CORPORATE GOVERNANCE IN CHINA

Thesis submitted for the

Master of Arts

By

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“Abstract”

Corporate Governance in China

Since the late nineteen nineties, corporate governance has been recognised by the Chinese leadership as being an integral and vital part of economic reform. At the macro level the reform is to transition to a market economy and at the micro level, business enterprises are adopting sound standards of corporate governance.

This thesis analyses the various models: the shareholder value, the stakeholder, the stewardship and the convergence models of corporate governance. It looks at the Chinese scenario - what model of governance has China adopted and is it appropriate? What problems of corporate governance are special to China and how are these problems being resolved?

Many of the problems are due to the fact that China has adopted the shareholder value model – a model based on the UK / USA. However, unlike them, China does not possess the requisite institutions necessary to underpin the efficient functioning of the model. The Chinese capital markets are nascent and not well regulated, the rule of law is tentative and the regulatory bodies are lacking in enforcement powers.

In an effort to encourage good corporate governance, the China Securities Regulatory Commission promulgated the QFII (Qualified Foreign Institutional Investor) scheme in December 2002 in the hope that by opening the domestic securities market to foreign financial institutions, this would result in the implementation of sound corporate governance in Chinese listed companies as they vied to attract foreign shareholders.

A survey was carried out and the results have only been mildly encouraging. The QFII has not had the dramatic impact that was expected of it initially and the reason is that the quotas allocated have been small and the QFII have had many restrictions placed. Until these are loosened the impact of the QFII will continue to be modest.
Acknowledgment

My grateful thanks to Associate Professor Dr Hans Hendrischke, Head of School of Modern Language Studies from the University of New South Wales who acted as my supervisor and mentor over the last two years. This thesis would not have been possible without his guidance and tutelage over the past two years. My appreciation too of Dr Jon Kowallis from the Department of Chinese and Indonesian Studies at the University of New South Wales who was my co-supervisor and who was a source of encouragement and inspiration and to my wife and children who egged me on when spirits were flailing.
Introduction

Why do problems of corporate governance continue after over a decade of supervision by the China Securities Regulatory commission (CSRC)? One important reason is because the institutional determinants and market forces that help bring about good corporate governance in Western free market economies are absent in China.

This thesis is about Corporate Governance of the State Owned Enterprises (SOEs) in China. It is not about the corporate governance of family owned and private enterprises nor is it about the corporate governance of joint venture enterprises or collective enterprises. It is concerned with the SOEs which are listed on the stock exchanges in China. It starts off by considering the various theories of corporate governance (Chapter 1) and proceeds onto “The Chinese Perspective of Corporate Governance” (Chapter 2). The model practiced and problems faced are considered in Chapter 3 and then institutional determinants are considered. (Chapter 4) In an attempt to overcome problems of Corporate Governance in China, the CSRC established the Qualified Foreign Institutional Investors (QFII) scheme in December 2002 and Chapter 5 is about our survey on the “Impact of the QFII scheme on Corporate Governance.”

In the first chapter on models of corporate governance, the question is posed “who should the corporation be managed for the benefit of?” The “Agency or Shareholder value” theory of corporate governance as practiced in the UK/USA states that the shareholders should be the beneficiaries but there are other competing theories. The “Stakeholder” theory articulates that there are various stakeholders in any corporation and hence it should be governed for the benefit of all stakeholders; but then again there is the “creation of wealth for society” model. Then there is the “stewardship” theory model, the “transitional economy” model and finally the “convergence” model. These theories are considered and explained.

This leads on to chapter 2 on “The Chinese Perspective of Corporate Governance” which looks at how Chinese scholars and academics view corporate governance in China. What theories are current, which ones were considered and which is most suitable for China? The debate on corporate governance is crucial for an understanding of the model practiced in China.

“The Practice of Corporate Governance in China” is examined in Chapter 3. Which model of corporate governance does China practice and why? China today has adopted the Anglo American model of corporate governance and critics believe it not to be entirely suitable as China does not possess the institutional framework and market determinants that make the Agency theory model function so well in the UK/USA. Problems of corporate governance of the listed entities are reflected in the downward trend of stock prices since 2000 inspite of strong economic growth of the overall economy. China is a command economy in transition to a market economy and Hu Angang describes the current corporate governance model as an “evolutionary model” but a more appropriate description is “Politicized Capitalism”\(^1\) - a term used by Nee,V and Opper, S to describe the economic order in China today.

This leads onto chapter 4 which is an examination of the weaknesses of the institutional framework in China and its performance in recent years. Comparisons are made with Western European countries and other free market economies in Asia. The conclusion is that China fails the test of governance.

The Chinese authorities having realized their inability to overcome problems of corporate governance from within look outwards for solutions. The China Securities Regulatory Commission (CSRC) which has the responsibility of regulating the listed entities on the stock exchanges decided to open the domestic share and bond markets to “qualified foreign institutional investors (QFII).” The hope was that with large foreign financial institutions investing in the domestic capital markets, they would demand high standards of corporate governance.

This empirical part of this thesis is presented in Chapter 5 on “The Impact of the QFII on Corporate Governance” which gives a solid foundation to our findings. The twelve leading players in the QFII scheme were invited to participate in a survey and 58% of them holding 76% of their QFII allocated quotas did. How did the QFII choose Chinese companies to invest in? The paramount consideration was financial performance but an important finding from our survey was that the QFII also looked for good corporate governance in their target companies. The results of our survey indicate that although there has been improvements to corporate governance as a result of the QFII scheme, these improvements have been limited.

The results of the survey lead us to modify our general views of the QFII and its impact on corporate governance. No, it has not had the impact that Ferguson, M & McGuinness, P suggested in their paper that “the QFII scheme carries tremendous potential as a vehicle for raising corporate governance standards.”² There have been limited improvements but they are through training schemes, seminars, other management support and financial advisory services. The improvements to corporate governance have been limited because the QFII members themselves have no desire to take an active management role in the Chinese companies. The QFII scheme may be described as “tinkering with the system” because important institutional deficiencies have not been addressed and are still missing in China. Strong, independent judicial and other institutions support the practice and existence of good corporate governance in Western democracies but they are not likely to emerge in China in the near future.

The thesis concludes that the QFII scheme cannot be seen as a panacea for China’s problems of corporate governance. At best it can have a greater impact over time if the QFII quotas are greatly expanded and the rules loosened considerably to encourage greater participation by foreign institutions.


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## ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ABC</td>
<td>Agricultural Bank of China</td>
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<tr>
<td>AGM</td>
<td>Annual General Meetings</td>
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<td>AMF</td>
<td>Authorities des Marches Financiers (France)</td>
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<td>ASIC</td>
<td>Australian Securities Investments Commission</td>
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<td>BOC</td>
<td>Bank of China</td>
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<td>CASS</td>
<td>Chinese Academy of Social Sciences</td>
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<td>CBRC</td>
<td>China Banking Regulatory Commission</td>
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<td>CCB</td>
<td>China Construction Bank</td>
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<td>CCP</td>
<td>Chinese Communist Party</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CFO</td>
<td>Chief Financial Officer</td>
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<td>CIBC</td>
<td>China Insurance Regulatory Commission</td>
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<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
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<td>EAS</td>
<td>Enterprise Accounting Standards</td>
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<td>EGM</td>
<td>Extra-ordinary General Meeting</td>
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<td>FSA</td>
<td>Financial Services Authority (UK)</td>
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<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<td>HSBC</td>
<td>Hong Kong &amp; Shanghai Banking Corporation</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<td>ICBC</td>
<td>Industrial &amp; Commercial Bank of China</td>
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<td>IPO</td>
<td>Initial Public Offer</td>
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<td>NPC</td>
<td>National People’s Congress</td>
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<td>OECD</td>
<td>Organisation of Economic Cooperation &amp; Development</td>
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<td>PBOC</td>
<td>People’s Bank of China</td>
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<td>PRC</td>
<td>People’s Republic of China</td>
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<td>QFII</td>
<td>Qualified Foreign Institutional Investor</td>
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<tr>
<td>RMB</td>
<td>Ren Min Bi – China’s currency</td>
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<tr>
<td>SAFE</td>
<td>State Administration for Foreign Exchange</td>
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<td>SASAC</td>
<td>State Asset Supervision &amp; Administration Commission</td>
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<td>SEC</td>
<td>Securities Exchange Commission</td>
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<td>SOB</td>
<td>State Owned Banks</td>
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<td>SOE</td>
<td>State Owned Enterprises</td>
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<td>UBS</td>
<td>Union Bank of Switzerland</td>
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<td>WTO</td>
<td>World Trade Organisation</td>
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Chapter One

Theories of Corporate Governance

1 Introduction

This introductory chapter is an explanation of the different concepts of corporate governance. China being an economy in transition could have chosen any one of these models to follow. So which model is most appropriate for China? Which model of corporate governance did China choose and what are the consequences?

The OECD defines corporate governance as: “…the set of relationships between a company’s management, its board, its shareholders and other stakeholders. It provides the structure through which the company’s objectives are set, and the means of attaining these objectives and monitoring mechanisms are determined.” There is another more generalized view of corporate governance from Lord Cadbury (who headed the Cadbury Code of Conduct of Corporate Governance adopted by the London Stock Exchange in 1994), who opined that “...the purpose of corporate governance of a corporation is to align as nearly as possible the interests of individuals, corporations and society.”

The scope of corporate governance is therefore wide and the studies differ in approach, methodology and emphasis. Sometimes these conclusions are contentious, sometimes not. Corporate entities are governed differently in different countries because of differing emphasis on the relationships between the various parties that comprise the corporation, because of different legal frameworks; because they evolved from different economic and political systems and sometimes because the economic environment they operate in are in a state of transition. Should China aim to evolve and adopt a different system of corporate governance?

This chapter delves into the tools and mechanisms of corporate governance and considers the different approaches - agency, organizational, stakeholder; stewardship and the transitional approach. The form and content of each model of corporate governance is considered and evaluated.

2 The theory of corporate governance

How should a corporation be managed? Should it be managed solely in the interests of the shareholders or is there a broader agenda? If so, how broad should the agenda be? What is the role of management? How should they be rewarded? Should the interests of employees, customers and creditors be considered? What about other interest groups? Is there convergence towards an internationally accepted code of good corporate governance? If so which model should be adopted? These are all relevant questions and the answers determine the tools and mechanisms employed in the corporate governance structures of corporations.

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An additional question would be – who should be the arbiters and supervisors of good corporate governance? Today, in response to changed economic circumstances, financial institutions like pensions funds\(^4\), insurance companies, and mutual funds are the largest shareholders of many of the large listed corporations.\(^5\) As a result these institutions are now the arbiters and supervisors of good corporate governance, a role that they play very well. The various types of approaches are as follows:

### 2.1 The Agency Theory

The separation of ownership and control is inevitable in modern business corporations nowadays as these entities necessitate huge capital outlays resulting in equally large numbers of shareholders\(^6\). This has resulted in the creation of a class of professional managers and the relationship between the shareholders and the management is the paramount relationship in any corporate entity. This is enced in the agency theory where the shareholders are the principals and the management are their agents. The Agency Theory does not take into account competing interests of other groups and merely defines corporate governance as being “how to ensure that shareholders returns are maximised” and simultaneously “how shareholders should control managers.”\(^7\) But how do shareholders ensure that management act in the best interests of the principals? According to economic theory, both shareholders and managers would want to maximize their own individual utility\(^8\); the shareholders wanting to maximise profits and the managers wanting to maximise their own personal interests resulting in a dichotomy of interests. How do shareholders ensure a similar alignment of interests between principal and agent?

There are various ways for the shareholders to ensure a congruency of interests. A stick and carrot approach is usually employed. First there must be sufficient controls in place to monitor and control the actions of managers to ensure that they do not make corporate decisions in their own selfish interests which are detrimental to the shareholders. These are monitoring costs and would comprise, in addition to the supervisory role of the Board, the formation of audit, remuneration and investment committees who supervise managerial decisions. Secondly incentives can be established to reward managers when the company’s objectives, primarily profits are met. These incentives would be usually financial and may comprise either stock options, or remuneration or a combination of both. However, there is also the performance / cost element to be considered and where the managerial performance is lacking, the shareholders have every right to change the CEOs. This is usually done at the company’s Annual general Meetings where the non performing CEO is replaced.

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\(^4\) The Californian Public Employees Retirement Scheme is one of the largest in the world and had US$45.3 bns invested in International Equities out of total assets of US$200.9 bns as at 31-12-2005. Source: 2005 Annual Report from website: http://www.calpers.ca.gov.


This is a standard mechanism used in corporate governance to ensure corporate objectives are met and to prevent entrenchment of ineffective management.

In the Anglo American context, the workings of the corporate market place may also result in the breakup or takeover of the non-performing corporation. When the management is ineffective, this is reflected in the listed share price and the company becomes a target for takeovers. It must be emphasized that the Agency model of corporate governance works best in the UK-USA context where there are substantial well regulated stock markets with active and prolific players in the corporate market for mergers and acquisitions. The corporate market place also needs to be backed by a plethora of financial and securities analysts, corporate lawyers, merchant bankers and funding specialists.

What are the implications for corporations with strong shareholder rights? A paper from the Harvard Business School indicates that stronger shareholder rights result in higher firm value, higher profits and higher sales growth.9

Various questions however, arise vis-à-vis the nature of the relationship: is this a typical commercial agency relationship wherein the shareholder as principal is accorded all the normal rights of ownership associated say, with the ownership of a piece of private property? Or are the ownership rights somewhat diluted? Berle & Means in their seminal work in 1932 on The Modern Business Corporation & Private Property opined that shareholders should not be accorded the same ownership rights as they had effectively assigned their control rights to the managers and had therefore only retained for themselves the role of “recipients of wages of passive capital."10

The Anglo American approach to corporate governance over the last century has been that the corporation should be managed exclusively in the interests of the shareholders and this model has worked very well. Nevertheless, when carried to extremes as happened in the spate of recent cases affecting Enron, World Com and others, it has resulted in distinct corporate mis-governance. How did this happen? A historical journey into the American corporate landscape is necessary.

From the nineteen sixties until the early eighties, during a period of long and sustained economic growth, the American corporations grew big and fat – they all wanted to be conglomerates and mergers and acquisitions were the rage. The credo of the corporate manager was to “retain and re-invest” ie they retained corporate earnings and re-invested in an expansion of the existing business or acquisitions of competitors. However from the late nineteen eighties onwards, with the rise and increased usage of the junk bond market, these same corporations suddenly found

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10 Berle, Adolf & Gardiner Means. “The Modern Corporation & Private Property.” Macmillan Press, New York,1932. The authors justified this on grounds that shareholders had the option of bailing out of the corporation by selling the shareholding and therefore were not entitled to residual wages as they did nor bear residual risk.
11 Lazonick, W & O’Sullivan, M “Maximising Shareholder Value: A New Ideology for Corporate governance.” Jnl of Economy & Society, 2000 wrote that Ivan Boesky & Michael Milken were the epitome of the Wall Street Corporate Raiders who used junk bonds in takeovers and acquisitions. They were assisted by the financial deregulation of the Banking industry in the 1970’s which culminated in
themselves under attack from corporate raiders who found these huge bumbling conglomerates easy targets. In order to thwart corporate raiders, corporate managers quickly changed their motto from “retain and re-invest” to “downsize and distribute” and a return to core values of maximisation of shareholder value. An example of how much the trend had taken root in American corporate culture can be found in the fact that by the nineteen nineties, even solid lifelong career culture companies like IBM, DEC and Delta had downsized significantly their blue and white collar workers.

During the nineteen eighties and nineties, US corporations not only downsized, they also distributed an even larger portion of their earnings when compared to the sixties and seventies. This was done by an increased dividend payout and by the implementation of substantial stock repurchase program. Similarly in the UK, Stephen Dorrell former financial secretary to the Treasury stated in 1994 that he felt that the dividend payout policy pursued by UK listed companies was too high and too inflexible. As recently as October 2002, Michael McLintock CEO of M & G which is part of the Prudential Group, one of the largest financial institutional investors sent a letter to major UK companies emphasizing the importance of maintaining dividends even in the face of falling profits.

2.1.1 Shareholder values

A corollary to shareholder value maximisation value was the need to incentivise the corporate manager. CEO’s pay scales rocketed with the increased incentives paid to senior managers. Statistics show that in 1965 average CEOs pay packages were 44 times that of factory workers but by 1998, the multiple had gone up to 419 times. In such a situation the question may be rightly asked as Bruno Frey posed in his writings – is this financial compensation or just plain bribery? If it is indeed bribery, where does one draw the moral line? Is it not an indication of things gone wrong; of failure of this model of corporate governance?

Stock options too became an increasingly important component of corporate managers’ remuneration. As stock options became an ever more important part of corporate managers’ rewards, they became obsessed with the need to keep the listed share price as high as possible in the short term; so that they could either cash out or prevent their corporation from becoming a target of corporate raiders. This resulted in financial irregularities and creative accounting, sometimes with the connivance of senior accounting and audit partners of the Big 5 International firms. The disasters of the corporate giants in the USA in 2001-2002 surely prove that the obsession that

the Garn St-Germain Act of 1982 which permitted Savings & Loan Financial Institutions to invest and hold junk bonds.

13 Ibid page 5
16 Business Week, 20 April 1998 19th April 1998
Wall Street has for the doctrine of “maximisation of shareholder value” when carried to extremes has resulted in failure.¹⁷

What was the response to the Enron / WorldCom debacle? First there was the Sarbame Oxley Act passed by Congress in 2003 which required the Chief Financial Officer to certify various financial and internal control documents. More important there was a swing away from excessive financial incentives for the CEOs and corporate managers. In the China scenario, there are few financial incentives for the corporate managers unlike their overseas counterparts and the system has not evolved to the UK/USA standards.

2.2 Alternative Approaches to Corporate Governance

Margaret Blair in her paper “Ownership & Control: Rethinking Corporate Governance in the 21st Century”¹⁸ poses the question “Whose interests should the corporation serve?” and goes on to examine the “socially responsible corporation” This leads onto another – the organizational approach to the governance of a corporate entity. In this theory of the firm approach, the corporation is “a nexus of contracts” with shareholders, management and employees being of value and importance although not necessarily of equal importance. Under this approach the management is required to take cognizance of this fact that the corporation comprises various stakeholders and govern accordingly. The Europeans may be said to adhere to this model of corporate governance more so than the Anglo Americans who tend to emphasize the role of the individual whereas the Europeans tend towards group and joint efforts. There is thus a cultural bias which is reflected in corporate governance.

2.2.1 Wealth Creation for Society

The agency theory of corporate governance focuses on the shareholder- management relationship, but other participants are important too. Taking a macro view of the framework of the modus operandi of a corporate entity, there is also another school of thought on corporate governance which defines the objective of corporate governance as the creation of wealth for society. This is because as the historian Dow Votaw noted: the selfish corporate buccaneers of the late nineteenth century gave way to the more statesmanlike professional managers of the 20th century¹⁹ and furthermore these professional managers did take into consideration the interests of various groups in their corporate governance processes.

This school of thought has arisen because it became obvious to scholars and economists²⁰ during the nineteen seventies and eighties that many corporations wielded enormous economic power and had become colossal institutions. It would thus be a travesty of justice to govern these corporations solely for the benefit of the

¹⁷ Coffee, J Jnr “What caused Enron's failure?” Cornell Law Review, 2004 attributes the collapse to the failure of gatekeepers like the auditors etc.
²⁰ Berle, A wrote in the preface to “The Modern Corporation & Private Property,” Macmillan Press, New York,1932 ‘that the American corporation had ceased to be a private business device and had become an institution.’
shareholders and ignore the society in which the entity operates in and draws sustenance from. This approach to corporate governance had its adherents not only among the Europeans and the Japanese but also amongst the Americans from the nineteen sixties right through to the early eighties and resulted in corporations becoming more responsive to various pressure groups, viz consumer groups, ethnic groups, religious groups and charity and educational institutions.

Another reason why this model of corporate governance came about was in response to changing political conditions worldwide. The ideological struggle against Communism intensified in the nineteen sixties and seventies and capitalism as practiced in the west needed a more human face\textsuperscript{21} and that was another reason why corporate governance evolved to denote the “creation of wealth for the society.”

What were the implications of this model? Obviously once the corporation is no longer governed solely in the interests of shareholders, profits drop and this is usually reflected in falling share prices. In an imperfect market or in an oligopolistic situation, the corporation may survive and even prosper but definitely not in a free market environment. In a free market environment, falling share prices open up the corporation to takeovers and mergers.

The implications of this approach are that this model is more suited in an environment where the players are in an oligopoly or when the market is imperfect. In China’s case, a wealth creation for society model appears more suited but the problems arise on how to allocate and share the wealth generated if it does not accrue to the shareholders.

2.3 The Stakeholder Approach\textsuperscript{22}

A derivative of the above approach is the stakeholder approach to corporate governance. The stakeholder theory is attributed to Freeman\textsuperscript{23} who wrote that “the emergence of numerous stakeholder groups require a re-thinking of the traditional picture of the firm…” This stakeholder approach postulates that corporations should be governed for the benefit of all stakeholders, stakeholders being defined by The Stanford Research Institute as “those groups without whose support the corporation would cease to exist.” This theory broadly takes cognizance of the fact that the success of any corporation is due to teamwork and contributions from a large number of resource providers including employees, creditors, bankers, suppliers and not just shareholders, directors and senior management. In addition, in an imperfect market, the stakeholder model of corporate governance may be more appropriate than the traditional model of shareholder value.

\textsuperscript{21} The term “Unacceptable Face of Capitalism” was used by Edward Heath, Prime Minister of UK in the early 1970’s to describe the unethical corporate practices of some British companies. Source: Oxford Dictionary of Modern Quotations.

\textsuperscript{22} The OECD’s view is that the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporation and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. (Principles of Corporate Governance 2004)

So what is the theoretical basis for this approach? First the corporation is a bundle of relationships; some formal and others informal. Formal relationships would be those between the firm and the shareholders, the managers, the employees, the creditors and external professionals (auditors, lawyers, etc) Informal relationships would be those between the firm and the media, consumers, various associations, political parties, government departments, charities, schools of higher learning, religious groups etc. The economic well being of the society in which the corporation operates in is also a relationship that must be paid attention to.

What are the tools of governance in this approach? Because the company has to take into account various stakeholders in the corporate governance processes, it means that their voices must be heard and representation given to them. This is done by having proportionate representation on both the Board of Directors and to a lesser extent the Board of Supervisors.

Under the stakeholder system the board of directors has representatives from large shareholders, senior management, employees, banks, financial institutions, bureaucrats (sometimes) and independents. The board of supervisors would however be more select and comprise representatives from the employees and management. Yet another is to establish employee share schemes to ensure that employees also benefit from the growth and profitability of the company they work for.

Germany and Japan are two countries who have adopted “The Stakeholder Theory” as a means of corporate governance. It is said that this has been responsible for their industrial success and social stability. Why is this so? The reason is because this model allows the board of directors to govern for “the long term” unlike the Agency Theory which tends to concentrates on short term results.

Another tool of corporate governance is the payment of dividends and research has shown that dividend payments in stakeholder economies like Germany show greater consistency over time and that a lower proportion of net profits are paid out as dividends when compared to the UK / USA.

Has the stakeholder theory found support elsewhere? Yes, in fact in the USA, 38 (out of 51) State legislatures have passed laws that require corporations to consider the impact of their activities on constituencies other than shareholders – including employees, customers, suppliers and the community.24

In China’s case the stakeholders would include not only all of those mentioned in the preceding paragraph, but because of its socialist background, include the State, society and even the CCP. This is because under China’s Company Law, Article 17 states that the activities of the elementary-level cell of the Chinese Communist Party in a company shall be conducted in accordance with the constitution of the Chinese Communist Party.

In addition, article 31 sub section 7 of the CCP constitution explicitly assigns the local party committee to “supervise party cadres and any other personnel to ensure that they

strictly abide by the state laws and the administrative disciplines and refrain from encroaching on the interests of the state, the collectives and the masses”. As the majority of the SOE managers are CCP members, they thus fall under the supervision of the local party committees. Zhang Weiyang from Guanghua School of Management at Beijing University in his article on “China’s SOEs: A Corporate Governance Perspective” noted that senior management of the listed SOEs was appointed by State bureaucrats (who are also CCP members) who had ‘the authority to select managers but do not bear the consequences of their selection.’ These SOE managers are thus beholden to interests other than the business enterprises that they are in charge of. S Oppen, S. Wong and R. Hu in their article “Party Power, Markets, & Private Power: CCP Persistence in China’s Listed Companies” find that the local party committees still succeed in keeping their fingers in the decision making process even after two decades of economic reform.

2.4 The Stewardship Theory

Stewardship Theory has its roots in psychology and sociology and postulates that a corporation’s management can find greater utility in acting as a steward of the corporation and shareholders concomitantly than acting in his own selfish interests. When management act as stewards, they identify with the corporation and the corporation’s success becomes their own personal success; the corporate goals become their own personal goals. In other words stewards are completely pro-organisation and they will always act in the organisation’s best interests even to the detriment of their personal self interest.

For the stewardship theory to be fully implemented, stewards would want wide sweeping powers believing as they do that all decisions they make will be in the best interests of the corporation (and by inference the shareholders). Davis, Schoorman & Donaldson in their paper “Towards a Stewardship Theory of Management” argued that stewardship theory demands that structures be put in place that empower the CEO and not restrict or monitor him. This is because the CEOs identify themselves completely with the corporation and the company’s goals are their goals and the company’s successes are their own success.

The CEOs who are stewards should also chair the board of directors. Reality however does not always follow theory and this is because of the risk factor: the possibility that manager stewards may wittingly or unwittingly make corporate decisions that are detrimental to the interests of the shareholders. Monitoring and internal control measures will therefore always be present as a safeguard measure for the shareholders.

The search for steward managers may lead to employ senior managers with “credible reputations” and “proven track records of excellence.” In such a scenario, monitoring costs are alleviated while financial incentives would naturally be higher. “Reputations” of managers is a form of self-governance that shareholders and the market place should pay attention to.

In the China scenario however, the case for the stewardship theory is less compelling as currently many of the corporate managers of the SOES and listed entities are bureaucrats and officials who do not make for good stewardship.

2.5 Economies in transition

The above models of corporate governance can be readily applied to mature economies – economies like those of Europe, the USA and Japan that over the last century and more have progressively created and refined the tools and mechanisms of corporate governance. But what about economies in transition? Since the nineteen eighties there have been a whole host of socialist planned economies making the transition to market economies. How have they attempted to solve their problems of corporate governance? What tools and mechanisms have they used and how successful have they been? Studies of corporate governance in transitional economies focus on two areas: Eastern Europe including Russia and China. The former may be said to have adopted the instantaneous “Big Bang” approach whilst the latter has taken the gradualist approach - an approach which has been described as “walking on two legs” or “growing out of the plan.”

In most of these economies, it has been a steep learning curve as they made the change to market economies. Along the way they have encountered numerous problems as many of the basic financial and legal infrastructure present in Western democracies are absent in the Eastern European countries and China. Ownership and private property rights are also either weak or absent. The legal framework in these countries is also fragile and subject to manipulation and enforcement is often feeble. The judiciary often functions as an extension of the executive and is subject to corrupt practices. Transparency and information disclosure is often non existent and related party transactions are the norm – not the exception.

The Russian experience with the transition to a market economy in the early to mid nineties has been a failure as the Big Bang approach has resulted in chaos and bedlam. The economic framework was simply not ready for it and the Russian mafia has emerged as a powerful force in the economic environment. The Moscow stock exchange has listed companies but they languish and problems of accountability and transparency are overwhelming. Shareholder’s rights are routinely trampled upon and share registers sometimes destroyed and recreated. Directors and senior management clash over their roles and authority limits and foreign investors appear not too bothered about corporate governance issues; being obsessed with investing in companies with undervalued assets and their ability to transact special deals.

China was the first socialist economy to reform in the late nineteen seventies but there was no theoretical basis or historical precedents to facilitate the process. Thus the authorities took the gradualist path to effect change and scholars today consider the process successful. Nevertheless numerous problems remain as listed entities – once upon a time State Owned Enterprises (SOEs) grapple with the demands of corporate

governance in a modern corporate environment. The transition from being an “iron rice bowl” outfit in a command economy to a profit oriented corporation with hard budget constraints in a market economy has not been complete. Many of the listed companies have the State as the largest shareholders - conflicts of interest thus arise and such ambiguity leads to opportunities for fraud and misrepresentation.

As Wong S, Opper, S and Hu, R have found in their study, the CCP also continues to wield influence on the operations of the business enterprises through the local party committees at the enterprise level 27 although the party's level of decision-making power is negatively related to the proportion of shares held by domestic individual shareholders and to the existence of large institutional investors.

The Chinese legal framework is also not fundamentally sound and incomplete and many loopholes exist to prevent good corporate governance. In addition although many laws have been passed, their enforcement remains problematical. In other words there is form but no substance in China.

The free market forces that govern corporate entities in the West are therefore absent or ineffective in these transition economies. Foreign investors in these countries must therefore go in with their eyes wide open for there are not many avenues available for redress if there has been fraud or corporate mis-governance.

Chinese scholars have mainly concerned themselves with the study of the convergence theory of corporate governance. Is China gravitating towards the “shareholder value” or the “stakeholder” model? Which is more appropriate? M Guillen poses this question in his article “Corporate Governance and Globalisation: Is there convergence across countries?” And the answer is yes, there is convergence towards the shareholder value model - as how else can investors be assured of a fair return on their capital as multi-national companies seek new investment opportunities world wide.

Institutions, both formal and informal impact on corporate governance and no where is this more true than in China. China has introduced formal mechanisms of corporate governance based on the shareholder value model as practiced in the USA/UK without establishing the underlying supporting institutional mechanisms. Formal institutions that impact on corporate governance would include rule of law, the efficacy of regulatory bodies, accountability, the fight against corruption, government efficiency and political stability. For example various regulatory bodies have been set up eg CSRC, CBRC and the CIRC but unlike the SEC, (USA) FSA (UK) and ASIC (Australia) they lack enforcement and punitive powers. Again China’s Company Law was promulgated in 1994 to clearly define the roles of various parties that comprise the body corporate eg the shareholders, board of directors, the management, the employees and yet fraud, disputes and oppression of minority shareholders continue. This happened because the Chinese judiciary was not primed to cope with the demands made on it arising from the establishment of the Company Law. Thus, the institutional environment was lacking in China and this has resulted in an inability to achieve the same results in the Western democracies.

2.6 The Convergence Theory

The convergence theory of corporate governance simple assumes that with increasing globalisation and the stupendous growth of multi-national corporations over the last few decades, international boundaries and borders are becoming irrelevant as investment capital seek out new markets and profit centres. These capital movements are huge and as a result of these massive investments, there is a theory that this will lead to a convergence of systems and the adoption of an “international model of corporate governance.” This is true to a certain extent with the proliferation of International Accounting Firms and their models of corporate practices.

In addition as London and New York are the two biggest financial centres of the world where the most finance is raised, their corporate governance practices and models serve as an example to follow. Thus Daimler Benz, the first German company to list on the New York Stock Exchange in the nineties had to change its accounting standards to comply with the NYSE rules. Several Mainland Chinese firms have also listed on the NYSE and adopted the American model of corporate governance, thus setting the standard for other Chinese corporations. In Russia, the standards of corporate governance are patterned on the USA too and as in the Chinese experience, several companies have listed on the NYSE.

The convergence theory postulates that there is convergence towards a model of corporate governance that is universally accepted. There is widespread acknowledgment that the agency theory with its emphasis on shareholder value is not only necessary but practical for how else can the interests of shareholders who are scattered all over the world be protected as global corporations invest in the economies of the developing world.

The emphasis on shareholder value however received a setback with the Enron & World Com scandals and the American theories of corporate governance were not seen to be as robust as they were made out to be. There was widespread disillusionment with Corporate America and a realisation that as with the junk bond traders of the late nineteen eighties greed had reared its ugly head again. The result was the demise of one of the top 5 Accountancy firms in the world and the introduction of several pieces of legislation curtailing the scope of audit firms and the

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28 Guillen M: “Corporate Governance & Globalisation: Is there convergence across countries?” Jnl of Advances in International Comparative Management, 2000
30 The Big 3 International Accounting firms are Pricewaterhouse Coopers, KPMG & Ernst & Young.
32 Anderson & Partners auditor for Enron was completely discredited and expunged.
mandatory requirement of senior managers to sign off on accounting statements and audit reports.  

A more important implication of the Enron fiasco is that the agency theory of corporate governance received a setback. There is now greater pressure for the adoption of the stakeholder theory of corporate governance as the convergence model given that the stakeholder model seems to be less likely to display the excesses exhibited by the agency theory and its shareholder maximisation value approach.

The application of the convergence theory of corporate governance though is not without its problems in the Chinese context given that China lacks the institutional determinants that underpin the corporate governance mechanisms as practiced in the Western democracies. These would include accountability, regulatory quality, political stability, rule of law, government efficiency, and absence of corruption. These six measures of governance are elaborated in Chapter 4 of this thesis which shows the results of a World Bank Survey in China and various other countries.

How does accountability impact on corporate governance? In western democracies, it impacts by ensuring that everyone in the company from the Chairman down to the junior clerk is accountable for everything he/she does and may be liable for negligence, malfeasance, fraud or corrupt acts. As Tenev & Zhang noted in their book on “Corporate Governance & Enterprise Reform” China’s listed SOEs have a problem in that some two thirds of them are majority owned by the State with the result that often corporate decisions are made to favour the majority shareholder, there being no accountability to the minority shareholders. Legal redress is usually not contemplated as the rule of law is at best tenuous and the judicial system is somewhat stretched.

Regulatory quality is best manifested not only by the efficiency of the regulatory bodies like the CSRC, the CBRC and the CIRC but also by the degree of self regulation by the individual companies. In the USA and the UK, with the hundreds of years of corporate history and traditions, there is a high degree of self regulation by the listed companies with the result that the regulatory bodies like the SEC and the FSA do not need to have bloated staff and large budgets to supervise them. However in China, the reverse is the case: there is a very short corporate history (the Shanghai & Shenzhen stock exchanges were established in 1990) and the regulatory bodies spend much time teaching the listed companies the rules and regulations that come with listing. Regulatory quality in China is thus not up to world standards and understandably so. In addition it is observed that regulatory bodies like the SEC, the FSA and the ASIC have enforcement and punitive powers – something which the Chinese regulatory bodies lack. In China, the CSRC works in tandem with the Public Security Department on enforcement issues.

The Chairman of the CSRC in an address to the Euro-money Conference in Beijing in December 2004 noted that the Chinese government plays a very important role in

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33 The Sarbane-Oxley Act that was passed by Congress in 2003 and requires the CFOs of companies to sign off on internal audit and other regulatory documents

34 Zhou Xiao Chuan: Speech at the Euromoney Conference “Capital Market & Corporate Governance” Beijing December 2004
the corporate governance process. In addition, Government efficiency, political stability and lack of corruption are all key issues in the implementation of corporate governance. In terms of government efficiency, China scores respectably but in comparison to Hong Kong and Singapore, efficiency is still below par. An example is the lengthy time needed to register a company or to get an export license. Corruption is acknowledged by Chinese authorities to be a serious problem too. In regards to corporate governance, corruption results in additional costs to the business enterprise, rent seeking activities and possibly misallocation of scarce resources. However, there is collective determination to reduce if not eradicate it and there is widespread media coverage given to government actions combating corruption cases.

3 Summary

Which model of corporate governance works best? It depends which viewpoint one adopts. From the viewpoint of the investor – the agency theory is ideal because it calls for the maximisation of shareholder value. From the point of view of the CEO, the stewardship theory would be ideal as he would be endowed with more powers. For the bankers, creditors and employees, the stakeholder theory would protect their interests better and finally for governments, they would prefer that the corporation be governed for the benefit of the society as a whole.

Which model of corporate governance is most appropriate for China? Is it the Agency model, the Stakeholders model or some other? The model of corporate governance of China’s entities is encapsulated in the Company Law which was promulgated in 1994.

China’s Company Law is mainly based on the UK/USA model with substantial powers being placed in the hands of the board of directors who have to report to the shareholders. There is some obfuscation in that China’s Company Law, Article 17 provides for some input by the local committee of CCP in a company’s activities.

What was the Chinese experience with corporate governance? What was the model of corporate governance that they adopted? Was there any debate on which model of corporate governance was to be chosen? What were the views of the leading scholars and academicians? The next chapter will examine and discuss these issues.
Chapter 2

The Chinese Perspective of Corporate Governance

1 Introduction

This chapter looks at the Chinese perspective of corporate governance through the writings of several Chinese academics and scholars. Their writings are summarised in Sections 2-6 of this chapter. Hu Angang in his book on “Corporate Governance in China and Overseas: A Comparison”35 made the observation that corporate governance is about control of corporations and that control (of a corporation) is determined not only by the internal power structure but by external forces as well. The model of corporate governance that best describes control and the power structure from the internal point of view is the “Shareholder – value perspective” model whereas the model that is more inclusive of external elements is the “stakeholder perspective” model. Hu observes that the “Shareholder value Perspective” model is characterised by a widely dispersed share ownership and strong financial institutions and market determinants that control the behaviour of corporations whereas the “Stakeholder” model is characterised by large shareholders with the State and the Banks playing a more prominent role in its corporate governance.

China, being an economy in transition, is in Hu’s view practicing a model of corporate governance which he calls the “evolution” model. He acknowledges that there are two major models of corporate governance: the “shareholder value model” and the “stakeholder model”. However, he does not specify what model China is evolving towards and although Hu does not specifically criticize the “shareholder value” model as being inappropriate, he does mention that the “Stakeholder perspective” model is worthy of more research.36

The internal participants who impact on corporate governance would be the shareholders, the managers and the employees whereas the external parties that impact on corporate governance would be the lenders, suppliers, the clients, the government and society in general. Hu further makes the obvious statement that China’s model of corporate governance is in evolution and that the whole process of corporate governance is an extremely complex issue. He does state that self regulation is a pre-requisite for successful implementation of corporate governance.

My summary conclusion at the end of this chapter is that while all the Chinese scholars have written volumes about the theories of corporate governance and its importance in the Chinese economic and financial system, there has been little discussion on the suitability of the current model adopted: the shareholder value model or indeed on the suitability of the basic framework within which the models of corporate governance operate. Is there not a need to make basic alterations to the institutional determinants; is there not a need to think outside the square?

36 Ibid page 1
There was little or no debate in the middle to late nineties when the “Shareholder value” model of corporate governance was adopted and there continues to be no debate on the appropriateness of this model now adopted as a standard for China. All that happened was that the 14th and 15th Congresses of the CCP laid down guidelines that were entrenched in the Companies Act that was promulgated in 1994 and this Act is based on the UK/USA model. The model of corporate governance adopted must needs be based too on the UK/USA model which is the “Shareholder value perspective” model.

As mentioned in the General Introduction at the beginning, this thesis concerns itself solely with the corporate governance of SOEs as SOEs play an important role in the Chinese economy. In 1980, SOEs produced 80% of China’s total industrial production and although it trended downwards, SOEs still produced 44% of its total industrial production in 2000. In 2003, SOEs provided 37.6% of total industrial employment, contributed 45.1% of total industrial sector profits and paid 61.2% of the tax paid by the sector.

The main problems of corporate governance in China are the following:

- High degree of State ownership of listed companies resulting in oppression of minority shareholders
- Separation of ownership and management control not clearly defined
- Insider control of company by key managers
- Inability of directors to discharge their duties required by Company law
- Insider trading, non arms length transactions
- Lack of transparency and information disclosure
- Interference by State / CCP local committees in company management issues.

The debate in China over how best to tackle the problems of corporate governance revolve around attempts to resolve the above issues from either the “Big Bang” approach or the “transitional” approach. The former would necessitate the immediate and full scale privatisation of ALL of the SOEs and SOBs while the latter contends that in transitional economies like China, corporate governance is best achieved with a transitional approach but under government control. The former view has few adherents as most Chinese scholars do not believe in full scale privatisation of the SOEs as a means of bettering corporate governance (the results of massive privatisation of the SOEs in East Europe and Russia are largely perceived by the Chinese as negative) but this view is supported by Zhang Weiyang from Guanghua School of Management at Beijing University who calls for the full privatisation of

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39 “China’s SOEs: A Corporate Governance Perspective”
both SOEs and SOBs inspite of the lack of strong property rights and ownership laws in China.

Most of China’s intellectuals subscribe to the latter approach of “transitional corporate governance” approach which may also be described as “corporate governance under government control” model. This view has as its protagonists various academics including Li Wei-an, Hu Angang and Lu Tong. They contend that in transitional economies because of imperfect market institutions, this would be the second best outcome.

Transitional corporate governance is a term that denotes that the mechanisms of corporate governance are in a state of flux and will change as the Chinese economy graduates to a full fledged market economy. The institutional determinants themselves are in a state of flux with pragmatic changes being made according to need and practice. For example the judiciary in China is being strengthened with the help of the EU and this will result in positive changes to the “Rule of Law” in China. The need to strengthen the legal framework is shared by Guo Feng from the Legal and Financial Research Institute of the People’s University of China who advocates legal class actions as a means of enforcing corporate governance by making it very expensive for companies who fail to do so.

The CASS (Chinese Academy of Social Sciences) in Beijing has a Research Centre that encourages the debate on corporate governance in China and since 2003 publishes a quarterly “Corporate Governance Bulletin” which reports on developments in corporate governance both within and outside of China. The Centre also has published separate articles contributed by Lu Tong, Liu Ming Kang, Zhang Chun-lin and Wang Wei on the subject. All of these articles basically consider corporate governance from standardised Western points of view and investigate China’s corporate governance problems in that context. Zhang’s article looks at the convergence model of corporate governance from the shareholder and the stakeholder perspectives without coming out in favour of either model. Liu’s article on “Various issues to consider in the reform of corporate governance structures” stresses the reform of the internal governance structures including the boards of supervisors and directors. Wang Wei compares the three models of corporate governance (shareholders, stakeholders, family based) extant world wide and notes they all have their own special shortcomings.

Lu Tong, the director of the Centre for Corporate Governance at CASS writes prolifically on the subject and when the CSRC passed the ruling in August 2001 that one third of the board of directors of all listed entities must be independent, she observed in her article “Practice and Development of Independent Directors in China” that independent directors are not the complete answer to all the problems of corporate governance in China. If the pre-conditions and pre-qualifications of independent directors are not met, there is the real danger of their lack of

40 Director of the Nankai University’s “Center of Corporate Governance” in Tianjin, China
42 Website of CASS on corporate governance: www.iwep.org.cn
43 Ibid. Website of CASS on corporate governance: www.iwep.org.cn
effectiveness as has happened to the Supervisory Boards. Her other article on “Corporate Governance Perspective - Lessons from Enron” highlighted the danger of having one accounting firm doing both the audit and management consultancy work for Chinese listed companies.

There is an underlying assumption though that the transitional corporate governance changes will always be for the better but there is no guarantee. It is probable that the transitional reforms made in response to changing economic and market conditions will have positive ramifications but negative impacts are also possible. The writer believes that for transitional corporate governance to be successful, it must be not only gradual but also incremental. These incremental changes can be reversed if needs be.

2 “Evolution theory” of corporate governance.

In China, the concept of “control” permeates throughout every strata of society and Hu Angang identifies “control” as being one of the key concepts of corporate governance which he incorporates into his “evolution” model of corporate governance. 44 Corporate governance may be analysed at both the micro and the macro levels from the “control” angle which he proceeds to do so in his article “Corporate Governance in China in the Transitional Era: Review & Foresight”

Lu Tong agrees with Hu Angang that China is an economy in transition but she suggests that China is in transition to the UK/USA model of corporate governance. However, she does not mention what makes the “Agency” model successful in the UK/USA nor does she analyse whether similar conditions exist in China. She praises the fact that the UK/USA are the leading countries in the international efforts to establish better corporate governance.

Although Lu Tong and Hu Angang are both leading academics on Corporate Governance Reform in China, they do not come out explicitly with radical suggestions on how to overcome problems of corporate governance in China. Why are there shortcomings in the legal system, why is there misappropriation by controlling shareholders? Why are the directives from the CSRC not being followed? Is the answer more bureaucracy, more power to the bureaucrats?

Hu Angang the traces the evolution of corporate governance in China through four stages using the control mechanism as a means of defining the mode of corporate governance practiced. They are:

- The original stage (Pre 1978)
- The primary stage (1979-1992)
- The transitional stage (1992-2002)
- Convergence stage (Post 2002)

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2.1 The Original Stage (Pre 1978)

This is the pre-reform era when the State decided on what the production plans were for each business enterprise. Production inputs including bank credits were supplied and products manufactured were sold at state controlled prices. The profit or loss was absorbed by the State. In the original pre-reform stage the business enterprises were the State's workshop and there were no corporate governance structures – the CCP and the government were indivisible and in fact the local party secretary often wore two hats and served as the production chief.

Control of the business enterprises during the pre-reform period therefore rested with the CCP and the government.

2.2 The Primary Stage (1979-1992)

The primary stage may be considered to be from 1979 to 1992. This was when China’s economic reforms began in earnest with various strategies implemented including the contract system where business enterprises were under contract to produce fixed quantities for the State and any excess produced by the enterprise would be shared amongst the workers. This was also the period when some SOEs were corporatized and others were listed on the stock exchanges which began in 1990.

During this period corporate governance was in its infancy as managers attempted to grapple with the demands of managing a business enterprises free of the strictures of the command economy and more attuned to the needs of a market economy. At this stage however, the separation of ownership and control was not clear nor was any attention paid to the various theories of corporate governance and their applicability to China.

During the “Primary Stage” of the evolution theory, control of the business enterprises still rested mainly with the government. SOEs were initially registered according to the “Enterprise Law” which did not allow for Boards of Directors; the SOEs had General Managers who were appointed by the Government and they reported to the Government. However this resulted in confusion, contradictions and corruption and the Chinese authorities realised that there had to be a separation of ownership and control. This led to the next stage of corporate governance when the stock exchanges were established and SOEs were gradually listed. This was the beginning of corporate governance structures in that SOEs listed on the stock exchanges under the Companies Law allowed for clear separation of ownership and control.

2.3 The Transitional Stage.(1992-2002)

The Companies Act was promulgated in China in 1994 and it ushered in a new era of corporate governance. First of all, the government officially proclaimed its intention to develop China into a market economy and that the SOEs were to be transformed into modern corporate enterprises.
The importance of corporate governance was underscored by the Asian Currency Crises which reverberated around Asia in 1997-1998 when freely convertible currency countries with badly managed Banks with a high percentage of non performing loans (NPLs) had their currencies savagely attached by international speculators.

Under the Companies Act that was passed in 1994 and amended in 1998, the rights, duties and responsibilities of shareholders, managers and directors were clearly laid out. Responsibility was transferred from the government and the CCP to the directors and shareholders who were to be responsible for profits and losses and the operations of the company. However the Companies Law had a proviso to allow the local committee of the CCP to have input into the management of the corporate entity and this proviso appears to have retained vestigial influence for the CCP.

Under the transitional stage control was thus clearly placed in the hands of the directors who had to report to the shareholders during their shareholders meetings. The model of corporate governance adhered to the Companies Act which itself was based on the UK/USA laws on companies.

2.4 The Convergence Stage (Post 2002)

Hu Angang sees the post 2002 period as the “Convergence Stage” whereby the model of corporate governance practiced in China is converging towards the international model of corporate governance. This is buttressed by the fact that the Chinese government acknowledged that “Large and medium state-owned enterprises must continue their reform to convert themselves into standard companies in compliance with the requirements of the modern enterprise system and improve their corporate governance.”45. This was the first time a government pronouncement had paid such explicit importance to corporate governance which added urgency to the matter.

Hu does not mention what model of corporate governance China is evolving towards but makes the cryptic observation that self regulation is a pre-requisite to the successful implementation of corporate governance.

2.5 Summary

Both Hu Angang and Lu Tong propose the “evolution” model of corporate governance as being extant in China. Hu identifies the “control” factor as being the key determinant of corporate governance: who controls the micro or the macro participants in the corporate governance models. What model of corporate governance is China evolving towards? Is it the “shareholder value” model or is it the “stakeholder” model? Lu Tong suggests the “shareholder value” model. Hu Angang does not presume an answer but he suggests that the “stakeholder” model is worthy of further research.

Hu also identifies the major problems of corporate governance in China and proposes a bureaucratic response in term of strengthening the supervisory and legal infrastructure. This is not new and while recognizing the problem of conflict of interest between the state as a shareholder and the state as a stakeholder representing social interest, it does not suggest a solution. The issue of protecting the interests of minority shareholders is only addressed in the form of proclaiming positive intent to do so, but not in any meaningful way that could make a difference or lead to change.

3 The “Shareholder value” model of corporate governance

China may be an economy in transition but most scholars and academicians in China agree that the model of corporate governance that it is trying to copy is the “shareholder value” model. (Lu Tong, Wang Tianxi, Hu Ruiyin, Cui Rupi) But is it the most appropriate model for China to follow? Given China’s socialist background, given that it is a command economy in transition to a market economy, is the “shareholder value” or the “agency” model suitable? On Kit Tam has expressed serious reservations on this issue.46

We have already stated that the “shareholder value” model works best in the UK/USA environment because the shareholdings are highly dispersed and there exists a strong legal and regularity framework, strong financial institutions buttressed by forces that ensure free market competition and control. In China, these institutions are absent, corporate takeovers cannot occur without the approval of the State and the shareholdings of listed entities are largely concentrated in the hands of the State, legal persons or State controlled companies. In China too, enterprise finance comes mainly from the State owned banks whereas the stock markets are the main source of financing in UK/USA.

3.1 What has been done to overcome corporate governance problems?

Hu Ruiyin, Director of the Research Department at the Shanghai Stock Exchange has co-authored several articles on corporate governance in China with Sonya Opper 47 and is well aware of its problems. He identifies the current problems of corporate governance in China’s listed SOEs as follows:

- Serious problem of “key person” model
- Legal framework with poor shareholder protection
- Information disclosure inadequate
- CCP appointment of Chairman/CEO

In his paper on Corporate Governance of China’s listed SOEs,48 he enumerates the steps taken by the CSRC to improve corporate governance which include the following:

- Code of corporate governance promulgated by CSRC in 2002
- Quarterly reports to be submitted to the Stock Exchanges
- Supreme Court strengthened rights of shareholders to sue directors and management
- Strengthen legal rules and enforcement
- Diversify ownership of shares
- Strengthen independence of board of directors
- Develop the market for corporate control

Although Hu Ruiyin is able to identify problems and state steps taken by the CSRC to combat them, he does not ask why they have not been successful. The CSRC has been unsuccessful because the basic framework is inadequate, the bureaucracy is overladen with duties and responsibilities which it is unable to execute. They are unsuccessful because the courts and the judiciary are not doing their duty of impartial discharge of the “rule of law” and because other institutional determinants are missing in China.

4 The Stakeholder theory

A derivative of the “shareholder value” theory is the “stakeholder” theory of corporate governance. The stakeholder theory is in many ways more suited to China than the shareholder value model because this model recognises that the success of any corporation is due to teamwork and contributions from a large number of resource providers including employees, creditors, bankers, suppliers and not just shareholders, directors and senior management. In addition, in an imperfect market, the stakeholder model of corporate governance may be more appropriate than the traditional model of shareholder value. Hu Angang too has expressed the sentiment that the stakeholder model is deserving of more research.

One important reason why the stakeholder model would be more appropriate for China is that under the stakeholder system the board of directors has representatives from large shareholders, senior management, employees, banks, financial institutions, bureaucrats (sometimes) and independents. The structure of the Board of Directors allows them to govern for the long term unlike the “shareholder value” or “agency” theory which tends to focus on short-term profits and results.

5 The role of directors in China.

In the Western free market economies, directors play a very important role in the corporate governance models. The majority of the board directors are independent directors and there are very strict criteria for selecting such directors. The nomination committee has the responsibility of recommending independent directors for confirmation in AGMs. The US National Association of Corporate Directors for example has very strict guidelines.

China however has widely different rules and norms for the selection of directors. Currently most of the directors are appointed by the State who is the majority shareholder in most cases. Although required by the CSRC that one third of their board members should be independent by December 2002, the fact remains that many
have not complied and those that have are not generally perceived to have appointed genuinely independent directors. There are simply not enough professionals and senior executives with expertise and experience to merit such descriptions as many of the independent directors are ex-management who have connections to the listed company or who have business dealings with the listed entity.

Wang Tianxi\(^49\), an academic, has written a book about independent directors and the role they play in China. Wang traces the history and development of corporate governance in China and defines the three major problems as being:

- Major shareholders embezzle the assets of the listed entities
- Major shareholders conduct non arms length transactions detrimental to the interests of the minority shareholders
- Major shareholders oppress minority shareholders

It was recognised that in many cases, the Board of Directors was being controlled by the major shareholder and that there was a need for independent directors. In order to better protect the rights of minority shareholders, the CSRC issued the “Guide for appointing Independent Directors in Listed Companies” in August 2001. This edict provided that as from December 2002 at least one third of the board must be independent directors.

Unfortunately the independent directors are often not really independent at all and are mainly recruited by the listed companies themselves. They also tend to be former advisers to the companies and are usually elected because of their reputation and expertise.

By comparison the US National Association of Corporate Directors\(^50\) defines an independent director as one who:

(a) has not been employed by the company in the last 5 years  
(b) is not affiliated with a company that is an adviser in the last 5 years  
(c) is not affiliated with a significant customer or supplier to the company  
(d) has no personal services contract with the company or the senior management of the company  
(e) is not affiliated with a company that receives significant contributions from the company  
(f) has not had any business relationship with the company in the last 5 years other than as a director  
(g) is not employed by a public company for which an executive officer of the company serves as director  
(h) has not had any of the above relationships described above with an affiliate of the company  
(i) is not a member of the immediate family of any of the persons described above

\(^49\) Wang T X: “Corporate governance and the Role of Independent Directors.” Wuhan University 2005  
\(^50\) Data retrieved from their website. www.nacdonline.org
Therefore it can be seen very clearly that although the CSRC has taken the first steps to implement independent directors there is some way to go before the USA standards are reached.

Wang examines the role of how independent directors evolved in UK/USA and finds the concept of “shareholder sovereignty” to be the compelling difference between China and the UK/USA. In the UK/USA the shareholder sovereignty concept is paramount but over time it has evolved to embrace the “stakeholder theory” where the company is still the shareholders’ company but other stakeholders must also be considered.

Wang points out that the theory and practice of independent directors arose from this school of thought as outside competing interests had to be considered. He investigates the record of directors and independent directors in China and comes to the conclusion that independent directors will not cure all the ills and problems associated with corporate governance in China. He suggests a closer look at the Board of Supervisors and to strengthen its powers and functions so that it actually supervises the Board of Directors as it was originally meant to do. He also suggests that the Board of Supervisors be strengthened so that decisions of the Board of Directors should be ratified by the Board of Supervisors before implementation. My criticism of the author’s proposal is that this may not be practical as this will necessitate a rewriting of the Company’s Law in China.

Wang basically subscribes to the Agency theory of corporate governance which places emphasis on the shareholders and their quest for “values.” While it is true that independent directors can and should play a more prominent role in the corporate governance of corporate enterprises in China, he does not explain why it has not happened and his suggestion that decisions of the directors be ratified by the Board of Supervisors is a backward step that will only result in confusion.

6 Some Chinese Readings on Corporate Governance:

He Jiachen: Corporate Governance: Structure, Mechanisms and Efficiency: A Comparison of International Case Studies  

He Jiachen’s study, which is a translation work is an interesting analysis of good corporate governance in some of the top American Fortune 500 companies (Pfizer, GE, General Motor, Walmart, Exxon, Fluor, American Electric Power and others). It demonstrates how far behind the Chinese listed companies are in terms of corporate governance by comparison.

His work compares the mechanisms of corporate governance between China and the American companies and points out the vast differences in the functions of the board of directors, the pay scales of the managers, the various committees (audit, investment, remuneration) and how they function. He shows why some USA companies have achieved good corporate governance and points the direction that Chinese companies must go to achieve similar standards.

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He basically subscribes to the “shareholder value” model or the Agency model of corporate governance as being best suited for China. He points out how successful the model of corporate governance is in the USA and cites case studies from top American companies like Boeing, Walmart, Exxon and General Motors, but he fails to mention the institutional framework under which they operate. Those very same institutions which are the foundation of good corporate governance are just missing in China or if present are present in limited restricted form which hinders the practice of good corporate governance.

6.1 Cui Rupi “Corporate Governance - System and performance”

Cui’s book is basically a survey of articles on Corporate Governance written by Western academics. Cui approaches the topic from the historical viewpoint and charts Berle and Means articles on Ownership and Control, the growth of modern corporations and how it came to result in the separation of ownership and control. He next reviews the Cadbury Report on Corporate Governance – its inputs, origins into corporate governance in the UK. This is then compared with corporate governance in China. The corporate governance system in China is analysed and the role of independent directors examined. Problems of transparency and information disclosure are discussed.

The writer realizes that in order to have a sound system of corporate governance, it must be both applicable and practical. It is no use having a beautiful theory of corporate governance that does not work in practice. Cui concludes that China’s economy is a transitional economy and therefore it will take time to attain the standards of the western countries - the aim is to arrive at the UK/USA model of corporate governance which is based on “Shareholder Value maximisation.

Cui is a prominent intellectual in Chinese academic circles with strong connections to the CCP and yet his writings do not propose any strong remedies to China’s current corporate governance malaise. As in Hu Angang’s case, Cui merely describes the problems and suggests a bureaucratic response without examining why the problems exist in the first place.

7 Summary

The “Chinese Perspective on Corporate Governance” is based on the writings and publications of some leading academics and scholars in research and academic institutions. Their writings mainly are observations and studies on Western concepts and practices of corporate governance and its applicability to China. There is general consensus that the Agency Theory is the optimal model of corporate governance for China (Lu Tong, Cui Rupi, Wang Tianxi, Hu Ruyin) but there is also a desire for research on how the stakeholder theory may be applied to China (Hu Angang). As On Kit Tam has mentioned the Agency model is more applicable in open and free market economies where the institutions of good corporate governance already exist. That is not the case in China.

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The debate on corporate governance also centres on the privatisation debate: should China enact strong ownership laws and simultaneously fully privatise the SOEs as a means of completing the transition to a market economy and hence ensuring “proper corporate governance” or should China in the absence of strong institutional determinants rely instead on governmental controls of corporate governance. China has opted for the latter and while it may result in apparent deficiencies of corporate governance in some instances, it is “the next best solution.”

Our research as shown in the survey in chapter 5 indicate China’s corporate governance to be a model where the authorities implement changes on an incremental basis. If the incremental changes work, larger doses are applied. It is also a pragmatic model based on the needs of the economic system at the time of reform. Comparison may be made to Barry Naughton’s description of China’s gradual economic reform in the late eighties and early nineties as described in his book “Growing out of the Plan.”

We also analyse the evolution of corporate governance in China. We first consider the writings of various Chinese scholars who trace the problems of corporate governance to a few root causes: ranging from the historical legacy of the command economy \(^{(53)}\) (Hu Angang) to the problems associated with the transition to a market economy \(^{(54)}\) (Lu Tong). Our own analysis of the problems of corporate governance is that China has embarked on the gradualist approach towards the solution of its problems of governance. This approach is a better reflection of what is happening in China than the explanations for the problems of corporate governance in China.

Explanations given for the problems of corporate governance include the method of listing of the SOEs, the resulting new ownership structure of the SOEs and finally the institutional environment they operated in. Thus J. Chen and R. Strange wrote that as the listings of the SOEs resulted in new ownership structures (including minority shareholders) each category requires protection and satisfactory financial returns\(^{(55)}\). This view has the support of Hu Ruiyin, Director of Research at the Shanghai Stock Exchange who noted that China suffers from a legal framework with poor shareholder protection and advocated legislation to improve shareholder protection and stronger sanctions against violations of laws.

The lack of well established institutional determinants in China is another reason for the corporate governance problems in China and this is pointed out by L Jing, W Zhou and Y Tse\(^{(56)}\) who identified the problems of weak regulatory framework and enforcement and low business ethics in their paper entitled “Corporate Governance in China: Ethical & Legal Problems.” This view is reinforced by E. Leung, L Liu, L Shen & K Tab\(^{(57)}\) who observed that China needs to develop market based institutions in their paper “Financial Reform & Corporate Governance in China.”

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\(^{(56)}\) Jing, Lihua, Zhou Wenqun, Tse Yuen-ching “Corporate Governance in China – Ethical & Legal Problems” City University of Hong Kong Department of Economics Working Paper.

We observe that China has adopted an evolutionary path in its corporate governance structure. This evolutionary path is a gradualist approach and is characterised by pragmatic measures to meet problems of corporate governance as and when they arise. The measures are not driven by ideological or theoretical content but are designed to meet China’s own special needs and circumstances.

Corporate governance in China emerged as a key research area during the late nineteen nineties as the listed entities on the Shanghai and Shenzhen stock exchanges began to show severe symptoms of corporate misgovernance. Former SOEs which had been weaned and listed on the stock exchanges continued with their old practices showing scant regard for the principles of corporate governance that govern listed entities in the world financial markets. The result was that the Chinese stock exchanges became “like casinos” and highly speculative and volatile. Lack of transparency, information disclosure, insider trading, non arms length transactions, oppression of minority shareholders became the norm. Corporate governance measures and directives were enacted as Chinese authorities realised that robust corporate governance was essential to a modern enterprise system.

However, there was no healthy open debate on which model of corporate governance should be adopted for China. In the European countries there would have been heated debates arguing the pros and cons of each model before a consensus was reached. In China there was no discussion but the directive came from “bureaucrats up above” that the “shareholder value” was preferred and everybody down below including the academics and scholars hastened to follow suit.

My conclusion is that China has been saddled with a model of corporate governance which may not be entirely suitable to its needs. However, it is now the duty and responsibility of the Chinese bureaucracy to make it work. This means that there will be more changes probably along the evolutionary path as stated by Hu Angang and Lu Tong. The reform of Chinese corporate governance will follow the gradualist path that Barry Naughton has outlined for the earlier decades of Chinese economic reforms by focusing on practical measures rather than on theoretical breakthroughs. The next chapter deals with the practice of corporate governance in China.

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Chapter 3

Practice of Corporate Governance in China

1 Introduction.

Corporate governance is the study of how companies are governed and the phrase “Corporate Governance in China” conjures up many negative images. Images of badly managed companies, of virtually bankrupt state owned enterprises (SOEs), of massive portfolios of non performing loans (NPLs) of the state owned banks (SOBs) and finally of the lack of the “Rule of Law” as understood in the Western democracies. What are the reasons for this negative images? How did it happen and what can be done to alleviate these problems?

The Chinese government, the bureaucrats, business and political leaders are aware of these unflattering perceptions and yet they remain. As China continues the transition from a command to a market economy, unless these problems of corporate governance are fixed, China will continue to suffer from misallocation of scarce economic resources, from fraud and misappropriation, from inadequate risk protection and poor credit evaluation which will be reflected in non-performing loans, ailing SOEs and a moribund stock market.

This chapter investigates China’s corporate governance and its nexus with China’s economic reforms. What were the aims of the economic architects when planning the reforms? How did economic reforms impact on corporate governance and vice versa? As an economy in transition, were the corporate governance measures adopted suitable or adequate to meet the challenges faced?

In this context we analyse the evolution of corporate governance in China. We first consider the writings of various Chinese scholars who trace the problems of corporate governance to a few root causes: ranging from the historical legacy of the command economy (Hu Angang) to the problems associated with the transition to a market economy (Lu Tong). Our own analysis of the problems of corporate governance is that China has embarked on the gradualist approach towards the solution of its problems of governance. This approach is a better reflection of what is happening in China than the explanations for the problems of corporate governance in China.

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The Bank of China disclosed its NPLs reached 12.4% of total assets in 2000 using international standards.


shareholders) each category requires protection and satisfactory financial returns\textsuperscript{61}. This view has the support of Hu Ruiyin (Director of Research at the Shanghai Stock Exchange) who noted that China suffers from a legal framework with poor shareholder protection and advocated legislation to improve shareholder protection and stronger sanctions against violations of laws.

The lack of well established institutional determinants in China is another reason for the corporate governance problems in China and this is pointed out by L. Jing, W. Zhou and Y. Tse\textsuperscript{62} who identified the problems of weak regulatory framework and enforcement and low business ethics in their paper entitled “Corporate Governance in China: Ethical & Legal Problems.” This view is reinforced by E. Leung, L. Liu, L. Shen & K. Tab\textsuperscript{63} who observed that China needs to develop market based institutions in their paper “Financial Reform & Corporate Governance in China.”

In summarising, we observe that China has adopted an evolutionary path in its corporate governance structure. This evolutionary path is a gradualist approach and is characterised by pragmatic measures to meet problems of corporate governance as and when they arise. The measures are not driven by ideological or theoretical content but are designed to meet China’s own special needs and circumstances.

The chapter is in two parts: Part 1 looks into the Corporate Landscape in China while Part 2 examines the practice of corporate governance in China.

4 Corporate Landscape in China

China’s business landscape today comprises the state and private sector with the private sector rapidly gaining prominence. The private sector currently accounts for about 60\% of China’s total industrial output and comprises family businesses, privatized town and village enterprises, privatized small and medium SOEs, joint ventures and wholly owned foreign companies. As this sector is subject to free market forces it does not enjoy the soft budget constraint that SOEs do and to a large extent do not suffer from the corporate governance issues elaborated in the following pages. This chapter analyses the corporate governance problems which are symptomatic of the larger SOEs and listed entities on the Stock Exchanges in Shanghai and Shenzhen.

The listed entities and SOEs in China today practice a mixture of old and new corporate governance. On the one hand, there are the traditional concepts based on \textit{Guanxi} and \textit{Li}\textsuperscript{64} which can be translated as “propriety” and \textit{renqing} which can be translated as “reciprocity.” These concepts are woven into the fabric of commercial financial systems.


\textsuperscript{62} Jing, Lihua, Zhou Wenqun, Tse Yuen-ching “Corporate Governance in China – Ethical & Legal Problems” City University of Hong Kong Department of Economics Working Paper.


\textsuperscript{64} One of the 5 virtues propounded by Confucious: the others being Ren (benevolence) Yi (righteousness) Zhi (wisdom) and Xin (sincerity)
and social life in China right up to the first half of the twentieth century. Guanxi or networks are a response to and substitute for weak state and economic institutions.\textsuperscript{65}

The adequacy and the ability to raise capital is one of the main reasons for the success of any enterprise. In China this process has evolved over the decades. Under the command economy the state provided the credits and absorbed the profits and losses of enterprises. However, with economic reforms, the central government found it increasingly difficult to finance new projects from public reserves as fiscal revenue declined as a result of decentralisation. From 1978 to 2001, fiscal revenues declined form a surplus of 1 bns RMB to a deficit of 251.7 bns RMB in 2001.\textsuperscript{66}

How and why did corporate governance issues arise? With economic reforms in the late nineteen eighties in full swing, the need to have a system to reward corporate managers became more urgent with the contract system in place then. This system was prone to manipulation and corruption as there was a two tier marketing system. This system was abandoned gradually in favour of corporatisation and the listing of the SOEs. With the listing of many SOEs in the nineties and lax supervision by the CSRC, corporate governance resounded loudly as fraud and misappropriation became commonplace. Corporate governance issues therefore arose out of the need to control and stamp out the rampant fraud, corruption and misappropriation that became commonplace in the nineties.

And so, the Shanghai and Shenzhen Stock Exchanges were set up in 1990\textsuperscript{67}. Initially regulated by the Peoples’ Bank of China, the regulatory functions were transferred to the China Securities Regulatory Commission which was set up in 1992. Soon after, the Company Law was promulgated in 1994. China’s Companies Law was based on the Anglo American model as it was seen as the most successful in the Western hemisphere. Residual and ultimate powers resided with shareholders through their shareholders’ annual and extraordinary general meetings although boards of directors and the CEO were given powers to carry out their duties. The Supervisory Board comprising representatives from the management and employees sat on top of the Board of Directors as per the German model but unlike the German model it did not have representatives form the Trade Unions.

The Companies Law specifically transferred powers and rights within a business enterprise to the board of directors, the supervisory board, the shareholders meetings and the managers. This was thus a clear attempt to separate ownership and control and to substantially reduce the power of the local committees of the CCP, the labour unions and the workers congress.

The “new model of corporate governance” that China attempts to practice today is thus a derivation of the agency theory of corporate governance and is based on the Anglo American system. The Agency theory of corporate governance postulates the separation of ownership and control with the principals as the owners and the corporate managers as their agents. In the UK/USA context, where there are free

\textsuperscript{66} J Chen & Strange, R: “Evolution of Corporate Governance in China,” Research Paper 025, King’s College London,April 2004
\textsuperscript{67} CSRC Year Book 2004 Page 3 Para Line 1
market forces in operation, this theory allows both principal and agent to maximize their own individual utility\textsuperscript{68}; with the shareholders wanting to maximize profits and the managers wanting to maximize their financial rewards.

Schleifer & Vishny in their paper “A Survey of Corporate Governance”\textsuperscript{69} declare that “corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” In other words the emphasis is on the shareholder value perspective. Unfortunately in the Chinese context, this shareholder value perspective does not hold true. As D Clarke in his paper “Corporate governance in China: An Overview”\textsuperscript{70} postulates, the purpose of listing SOEs was “not to maximize profits but to raise funds and retain state control.” In China where the agents (managers) do not enjoy commensurate financial rewards for superior performance and the principals (the state) do not seek to maximize profits, it has been argued that the Anglo American theory of corporate governance is not appropriate.\textsuperscript{71} The Chinese corporate managers of listed entities are paid salaries somewhat similar to state bureaucrats and many aspire to be transferred to state or provincial positions.

The model of corporate governance adopted in China was a decision made by the Chinese authorities without general discussion and consultation with interested parties as to which might be the most appropriate model to adopt. Corporate considerations demanded that the agency model be adopted although bureaucratic reasoning would suggest that in China’s case, a more sanguine model of corporate governance would be the stakeholder model. However, it would appear that in this instance corporate considerations won over bureaucratic reasoning.

Why does the Agency model not work in China? Adam Smith in his 1776 scholarly work “The Wealth of Nations” theorised that the workings of the free market forces are able to bring about optimum supply and demand in the economic equation because of the workings of the “unseen hand.” This practice in the UK/USA is strengthened by the workings of free market forces as buttressed by strong domestic institutions and property rights. Thus the Agency theory of corporate governance works best in a free market with a strong and comprehensive legal framework - a market that facilitates takeovers and acquisitions and when enterprises do not perform, they are either sold off or their corporate managers dismissed. In the UK/USA there is also a large and active capital market with many players all effectively contributing to the free market forces and seeking to maximize their own individual profitability by buying or selling profitable or loss making companies. In China there is no such presence.

Boards of Directors in the UK/USA are governed strictly by codes of ethics, laws on fiduciary and corporate responsibilities. There are also independent directors appointed who are genuinely independent and look after the interests of their constituency. In China, the board is usually dominated by internally appointed


executive directors and the genuineness of the independent directors is at best
doubtful\textsuperscript{72} as many are cronies and former associates of the corporate managers.

Margaret Blair in her paper “Ownership & Control: Rethinking Corporate
Governance in the 21\textsuperscript{st} Century” \textsuperscript{73} poses the question “Whose interests should the
corporation serve?” and goes on to examine the “socially responsible corporation.” In
this respect, her observations on corporate governance are more applicable to China
where the enterprise is governed in the interests of various parties who have an
interest in the company including not only the managers and the shareholders but also
the creditors, employees, consumers and the society at large. China’s corporate
governance practice is closer to the Stakeholder – society model of corporate
governance than the agency model. The stakeholder model is usually regarded as
being practiced in Germany and Japan.\textsuperscript{74} However it must be admitted that China does
not possess the basic institutions that are also common to both Germany and Japan – a
comprehensive legal framework, well regulated stock markets and strong financial
institutions (banks) who play an important role in monitoring good corporate
governance in the listed companies.

Another viewpoint is that China is an economy in transition and as such corporate
governance practices reflect this scenario. To achieve the optimum agency model of
corporate governance would require not only the workings of the free market forces
but also the privatization of the vast majority of the SOEs, something which may be
anathema to the State in the current context. What is currently being practiced is
therefore a model of corporate governance which has been described as “the control
model.”\textsuperscript{75} This is because the State owns the controlling interest of the vast majority
of the listed entities which allows the government to play a pervasive role in corporate
governance. Hu Angang and Hu Guangyu both agree that China is an economy in
transition and the corporate governance model merely reflect this scenario. However,
various building blocks are in place for the establishment of better corporate
governance and they should be seen in this light. They suggest that as China makes
the transition to a fully fledged market economy, corporate governance will improve
to simulate the Western models.

3 Corporate Governance in China – The Practice.

The above section investigates the theory of corporate governance in China. What has
the result been? Has it been effective? If not why not? This investigation finds that the
practice of corporate governance in China to date has been dismal and the results have
been disheartening. The conclusion suggests that China strengthen the domestic
institutions that can strengthen free market forces and encourage good corporate
governance from a bottom up rather than just from a heavy handed top down
approach which has been the case over the last decade.

\textsuperscript{72} The CSRC issued ruling that as from 1-1-2003 one third of all directors must be independent. “Code of
Corporate Governance for listed companies in China.” CSRC, Beijing, 7\textsuperscript{th} January 2001
\textsuperscript{73} Blair, M. “Ownership & Control: Rethinking Corporate Governance in the 21\textsuperscript{st} Century” Copy right
presented at conference “Corporate Governance in Perspective: Diversity or Convergence.” Tokyo,
Japan. 9\textsuperscript{th} Jan 2003.
\textsuperscript{75} Chen, J & Strange, R: “Evolution of Corporate Governance in China.” Research paper 25, Kings College
Scholars generally agree that for good corporate governance to prevail, there should be a strong legal and regulatory system in place. La Porta et al postulated that the legal regulatory framework of different countries provided a basis for the sound understanding of the corporate governance issues faced. The question may be asked: why China had a relatively undeveloped legal and regulatory system when economic reforms began in the late nineteen seventies. In 1978, China had no Commercial Law Code, there was no contract law, company law, securities law, bankruptcy and liquidation laws. Why? It all dates back to history - China developed as a relationship based society with the general population having an ingrained aversion towards the law courts and the judicial system. During the planned economy phase from 1949 to 1978, such commercial laws were totally unnecessary.

In 1949 the CCP assumed the mantle of supreme power. There was no separation of powers between the legislative, the executive and the judiciary as had developed in the western democracies which eventually led to good corporate governance. In China the judiciary often operated as an arm of the executive and the local law courts are still subordinate to the local party committees which allows local party committees to provide some political guidance which the local courts can hardly oppose. Another form of interference is the party’s political and legal affairs committee which controls the legal system by reviewing the local legal matters and often times reviews local cases with judges before they come to court.

China’s legal reforms of the Capital Markets were augmented by three key pieces of legislation which impinge on corporate governance: the Companies law, (passed 1994) the Securities Law (passed 1998) and the Securities Investment Fund Law (passed October 2003). As at 31 December 2003, there were in excess of 300 pieces of regulations, guidelines and codes governing securities and futures markets based on the principles of “transparency, fairness & justice.” These sentiments however may be construed more as a statement of intent than of fact. There is currently a heavy top down approach with many laws and regulations being enacted, regulatory bodies being set up to measure, monitor, adjust and control all aspects of corporate activity. The result is that straitjackets are imposed on the legal and corporate framework under which enterprises operate.

In order to protect investors, both the Companies Law and the Securities Law provide for priority of settlement of civil compensation claims. Article 207 of the Securities Law provides that “Violations of this law shall be liable to civil compensation and such penalties shall have priority over other claims.” Article 63 of the same law states that “Any issuer, underwriting agency that has falsified records, made misleading statements or major omissions in its prospectuses, financial and accounting...
statements, reports and documents required for listing, mid-year and annual reports

The Companies Law of the PRC also states in Article 63 “Directors, supervisors and
the manager shall be held liable for compensation if they violate laws, administrative
rules and regulations of the articles of association in performing their duties cause
damage to the company.”

Why then is it that in spite of the above strong language enshrined in law that
minority shareholders’ rights continue to be trampled upon; that there is frequent
misrepresentation in IPO documentation and that legal actions by investors are few
and far in between? The reason is because the system is stacked against them.

The following are some of the examples:

• The Securities Law of 1998 does not have provisions for civil compensation
arising from insider trading and manipulation of the stock market. Hence
defrauded investors find it difficult to take legal action. They have to take legal
action under General Procedures for Civil Law of the PRC which is a loose piece
of legislation.
• The judicial courts have no experience of hearing civil compensation cases and
judges have little knowledge of procedural and related and technical accounting
matters. The Companies Law and the Securities Law were only passed in the
nineteen nineties.
• Currently the onus of proof and presentation of evidence lies with the plaintiff.
The procurators in the Chinese courts are under resourced and normally do not
carry out investigations, unlike in the USA and UK/ Australia where the Attorney
General’s Office will step in and investigate commercial fraud cases together with
the help of the police. As the plaintiffs are usually individual minority
shareholders, they have little or no resources to collect the data and evidence
required to plead their case. Courts and quasi government organisations are also
often reluctant to assist in such matters.

The Rule of Law as it exists in China today is therefore quite different from our
understanding of the concept in Western democracies. There are laws and there are
rules but because of the widespread practice of “guanxi” and “renqing” it would be
more accurate to designate China as being under the “Rule of Man” rather than under
the “Rule of Law.”

3.1 Politicized Capitalism

China is a command economy in transition to a market economy. The model of
corporate governance practiced must from necessity also evolve from what was once

81 The EU has facilitated some progress in this area by sponsoring training programs for lawyers,
judges and legal personnel under the EU-China Legal & Judicial Cooperation Program 2000-2005.
http://www.legaljudicial.org: Details of the European Union’s judicial assistance program to China.
82 In the USA & Australia, the regulatory bodies viz SEC & ASIC also have civil punitive powers. Websites:
a command and control structure to a more market oriented model. The State which was once in complete control of enterprises is loathe to lose control and yet this is necessary for a free market economy to function effectively. Hence the corporate governance model in China contains and combines aspects of both models.

The model of corporate governance that best describes the practice in China today has been described by Nee & Opper as “Politicized Capitalism.” In their paper on “Economic Transformation in Post Communist Societies.” Nee & Opper describe this type of economic order as a hybrid model where the State sets the regulatory framework and remain directly involved in guiding transactions at the enterprise level. It best describes a command economy in transition to a market economy where hybrid institutional order comprising elements of the old order combine with new organisational practices oriented to a market economy.

4 Why listing did not improve Corporate Governance

The first companies to be listed were all SOEs and they were allocated to various provinces on a quota basis. Provincial bureaucrats thus decided which SOEs to list and those chosen were those in most need of funds. Listing of SOEs was thus a highly charged political process and roughly only a third of the share capital of SOEs was listed on the stock exchange. Again after listing many of the SOEs had to siphon some of the funds to their controlling shareholder and engage in related party transactions. And lastly the State did not want to give up control of the listed SOEs and embrace full privatisation. All these meant that corporate governance did not improve after listing.

When the Chinese Companies Law was promulgated in 1994, power within the SOEs devolved from the local committee of the CCP to the management, the board of directors, the board of supervisors and the shareholders meeting. Nevertheless there was ambiguity as Article 17 of the Companies Law states that “the activities of the local branch of the CCP in a company shall be carried out in accordance with the constitution of the CCP.” As a result the local committee of the CCP was able to cling on to vestiges of its former power.

In addition, article 31 subsection 7 of the CCP constitution explicitly assigns the local party committee to “supervise party cadres and any other personnel to ensure that they strictly abide by the state laws and the administrative disciplines and refrain from encroaching on the interests of the state, the collectives and the masses.” This clause gives the local party units the right to interfere and supervise personnel in the companies. There is therefore a lack of autonomy in the listed entities.

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The lack of autonomy in the listed SOEs is borne out by research and S. Opper, S Wong & R Hu write in their article “Party Power, Markets, & Private Power: CCP Persistence in China’s Listed companies” that there is still a degree of interference in the management decisions of the listed SOEs by the CCP. In addition E Chang and S Wong in their paper on “Corporate governance, Political Interference & Corporate performance of China’s Listed companies” offer evidence that political interference in the company decision making process negatively affects their performance. And finally S. Opper, S Wong & R Hu find in another article “Depolitisizing China’s Listed companies” that ownership reform has impacted the level of political interference. Their conclusion is that there are beneficial effects of privatisation on the enterprise depolitisation process. Specifically holders of legal shares and A shares are able to reduce the level of political interference – the former by using the “voice channel” and the latter by using the “exit channel.”

Thus, although the Company Law of 1994 clearly transfers much of the decision making powers of the listed SOEs to the Board of Directors and the management and yet, the local committee of the CCP still manages to retain some influence over the decision making process of the listed SOEs. It is likely that this will continue for some time to come as S.Opper and V. Nee have described this practice as “politicised capitalism”

5 How Companies are listed

Typically an SOE chosen for listing is a large diversified group and because SOEs traditionally provide a plethora of services including schools, hospitals, nurseries, housing, these have to be hived off and only the profitable parts listed. The unprofitable and social services are hived off into the parent company.

Because all this results in “an artificial and newly created entity” the CSRC allows the entity to use pro-forma accounts: accounts prepared as if the entity had been in existence for a number of years. Often the parent and the listed companies are in similar or allied businesses and the listed entity depends on the parent company for a large portion of its profitable operations. There is thus an incestuous relationship which continues well after listing.

Typically, the share price of the listed company shows a big price increase in the first year because the IPO offers the shares at a discounted price. Then the share price begins to slide in the second year and by the third year it is often in free fall. Such volatility of share prices is extremely unhealthy and of course deters long term investors. In fact statistics show that the average term of investors is less than 6 months.

88 Chang, Eric & Sonya Wong “Corporate governance, political interference & corporate performance in China’s listed companies” Hong Kong University working Paper March 2002
The CSRC has come out very strongly against such relationships and has also warned promoters and securities firms that they are responsible for the profit claims and projections of IPOs and if performance of listed entities does not match the prospectus, then they will be penalised.

In western market economies, the market place is the determinant for which companies get listed and there are a whole host of intermediaries, including merchant banks, law firms, brokerage houses, underwriters, accounting firms etc who then assist the applicant in its listing process. However, in China, many of these intermediaries are missing (or if present not well developed) and the CSRC has the unenviable task of approving applicants for listing. Thus the CSRC has set up a Public Offering Review Committee who will review and recommend all applications. This committee has 25 members, of whom 5 are from the CSRC and the other 20 being external experts. Their recommendations are usually accepted by the CSRC so the Review Committee is the defacto decision making body.

Being a government entity the CSRC has tried to be even-handed. The result was that the vast majority of the listed companies are SOEs with representation from each and every province. Often those SOEs listed were not the most eligible, but they were those with the greatest need for funds and corporate governance as selected by the provincial governments. However, the CSRC now claims that applicants are now evaluated by the Public Offering Review Committee on a merit basis.

As at Dec 2003, Shanghai has the most listed entities at 144, followed by Jiangsu at 81, Shenzhen at 77, followed by Beijing at 76 and Shandong at 69. The top 5 areas thus account for almost 35% of the total. However even remote provinces like Tibet have 8 listed companies, Qinghai with 9, Xinjiang with 26 and Inner Mongolia with 20. One can only come to the conclusion that there are political considerations in the listing process.

6 What are the objectives of Listing?

One of the major purposes of a stock market is to assist in the efficient allocation of resources which in this case pertains to the raising of capital for companies. In a free market economy this is done by the market place which ensures that companies that seek to raise capital are profitable and have a credible track record. However, in China this is not the case and as Mary Cooper has pointed out rightly there are other considerations including the following:

- As a means of maintaining employment
- As a means of building political support
- As a means of getting rid of loss making SOEs
- And lastly as a means of encouraging economic growth.

89 “China’s Securities & Futures Market”: Publication by CSRC, April 2004.
It is important that the reasons are clear to the regulators and these reasons should also be made clear to the investing public. In the western free market economies, the *raison d’etre* of the listed entities is clear: it is to maximise shareholder value and it is the duty of the Board of Directors to ensure that this is done. If it is not done the directors and CEOs may be removed.

In China the danger is that while the protagonists may proclaim loudly that they too are following market dictates and desire profit maximisation, the reality is somewhat different.

7 Regulatory Bodies in China


Did these three regulatory bodies engage in any debate or have any input into which model of corporate governance is best suited for China? No there was no debate at all on the matter and this is another example of China’s “top down” approach in government matters. This happens because the bureaucracy exerts so much power and the general populace is also very docile. The lack of debate typifies China’s bureaucratic authoritarianism which also indicates the lack of freedom of speech and freedom of the press.

The CSRC and the CBRC both play very important economic roles as the CSRC regulates some 1300 listed companies whose total market capitalisation as a percentage of GDP stood at 36.4% \(^91\) (31-12-2003) while the CBRC regulates the banking industry. China’s SOBs and their NPLs are shown in the table below. S & P in 2002 estimated the write offs required of China’s NPLs to be at RMB 1.1 trillion or US $518 bns – approximately half of China’s GDP as at 2001.\(^{92}\)

<table>
<thead>
<tr>
<th>RMB Bns</th>
<th>Outstanding Loans</th>
<th>NPLs tfr to AMC</th>
<th>Remaining NPLs</th>
<th>NPLs as % of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial Commercial Bank</td>
<td>2414</td>
<td>410</td>
<td>796</td>
<td>42.7</td>
</tr>
<tr>
<td>Agricultural Bank China</td>
<td>1484</td>
<td>346</td>
<td>490</td>
<td>45.7</td>
</tr>
<tr>
<td>Bank of China</td>
<td>1378</td>
<td>296</td>
<td>394</td>
<td>41.2</td>
</tr>
<tr>
<td>China Construction Bank</td>
<td>1386</td>
<td>280</td>
<td>394</td>
<td>40.4</td>
</tr>
<tr>
<td>Total</td>
<td>6662</td>
<td>1332</td>
<td>2074</td>
<td>42.5</td>
</tr>
</tbody>
</table>


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\(^{91}\) China’s Securities & Futures Markets : Publication by CSRC, April 2004 page 3

8.1 The CSRC.

Mandated in 1992 by the State Council to establish good corporate governance in the listed entities, the CSRC has patently failed in its role of supervising and regulating the Shanghai and Shenzhen stock markets. The fact that the stock exchanges of Shanghai and Shenzhen are seen by many investors as casino like institutions and further that the stocks are trading at a eight year low as at 1st June 2005 (Shanghai composite index fell to 1039) in spite of strong economic growth over the last decade is a damning indictment of the efficacy of the CSRC and its activities since inception.

Financial Performance and Corporate Governance of SOEs after listing

How have SOEs performed after listing? Have they performed better financially? Have they shown better corporate governance? Studies show however that this has not happened. In a study funded by the World Bank, Wang, Xu & Zhu found that between 1990 and 2000 the financial performances of SOEs deteriorated after listing. Table 1 below shows that, after listing, average return on assets dropped from 19.6% before listing to 2.7% in the 6th year after listing. The average return on sales also dropped from 16.6% before listing to 0.2% in the 6th year after listing. Also capital expenditure as a percentage of total assets dropped after listing.

Table 1 Selected mean performance statistics of listed SOEs

<table>
<thead>
<tr>
<th></th>
<th>Year -1</th>
<th>Year 0</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>19.6%</td>
<td>15.4%</td>
<td>9.7%</td>
<td>19.6%</td>
<td>2.7%</td>
</tr>
<tr>
<td>ROS</td>
<td>16.6%</td>
<td>16.2%</td>
<td>19.6%</td>
<td>13.76%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Capex/Sales</td>
<td>74.3%</td>
<td>57.7%</td>
<td>19.6%</td>
<td>43.1%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Sales growth</td>
<td>28.7%</td>
<td>47.8%</td>
<td>19.6%</td>
<td>10.5%</td>
<td>16.5%</td>
</tr>
</tbody>
</table>


The post IPO financial performance of SOEs has also been disappointing. In 1999 of the 90 companies that were listed only 25 met their forecasts in the IPOs. In addition although the CSRC issued a set of guidelines in June 2000 called “Announcements Regarding Listed Companies Loan Guarantees for Others” prohibiting such actions, yet a year later New Fortune reported 159 new cases totalling RMB 23.1 bns which were disclosed in 2001.

8.2 The CBRC

The China Banking Regulatory Commission was set up in April 2003 when the regulatory functions of the PBOC (People’s Bank of China) were hived off from the central bank and a separate regulatory body set up. As the main source of funding for

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93 Ibid .pp 16
business enterprises is still mainly through banks, their regulation is extremely important. China’s four major banks – (BOC, CCB, ABC, ICBC) hold more than 60% of the country’s banking assets.

The main function of the CBRC is to transform the domestic banking system and place it on a sound basis. This can only be done when the existing NPLs are substantially reduced and when there is established in place a credible system of credit evaluation and risk protection. Bureaucrats hope to achieve the twin goals by commercialising the SOBs and to list them on the Stock Exchanges of Hong Kong, London or New York. The process has already started with the government injecting US$45 bns into the BOC and the CCB in late 2003 to capitalise their reserves and to prepare them for listing.

So how has the performance of the CBRC been since inception in 2003? It was established because the PBOC had obviously failed in its duty to ensure the integrity of the domestic banking system with the virtually bankrupt SOBs and their massive NPLs. The jury is still out on the CBRC (it was only established in 2003) but it must act fast and hard if it is live up to its mandated objectives.

The general conclusion is that the CBRC has been a regulatory body executing the government’s directives and policy lending initiatives but it has not played an effective role in improving corporate governance of the Banking institutions. This role has been left largely to the CSRC and the stock exchanges on which the Banks are listed.

8.3 The CIRC (China Insurance Regulatory Commission)

This commission was established in November 1998 when the regulation of insurance companies was detached from the PBOC to the CIRC. Today it supervises the business activities of all insurance companies in China. The China Insurance Company and Ping An Insurance are the major local insurance companies but life insurance licences have been issued to many large international insurance companies too. The insurance companies currently have a limited presence on the stock market – less than 9% of their investments are in stocks. It is anticipated however that in the years ahead their presence will be much greater.

The CIRC does not play a role in establishing, implementing or improving corporate governance and this role is left entirely to the CSRC.

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96 Takeshi, J: “Moving Forward in Reforming China’s Capital Markets.” Nomura Research Institute. January 2003 pp2 finds that bank borrowings account for some 70% of total funds raised by business enterprises.


99 Tenev, S & Zhang, C. “Corporate governance & enterprise reform in China.” World Bank, 2002 pp 113
9 Current Corporate Governance Issues

What are the current corporate governance issues faced today in China? A list of the problems would include the following:

- High state ownership of listed entities
- Interference by controlling shareholders and local CCP party committee
- Oppression of minority shareholders
- Related party transactions resulting in fraud and misappropriation
- Weak creditor rights
- Lack of transparency and information disclosure
- Lack of uniformity of accounting standards
- Lack of media independence and press freedom

After over two decades of economic reform, the State still plays a dominant role in the ownership stakes of the economy. Tenev & Zhang in their authoritative work on “Corporate Governance & Enterprise Reform in China” surveyed data in 1999 indicating that for the listed companies, the three largest shareholders held on average 59% of the total shares with the state being the major shareholder.

The impact of the high State ownership means that there is practically no chance of there being any opportunity of mergers and acquisitions without State blessing. The workings of the free market place do not exist in China where non performing listed entities are not subject to the takeover threat as would be in the case in the USA/UK and Australia.

The consequences of state control in China are many and negative. First of all the senior management of the listed entities are appointed by the State. Secondly their remuneration and career structure are determined by these same bureaucrats and lastly as a result of the above two determinants, the managers of the listed SOEs take their orders from the controlling shareholders. They do not take into consideration the interests of minority shareholders when making corporate decision. This is an example of the Agency Theory of Corporate Governance gone awry: there is no separation of ownership and control.

It is generally agreed that the presence of large and substantial institutional investors will bring along stability, expertise and better corporate governance. To this end in December 2002, new regulations to allow for the Qualified Foreign Institutional Investors (QFII) were promulgated and as at end December 2005, thirty two overseas financial institutions had been licensed with an investment quota of US$5.65bns.100

However, in spite of the QFII scheme, the stock markets have continued to face problems of corporate governance and prices have languished. The anticipated influx of professionals including securities analysts, merchant bankers, stockbrokers, corporate lawyers, auditors, accountants, mergers and acquisition specialists etc did not occur. Such professionals would be mature users of financial information and monitors of good corporate governance.

100 Please see Chapter 5 Table 1 for details
China currently has only weak creditor rights. Although the Bankruptcy Law was promulgated in 1986 it has been seldom brought to bear and most listed companies are repackaged or bought over when insolvent. In addition, bankrupt companies are required by law to give preference in the liquidation proceedings to workers rights and pension entitlements. This has weakened the position of Banks considerably and they therefore do not play a strong role in corporate governance.

Transparency and timely information disclosure is a tool of corporate governance. By letting the public know the latest up to date financial position of the company, investors are able to interpret and act accordingly. In so doing the management ensures that there is no information asymmetry and the free market forces are able to respond appropriately.

10 Summary

The three regulatory bodies CSRC, CBRC and the CIRC are regulatory bodies. However the CBRC and the CIRC do not perform any role in regards to the establishment, implementation or improvement of corporate governance. This is left entirely to the CSRC which was mandated to regulate all listed entities. How effective has the CSRC been in improving corporate governance? The answer is very negative. It has failed to do so.

In the western economies which allow for free market forces, there is good corporate governance. It has come about not because of authoritarianism or monopolistic control by governments in power. Good corporate governance exists in these economies because of the plethora of institutions, both financial and non financial, governmental and non governmental that have been built up over the decades, each adhering to its own high standards of excellence and professionalism. It is the sum total of standards of corporate behaviour exhibited by corporate managers, of standards of general morality of the people and of what is construed as acceptable and unacceptable corporate behaviour in a society.

Good corporate governance will not happen overnight in China – but it is too important a role to leave to a few regulatory institutions. China currently professes to the Anglo American model of corporate governance but the institutions and market forces that allow the working of the free market economy are not present.

The Corporate Governance reforms that have been instituted in China to date are all “Top Down” measures – rules and regulations that have been promulgated by the government and the various regulatory bodies. It is important to not only to have the “top down” approach but also to encourage corporate governance from the “Bottom Up” perspective as well.

When the State’s role is progressively reduced by building up strong local domestic institutions which strengthen free market forces, good corporate governance will become the norm. Meanwhile the model of corporate governance practiced in China today is best described as “Politicized Capitalism.” This is a hybrid system where elements of the old socialist order are combined with the practices of the new organizational practices to meet the demands of a transitional economy.
The British and American economies practice the agency theory of corporate governance and China is attempting to do so likewise. However, the Chinese economy does not share the same institutional parameters that facilitate good corporate governance. These institutional determinants will be examined in Chapter four.
CHAPTER 4

INSTITUTIONAL DETERMINANTS

1 Introduction - New Institutional Economics

One of the key messages of New Institutional Economics is that not only do firms matter in the economic production equation but that institutions are important too. R Coase argued that firms, institutions and other economic organizations exist because agents find in them a useful means of minimizing transaction costs.\(^{101}\) In fact it is the institutions like the legal system, the political system, its social system and its educational system that govern the performance of an economy.\(^{102}\) In addition R. Coase postulated the theory of property rights which was further developed by H Demsetz who stated that the institution of property rights was a necessary precondition for the efficient functioning of markets. New Institutional Economics is thus concerned with the choice of a governance structure of economic participants under a given institutional environment as well as with the effects that various institutions have on economic performance. According to Postma, T & Hermes, N "the strengthening of the formal institutional setting and in particular the corporate governance institutions is crucial to further enhance the process of economic transition of the country."\(^{103}\)

Institutions are usually articulated in formal terms and would be laws, property rights, regulatory bodies and organizations set up to assist in the efficient allocation of resources within an economic system. They may impact at both the internal and external level of the corporate entity. M Roe in his paper on the Institutions of Corporate Governance\(^ {104}\) goes so far as to define institutions as the mechanisms that allocate authority among the directors, managers and the shareholders of the firm. Decision making and accountability therefore can rightly be construed as a formal institution of corporate governance. In this chapter we have interpreted institutions to include the practices of accountability and corruption which impact on corporate governance.

Why are institutions important? They are important because they set the standards for business activities, for transaction costs in corporate enterprises. In well defined and well regulated market economies, institutions reduce transaction costs, extend the time frame of economic contracts and bring certainty to an otherwise unstable economic environment.\(^ {105}\) In other words institutions facilitate business activity and the transaction costs of doing business are reduced. Imagine a scenario where property rights are not adequately structured; where the rights of ownership and

\(^{101}\) Coase, R. “The nature of the firm.” *Jnl Economica.* Nov 1937 pp 386-495
control are subject to the whims and fancies of lackadaisical regulators and a corrupt judiciary. Imagine a further scenario where contracts are weakly protected, where the sanctity of law is askew, where information is asymmetrical and transparency is absent. All these conditions indicate weak institutions and they result in fewer transactions, to less capital investments and to less business activity. - where would all this lead to? Corporate mis-governance of course!

It is emphasized that the lack of good corporate governance however cannot be attributed entirely to the relationships or the contradictions within the corporate entity; in addition the macro level and the external determinants must also be considered. This chapter looks at institutional determinants that impact on corporate governance at both micro and macroeconomic levels.

2 Corporate governance in China

What impact have institutions had on corporate governance over the last two decades? How do the Chinese institutions compare with their Western counterparts? How successful have they been? What are the reasons for their success or failure?

Generally speaking, institutions in China have been playing “catch up” in response to the monumental changes in the economic landscape brought about by reforms. In retrospect, it was inevitable that the cart came after the horse because the Chinese authorities’ reform strategy was to experiment – to let the horse out of the stables and when it cantered to harness it to a cart. When the time for harnessing came however, there was often little or no time to choose a suitable cart to complement the runaway horse and so a bumpy ride resulted. But the point made here is that the rough ride encountered came not only from the lack of synchronization of the cart to the horse but also from the pathway that the horse was galloping along^{106}.

This chapter examines the impact of institutions on governance issues and draws on the World Bank survey of 175 countries carried out by Kaufmann D, A Kraay, & M Mastruzzi which shows the governance index from 1996 to 2004^{107}. Comparisons are made for China and relevant countries.

These institutional determinants are referred where possible back to Chapter 2 where the Chinese perspectives of corporate governance are analysed in context.

- Voice and Accountability
- Political stability
- Government effectiveness
- Regulatory framework
- Rule of Law
- Control of corruption

^{106} Two examples of this analogy are: The CSRC the regulatory body for listed entities came into existence being mandated by the State Council in 1992, two years after the stock exchanges in Shanghai and Shenzhen opened for business. The Corporations Law was passed by the NPC in Dec 1993 although the process of corporatization of SOEs had commenced in the late eighties.

^{107} See Tables 1 to 8 in this chapter.
The above six are the institutions of governance which were evaluated by the above mentioned World Bank Survey. These six measures are based on 17 separate sources of subjective data on perceptions which represent aspects of governance. Governance is defined as “the traditions and institutions by which authority in a country is exercised.” The following paragraphs will explain how these six institutional determinants of governance impact on corporate governance in China.

4 Voice and Accountability

Accountability in any economic system depends on transparency and acceptance of the notion that all (including politicians, the State and the party) are subject to the rule of law and that none is above the law. A free press is necessary in order that transgressions are publicised. In the West democracies such practices are not only theorised but also practiced, hence the impeachments of Presidents Nixon and Clinton in the USA. In China, transgressions by CCP officials tend to be subject to the Disciplinary Committees of the CCP and the lack of free press hinders transparency.

In China, generally speaking there is a lack of accountability in the corporate governance arena. Where the State is the major shareholder, which often is the case, the perception is that “nobody owns the corporate entity as it is owned by everyone.” Managers do not hold themselves accountable to the minority shareholders and shareholders – large and small do not have a culture of monitoring the managers. Employees also do not hold themselves accountable to management as “nobody owns the entity”.

Where the senior management and executive directors are appointed by the largest shareholder – the State, they report to the State. However, these political appointees are rarely held accountable for their performance as the appointments are made by bureaucrats who do not have the objective of profit maximisation. The management’s accountability is not to all shareholders per se, but purely to the controlling shareholder. There is therefore no equitable treatment of shareholders and the Chinese investors understand that. The result is the vast majority of the investors are speculators and not long term investors. This results in casino like stock exchanges – the current situation in the Shanghai and Shenzhen stock exchanges.

The Companies Law came into effect in 1994 and it was based on the UK/USA model – it is a document with corporate governance mechanisms in place and the allocation of rights, duties and responsibilities to the directors, managers and shareholders. The accountability factor in theory is there but in practice is missing because there are no stern penalties for malfeasance.

The CSRC published guidelines for appointing independent directors of listed companies in August 2001 and further published the Code of Corporate Governance for Listed Companies in January 2002. All these are supposed to bring about

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108 Tenev S & Zhang, C: “Corporate Governance & Enterprise Reform in China.” World Bank, 2002 pp 7. In 1999 the State controlled directly or indirectly more than 95% of the listed entities.

109 The 2 stock exchanges had a total of 70 million investor accounts of whom over 95% were individual investors. Investors shareholdings were held on average less than six months. CSRC 2004 Year Report
transparency and accountability but it does not seem to have brought the desired effect.

What are the reasons for this problem? Freedom of the press (Voice) goes hand in glove with accountability and as investigative journalism is absent in China, no one blows the whistle, no one knows about corporate transgressions which result in a lack of accountability.

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>Year</th>
<th>China Percentile Rank (0-100)</th>
<th>Taiwan Percentile Rank (0-100)</th>
<th>USA Percentile Rank (0-100)</th>
<th>Japan Percentile Rank (0-100)</th>
<th>Germany Percentile Rank (0-100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voice and Accountability</td>
<td>2004</td>
<td>7.3</td>
<td>75.7</td>
<td>89.3</td>
<td>78.2</td>
<td>94.7</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>10.1</td>
<td>73.2</td>
<td>89.9</td>
<td>79.3</td>
<td>95.5</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>10.5</td>
<td>70.2</td>
<td>85.3</td>
<td>76.4</td>
<td>91.1</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>7.9</td>
<td>68.6</td>
<td>93.7</td>
<td>78.5</td>
<td>90.1</td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>12.0</td>
<td>65.4</td>
<td>95.3</td>
<td>81.2</td>
<td>95.8</td>
</tr>
</tbody>
</table>

Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004. World Bank Survey (For Full Comparison Tables See Appendices 1 & 2)

The table above shows the results of a World Bank Survey into the voice and accountability factor for China compared to the 4 leading countries for governance. It is self explanatory and shows that China lags far behind the UK/USA/France and Germany in voice and accountability. Germany scores the highest with a score of 95.8% in 1996 and 94.7% in 2004 while by comparison China scored 12% in 1996 and it fell to 10.5% in 2000 and to 7.3% in 2004. This is a worrying trend as it shows that the system and the bureaucrats is becoming less accountable. By any standards, China fails abjectly on the scale of accountability.

The lack of accountability is not seen by the Chinese academics as a major problem and Hu Angang and Lu Tong do not stress it in their writings This is unfortunate as it send the wrong message to the managers and directors of the listed SOEs and can only result in continuing corporate mis-governance. Amongst the western democracies, accountability is a key component of sound corporate governance and the conditions are created to ensure that a robust regime of accountability exists.

5 Political Stability

Political stability in the west rests on the practice of liberal democracy and the rule of law whereas China is a one party state whose leaders peer warily into the future.

Senior management of Chinese corporate entities is not able to pursue the normal commercial objectives associated with their Western counterparts including profit maximization because of constraints placed on their actions by the controlling shareholder – the State. Many of the listed SOEs have bloated staff numbers whose productivity are a fraction of their Western counterparts but retrenchment is out of the question as the State fears that mass unemployment will lead to social and political
instability and the possible demise of the CCP. Today’s CCP justifies its continued leadership and existence on the modernization and economic development of post socialist China.110

Furthermore profitable SOEs are often requested to take over ailing SOEs and in a bid to prop them up, the soft budget constraint is offered as a sweetener. At the enterprise level there is a continued role played by the CCP local committees who have an input in the enterprise management decisions.

All this has resulted in the general underperformance of SOEs. It has been estimated that only one third of SOEs are profitable with a second third being borderline cases and the balance being virtually bankrupt.

China’s past history of political instability is of prime concern to China’s leaders and it cannot be taken for granted that China will enjoy uninterrupted political stability. When the USSR and Yugoslavia fell apart over a decade ago, the events shocked China and her political leaders are aware that it can happen to China too.

Table 2  Political Stability

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>Year</th>
<th>China Perentile Rank (0-100)</th>
<th>Taiwan Perentile Rank (0-100)</th>
<th>USA Percentile Rank (0-100)</th>
<th>Japan Percentile Rank (0-100)</th>
<th>Germany Percentile Rank (0-100)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
<td>46.6</td>
<td>62.6</td>
<td>60.7</td>
<td>83.5</td>
<td>79.1</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>45.9</td>
<td>74.1</td>
<td>49.7</td>
<td>90.3</td>
<td>82.2</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>54.5</td>
<td>73.3</td>
<td>89.1</td>
<td>88.5</td>
<td>89.7</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>49.7</td>
<td>83.6</td>
<td>86.7</td>
<td>87.9</td>
<td>92.7</td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>50.6</td>
<td>84.1</td>
<td>86.0</td>
<td>86.6</td>
<td>93.9</td>
</tr>
</tbody>
</table>

Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004. World Bank Survey (For Full Comparison Tables See Appendices 1 & 2)

Political stability helps foster investor confidence and China barely passes the test here with a score of 50.6% in 1996 which improved to 54.5% in 2000 but slipping to 46.6% in 2004. By comparison the USA scored 86% in 1996; 89.1% in 2000 but fell to 49.7% in 2002 in the wake of the 911 bombings on New York and climbed to 60.7% in 2004.

The subject of political stability of the CCP and the existing order of government is taboo in China and no academic or political leader dares openly debate this topic. Hu Angang, his colleague, Hu Guangyu and Lu Tong and other academics do not mention the subject of political stability in their writings at all. Does that mean all is well in China on political stability? On the contrary, the Chinese leadership recognises that there are massive social and economic problems like income disparity, regional unemployment, corruption and endemic poverty that could cause great

political instability. But choosing not to mention these problems will not make them go away, on the contrary, it creates pent up unstable forces if not addressed.

The Chinese political leadership has tried to ensure regional political stability by giving quotas to each province for listing their SOEs on the stock exchanges. This has not necessarily resulted in the most eligible SOEs being listed but in a pro-rata disbursement to the provinces.

The above table on political stability gives very low marks to China compared to its Western counterparts. This is based on Western perceptions of what constitutes political stability and does not necessarily indicate the true situation in China. In China, as the leadership has pointed out many times, politics is in command and stability is of the essence for there to be modernisation and economic progress. Hence in spite of the low marks attributed to China for political stability, this measure has not been reflected in the amount of foreign direct investment which continues to pour into China.111

6 Government effectiveness

Government effectiveness in the western democracies is based on the practice of meritocracy, equal opportunity employment laws and a level playing field to ensure that the best and most deserving get promoted. In China, promotion is based on the nomenklatura112 and length of membership of the CCP. This hardly results in efficient government administration.

The effectiveness of government impacts on corporate governance. When it takes three months for a business to be registered and lengthy time to get various permits the effectiveness of the Chinese government is called into question113. In comparison Singapore claims that businesses can start up in a week if not earlier.114 Singapore also scores 100% on government effectiveness in this survey.

And yet businesses continue to be attracted to China as provincial governments scramble over one another to attract new investments into their locality promising to expedite applications and approvals. The buzzword here is “Guanxi” and authorities promise the earth to entice new investors. But there is a catch to all this as such practices lend themselves to rent seeking activities and point to weak institutions.

The World Economic Forum which meets in Switzerland yearly has published a survey on the Global Competitiveness Index and China comes out at number 44 out of

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111 China was the largest recipient of Foreign Direct Investment in world in 2004/5 of about US$65 blns.
112 Literally the name on the list – an accepted means of promotion in socialist countries.
113 The complaint is that there are too many departments and bureaux who each have a hand in approving projects. Obscure bureaux like the Environmental bureau, Public Security Bureau and the Civil Defence Bureau all come into play for approving property development projects in Shanghai. Writer was involved in Housing projects in Shanghai in 1997/8.
114 See Appendix 2 Singapore scores 100% in the scale on Government effectiveness and regulatory quality.
a total of 102 countries, way behind UK, USA, France, Germany, Singapore, Hong Kong, Taiwan, Korea.  

Table 3  Government Effectiveness

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>Year</th>
<th>China Percentile Rank (0-100)</th>
<th>Taiwan Percentile Rank (0 – 100)</th>
<th>USA Percentile Rank (0-100)</th>
<th>Japan Percentile Rank (0 – 100)</th>
<th>Germany Percentile Rank (0-100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Effectiveness</td>
<td>2004</td>
<td>60.1</td>
<td>85.1</td>
<td>93.8</td>
<td>86.5</td>
<td>88.5</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>65.2</td>
<td>85.1</td>
<td>91.5</td>
<td>84.6</td>
<td>92.0</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>64.0</td>
<td>83.9</td>
<td>93.5</td>
<td>85.5</td>
<td>95.7</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>64.5</td>
<td>90.7</td>
<td>91.8</td>
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<td>92.3</td>
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<td></td>
<td>1996</td>
<td>66.5</td>
<td>87.7</td>
<td>95.5</td>
<td>87.2</td>
<td>92.7</td>
</tr>
</tbody>
</table>

Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004. World Bank Survey (For Full Comparison Tables See Appendices 1 & 2)

The table above shows that China passes the test of government effectiveness scoring 66.5% in 1996, 64% in 2002 and 60.1% in 2004. By comparison the UK scored 96.6% in 1996, 96.8% in 2000 and 94.2% in 2004. This is the only measure of governance where China scores a respective pass mark.

China scores modestly on the measure of Government Effectiveness. This is because of the entrenched power of the bureaucracy. When there are goals and objectives to be achieved, the bureaucracy responds in spite of limitations, some self imposed and others because of the changing market forces. Professor Hu Angang recognises that there are external forces that impact on corporate governance and he does suggest that the role of the government in corporate governance be clearly defined. This view is also echoed by Zhou XiaoChuan the governor of the PBOC who also has a regulatory role over the Banks.

7  Regulatory Framework

The main regulatory body for the listed entities in the USA is the SEC (Securities Exchange Commission) and in the UK it is the FSA (Financial Services Authority) Both are well staffed and well equipped to execute their regulatory activities in an environment subject to the rule of law.

By comparison there are many institutions which have a regulatory function in China, the CSRC which supervises the listed entities, the CBRC which regulates the Banking industry and the CIRC which oversees the Insurance industry.

The CSRC is the main regulating body as it approves and regulates the corporate behaviour of over 1380 listed entities on the Shanghai and Shenzhen stock exchanges.

See Appendix 3
Over the past five years, it has promulgated a plethora of rules and regulations relating to the following:

- Aug 2001: Guidelines for establishing independent directors of listed companies.
- Nov 2002: Issues on the transfer of state owned shares and legal entity owned shares to foreign owned entities
- Dec 2002: Measures on the merger and acquisition of listed companies and measures on the administration of information disclosure on shareholding changes.
- Dec 2002: QFII came into force allowing Qualified Foreign Institutional Investors to invest in the A shares of China’s listed companies
- Feb 2004: Additional Measures relating to Company delisting.

The above are but a fraction of the regulations issued by the CSRC but in spite of the many rules issued, corporate misgovernance continues to be rampant. Fraud is common, misrepresentation of financial statements occur on a regular basis and insider trading happens so often that it is almost impossible to detect instances. As a result there is little or no investor confidence amongst the Chinese public in their local stock markets.

One of the main criticisms of the CSRC is that it performs the dual functions of approval and regulation including delisting which are contradictory in character. In the Western market economies, the listing procedure is a market driven process and the regulatory body does not have any baggage to carry which makes the regulatory job much simpler.

The contention is that once approval is granted to the corporate entity to list, the CSRC is reluctant to admit it was wrong. That is one of the reasons why enforcement by the CSRC has been lax.

Another criticism of the CSRC is that it lacks the will to enforce its own rules and regulations and instead tries to get others to do its work. An example is the recent approval given to QFII (qualified foreign institutional investors) to invest in the domestic securities markets with the expectation that they will help monitor and supervise the listed entities and thus bring about more transparency and better corporate governance.\textsuperscript{116}

\textsuperscript{116} Under the QFII rules passed by the CSRC in Dec 2002, certain foreign institutions are allowed to invest in the domestic share & bond markets. These include all the big foreign banks like Citibank, HSBC Bank, ABN Bank etc.
The above table shows that China’s regulatory bodies fail miserably scoring 47% in 1996, 36.9% in 2000 and 35% in 2004. The trend is alarming as it shows that not only is there no improvement but there is substantial deterioration. By comparison the UK scored 97.8% in 1996, 96.8 in 2000 and 94.1% in 2004.
In China the CSRC has taken little enforcement actions. Alan Cameron, the former Head of the Australian Securities Investment Commission (ASIC - which is the Australian equivalent of the CSRC) presented a paper at the 2nd International Roundtable Conference on Securities Markets in China in June 2002. What was the relationship between enforcement, legal regulations and good corporate governance, he asked? What was the best way to ensure good corporate governance? He drew on his Australian experience of dealing with the corporate cowboys of the late nineteen eighties and he came to the conclusion that enforcement was the most important. This view on enforcement is echoed by Kim Yongboem et al. Senior Economist at the World Bank who wrote that “fair and prompt enforcement without favouritism is vital since drafting laws and regulations will not in itself produce an honest and fair market.”

Regulatory Quality is another facet of the lack of institutional support in China and again many of the Chinese academics do not pay attention to this area at all. None of the academics mentioned earlier see this lack of regulatory quality as a major problem although in the western democracies, this is probably seen as the single most important tool for enforcing sound corporate governance.

Regulatory quality is one area that the Chinese academics agree is lacking and important in China. Professor Hu Angang, Dr Hu Ruyin and Professor Lu Tong all propose more and better enforcement by China’s regulatory authorities. But as mentioned before this is merely a bureaucratic response to a serious existing problem.

8 Rule of Law

Does China enjoy the Rule of Law? According to Randall Peeremboom, China does enjoy a form of Rule of Law – a thin rule of law. Does it enjoy the Rule of Law as construed and understood in the western democracies? The answer must be no – China’s Rule of Law is certainly different from Westminster’s version and different from Capital Hill’s version. However, the CCP in drafting the State constitution in 1982 committed the State and the CCP to the basic principles of rule of law, that all must abide by the law and that none is above the law. This concept was further strengthened in March 1999 when the constitution was amended to incorporate the new policy formulation of yifa zhiguo, jianshe she hui zhu i fazhiguo. (to govern a country in accordance with law and to establish a socialist rule of law state)

The question is - does it impact on Corporate Governance? The answer is yes. It must be yes because the rule of law impacts on the judiciary, the law courts, the judges, the organizations initiating laws, the implementation of laws, the enforcement of laws and the quality of legal decisions. All of these impact directly or indirectly on business.

117 The Shanghai Stock Exchange had 837 listed companies as at 31-12-2004. Operations started in 1990 and the first delisted company was PT Narcissus in April 2000. In spite of the many fraudulent activities there were only 6 companies under temporary suspension as at end Dec 2004. Source: CSRC Yearbook 2004.
120 Author of “China’s long march toward Rule of Law.” Cambridge University Press 2002.
121 Thin rule of law theory excludes civil and political rights and basically incorporates laws that help rule the country. R. Peeremboom’s : China’s long march to rule of law. Cambridge Press 2002. pp5
122 Ibid, pp 61
activities and hence corporate governance. *La Porta, Lopez de Silanes, Schleifer and Vishny* theorized that the legal approach to corporate governance laid down the best basis for the protection of both shareholders and creditors with laws and their enforcement being of primary importance.\(^{123}\)

The rule of law calls for an independent judiciary, not one which is at the beck and call of the CCP. The rule of law calls for a uniform system of laws to be applied impartially throughout the whole country: instead we have a history of local courts adjudicating in favour of local plaintiffs or defendants in China. The rule of law calls for the enforcement of court decisions and yet they are often ignored. In China too much power is in the hands of bureaucrats who rule by administrative fiat.\(^{124}\)

Generally speaking the presence of strong property rights are an indication of strong rule of law and this is an area somewhat lacking in China. For example Shanghai in the mid nineteen eighties granted only 30 year leasehold lands for the construction of hotels but by the mid nineteen nineties was prepared to lease land on 70 year leasehold tenure.\(^{125}\) However, a new Property Rights law is being enacted in 2006 and draft copies have been sent out to interested parties for comments and revisions.

### Table 6

**Comparison of China’s Property Rights with UK/USA/Western Europe**

<table>
<thead>
<tr>
<th></th>
<th>China</th>
<th>USA</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freehold Land ownership</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Leasehold Land Ownership</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Control rights</td>
<td>Weak</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
</tr>
<tr>
<td>Ownership rights</td>
<td>Weak</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
</tr>
<tr>
<td>Residual Rights</td>
<td>Weak</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
</tr>
<tr>
<td>Overall Property Rights</td>
<td>Weak</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
<td>Strong</td>
</tr>
<tr>
<td>State interference</td>
<td>Often</td>
<td>Rare</td>
<td>Rare</td>
<td>Unusual</td>
<td>Unusual</td>
</tr>
</tbody>
</table>

*Note: China’s NPC is in process of drafting a new Property Ownership Law in 2006*


\(^{124}\) An example is the Singapore listed company CapitaLand’s 50 storey Raffles Square project in the People’s Square in Shanghai. It was a US$600 mlns project and construction commenced in 1997 after contracts had been exchanged for the purchase of the land. However after the foundation work had been completed, further work was halted by administrative fiat for two whole years.

\(^{125}\) The Mandarin hotel in Shanghai was built on a 30 year lease in 1988 and later CapitaLand’s property project in Pudong was granted 70 year leasehold in 1997. Freehold land ownership is not available as all land belongs to the State.
### Table 7  
**Rule of Law**

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>Year</th>
<th>China Percentile Rank (0-100)</th>
<th>Taiwan Percentile Rank (0 – 100)</th>
<th>USA Percentile Rank (0-100)</th>
<th>Japan Percentile Rank (0 – 100)</th>
<th>Germany Percentile Rank (0-100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rule of Law</td>
<td>2004</td>
<td>40.6</td>
<td>77.8</td>
<td>92.3</td>
<td>89.9</td>
<td>93.2</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>48.5</td>
<td>78.6</td>
<td>91.3</td>
<td>88.3</td>
<td>92.3</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>48.7</td>
<td>79.1</td>
<td>92.5</td>
<td>90.9</td>
<td>92.0</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>52.4</td>
<td>84.9</td>
<td>91.4</td>
<td>90.3</td>
<td>92.4</td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>37.3</td>
<td>84.3</td>
<td>92.2</td>
<td>88.0</td>
<td>94.0</td>
</tr>
</tbody>
</table>

Source: **Kaufmann, D., A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004.** World Bank Survey. (For Full Comparison Tables See Appendices 1 & 2)

This above table measures the rule of law in China and is based on the liberal democratic interpretation of the term. China fails on this count scoring 37.3% in 1996 rising to 52.4% in 1998 but falling to 40.6% in 2004. The UK and Germany score the highest being in the nineties throughout the period under measurement.

It is worrying that with China’s entry into the WTO in December 2001 that the rule of law has not improved but deteriorated. The EU has recently funded a program to expose Chinese lawyers, judges and other legal professionals to the Western judicial institutions and practices.126

The inadequacies of China’s legal system are well known and acknowledged by Chinese academics and scholars. Knowing and acknowledging the problem is but the first step and my criticism of them is that they do not propose a solution. The lack of the western concept of “Rule of Law” is because in China the judiciary exists as a branch of the executive. It has no independent existence and that is why often times its decisions are flawed and corrupt.

No Chinese academic has written extensively to propose that the whole power structure be reorganised so that the judiciary can be truly independent and the “rule of law” be comprehensively and strictly implemented.

### 9 Control of Corruption

Corruption impacts at both the micro and macro economic levels: at the micro level by adding on a layer of transaction costs and at the macroeconomic level by deterring new investments and thus impeding growth. It is an insidious cancerous practice which has threatened the very existence of the CCP127.

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126 Under the EU-China Legal & Judicial Program, over 200 lawyers, judges and legal professionals have been sent to EU countries for training and exposure to western judicial practices. 2001-2005 under a grant of over 13.5 mlns Euros. See EU website. http://www.legaljudicial.org.

127 The Tiananmen Square incident in 1989 was sparked by gross disaffection with the CCP because of perceived widespread corruption.
Corruption is a common occurrence in China because of the generally low per capita income and the opportunities and temptations are many. This is further exacerbated by the systemic corruption of CCP officials and the Chinese traditions of Guanxi and Renqing which muddies the water. When Deng Xiaoping enthused in 1992 that “to get rich is glorious” he opened the floodgates and many of the nouveau riche are senior CCP cadres (or their scions) who have utilised their positions for self-enrichment.

There is also a phenomenon in China known as the 59 year old phenomenon and it involves top bureaucrats who have only one more year of service before they retire. Many of those corrupt officials prosecuted fall into this category as the prospect of living their retirement years on half an income is rather daunting.

Does corruption impact on business activity? Of course it does! Does it impact on corporate governance? Yes it does and research shows that corruption inhibits investments and results in lower economic growth rates.

Table 8 Control of Corruption

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>China Percentile Rank (0-100)</th>
<th>Taiwan Percentile Rank (0-100)</th>
<th>USA Percentile Rank (0-100)</th>
<th>Japan Percentile Rank (0-100)</th>
<th>Germany Percentile Rank (0-100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control of Corruption</td>
<td>2004 39.9</td>
<td>2002 44.4</td>
<td>2000 44.6</td>
<td>1998 60.7</td>
<td>1996 58.7</td>
</tr>
<tr>
<td></td>
<td>2002 44.4</td>
<td>2000 44.6</td>
<td>1998 60.7</td>
<td>1996 58.7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2000 44.6</td>
<td>1998 60.7</td>
<td>1996 58.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1998 60.7</td>
<td>1996 58.7</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


In the western democracies, authorities fight corruption by a combination of transparency, an independent judiciary, an unfettered press and strict enforcement of the rule of law. These ingredients are present in China in limited dosages only.

The above table shows control of corruption in China falling from 58.7% in 1996 to 44.6% in 2000 and to 39.9% in 2004. By comparison the UK had control of corruption at 94% in 1996, 95.2% in 2000 and 94.6% in 2004. The table shows that corruption is getting worse in China and it would appear that the authorities are unable to do anything about it. Again it is an indictment on China’s institutions of corporate governance as, in spite of China’s admission into the WTO which should have brought about more transparency and less corruption, the reverse has happened.

Not much is written on the subject of corruption or the impact of corruption on corporate governance. None of the academics mentioned in Chapter 2 “A Chinese

128 Peeremboom, R. “China’s long march to rule of law.” Cambridge University Press. 2002
129 Ibid pp 322
130 Peeremboom, R. Op Cit., (note 108) pp 500
Perspective on Corporate Governance” have debated the subject nor suggested any solutions. Everybody knows it exists but nobody is brave enough to investigate or research the topic further as fears of treading on powerful toes are strong. In China there is the belief that the CCP will tolerate corruption so long as its stranglehold on power is not challenged. This may not be correct but unless corruption is not only controlled but weeded out, it will continue to adversely impact on corporate governance.

The Chinese leadership wants to eradicate corruption but to do so would necessitate the invigoration of the judiciary and the press. In addition, the disciplinary committee of the CCP also plays an important role in the corruption charges of party cadres. Specifically speaking, in such cases, litigation proceedings can only begin after an investigation by the Disciplinary Committee of the CCP\(^{131}\). In some instances, the Disciplinary Committee may even bypass the judiciary and decide on some of the cases, thus abrogating the role of the courts. The ideal situation would be an independent judiciary but this is not likely to happen as China does not practice the doctrine of the separation of powers nor is the fourth estate\(^{132}\) given its just due. There is ample press coverage of corruption but it is all done under the supervision of the CCP and/or official institutions. This does not lend itself to public confidence that an unfettered Press has investigated impartially and reported its findings.

10 Summary

We show early on in this chapter that one of the key messages of New Institutional Economics is that not only do firms matter in the economic production equation but that institutions are important too. While there is no doubt that corporate governance begins at the enterprise level in the relationship between the owners and the managers, it is severely impacted by the institutions within which it operates. R Coase argued that it is the institutions like the legal system, the political system, its social system and its educational system that govern the performance of an economy.

The practice of good corporate governance ensures the smooth and efficient functioning of the business enterprise. China has a long way to go if she aspires to climb the heights achieved by the western economies. Admittedly China is an economy in transition from a command to a market driven economy but the statistics show a gradual deterioration and not an improvement and this is after admission to the WTO in December 2001. The World Bank survey of governance index shows that China lags far behind in every measure of institutional governance compared to not only the liberal democracies but also to her Asian neighbours.

In this chapter we have examined six crucial institutional determinants in China: accountability, rule of law, political stability, government efficiency, corruption and regulatory quality. We compare China’s experience with that of other countries. The

\(^{131}\) CCP Leadership & Judicial Independence by Prof Li Yayun Oct 2003: www.carnegieendowment.org

\(^{132}\) The Press was given the name “The Fourth Estate” by Edmond Burke in the nineteenth century as being more powerful than the other three which were the church, the nobility and the commoner.
question may be raised – is the World Bank Survey skewed in favour of the Western democracies?

China currently does not have the institutional ability to conform to the governance standards measured in the World Bank survey. Again it can be attributed to the fact that China is an economy in transition; the Chinese institutions themselves are in transition but the World Bank survey does not take into this fact into account. On the other hand, our own empirical survey obtained through interviews with senior managers of QFII as detailed in Chapter 5 shows that there is continuing interest in good corporate governance by Chinese companies. Our interviews indicate that on ground level, there is gradual change for the better in corporate governance. The Chinese authorities too have throughout the late nineteen nineties and subsequent years been trying to introduce higher standards of corporate governance without giving theoretical or ideological foundations. Pragmatic measures from above were instituted and it was hoped that over time, these measures would solve the corporate governance problems at hand. This can be compared to Barry Naughton’s analysis of China’s economic development in his book “Growing out of the Plan” where China’s economic planners throughout the nineteen eighties and nineties adopted a step by step approach to gradually ease China out of a command economy to a more market oriented economy.

An analysis of the six institutional determinants discussed earlier in the chapter indicate that China is lacking in many of these areas. Why is this so? The main reason is that China is an economy in transition from a command economy to a market economy and institutions need time to build and develop and mature. Even today with all of its regulations and institutions in place the USA had its corporate governance problems in 2001 as exemplified by the collapses of Enron, Tyco and Australia had its largest ever corporate failure when HIH collapsed in 2002 because of fraudulent dealings by directors. China today does not have the institutions to conform to those indicators but things will change. An example of this change is indicated in Chapter 5 where our empirical findings indicate that there is a desire by the Chinese listed companies to improve corporate governance and they are doing this with the help of the QFII.

Chinese authorities are concerned about the lack of progress in corporate governance despite strenuous efforts by the CSRC, the CBRC and other regulatory bodies. They studied the options available and decided that one of the ways was to invite large foreign financial institutions to invest in the domestic securities markets. It was thought that these foreign institutions would help bring about better corporate governance through their long term investment horizons which would require fiscal transparency, information disclosure and better accountability. Thus the Qualified Foreign Institutional Investor (QFII) scheme was conceived and came into effect on 1st December 2002. The impact of the QFII on corporate governance is considered in the next chapter.
Chapter 5

Impact of QFII on Corporate Governance

1 Introduction.

Previous chapters narrated the problems of corporate governance in China and the inability of local regulators to deal with them. The Chinese authorities then decided that one of the ways to overcome the problem was through the QFII scheme where foreign financial institutions were invited to invest in the domestic securities markets and thus play a role in bringing about better corporate governance. Thus the Qualified Foreign Institutional Investor (QFII) scheme was conceived by the CSRC taking as an example the model of the QFII scheme adopted by Taiwan in 1991133.

What were some of the objectives attributed to the QFII in regards to corporate governance? The following three articles all state that corporate governance was a major objective. M Ferguson & P McGuinness’s article titled “Chinese Securities Reform: the Role of QFII in the corporate governance process”134 articulates that “the QFII scheme carries tremendous potential as a vehicle for raising corporate governance standards.” (page 60) and Steven Yeo’s article in the China Economic Review 135 (pg 448) states that “with the advent of foreign institutional investors in the PRC market, with their more robust due diligence and investment disciplines, it is anticipated that the QFII Provisional Measures will further encourage greater transparency and improve the compliance and corporate governance process of A share companies.....” Fred Hu’s article on “Capital Flows, Overheating & the Nominal Exchange Regime in China”136 on page 361 states that “the participation of global investors in China’s domestic securities market has introduced professional funds management expertise and provided a new advocate for improving corporate governance.......” This view was further echoed by Richard Ward, Chairman of UBS Warburg 137 who stated on 26th Nov 2002 “that QFII will be an important stimulus for improving corporate governance in China because increasingly Mainland companies will be benchmarked against their international peers.”138

It was the hope of the CSRC that the QFII scheme would contribute to better corporate governance and this view was stated by the Director General of the CSRC who stated at a seminar in Hong Kong on 8th November 2002 stated that with the promulgation of the Qualified Foreign Institutional Investor (QFII) scheme, “foreign institutional investors would be able to play a positive role in improving corporate governance in China”. This is because it was presumed by the CSRC that the QFII participants, all of whom would be from countries with well regulated financial

137 UBS Warburg currently has the largest quota allocated under the QFII scheme being US$800 mns.
systems, would require sound corporate governance in their target companies to justify their long term investment horizons.

Our survey sought to ascertain what areas of corporate governance were impacted after two and a half years of operations.

(1) How did QFIIs impact on shareholders.
(2) How did QFIIs impact on management
(3) How did QFIIs impact on board of directors
(4) How did QFIIs impact on market discipline

2 The QFII scheme

2-1 Rules and regulations

The legal basis for the QFII scheme is laid out in the “Provisional Measure on Domestic Securities Investments by Qualified Foreign Institutional Investors – Decree No 12” dated 5th Nov 2002. It was promulgated by the heads of the CSRC and the PBOC and came into effect on 1st Dec 2002. The objectives as stated in Article 1 are twofold

(1) To govern Qualified Foreign Institutional Investors' investments in China's securities market and
(2) To promote development of China's securities market.

What can QFII invest in? Article 18 of the Provisional Measure states that the QFII can invest in the following RMB financial instruments:

(1) Shares listed in China's stock exchanges (excluding B shares);
(2) Treasuries listed in China's stock exchanges;
(3) Convertible bonds and enterprise bonds listed in China's stock exchanges;
(4) Other financial instruments as approved by CSRC.

The provisions require the QFII institutions to get approval from the CSRC and be granted investment quotas by State Administration of Foreign Exchange (SAFE).

2 – 2 Conditions of the scheme

The rules are very clear on who can participate in the QFII scheme: only the very large foreign financial institutions need apply. For fund managers, they must have assets in excess of US$10 bns during the most recent accounting year and have operated for over 5 years; for insurance companies they must have assets in excess of US$10 bns during the most recent accounting year, paid up capital of US$1 bns and operated for over 30 years and finally for commercial banks, they must be within the

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139 “Provisional Measure on Domestic Securities Investments by Qualified Foreign Institutional Investors” – Decree No 12 dated 5th Nov 2002.
141 Interpreted by Ferguson, M & McGuiness, P as steps taken “to promote corporate governance.”
world’s top 100 banks in terms of assets and have assets in excess of US$10 bns during the most recent accounting year.

Another condition requires that the applicant have “a sound management structure and internal control systems” and be from a home country with “sound legal and regulatory system” (Chapter 2 Article 6 (3)

Two important conditions of the regulations impacting the investment operations of QFII arises from Article 20 (1) which states that “shares held by each QFII in any one listed company should not exceed 10% of the total outstanding shares of the company.” And Article 20 (2) states further that “Total shares held by all QFII in one listed company should not exceed 20% of the total outstanding shares of the company.

Yet another important restriction relates to the repatriation of funds by QFII participants. Under Article 26 of the Provisional Measures QFII (except for closed end funds) members can repatriate their capital only after one full year and then only in instalments.

The promulgated regulations are “provisional” and therefore allow the Chinese authorities flexibility to relax the rules or enlarge the quotas any time they wish to.

3 Who are the participants in the QFII scheme?

The first batch of four QFII approved in May and June 2003 comprised UBS Limited, Nomura Securities, Citigroup Global Markets and Morgan Stanley International. They were soon followed by Deutsche Bank, HSBC Bank, Goldman Sachs, ING Bank and JP Morgan Chase Bank. These nine institutions may be considered to be the pioneers of the QFII scheme.

As at 31st December 2005, there were a total of 32 qualified foreign institutional investors who had been granted membership. They all are large international financial institutions from major countries like the USA, UK, Germany, France, Japan, Canada, Netherlands, and Switzerland. The total QFII quotas allocated amount to US$5.645 bn. The quotas range from US$800 m (UBS Warburg) to US$50 m.(Franklin Templeton Fund, Power Corporation of Canada, Hang Seng Bank).

The current QFII quotas were however progressively raised from US$1.65 bn on 19th November 2003 to US$3.425 bn as at 31st December 2004 to US$5.645 bn as at 31-12-2005. Most of the QFII had their quotas gradually increased too eg UBS had its quota gradually increased from US$300 m to its present US$800 m. UBS, CSFB and Nikko Securities have all requested for additional increases but the CSRC has been slow to respond.

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142 This proves D Clarke’s assertion that SOEs were listed with 2 objectives in mind: to raise funds and to retain State control. (D Clarke. “An Overview of Corporate Governance in China” China Economic Review, 2004 )
143 Closed end funds can only repatriate capital after 3 years. Chapter 5 Article 26 Provisional Measures… dated 5th Nov 2002
144 See Table One for list of QFII as at 31st Dec 2005
<table>
<thead>
<tr>
<th>QFII registration number</th>
<th>QFII Name</th>
<th>First Approval Date</th>
<th>Custodian Bank</th>
<th>Current Quota</th>
</tr>
</thead>
<tbody>
<tr>
<td>QF2003E US001</td>
<td>UBS Limited</td>
<td>23.5.2003</td>
<td>Citibank (Shanghai Branch)</td>
<td>$800 million</td>
</tr>
<tr>
<td>QF2003A SS002</td>
<td>Nomura Securities Co.,Ltd</td>
<td>23.5.2003</td>
<td>Citibank (Shanghai Branch)</td>
<td>$50 million</td>
</tr>
<tr>
<td>QF2003N AS005</td>
<td>Goldman, Sachs &amp;Co</td>
<td>4.7.2003</td>
<td>HSBC (Shanghai Branch)</td>
<td>$200 million</td>
</tr>
<tr>
<td>QF2003E UB006</td>
<td>Deutsche Bank Aktiengesellschaft</td>
<td>30.7.2003</td>
<td>Citibank (Shanghai Branch)</td>
<td>$300 million</td>
</tr>
<tr>
<td>QF2003A SB007</td>
<td>HSBC</td>
<td>4.8.2003</td>
<td>China Construction Bank</td>
<td>$400 million</td>
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Note: Data Compiled from Website of CSRC as updated with Media releases regarding the allocation of additional QFII quotas

### 4 The Survey

In carrying out research for this survey, those QFII participants who had been allocated investment quotas for at least two years prior to 31 Dec 2005 were contacted.\(^\text{146}\) The reason for the time frame cut off is because to be fully participative and cognizant of the QFII scheme, a two year membership was considered necessary. (Some of the newer QFII members approved within the last twelve months have barely got started!) Of the twelve qualifying QFII participants, seven agreed to take part in the survey.\(^\text{147}\) The survey was conducted by verbal interviews which used a standard questionnaire as a basis for open discussion and clarification of their responses to the topic of the QFII and its impact on corporate governance.

The Chairman, CEOs or General Managers of the QFII were contacted about participating in the survey and when they personally could not, responsibility was delegated to the Heads of Department or the Managers in charge who then communicated with the writer and answered the questions. The survey questions included the following:

- How QFII select investments
- How QFII has impacted on corporate governance

\(^\text{146}\) See Appendix 4 for list of QFII contacted to participate in survey.
\(^\text{147}\) See Appendix 4 for list of those who participated in survey.
• Direct and indirect impact by QFII on corporate governance
• Areas of influence, lack of influence

Out of a total of twelve potential QFII participants seven institutions or 58% of those contacted participated. More important, most of the QFII respondents were the pioneers and major players in the QFII scheme holding US$2.45 bns or 76% of the QFII quotas allocated to the twelve members. Some respondents have requested that their identities be kept confidential as they do not wish to be identified individually whilst others are happy to be mentioned. (See Appendix 4)

5 How do QFII choose companies to invest in?

Most of the QFII have invested in a mixture of bonds and equities. UBS Warburg as at December 2005 had invested in one hundred and twenty A share companies, thirty convertible bonds, and over thirty mutual funds. They were in the top ten shareholders of over fifteen Chinese companies and top ten investors in convertible bonds of over ten Chinese companies. 148 A report from the China Economic Net states that as a 30th Sept 2005, statistical returns from 1364 listed companies showed that a total of 19 QFIIs were among the top 10 shareholders of 58 A share companies. Citigroup Global Markets was a shareholder in 42 A Share companies.

Richard Ward, CEO of UBS Warburg predicted when the QFII scheme was announced in December 2002 that “QFII investors will concentrate on those companies with good management, sound strategies, sustainable earnings and accounting transparency.149 “And this has been borne out by our survey results below.

First of all, a list of potential candidates is drawn up according to the QFII’s own investment guidelines. Currently six out of the seven QFII surveyed invest only in the top 100 listed firms. QFII members invest in the top 100 because of their greater liquidity and marketability. Research data on these companies are also more readily available.

The list of candidates chosen will vary because different QFII will have different preferences, priorities and research capabilities in different types of companies: eg infrastructure companies or resource stocks or financial stocks. From this target group, the list of companies are subject to further evaluation by the QFII before a decision is then made on which stocks to invest in. This will depend on the following:

5 – 1 Evaluation criteria

All of the QFII stated that the financial performance of the Chinese companies was the most important criteria for choosing which companies to invest in. An evaluation of the financial performance includes not only past performance but also future projections as well. A very important parameter in financial evaluations was the return on shareholders’ funds. Both UBS Warburg and Citigroup require their target

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148 UBS Warburg as at December 2005 had invested in 120 A share companies, 30 convertible bonds, and 30-40 mutual funds. They were in the top ten shareholders of over 15 Chinese companies and top ten investors in convertible bonds of over 10 Chinese companies. Results from own Survey.

Chinese companies to have maximization of shareholder value as one of their stated objectives.

An evaluation of future financial performance requires the voluntary disclosure of additional financial data and financial projections. Thus the Chinese company must be ready and prepared to disclose voluminous financial information to the QFII. If Chinese companies do not cooperate here, they do not get short listed.

This increased transparency affirms Ferguson & McGuinness’s prediction that QFII are likely to have an impact on the voluntary disclosure of additional information. The QFII has thus forced the Chinese companies to be more transparent, information disclosure being a key part of the process.

While the financial performance of the Chinese company is paramount, the majority of the QFII members surveyed (5 out of 7 or 71%) do place emphasis on the existence of guidelines on good corporate governance and as part of their evaluation process inquire into measures of corporate governance implemented. However, two QFII members (out of the seven respondents), do not pay attention to corporate governance structures in the Chinese companies at all.

According to a QFII member, there are three groups practicing different standards of corporate governance amongst China’s listed companies. One group comprises the large listed SOEs who are genuinely trying to implement sound corporate governance (and they are making good progress). A second group comprises smaller listed companies who lack transparency and sometimes resort to deception to achieve their corporate goals. The third group are the resource rich companies, natural monopolies, big banks and telcos which have dual listings in both China and overseas stock markets. These companies enjoy fairly good standards of corporate governance because of their international exposure and operations.

Citigroup has an index of good corporate governance that they use to evaluate potential Chinese companies. ING Bank through their joint venture fund China Merchant Fund chooses quality companies to be included in the investment universe and the quality of corporate governance is part of the evaluation criteria.

During the evaluation of the Chinese companies, the QFII will have had exploratory meetings with the management of the company where the company’s financial performance, strategies and future plans are presented and scrutinized. Where necessary, meetings with key decision makers are arranged. Such meetings may be with the General Manager, or the Executive Chairman or the CEO.

The QFII manager also arranges for meetings between the Chinese clients and the foreign fund manager, institutional investor or the insurance company portfolio manager. These meetings are crucial to letting the foreign investors have an idea of how the Chinese companies operate and what they are like. If the Chinese company passes the financial test and the corporate governance test, the QFII may make a decision to invest.

The conclusion here is thus that while all of the QFIIs place priority on financial performance, the majority of the QFIIs (71% in our survey) also pay attention to corporate governance structures in the companies they invest in.

6 Role of the QFII scheme in promoting corporate governance

The QFII scheme has had a short history of just over two and a half years. Has it resulted in better corporate governance? We categorize the respondents of the QFII project into three categories:

- Those who exercise their rights as shareholders
- Those who provide management support
- Those who do not promote corporate governance

Of the seven QFII respondents who took part in the survey, three QFII (43%) actively promoted corporate governance by exercising their rights as shareholders. The other four QFII respondents do not attend shareholders meetings. Their reasons range from the fact that they “have many clients in China and by voting at the AGMs of Chinese companies may inadvertently negatively impact the interests of other Chinese clients” (e.g., there may be rival parties in a takeover bid) to “it is not our policy to attend AGMs of clients”.

A second group of five QFII (72%) promoted corporate governance through management support. Management support may take the form of dialogue sessions, seminars and training sessions and secondment of key Chinese staff for overseas training.

The third group comprising two QFII (28%) participants do not promote corporate governance at all. They are not small but large financial institutions holding fairly large QFII quotas who merely act as investment brokers for their foreign institutional clients. They may be the registered shareholders in the Chinese companies but they do not have ultimate beneficial interest in those shares as their ultimate beneficial owners would be the foreign pension funds, insurance companies or fund management companies. As brokers they have no direct equitable interest in the Chinese companies and they do not monitor these investments. Such a duty would be the responsibility of the foreign institutional investor. The QFII member in such cases merely provide research and custodian facilities.

6 – 1 Exercise of Shareholder’s Rights

Of the seven QFII respondents to the survey, three attend shareholders’ meetings of the Chinese companies they invest in and are active participants in these meetings. They vote for or against the appointment of directors, express their views on proposed independent directors and take a special interest in resolutions regarding proposed corporate restructuring, mergers and acquisitions. When resolutions prejudicial to the shareholders’ interests are proposed, they speak against it and this sends a powerful

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151 The first QFII quotas were issued in May 2003.
152 The list includes UBS Warburg, Citibank, HSBC Bank, JP Morgan, ING from the respondents
signal to other shareholders at these meetings as the QFII shareholders wield considerable influence being perceived to have better knowledge and expertise. This exercise of shareholders’ rights by the QFII members has therefore contributed to better corporate governance.

6 – 2 Board of Supervisors

Article 124A of China’s Company Law states that the board of supervisors shall comprise representatives of the shareholders and workers and Article 126 states that the board of supervisors shall be present at board meetings and exercise the following functions:

(i) review the financial affairs of the company;
(ii) monitor the acts of the directors or the general manager to guard against violation of national statutes, administrative regulations or the articles of association
(iii) require the directors or the general manager to make rectification when any act harms company interests;
(iv) propose interim meetings of shareholders' general committee.
(v) other acts prescribed by the articles of association.

The Board of Supervisors thus sits above the Board of Directors and has an important regulatory function. Our survey showed that no QFII had appointed any representative to the Board of Supervisors of any Chinese company. Furthermore none of the QFII exerted any influence over the board of supervisors directly or indirectly at all.

There was no impact by the QFII on the Board of Supervisors of the Chinese companies at all.

6 – 3 Board of Directors

It is generally recognized that the Board of Directors has overall charge of corporate governance and membership confers the ability to participate and effect change. According to China’s Company Law153 the board of directors is accountable to the shareholders' general committee, and shall exercise the following authority as provided for in Article 112154

(i) being responsible for calling meetings of shareholders' general committee, and presenting reports thereto;
(ii) implement resolutions adopted by the shareholders' general committee;
(iii) determine the company's operating plans and investment programs;
(iv) prepare annual financial budget plans and final accounting plans of the company;
(v) prepare the company's profit distribution plans and plans to cover company losses;
(vi) prepare plans for increasing or reducing registered capital by the company, and plans to issue company bonds;
(vii) draft plans for merger, division or dissolution of the company;
(viii) determine the structure of the company's internal management;

153 China’s Company Law came into effect on 1st July 1994
154 Details collected from China Company Law website: www.cclaw.net/download/company law.
(ix) appoint or removing the general manager of the company; appointing or removing, upon the general manager's recommendation, deputy general managers of the company and the officer in charge of finance; and determining the remuneration for those officers;
(x) formulate the company's basic management scheme.

Representation on the board is therefore crucial if QFII hope to impact the corporate governance of a company. Ferguson & McGuinness suggested that “it is likely that QFIIs investors will demand the right to appoint independent directors as a precondition to investment.” However, our survey results are negative and indicate that no QFII member has under the QFII scheme appointed any independent director to the Chinese companies they invested in.

All of the QFII participants stated they have no desire to become directly involved in the management of the client companies and that is why they have not sought board positions.

6–4 Specialized Committees

In countries with good corporate governance, it would be normal for listed companies to have an audit committee, remuneration committee, investment committee and nomination committee. These committees would be responsible for various functions which contribute to sound corporate governance eg the audit committee is responsible for the appointment of external auditors and the presentation of the auditors’ report to the Board; the remuneration committee is responsible for recommending financial rewards for directors and senior managers; the investment committee would be responsible for evaluating and recommending corporate investments and finally the nomination committee is responsible for the nomination of directors and the CEOs. However, except for a few Chinese companies, such committees are the exception rather than the norm in China.

China’s Company Law does not legislate for the setting up of any of the four specialized committees mentioned in the paragraph above and the duty is entrusted with the Board of Directors who are charged with the responsibility of

(i) determining the structure of the company's internal management; (Article 112 -8 )
(ii) formulating the company's basic management scheme (Article 112 -10 )

Our survey indicates that no QFII member has been appointed to any of the specialised committees of Chinese companies. As mentioned earlier all the QFII respondents expressed no desire to participate in any direct management role of the companies they invested in.

155 Ferguson, M & McGuiness, P. Op Cit., (Note 2 ) page 60
156 When HSBC invested 19.9% in Bank of Communication in Aug 2004 they got 2 board seats. Details from website:http//www.hsbc.com.cn. This investment is outside the QFII scheme.
6 – 5 Management Support

**Dialogue sessions with key decision makers of Chinese companies**

Management support is one way for the QFII to impact on corporate governance of the companies they invest in and this is one area that they have contributed to better corporate governance. This occurs through the regular meetings that the QFII participants have with the Chinese companies where a great variety of topics are discussed. These topics would include measures on improving corporate governance, foreign corporate organisational structures and how QFII evaluate prospective investments. The majority of the QFII members (6 out of the 7 surveyed or 86%) have frequent meetings with the Chinese companies they invest in. These meetings may be monthly, quarterly or half yearly depending on need and availability.

These meetings occur at different levels depending on necessity: sometimes at board level and others at the senior managerial levels. It all depends on the intimacy of the relationships established by the QFII vis-avis the Chinese companies. Meetings with key decision makers can arise because the Chinese company may wish a second opinion on the advisability of appointing new directors or proposed corporate acquisitions or restructuring of the company.

Both UBS Warburg and Citibank stand out in that both institutions have ongoing programs to help improve corporate governance of the Chinese listed companies so much so that the Chinese listed companies even consult them on a regular basis on other matters too. Proposed resolutions at shareholders meetings are routinely discussed with them and changed to take into consideration their views on the proposals.

**Seminars & training sessions**

Five of the seven QFII members surveyed contributed to better corporate governance by indirect means through the conduct of seminars and training sessions. These seminars and training sessions would include topics on the following:

- What constitutes good corporate governance
- How corporate governance is practiced in other countries like USA/UK
- Regulatory bodies in other countries and how they work
- Rights and responsibilities of the various corporate players in the marketplace
- Legal and corporate framework

At these seminars, the QFII organizers will invite representatives from the different organizations, eg fund managers, regulatory bodies like the CSRC, international lawyers and accountants to speak on their international experiences. The conduct of training sessions and seminars is an important contributory role that QFII have played in the furtherance of good corporate governance. These seminars help instil the culture of corporate governance because Chinese companies learn about international standards, they learn how corporate managers deal with governance issues in Europe, USA and the UK. They learn about what constitutes accountability and transparency.
Twenty eight percent of our QFII respondents do not conduct seminars and training sessions for the Chinese companies they invest in. When queried, their answer was that there was “no budget for corporate governance expenditure.”

7 An overall view of the QFII.

Our survey found that all the participants considered that the QFII scheme had contributed to better corporate governance although many felt that the impact had been “slow” “in its early stages” and “not significant” One QFII member felt that the rate of corporate governance progress cannot exceed the rate of progress of the overall economy and another felt that more education and training are needed.

It is possible that the initial expectations were too high. The CSRC had initially hoped that the QFII with their foreign expertise and expectations, would, amongst others things, insist on accountability, fiscal transparency, information disclosure and thus engender good corporate governance.

Another reason is that the QFII scheme has had a relatively short history. Although coming into effect on 1st December 2002, the first quotas were allocated to UBS Warburg, and Nomura Securities in May 2003 and as at 31st December 2003 there were 12 QFII members.

The QFII quotas allocated have also been quite small and currently stand at just over US$5 bns. Compared to the overall market capitalization of US$450 bns it is only just over 1%. The CSRC has announced that the QFII quotas were increased to US$10 bns in June 2005, but the quotas have not been disbursed.

Another reason for the slow progress of corporate governance is that not all of the QFII take an active role in promoting it. One of the QFII merely advises their foreign clients “that corporate governance in China being what it is to just add on an additional risk premium for their China investments”.

All the QFII who responded stated that the Chinese companies welcomed the QFII scheme and the prospect of having foreign institutional investors on their shareholders’ registry. The reason is that the presence of QFII presages the arrival of a long term investor.

4 Summary

Early on in the chapter we posed four questions regarding the QFII.

(1) How did QFIIs impact on shareholders.
(2) How did QFIIs impact on management
(3) How did QFIIs impact on board of directors
(4) How did QFIIs impact on market discipline

Our survey found that some of the QFIIs exercised their rights as shareholders and participated actively in shareholders’ meetings. However, there was no representation
on the board of directors at all and the influence of the QFII on appointments to the board of directors was at best indirect and tenuous. There was also no representation of the QFIIs on the board of supervisors or in any of the specialized committees. These are all key committees that impact strongly on corporate governance of a company.

One positive development of the QFII relates to the voluntary disclosure of additional financial information which encourages transparency. This came about as the QFII needed financial transparency to evaluate the financial performance of the Chinese companies. The other positive impact came about through indirect channels, when the QFII provided management support and advice through the conduct of seminars, meetings and dialogue sessions.

On an overall basis, the impact of the QFII on corporate governance has been limited. It has been limited because none of the QFII have appointed supervisors, directors or representatives to the specialized committees nor have they any desire to take a strong, direct role in the management of the Chinese companies. Furthermore some of the QFII are not even interested in the corporate governance of the companies they invest in.

Ferguson & McGuinness’s article observes that “the QFII scheme carries tremendous potential as a vehicle for raising corporate governance standards.” ¹⁵⁷ but our survey shows that the potential has not been realized.

A balanced concluding view of the QFII scheme is that perhaps too much was expected of it in the initial stages and perhaps not enough time has elapsed for it to be thoroughly implemented after all the QFII has been in existence for just over two and a half years. The QFII quotas granted to date have been small in the context of the overall market capitalisation. When the quotas are enlarged substantially and the QFII rules are loosened considerably, then there will be a greater impact of the QFII on corporate governance.

It is also appropriate to look back towards the late seventies and eighties when the “gradualist approach” was adopted for the overall pace of economic reforms. It appears that the CSRC has adopted a similar approach to the problems of corporate governance and intends to make gradual changes in response to changing socio-economic circumstances.

¹⁵⁷ Ferguson, M & McGuinness, P. Op Cit., (note 2) page 60
The problems of corporate governance in China arose because of the transition from a command to a market economy. With the beginnings of the market economy came the establishment of the stock markets in Shanghai and Shenzhen in 1990 and the problems of regulating the listed entities. Which model of corporate governance was to be chosen? There are two main models of corporate governance: the “Agency” model adopted by the Anglo Saxon countries of UK/USA/Australia and their former colonies and the “Stakeholder” model adopted by the European countries and Japan. The UK/USA model of corporate governance is the “Agency” model also sometimes referred to as the “Shareholder Value” model and is characterised by widely dispersed shareholdings and a strong and comprehensive financial system underscored by market control and the “rule of law.” By comparison the “stakeholder” model of corporate governance is characterised by shareholdings that are large and concentrated and where the State and the Banks play an important role in the governance structure.

Without fanfare and debate, China chose the Agency model in preference to the Stakeholder model but the reality is that the Agency model is not the most appropriate one. This is because China lacks much of the institutional framework and market determinants that the free market economies of UK/USA have. This does not mean that the Stakeholder model does not require a sound institutional framework and free market mechanisms. It also does but the Agency model proposes that the corporation be governed for the benefit of the shareholders solely whereas the Stakeholders envisages a more inclusive model.

Problems of corporate governance in China arose because the bureaucracy is riddled by inefficiency, corruption and a lack of accountability. These shortcomings are examined in Chapter 4 and a Chinese perspective is given as to why these institutional determinants have deteriorated and not improved. The basic flaws in the institutional framework make it difficult for the regulatory body, the CSRC to supervise and regulate the listed entities in an economy where there is no press freedom and there is no rule of law as understood in the west.

The CSRC had hoped that the introduction of the QFII scheme would lead to better corporate governance. This hope was based on expectations that the QFII when investing in the local Chinese companies would require them to adopt high standards of corporate governance “as the Chinese companies would be benchmarked against their international peers.”

Our results from a survey of the leading QFII players showed that while the QFII has improved standards of corporate governance the improvements have been limited. They have been limited because none of the QFII have any desire to take an active management role and hence directly impact on corporate governance in the Chinese companies they invest in. They have not appointed any independent directors or supervisors nor have they any representation on the specialist committees in the companies they invest in. Their influence is at best indirect and tenuous being through management support: dialogue sessions, the conduct of educational seminars and
training sessions and through the exercise of their voting rights at shareholders meetings. The management support given by the QFII though is important and where the relationship between the QFII and the Chinese company is close, the corporate governance impact can be effective.

One important point to remember though is that the QFII members do look for Chinese companies with sound corporate governance structures and mechanisms to invest in. Although financial performance takes paramount consideration, the fact that QFII members use corporate governance as an additional yardstick in the evaluation of target companies is an encouragement to Chinese companies to attain higher standards of corporate governance.

The Chinese authorities must eventually realise though that the QFII scheme has had a limited impact. For it to have a greater impact, the QFII quotas must be enlarged substantially and the rules loosened substantially to encourage more QFII to participate. The QFII scheme is not the panacea to all their problems and it is in essence “tinkering with the system.” The challenge for the Chinese authorities is how to make the QFII scheme work more effectively in the iron cage environment that it currently operates under.
## APPENDIX 1

### Statistical Table: Governance indicators for CHINA /UK/USA/France/Germany

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<th>USA Percentile Rank (0-100)</th>
<th>France Percentile Rank (0-100)</th>
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**Note:** The governance indicators presented here reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators in no way reflect the official position of the World Bank, its Executive Directors, or the countries they represent. As discussed in detail in the accompanying papers, countries' relative positions on these indicators are subject to margins of error that are clearly indicated. Consequently, precise country rankings should not be inferred from this data.
APPENDIX 2

Statistical Table: Governance indicators for CHINA, Taiwan, Korea, Japan & Singapore

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>Year</th>
<th>China Percentile Rank (0-100)</th>
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<th>South Rank</th>
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Appendix 3

Growth Competitiveness Ranking by country

<table>
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<th>Country</th>
<th>Growth Competitiveness Index 2003 Ranking</th>
<th>Growth Competitiveness Index 2002 Ranking</th>
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Note: World Economic Forum 2004. Compiled by Prof Klaus Schwab. Total number of countries surveyed 102
APPENDIX FOUR

List of QFII members contacted to participate in the survey

1  UBS Warburg
2  Nomura Securities Co Ltd
3  Morgan Stanley & Co International Limited
4  Citigroup Global Markets Ltd
5  Goldman Sachs & Co
6  Deutsche Bank Aktiengesellschaft
7  HSBC Banking Group
8  ING Bank
9  JP Morgan
10 Credit Swiss First Boston
11 Standard Chartered Bank
12 Nikko Asset Management Co Ltd

List of those who agreed to participate in the survey

1  UBS Warburg
2  Morgan Stanley & Co International Limited
3  Citigroup Global Markets Ltd
4  Deutsche Bank Aktiengesellschaft
5  HSBC Banking Group
6  ING Bank
7  JP Morgan

The questionnaire was answered by Senior Managers of the various financial institutions who however do not wish to be identified.

Note:

The 12 QFII members had allocated QFII quotas of US$3.22 bns as at 31-12-2005. The 7 who agreed to take part in our survey had QFII quotas of US$2.45 bns or 76% of their total. See Table 1 in this chapter for details.
APPENDIX 5

The following questionnaire was sent to the Presidents / Chairmen / CEOs of the various QFII participants for them to answer. Where they were too busy to attend to the questionnaire, they delegated the task to a senior manager responsible for or related to the QFII. Two of those chosen gave written replies while the others gave verbal answers to questions based on the questionnaire. The interviews were recorded with their permission.

Questionnaire

1. What is your opinion of the QFII scheme since its implementation in China?

2. Various foreign financial institutions have been quoted in the Press as saying that QFII status will contribute to better corporate governance of Chinese listed companies. In your own opinion has this happened and is it possible to indicate instances?

3. Do you release to the public names of Chinese companies your company has invested in.

4. What other categories of investments do you invest in apart from shares. Do you invest in convertible bonds, closed end/open funds?

5. How do you monitor your investments?

6. How long on average do you intend to hold these investments?

7. Are any of these investments short or long term? Short term < 1 year, long term > 4 years

8. Do you have board of director representation in any of the Chinese companies invested in?

9. If there is no board representation, do you have any influence over the board of directors of the Chinese companies invested in?

10. If there is board of director representation, do the QFII directors participate in all board meetings?

11. Is there any attempt by your company to transfer standard management procedures to the Chinese companies you invest in? Is there any resistance?

12. If management procedures are transferred, do they include formal and informal supervisory and risk minimising procedures?
13 Do you have representation in any of the audit committee, compensation committee, investment committee of any of the Chinese companies you have invested in?

14 Do you have representation on the board of supervisors in any of the Chinese companies.

15 If there is no board of supervisor representation, do you have any influence over the board of supervisors of the Chinese companies.

16 How does your company monitor share investments in other Western countries like USA, UK or Australia?

17 How can you contribute to better corporate governance of the Chinese companies it has invested in?

18 Have you been called upon to provide any training, assistance by Chinese companies or government agencies?

19 What kinds of training do you provide to the Chinese companies invested in.

20 Are there Chinese financial institutions or government bodies that you work with to ensure better corporate governance. Which are they?

21 How do you think the QFII scheme can be improved upon?

22 Are there any comments on QFII or any aspect of corporate governance in China you wish to make.

Note:

Please feel free to ignore any of the above questions if information requested are of a sensitive and confidential nature. We confirm that information will only be used for academic purposes only.

Questionnaire Prepared by

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University of New South Wales
Sydney
Australia

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Fax: 612-96598753
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APPENDIX 6

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http://www.iwep.gov.cn Website: Institute of World Economics & Politics, Corporate Governance Centre, Chinese Academy of Social Sciences, Beijing.

Word Count 34,338

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Sydney
4th July 2006