with pragmatic management, exceptional success. This transition was accompanied by several institutional and regulatory reforms and has led to the emergence and importance of CG in China. Although, CG is a relatively new concept to China, it has already become a crucial element of the governments' efforts to continue their reforms in order to establish a market-oriented economy system. This analysis has shown that the reform of SOEs transforming them into listed stock companies, with the state as the controlling shareholder has created a CG system, which is full of weaknesses. Despite the split-share reform, initiated in 2005, the state is still the controlling shareholder of most listed companies. On the other hand, the state can ultimately be seen as the main driver to develop and enforce CG. After the lock-up phase of all converted non-tradable shares (estimated for around 2012), market prices should gradually reflect the true value of a listed company. This should ease the set-up of monitoring functions, as the merger and acquisitions market starts to grow. At the center of a state-of-the-art CG framework the effective functioning of the BoD, market for corporate control and legal protection is crucial for a company's' survival. The ongoing global crisis however, has shown how severe shortcomings of CG can not only bring significant risks to a company but also to the entire economy. As China is developing a unique CG structure, it has to balance market-economic and ideological considerations. As a consequence, it is highly likely that China will develop a CG model which is not just copied from the west, but adapted to its political, social, ideological environment as well as to its business environment.

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