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Corporate Governance in China

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Corporate governance in China has undergone significant change during the past three decades as the Chinese economy has liberalized and developed. Prior to the historic reforms initiated in 1978 the economy had been structured as a state-owned, centrally planned economy; practically all enterprises were government or commune owned. Today, many companies are partially or wholly privately owned, and that historic change has brought a sea change in Chinese corporate governance, with securities policies well in place and governing boards well established.

The first significant changes in company ownership came in the 1980s as small state-owned enterprises and collectively owned enterprises in rural areas began issuing shares to the public. As the reforms spread to larger enterprises, the rapid increase in company-issued securities led the Chinese government to swiftly create a capital market from scratch. In 1990 it authorized the cities of Shanghai and Shenzhen to establish national stock exchanges.

The stock exchanges were tiny at the start: just 14 companies were listed at the outset, and in the early years state agencies and the listing companies kept some two-thirds of the shares out of the market. Company listing and trading volume rapidly increased in line with China's extraordinary economic growth, however, and the government created the China Securities Regulatory Commission (CSRC) in 1993 to provide regulatory oversight of the burgeoning listings and the fast-expanding capital market. China subsequently instituted the 'Company Law' in 1994, which prohibited self-dealing by executives and directors and delegated merger approval to shareholders, and the 'Securities Law' of 1998, which strengthened the CSRC's supervision of the equity market and its power to penalize improper behaviour. China opened its equity market to foreign institutional investors in 2003, and in 2005 it initiated a programme to convert untraded state and company-held shares into tradable securities.

With China's market reforms and accelerating growth, the stock exchanges have come into their own over the past decade. By mid-2008 the Shenzhen Stock Exchange by listed 540 companies with a total market value of RMB 1 trillion, and the Shanghai exchange listed 1,172 companies with a collective value of RMB 15 trillion. The combined 1,712 companies with a capitalization of RMB 16 trillion (£1.3 trillion) remained modest by comparison with the New York Stock Exchange's 2,800 companies and £11.4 trillion ($20 trillion) capitalization, and the London Stock Exchange's 3,000 companies and £3.5 trillion capitalization. The Chinese exchanges were expanding rapidly, however, and the basic institutions of an actively traded public equity market had been put in place.

In just two decades, China had created a capital market that measured up reasonably well by Western standards. Virtually all – 98 per cent – of the state- and company-held shares, for instance, had become tradable, eliminating the privileged ownership rights that had initially been reserved for state and company shareholders. The World Bank and the International Monetary Fund gave high marks to China's many reforms, and a study conducted in 2006 by Canada's Centre for International Governance Innovation (CIGI) concluded that China rated first among 10 Asian nations in adopting a set of governance principles put forward by the Organisation for Economic Co-operation and Development. Much remained still to be done, however, with company compliance and public enforcement of the reforms far from complete. The same CIGI study rated China's actual governance practices ninth among the 10 Asian countries.

6.2.1 Distinctive Features of Chinese Corporate Governance

Corporate governance practices in many countries have displayed some convergence towards Western standards in recent years (often emulating Britain's 1992 Cadbury Code and the United States' 2003 Sarbanes–Oxley Act), but countries generally retain a set of distinct practices. In building its own system, China has been no exception. Four distinctive features of Chinese corporate governance in the late 2000s are particularly notable: 1) highly concentrated ownership; 2) strong state ownership; 3) pyramid ownership structures; 4) weak markets for corporate control.

6.2.1.1 Highly Concentrated Ownership

Company ownership is generally diffuse in the United Kingdom, the United States and other Western economies, with relatively few shareholders controlling more than a few per cent of the shares of any given firm. By contrast, ownership in China's listed firms is highly concentrated. Of the 1,602 companies listed on the Shanghai and Shenzhen stock exchanges in August 2008, the single largest owner held 36 per cent of an average company's shares, the top three owned 49 per cent and the biggest five controlled 52 per cent. The high degree of concentrated ownership has remained relatively stable since the founding of the exchanges. As a result, owners tend to exercise more control over Chinese companies than is common among their Western counterparts.

6.2.1.2 Strong State Ownership

Despite a long-running process of privatization of state-owned enterprises, government agencies have maintained a high level of ownership and thus strong influence over many of the country's publicly listed firms. State-owned or state-controlled enterprises were responsible for 31 per cent of China's GDP in 2007, and the Shanghai Stock Exchange reported that the government held 51 per cent of its listed shares. Government officials overseeing the state's ownership stakes are not immune to political considerations, members of the Communist Party are often appointed to company boards, and Chinese regulations require that publicly listed companies provide 'necessary support' for the functioning of the Communist Party within their firms.

6.2.1.3 Pyramid Ownership Structures

Most major British and US publicly traded companies are owned and operated as stand-alone entities that work independently of one another to optimize investor returns. Many listed Chinese firms, by contrast, are owned or controlled by an unlisted parent company, and many of the listed firms in turn control other listed companies. The resulting pyramid ownership structure has opened the way for the malfeasance of tunnelling, in which a controlling firm extracts resources from other firms in its pyramid whose minority owners would disapprove if the transfer came to light. A 2006 study by the Shanghai Stock Exchange revealed that such practices had become widespread: of the 1,377 firms studied, 35 per cent had misappropriated to their parent companies funds totalling RMB 48 billion. As a sign of the breadth of the problem, in 2006 China added pyramid misappropriations to its criminal code.

6.2.1.4 Weak Markets for Corporate Control

Because two-thirds of a typical firm's shares were held by the state and the companies themselves, and were untradable before 2005, the market for corporate control in which companies and investors compete for control of other firms has been virtually non-existent. With the formal movement of untraded shares on to the open market completed by 2007, active contests for control became more feasible.

Yet even then, large blocks of a company's shares – often a third, half or even more – remained in the hands of public agencies. Unlike private investors, state organizations are concerned with a host of factors in addition to optimizing shareholder value, and few of the newly 'tradable' shares were actually traded in any case. A CSRC study in 2008 found that among the 10 largest market-cap companies on the exchanges, 8 of them had fewer than 10 per cent of their shares in active trading, and the other 2 had less than a third actively traded. As a result, most mergers and acquisitions were achieved through negotiation, and most required state approval as well. A hostile takeover bid for a financially underperforming company – the most prominent weapon in the Western arsenal for corporate control – could rarely attract the shares required or win government approval. More entrenched management at poorly performing companies has been one result.

6.2.2 The Chinese Governing Board

As the Chinese public equity market matured, the organization, composition and practices of boards of directors of some publicly listed companies in China came to acquire some features similar to those of Anglo-American firms. The personal computer maker Lenovo, for instance, brought several independent directors on to its boards after it acquired the IBM personal computer division in 2005. Chinese governing boards have nonetheless followed a distinctive path in the areas of 1) board structure, 2) shareholder rights, 3) disclosure and transparency, 4) corporate social responsibility, 5) the role of directors, and 6) executive compensation.

6.2.2.1 Board Structure

China has adopted a two-tier board structure similar to the German convention of having a supervisory board overseeing a board of directors. Chinese supervisory boards are required to have at least three members, and a third of the members must be employee representatives. In principle the supervisory board monitors the directors and management, but in practice virtually all supervisory board members are from inside the firm, and the supervisory board largely rubber-stamps the decisions of directors and management.

The board of directors in the Anglo-American system sits at the hub of company governance, while in China the annual shareholders' meeting has emerged more to the front and centre. Chinese company law endows the shareholders' meeting with powers normally reserved for the board in the United Kingdom and United States. The board of directors in China, for instance, is required to 'develop and formulate' the company's annual budget and business plan, not just review and approve the budget and plan, as is common in the Anglo-American world. Still, given that those attending the annual shareholders' meeting cannot effectively exercise discretionary authority in that venue, most of the real decision-making power remains in the hands of the directors and management.

Chinese regulations require a firm to designate one individual as the 'legal person representative' to act on behalf of the firm. This position is normally assumed by the chairman of the board, and this rule has had the effect of investing greater power in the board chair than is common among British or America companies when the chair and CEO roles are separated.

6.2.2.2 Shareholder Rights

China's Company Law, revised in 2006, requires greater disclosure of information to stockholders than is common in the West. Shareholders elect directors and vote at shareholder meetings, but they also have access to company charters, shareholder lists and the minutes of meetings of both the supervisory board and the board of directors.

To protect minority shareholders at companies where ownership is concentrated and pyramids prevail, companies are required to follow formal procedures for entering into related-party financial transactions. It is now mandatory, for instance, that shareholders approve a company's transactions with a controlling company, and the controlling company cannot vote its shares on such transactions. Minority shareholders have the right to introduce motions at, and to convene or even preside over, shareholders' meetings, and they can adopt a cumulative voting system for electing directors and supervisors.

6.2.2.3 Disclosure and Transparency

Compared to those in OECD countries, China's disclosure requirements have been vague and enforcement has been weak. A 2003 study by the Shanghai Stock Exchange reported that 'distortion of accounting information is quite common', and a 2007 CSRC report concluded that 'there are still many cases of management entrenchment or "insider control" in capital markets', and that 'fraud, price manipulation and insider trading by securities professionals' are still evident.

China has made many efforts in recent years to increase transparency and strengthen enforcement in the public equity market through four avenues. The National People's Congress has established the legal framework through such provisions as the Company Law, the State Council has created the regulatory framework though the Security Trading Management Regulation and related rules, the China Securities Regulatory Commission has offered even more specific guidelines though its Listed Company Disclosure Requirement Implementation Rules, and the Shanghai and Shenzhen stock exchanges have added their own specific listing requirements.

The People's Congress strengthened the penalties for market manipulation, and in 2006 explicitly prohibited the practice in many companies of maintaining two sets of accounting records. The Ministry of Finance imposed a set of accounting standards in 2005 that are largely in line with international accounting reporting principles. In 2007 the CSRC imposed stricter requirements on the disclosure of company information. Disclosure of material information now must be made simultaneously to all parties, and companies are now required to have an internal process in place to ensure that the CSRC disclosure standard is met.

6.2.2.4 Corporate Responsibility

China has placed formal emphasis on corporate social responsibility, more so than is common in many Western economies. The Company Law of 2006, for instance, has required that a company 'observe social norms and business ethics standards, operate honestly, accept monitoring by government and the general public, and assume its social responsibility'.

The exchanges have gone even further. Shenzhen demands of its listed companies that in the process of maximizing shareholder value, they must also 'consider' the interests of their creditors, must not sacrifice creditors' interests for the sake of shareholder value and must provide creditors with access to financial and operational data. Shenzhen companies must also 'commit themselves to social welfare services like environmental protection and community development in order to achieve social harmony'.

Despite such formal efforts, companies have often fallen short of properly combining company ownership and social responsibilities. The Shanghai Stock Exchange, for example, identified several especially problematic areas in 2007. Formerly state-owned enterprises were still sometimes shouldering social responsibilities that should have been shifted to public agencies. Company executives were still failing to faithfully fulfil their financial obligations to their owners. And because of pressures for rapid growth, many companies were failing to protect the environment properly, ensure safe working conditions, assure product quality and prevent fraud.

6.2.2.5 The Role of Directors

Prior to 2001, no law or regulation required that any directors be independent of management. The CSRC now requires that a third of the seats on a publicly listed company board be held by independent directors, and many companies have reached that threshold. A 2004 study by the Shanghai Stock Exchange found that independent directors constituted nearly a third of the board members, and on occasion have exercised a very independent role. In one widely publicized incident, for example, an independent director challenged related-party transaction by the board chair of a prominent food maker, and upon CSRC investigation the company ousted its chairman.

The 2006 Company Law strengthened the obligations of directors to include both 'duty of loyalty' and 'duty of care', though neither is defined very clearly. It did state that the loyalty obligations included forbade the use of company funds for personal use, the making of loans to others without authorization, the disclosure of proprietary information, self-dealing and bribes. It also held directors personally liable if director decisions violated state regulations or the company charter.

6.2.2.6 Executive Compensation

Executive compensation in China has been substantially lower than that in the West, though it has been rising rapidly. A survey conducted by the Shanghai Stock Exchange reported that the average compensation of the highest-paid executive of listed firms in 2003 was close to RMB 200,000 (£16,800), but just two years later the average had jumped to RMB 300,000 (£25,200). The highest-paid executive in 2005 received compensation of RMB 6 million (£500,000), but three years later the largest executive pay cheque had soared to RMB 66 million (£5.5 million). Not surprisingly, executive compensation in state-owned enterprises remained far below that in privately held corporations.

Even with the rapid rise of executive compensation, most pay remained fixed, rather than varying with performance. In many US and British listed firms the great majority of top executive compensation is variable, while in Chinese listed firms, according to a study in 2006, fully 97 per cent was still paid in the form of a fixed salary. Only a tenth of the firms used stock options at all. In 2006 the CSRC gave its blessing for more, though it declared that no more than 1 per cent of a company's shares can be used as options for the top executive, and no more than 10 per cent for any of its executives.

6.2.3 Chinese Governance

China has created one of the largest markets for publicly listed companies in the world. The total market capitalization the two

Chinese stock exchanges ranked below only those of the United States, Japan, Europe and the United Kingdom in 2008, up from no market capitalization at all less than three decades earlier.

China's regulatory regime has come to include everything from prohibitions against self-dealing and tunnelling to prescriptions for independent directors and contingent compensation. Though some features of Chinese corporate governance are akin to those found in most Western economies, several features remain distinctive, including highly concentrated ownership, much of it by the state, and a relatively weak market for corporate control.

Similarly, though certain aspects of the governing boards of Chinese publicly traded companies are similar to those elsewhere, distinct features are evident here too, including less influential boards, weaker disclosure enforcement, greater social responsibility and less contingent compensation. Whether Chinese corporate governance will converge with the Anglo-American model or retain its distinct features in the years ahead remains to be seen.

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