THE ROLE OF NON-LEGAL INSTITUTIONS IN CHINESE CORPORATE GOVERNANCE

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I. INTRODUCTION

Corporate governance in China has emerged in the last few years as a subject of considerable interest to scholars in law, economics, and business.[1] The economics and business literature has for the most part attempted to find correlations between corporate performance (measured in various ways) and a number of variables arguably relevant to corporate governance, such as concentration of ownership, number of independent directors, or proportion of state ownership. The legal literature has largely looked at the treatment of corporate governance in the Chinese legal system, including both the norms and the institutions—in particular, the court system and the China Securities Regulatory Commission—for enforcing those norms.

So far, however, relatively little systematic attention has been paid to the institutions outside the formal legal and regulatory structure that make up the environment in which corporate governance norms, both formal and informal, are expected to function. While that environment includes both state and non-state institutions, the particular focus of this paper will be on institutions not directly under state control.

This paper adopts a narrow definition of corporate governance, one that is concerned with issues of finance and agency cost and has a policy component: the prevention of the exploitation of those who supply the money by those who control it.[2] Stated pithily, it is about answering this key question: "[H]ow can financiers be sure that, once they sink their funds [into a firm], they get anything but a worthless piece of paper back from the manager?"[3]

The chief agency problems in this limited conception of corporate governance are of two kinds: first, vertical (the exploitation of stockholders as a whole by management) and second, horizontal (the exploitation of minority shareholders by controlling

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[1] A search of the Legal Resource Index using "corporate and governance and (china or chinese)" yields no results for 1993, the year China adopted its first Company Law. The same search yields five results for 2001 (the first year more than two results are returned). It yields 13 results for 2004, declining to eight for 2005. As for Chinese literature, in 1994, the year the Company Law came into effect, there were nine articles using the term in their title; in 2005, over one hundred times that number of articles appeared. These numbers come from a search of a widely used database of Chinese periodicals in law, economics, and related subjects (*Zhongguo Qikan Quanwen Shujuku* [*Chinese Periodicals Full-Text Database*], *at* http://www.cnki.net).

[2] *See generally* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[3] Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 740-41 (1997).

shareholders). In each case, the controller extracts rents or private benefits,[4] but may do so in different ways, and the means of mitigating such exploitation are different. Moreover, the means of mitigating one kind of agency cost may increase the other. Dispersed shareholding can lead to high vertical agency costs, because the free rider problem makes it difficult for shareholders to monitor management. But one solution—concentrated shareholdings—may result in higher horizontal agency costs.[5]

In the United States, the main agency cost problem is vertical; in the rest of the world, however, and especially in transition economies, horizontal costs dominate.[6] As I shall show, China seems to be no exception to this pattern. What is exceptional, however, is the identity of the controlling shareholder that is engaging in the exploitation: in most cases, it either is or is closely connected to a governmental entity. Thus, certain mechanisms for dealing with controller shareholder problems that work outside of China may not work within it because the controlling shareholder is too powerful or otherwise benefits from special protection.

A few caveats are in order. First, although this paper purports to be about non-state institutions, in China it is difficult to speak of any institutions not subject to state influence in some degree. The Chinese political system does not fundamentally accept the existence of an independent civil society; in principle, the state permits the existence of *no* organization not subject to government direction.[7] Second, I include within the category of "non-state institutions" certain mechanisms and structures (for example, independent directors) that ultimately depend in some sense on the state legal system for their effectiveness. Although a clear line cannot therefore be drawn between state

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[4] *See* Mark J. Roe, *The Institutions of Corporate Governance* 2 (Harvard University, John M. Olin Center for Law, Economics, and Business Discussion Paper No. 488, Aug. 2004), *available at* http://ssrn.com/abstract=612362.

[5] *See id*. at 4.

[6] *See* Rafael La Porta et al., *Corporate Ownership Around the World* (Harvard Institute of Economics, Research Paper No. 1840, Aug. 1998), *available at* http://ssrn.com/abstract=103130 ("[T]he central agency problem in large corporations around the world is that or restricting expropriation of minority shareholders by controlling shareholders[.]"); Roe, *supra* note 4, at 2-3; see also the literature summarized in Diane K. Denis & John J. McConnell, *International Corporate Governance*, 38 J. FIN. & QUANTITATIVE ANALYSIS 1 (2003). For a vivid account of controlling shareholder shenanigans in Russia, see Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000).

[7] This is no exaggeration. In 2003 the Ministry of Civil Affairs issued a list of proscribed organizations that included unauthorized fishing clubs and associations for the study of antique furniture and paper-cutting. *See* ZHONGHUA RENMIN GONGHEGUO MINZHENG BU GONGGAO [BULLETIN OF THE PEOPLE'S REPUBLIC OF CHINA MINISTRY OF CIVIL AFFAIRS], No. 41, June 6, 2003, *available at* http://www.legaldaily.com.cn/gb/misc/2003-06/06/content_30521.htm [hereinafter *Proscription Notice*].

and non-state institutions of corporate governance, I believe that it is still useful to attempt to single out the latter for special examination, if for no other reason than that so far so much attention has been concentrated on the former.

There is, however, a more important reason: the potential of such non-state institutions to contribute to more effective corporate governance if allowed to do so. China's corporate governance regime relies heavily on the announcement of rules by government authorities and relatively little on institutions for making those rules meaningful. Lawmakers expect that regulated parties will read the legal texts and voluntarily obey; if they do not, their ignorance or moral failings are blamed, not the lack of enforcement institutions.

Still less does the corporate governance regime look to non-governmental institutions for the making and enforcement of rules and standards. A major reason for this is simply political: as noted above, the political system of China does not yet accept the existence of institutions that are both powerful and independent of the state. Moreover, both Imperial China and China under the planned economy have left their legacy in official culture: it is hard for state officials to believe that the unplanned workings of the market might produce a better set of rules or procedures than they could come up with themselves.[8]

Yet in relying on the state legal and administrative system to make and enforce norms, the state has in a sense chosen to play its weakest card. For all its progress over the quarter century, the post-Mao Chinese legal system remains an institution of only modest importance in the polity. It may be that institutions outside the state legal system could do much more than they now do.

II. NON-STATE INSTITUTIONS OF CORPORATE GOVERNANCE IN CHINA

Rules and norms of corporate governance cannot be understood in the abstract. They function—or fail to function—within a particular institutional environment, and comprehensively understanding and critiquing the rules requires understanding that environment.

A common complaint among Chinese academics and lawyers, for example, is that the rules of the Company Law are too general and are not usable. Certainly this is true some of the time—how, for example, should one begin to interpret "relatively large

[8] I am making a generalization here about political culture; this does not imply that one cannot readily find Chinese commentators equally willing to question official assumptions of omniscience. *See, e.g.*, Fang Liufang, *Wen Gu Zhi Xin—Tan Gongsi Fa Xiugai* [*Reviewing the Old to Understand the New: A Discussion of Reform of the Company Law*], *in* GUO FENG & WANG JIAN, GONGSI FA XIUGAI ZONGHENG TAN [AN ALL-AROUND DISCUSSION OF REFORM OF THE COMPANY LAW] 40 (Falü Chubanshe 2000) ("The whole Company Law is pervaded with the attitude of 'making decisions on behalf of the people.' The legislator shows an excessive self-confidence. It believes it is more intelligent than the parties and can make arrangements in their stead.").

in scale" in Article 52 of the old Company Law?[9] But sometimes the expectations of the critics seem unrealistic. No piece of legislation can spell everything out; the key is to have an alternative system available to supplement legislative gaps. Often the detailed standards they cite with approval come not from the legislation of other countries but from case law, or have been developed through case law.[10]

A further complaint is that even when the rules of the Company Law are clear, regulated parties do not obey them, or else the forms provided by the law, such as the board of supervisors, remain decoratively on the shelf but do not function as the drafters intended. Commentators tend to blame the actors for acting in ways that do not conform to the law's idealized structure. But the real fault lies in the law's failure to provide an enforcement mechanism, in particular one that can be activated by those who are hurt by non-compliance. It is pointless from a policymaking perspective simply to blame the non-compliant, since the only policy consequence of blame is the hope that they will have a change of heart and do better in the future.

This section will not look at the enforcement mechanisms, such as they are, that exist as formal state institutions. Instead, it will attempt to enrich our understanding of the institutional context for corporate governance in China by looking at some particular examples of non-state (or semi-state) institutions and show both their abstract potential for playing a role in corporate governance and the specific possibility of their doing so in China.

A. *Markets in General*

Mark Roe lists a number of institutions for aligning the interests of managers and shareholders.[11] Among these are markets of various kinds—product markets, capital markets, and labor markets—because to the extent that a corporate governance scheme does not rely on public or private enforcement of legal obligations or simply the good conscience of parties to the corporate enterprise, it relies on markets to pressure parties to do the right thing. Managers and shareholders both wish to see the firm succeed in these markets by selling its products, raising funds for expansion, and hiring and retaining good employees, including management. Those markets impose a certain discipline on management, but the constraints they impose are loose, not tight. It may

[9] Or "relatively small in scale" in the corresponding article 52 in the new Company Law.

[10] *See, e.g.*, Xu Yongqian & Li Yulong, Gongsi Zhili yu Gudong Baohu [Corporate Governance and the Protection of Shareholders] 6 (Paper for 21st Century Commercial Law Forum, Qinghua Univ., Nov. 18, 2001) (citing with approval tests developed in U.S. law such as "interest or expectancy," "line of business," and "fairness").

[11] *See* Roe, *supra* note 4, from the list in which several of the institutions examined here are taken.

take considerable time for selection pressures to come to bear on firms operating sub-optimally.[12]

At the outset of economic reform in China, markets did not have a disciplining effect on managers, since very little economic activity of importance took place on a market basis. Over time, however, competition in product and other markets has increased. Nevertheless, a number of companies remain in protected markets; this gives their management considerable slack.

B. *The Role of Stock Markets and External Debt in Corporate Finance and Corporate Governance*

Two important markets are those for external debt and equity financing. To understand the Chinese corporate governance environment, then, we must understand both.

1. Historical Background

The traditional state-owned enterprise (TSOE) of the pre-reform era received all its funding from government bureaux of various kinds. There was no financial market in the sense of firms seeking financing by offering competitive terms, or suppliers of funds offering financing in the same way. There were banks that performed an intermediation function by collecting the funds of individual depositors, to be sure, but they allocated them to firms according to government direction, acting essentially as cashiers.[13]

If the firm received money directly from its government administrative superior, the funds would be characterized as a grant; if the money came from a bank, it would be called a loan. But even if the funds came with the label of "loan", firms operated

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[12] *See, e.g.*, Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOC. 481, 503 (1985) ("The operation of alleged selection pressures is . . . neither an object of study nor even a falsifiable proposition but rather an article of faith."). *See also* RATIONAL CHOICE 26 (Jon Elster ed., N.Y. Univ. Press 1986) (questioning the applicability of the biological analogy to economic activity on the grounds that the economic environment changes rapidly relative to the speed with which inefficient firms are eliminated from competition, and that therefore at any given time we are likely to observe efficient and inefficient firms coexisting).

[13] On the pre-reform era banking system, see generally NICHOLAS R. LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION (The Brookings Inst. 1998).

under a soft budget constraint[14] and were under no particular pressure to repay. While firms still competed for money, they did so on a bureaucratic, not a market basis.[15]

This system began to undergo reform in the 1980s. The People's Bank of China (PBOC) was separated from the Ministry of Finance and set up to operate as a central bank in 1984; the so-called Big Four specialized state-owned banks—the Bank of China, the Industrial and Commercial Bank of China, the Construction Bank of China, and the Agricultural Bank of China—were created to handle conventional banking.[16] Through these banks the state maintained its monopoly on commercial banking.

The 1990s saw the emergence of rivals to the Big Four state-owned banks and an effort to move toward more market-based lending. The so-called "policy banks" were created to handle non-market-based lending,[17] and the government authorized the creation of domestic "joint stock" banks owned by local governments together with other institutional and occasionally private investors.[18] The Commercial Bank Law of

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[14] The soft budget constraint is a concept developed most prominently by the Hungarian economist Janos Kornai in his *Economics of Shortage* (1980) and other works. Its essence is the notion that the difference between proceeds of production and costs of production is not a matter of life and death for the firm. Therefore, it does not act as an effective constraint on firm behavior. The major harmful consequence is that firms do not economize because nobody in the firm suffers the consequences of waste. Those consequences are externalized and are borne by society as a whole.

The features of hard, almost-hard, and soft budget constraints are outlined in JANOS KORNAI, ECONOMICS OF SHORTAGE 302-14 (1980). *See also* Janos Kornai, *The Soft Budget Constraint*, 39 KYKLOS 3 (1986).

[15] Readers familiar with the workings of the modern university may quickly gain an intuitive understanding of the process by substituting in the following paragraph the words "central administration" for "state", "departments" for "firms", and "deans" for "managers":

> State bureaus closely monitored many of the firm's activities; however, the need to monitor a large number of firms created informational asymmetries, and managers responded by hoarding resources and bargaining for favorable treatment. Bargaining for scarce capital was acute and financing was highly uncertain because funding varied with state political whims and the personal allegiances of high ranking officials.

Lisa A. Keister, *Capital Structure in Transition: Financial Strategy in China's Emerging Economy* 5-6 (Oct. 2000), *available at* http://ssrn.com/abstract=268130 (citations omitted).

[16] On the Chinese banking system, see generally LARDY, *supra* note 13 and, for a brief overview, U.S. Commercial Service, Department of Commerce, *Banking -- U.S. Commercial Service China*, *available at* http://www.buyusa.gov/china/en/bank.html.

[17] These banks—the Agricultural Development Bank of China, the China Development Bank, and the Export-Import Bank of China—were established in 1994 to take over the government-directed lending functions of the Big Four state-owned commercial banks.

[18] Such banks include the Bank of Communications, the Shenzhen Development Bank, China Everbright Bank, and the China Merchants Bank.

1995[19] called for banks to make loans on the basis of traditional commercial criteria and to wean themselves from state support. While these banks may be more profit-oriented than the Big Four, they are still subject to significant political influence in their functioning (they are typically owned in part by local governments) and have not been able to escape the obligation to make "policy loans".[20]

The role of stock markets in the story of corporate finance is inseparable from the recent history of the banking system. Although lending during the 1980s and 1990s was supposed to be on the basis of market-based criteria, politics continued to play a key role. Like many other elements of the Chinese state, banks were subject primarily to the principle of horizontal, not vertical, accountability: officials at local banks—where the money was—owed their jobs and allegiances to local political leaders. And if local political leaders thought a favored enterprise should get a loan, it got it. Bank lending grew faster than the economy during much of the 1990s, and the non-performing loan (NPL) holdings of the banks grew concomitantly. By the late 1990s, the system was insolvent.[21]

Although the stock markets had been in existence since 1990, it was in 1996 that national leaders, looking for an alternative to bank lending, turned to them as a way of providing a new source of financing for the troubled state sector. This marked the beginning of unequivocal state support for stock markets. It also solidified some key features of the Chinese stock markets: first, that their primary role has been not to allocate capital to the most efficient enterprises, but to raise money for restructuring SOEs,[22] and second, that the state has been both regulator and cheerleader, with the specific mission of keeping stock prices up in order to support the financing of SOEs.

The following discussion does not touch on the corporate bond market as a method of finance; in China it has been negligible.[23] Corporate bonds represent less

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[19] *Zhonghua Renmin Gongheguo Shangye Yinghang Fa* [*People's Republic of China Commercial Bank Law*], adopted May 10, 1995, effective July 1, 1995.

[20] *See* STEPHEN GREEN, CHINA'S STOCKMARKET: EIGHT MYTHS AND SOME REASONS TO BE OPTIMISTIC 22 (The China Project, Royal Institute of International Affairs and Cambridge University, Feb. 2003); Pamela Mar & Michael N. Young, *Corporate Governance in Transition Economies: A Case Study of Two Chinese Airlines*, 36 J. WORLD BUS. 280, 283 (2001). During the Asian financial crisis, for example, the government ordered the banks to lend heavily in order to stimulate the economy.

[21] *See* GREEN, *supra* note 20, at 22.

[22] *See* Yelin Zhang, *The Roles of Corporatization and Stock Market Listing in Reforming China's State Industry*, 32 WORLD DEVELOPMENT 2031, 2044 (2004).

[23] *See* Ji Chen and Stephen Thomas, *China's Bond Market Matures, Slowly*, CHINA BUS. REV., No. 1 (Jan. 2005), at 30, *available at* 2005 WL 886792.

than one percent of China's GDP, compared with 140 percent in the United States and 95 percent in Japan.[24]

2. The Stock Market in Recent Years

a. **How Important Is It?**

Given the support China's stock markets have received from the state, it is not surprising that much writing on them contains the stated or unstated assumption that they are critical to the Chinese economy. A look at the numbers suggests, however, that this is not in fact so; that if an earthquake were to swallow the Shanghai and Shenzhen exchanges tomorrow, the Chinese economy would not suffer appreciably.

As of the end of 2005, China's two stock markets listed 1,381 companies, with a circulating share[25] capitalization of 1.06 trillion *yuan* (approximately $132 billion),[26] or six percent of gross domestic product in that year.[27] This puts China around twentieth in the world in terms of market capitalization. Looking at market capitalization as a percentage of GDP, the United States showed 150 percent in 2002,[28] while Hong Kong shows 300 percent. Other transition economies such as the Czech Republic and Russia each show 25 percent. In short, the stock market is not large by any measure.

The analysis above may seem to conflict with widespread claims that the market capitalization is about $500 billion,[29] and the common perception of China ranking

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[24] *See id.*

[25] Listed company shares in China can be circulating or non-circulating. Circulating shares, as the name suggests, are available for trading on the public markets. They typically represent, however, only one quarter to one third of the total share capital of listed companies. The rest is in the form of non-circulating shares that, with minor exceptions, may be held only by state entities (state shares) or other corporate entities (legal person shares). Such shares are highly illiquid. For a fuller account of share types, see CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: THE STOCK MARKETS AND THEIR ROLE IN CORPORATE REFORM 71-87 (John Wiley & Sons 2003). At present, reforms are underway to gradually convert all non-circulating shares to circulating shares.

[26] *See* CSRC Web site, http://www.csrc.gov.cn.

[27] GDP in 2005 was 17.56 trillion *yuan*. *See* Xinhua News Agency, *China's GDP Up 9.8% in 2005: Vice Minister*, Jan. 2, 2006, *at* http://www.china.org.cn/english/2006/Jan/153953.htm.

[28] *See* Statement of Randal K. Quarles, Assistant Secretary for International Affairs, U.S. Treasury Department, *in EU's Financial Services Action Plan—American Financial Services Industry Implications: Hearings Before the House Comm. on Financial Services*, 107th Cong. (2002), *available at* http:/useu.usmission.gov/Article.asp?ID=DE002F6D-D724-4FA7-9F05-6C0D7A98AF4C.

[29] *See, e.g.*, Chong-En Bai et al., *Corporate Governance and Market Valuation in China* (William Davidson Institute, Working Paper No. 564, 2003), *available at* http://ssrn.com/abstract=393440; *China to Complete State-Share Reforms This Year*, CHINA DAILY, Internet ed., Apr. 24, 2006 (Agence France-Presse report); Written Statement of the Securities

ahead of Hong Kong and behind only Japan in Asia. This is because such claims quite unrealistically value non-circulating shares as if they were circulating shares. All the empirical evidence shows that non-circulating shares—some two thirds of capital stock—sell at a large discount to circulating shares, sometimes by as much as 90 percent.[30] Indeed, the reaction of the markets to the 2003 announcement of the state's intention to end the restrictions on circulating shares shows that the market believes that if all shares were listed, the market price of each share would be far lower.[31]

In terms of funds raised for investment, the stock markets also do not loom large. In 2002, for example, the stock market provided only $8.9 billion of corporate finance, a decrease of 30% from the previous year; in the same year, bank loans constituted $217.7 billion of corporate finance, an increase of 55% over the previous year. In total, the stock markets provided only about 5% of external corporate financing.[32]

More recently, statistics for the first quarter of 2006 show that bank loans constituted an overwhelming 91.3% of external financing for non-financial institutions[33] in China, compared with a paltry 0.5% share for equities.[34] Indeed, equity financing

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Industry Association, *in United States-China Economic Relations and China's Role in the Global Economy: Hearings Before the House Comm. On Ways and Means*, 108th Cong. (2003), *available at* http://www.sia.com/testimony/2003/siatestimony10-03.html.

[30] *See* ZHIWU CHEN & XIONG PENG, THE ILLIQUIDITY DISCOUNT IN CHINA (International Center for Financial Research, Yale Univ., 2002) (finding that the non-tradable state-owned shares and legal-person shares in China on average have a 70%-80% illiquidity discount when they are traded on informal markets); Chen Zhiwu et al., *Faren Gu Paimai Shizheng Yanjiu* [*Empirical Research into Auctions of Legal Person Shares*] (2000), *at* http://www.fsi.com.cn/fsi900/fsinews902/ 902011212.pdf. Walter and Howie also present data for sales of legal person shares in three companies, showing discounts of between 76 and 83 percent. *See* WALTER & HOWIE, *supra* note 25, at 186.

[31] For more extended discussions of how to value listed companies, see STEPHEN GREEN, DRAFTING THE SECURITIES LAW: THE ROLE OF THE NATIONAL PEOPLE'S CONGRESS IN CREATING CHINA'S NEW MARKET ECONOMY 6 (Royal Institute of International Affairs, Mar. 2003); WALTER & HOWIE, *supra* note 25, at 188-89.

[32] *See* Stephen Green, *Better Than a Casino: Some Good News from the Frontline of China's Capital Market Reforms* (Royal Institute of International Affairs, Asia Programme Working Paper No. 6, 2003) (citing sources); *see also* GREEN, *supra* note 20, at 29 (table showing comparative data for 1993 through 2002); Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China* (Wharton Financial Institutions Center Working Papers Series, No. 02-44, Dec. 23, 2002) 17-19, *available at* fic.wharton.upenn.edu/fic/papers/02/0244.pdf.

[33] Non-financial institutions includes households, enterprises, and government agencies.

[34] The statistics described here are contained in People's Bank of China, *Zhongguo Huobi Zhengce Zhixing Baogao Er Ling Ling Liu Nian Diyi Jidu* [*Report on the Implementation of China's Monetary Policy, First Quarter, 2006*] 13, issued May 31, 2006.

was down from the comparable period a year earlier, when it was 0.8% and bank loans had been 98.8%. The difference is accounted for largely by greatly increased corporate bond issues, which accounted for 5.7% of financing in the first quarter of 2006. This figure, while a substantial increase over the first quarter of 2005, is still small and reflects the state's—and the enterprises'—preference for more forgiving forms of financing. There is no compulsion to pay dividends on equity, and the repayment of bank loans can often be put off indefinitely.

While bank loans accounted for more than 91% of external financing in the above statistics, it is important to realize that external financing as a whole is much less important than one might think. In 2005, about 40% of fixed asset investment was funded by enterprise "self-owned" funds (probably retained earnings and possibly including depreciation and amortization amounts), compared with merely 0.05% funded by equity issues.[35]

The tiny amount of investment funded through equity issues has many causes. One is, of course, simply the youth of China's stock markets—they have been around only since the early 1990s. But there is more to it than that. More important is that equity financing has been repressed through state regulation.

First, initial public offerings were subject to a state-administered quota until 2000, and even now must be approved by the CSRC, which continues to exercise control over the number and type of listings.[36] Because the key role of the stock market is to raise funds for restructured SOEs,[37] it is necessary to restrict the supply of equity securities in order to keep prices high. And prices have been high: in September 2002,

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[35] *See* CEIC Data, *Premium China Database*, *available at* http://www.ceicdata.com/china.htm. Substantial amounts of investment also come from categories of unclear significance labeled "other". But the insignificance of the equity amounts is clear.

[36] On the quota system and current practices, see Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China* (Nov. 2004), *available at* http://ssrn.com/abstract=628065; GREEN, *supra* note 20, at 160-64. In the quota system, opportunities for listing were rationed out to provincial governments, who then determined the candidates. The candidates would ultimately have be approved by the CSRC. There is some debate over whether the political determinants for listing led to such opportunities going to the best firms (because local governments could use their superior information to prevent questionable firms from listing) or the worst firms (because local governments would wish to unload their worst performers most in need of cash onto an unsuspecting public). Although popular wisdom supports the latter thesis, academic studies seem to support the former. *See* Samuel Gui Hai Huang & Frank M. Song, *The Determinants of Capital Structure: Evidence from China* (Hong Kong Institute of Economics and Business Strategy, Working Paper, July 2002), *available at* http://ssrn.com/abstract=320088; Pistor & Xu, *supra*.

[37] *See* GREEN, *supra* note 20, at 22.

for example, the average price/earnings ratio of Chinese listed companies was 40 to 50, and one in seven companies had a PE ratio of over 100.[38]

Second, a significant portion of the stock of listed companies—approximately two thirds—has been kept off the markets in non-circulating form. Even when SOEs listed, therefore, their state shareholders were forbidden by state policy from listing more than about one third of their shares. This policy stemmed from a fear of privatization.

Third, regulations on share issues have a strong paternalistic flavor and attempt to make investment in securities as safe as possible. Prior to the 2005 revisions to the Company Law and the Securities Law, companies wishing to make a public issue of stock had to show profits for the preceding three years.[39] Such a rule favors established, stable companies such as large SOEs—precisely the companies that probably already have reasonably good access to bank loans. It automatically rules out young companies or companies whose business plan calls for initial losses funded by equity, to be set off by later profits.[40] In other words, equity financing in the stock market has in principle been conceived as a supplement to debt financing, not as an alternative source of financing for companies that are, for one reason or another, unsuited to debt financing.[41]

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[38] *See* WALTER & HOWIE, *supra* note 25, at 136. Although the authors do not specify, they are probably referring to the mean PE ratio. A better number, because not skewed by extremes, would be the median PE ratio; it might be lower.

[39] *See Zhonghua Renmin Gongheguo Gongsi Fa* [*Company Law of the People's Republic of China*], effective July 1, 1994 [hereinafter *1993 Company Law*], art. 137. This version of the Company Law was superseded in 2006. *See Zhonghua Renmin Gongheguo Gongsi Fa* [*Company Law of the People's Republic of China*], as amended Oct. 27, 2005, effective Jan. 1, 2006 [hereinafter *Company Law*]. Article 137 of the 1993 Company Law was removed in the 2005 revisions to the Company Law and the Securities Law. *See Zhonghua Renmin Gongheguo Zhengquan Fa* [*Securities Law of the People's Republic of China*], as amended Oct. 27, 2005, effective Jan. 1, 2006, art. 50 [hereinafter *Securities Law*], art. 13 (requiring the ability to earn profits continuously and a healthy financial state, but not specifying the three-year rule).

[40] Take, for example, a satellite radio company such as Sirius. It requires a tremendous initial investment in satellites before the first dollar of subscription revenues can be earned. The riskiness of the product and business model make it inappropriate for debt financing, but perfect for financing by numerous small equity investors.

[41] Equity is the most suitable financing tool when debt will not do because there is no specific collateral to back the debt and near-term cash flows are insufficient to make payments. It should be encouraged, not discouraged, in an economy such as China's:

> In fact, we do observe equity financing primarily for young, growing firms, as well as for firms in rapidly growing economies, whereas mature economies and mature firms typically use bank finance when they rely on external funds at all.

Shleifer & Vishny, *supra* note 3, at 765.

This bias has consequences not only for the economy—new firms whose main asset is the opportunity for growth will find it especially hard to get off the ground[42]—but for corporate governance as well. To the extent that the equity markets remain dominated by firms with a large state ownership stake, the rules and practices governing the relationships among minority shareholders, controlling shareholders, directors, supervisors, and management will have to take account of the special character of the controlling shareholder—a state institution. Moreover, what happens on the circulating share market will have a smaller disciplining effect upon management when the proportion of shares on that market is so small.

b. **Characteristics of Investors**

China is often said to have 60 to 70 million stock market investors,[43] which would be about one in five urban residents between the ages of 15 and 64. This is a wholly fictitious number based on an assumption that each stock account at brokerages equals a separate investor, an assumption that was was debunked years ago in both Chinese[44] and English writings. Walter and Howie, on the basis of a variety of data, put the number of actual holders of shares at five to ten million, and estimate the number of active traders to be from 500,000 to two million.[45]

Moreover, the picture of the average investor as a naive retiree staking his retirement savings is false. Only 17 percent are over 55, and they tend to play the market as a pastime, like bingo.[46] Institutional investors, not fickle individuals, play the

[42] *See* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 19 (2000).

[43] *See, e.g., 7000 Wan Gumin Qunian Meihu Junping Kuisun 2045* Yuan [*70 Million Stock Investors Lost 2045* Yuan *Per Person on Average Last Year*], BEIJING XIANDAI SHANGBAO [BEIJING MODERN BUS. NEWS], Jan. 5, 2005. One reason for the persistence of this grossly inaccurate number may be the interests of the securities industry. It has attempted to resist regulation by frightening the government with an argument amounting in effect to the claim that regulation would pierce a bubble of (unwarranted) public confidence, cause market prices to plummet, and send 70 million investors on to the streets in protest. A senior official in the Shanghai Stock Exchange cited this number at a meeting attended by the author in 2004; his subordinates readily admitted in subsequent conversations that everyone (including the official and others in the audience) knew the real number was nowhere near this.

[44] *See Woguo Zhen Gumin Buguo Yiqian Wan* [*True Shareholders in China Not More than Ten Million*], TIANJIN RIBAO [TIANJIN DAILY], Dec. 13, 2001, at 3.

[45] *See* WALTER & HOWIE, *supra* note 25, at 148.

[46] For a full analysis of the investor community, see GREEN, *supra* note 31, ch. 4 and WALTER & HOWIE, *supra* note 25, ch. 7.

dominant role in market movements.[47] Markets are thin; some sixty percent of listed companies have fewer than 50,000 shareholders.[48]

Understanding who the investors are and how they behave has critical implications for corporate governance. First, it helps us understand whether equity markets can in fact serve a disciplining function. Do they respond to failures of corporate governance? Second, it helps us to assess the necessity and urgency of measures to help the small investor who, in the popular image of the stock market, is getting roughed up by the big boys. If small investors threw up their hands and left, would it matter?

Current research presents a mixed picture. Knowledgeable commentators agree that institutional investors play a large role in market movements; it is not fickle individuals. And the trading strategy they adopt is largely speculative: the average holding period in China is about one to two months, compared with 18 months in the United States.[49] In addition, China's stock markets have a high degree of synchronicity: one study found that 80 percent of the stocks listed on the two exchanges moved in the same direction in a given week.[50] This degree of synchronicity is the second highest among stock markets in forty countries; it suggests that stock prices move in response to information about the market in general, not about specific firms.[51] In other words, Chinese investors rationally worry more about the latest twists and turns in government policy or other market-level rumors than about corporate results.

The above picture is certainly the dominant one. But it may not be entirely accurate. One study constructed a corporate governance index for a sample of 1004 companies from both exchanges, and measured companies against that index using six different measures of market valuation. It found that "better governed companies in China are highly regarded in China by investors who are willing to pay a premium for high governance standard."[52] Another study found that Chinese investors react to

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[47] On institutional investors, see HONG KONG STOCK EXCHANGE, INSTITUTIONAL INVESTORS IN MAINLAND CHINA (Jan. 2004), *at* http://www.hkex.com.hk/research/rpapers/IIMC.pdf.

[48] *See* WALTER & HOWIE, *supra* note 25, at 241.

[49] *See* Xiaonian Xu & Yan Wang, *Ownership Structure and Corporate Governance in Chinese Stock Companies*, 10 CHINA ECON. REV. 75, 85 (1999). A more recent study finds a turnover velocity of 509% in 2000. *See* Eric C. Chang & Sonia M.L. Wong, *Political Control and Performance in China's Listed Firms* 25 (March 2003), *available at* http://www.hiebs.hku.hk/working_papers.asp?ID=89. *See also* Bei Hu, *Exposure to Stocks Unhealthy; Trading Mostly Speculative*, S. China Morning Post, Apr. 16, 2002, at B4.

[50] *See* Randall Morck et al., *The Information Content of Stock Market: Why Do Emerging Markets Have Synchronous Stock Price Movement?*, 58 J. FIN. ECON. 215 (2000).

[51] *See* Chang & Wong, *supra* note 49, at 25.

[52] Bai et al. 2003, *supra* note 29, at 22.

accounting numbers[53]—a seemingly banal result, and one that explains corporate efforts to massage those numbers,[54] but one that is incongruent with the thesis that investors don't care about fundamentals. Still another study found that stock prices drop on the ex-dividend day by an amount corresponding to the amount of the cash dividend paid[55]—all quite predictable in theory, and suggesting that Chinese investors do respond rationally to corporate-level events.

Inconsistent as some of these findings are, it is nevertheless possible to draw a few tentative conclusions from existing research. First, the picture of the Chinese stock market as solely speculative is probably overstated. Investors are more concerned with fundamentals and governance than observers give them credit for. Thus, good governance will ultimately be rewarded.

Second, while a great deal of speculation does take place on the market, it is driven by institutional investors, not individuals. Therefore, current government policy—which blames individuals for speculation and attempts to curb it by encouraging institutional investors who will, it is assumed, take a longer-term perspective—is unlikely to be successful.

Third, policymakers in the field of corporate governance should not worry so much about the small investor.[56] He is not a major source of funds, and in any case can be no more than a price taker. Contrary to government fears, a market downswing will not bring 70 million angry citizens into the street protesting the loss of their life savings. It would, of course, create massive discontent among a small elite of the wealthy and powerful, which may be an equally good explanation of government fear of a falling market. But it is not the same thing.

3. Banks

Capital structure can be a source of oversight: a corporation with dispersed ownership and low leverage is one in which the managers have a great deal of slack. Conversely, high debt levels lead to close monitoring by creditors. While they monitor

[53] Charles J.P. Chen et al., *Is Accounting Information Value Relevant in the Emerging Chinese Stock Market?* (1999), *available at* http://ssrn.com/abstract=167353.

[54] See, for example, the Ministry of Finance study cited in WALTER & HOWIE, *supra* note 25, at 241, which found that 89% of listed companies falsified their financial data to show improved performance. Presumably their management thought that the markets believed the data mattered.

[55] *See* Nikolaos Milonas et al., *The Ex-Dividend Day Stock Price Behavior in the Chinese Stock Market* (Apr. 17, 2002), *available at* http://ssrn.com/abstract=314881.

[56] This is the advice for developing and transition economies generally of Erik Berglöf & Ernst-Ludwig von Thadden, The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries 24-25 (unpublished manuscript, June 1999).

in their own interests, and not those of the shareholders, their interests are sufficiently congruent most of the time to be beneficial to shareholders.

In many economies, banks play a critical role in corporate governance.[57] Unlike small shareholders, they have as creditors both the ability and the incentive to monitor the financial health of their debtors, and may impose loan covenants requiring their consent for certain corporate actions. Indeed, academic research suggests that investment financed with bank debt tends to be more efficient than investment financed with retained earnings, probably because the former must be justified to a possibly skeptical third party, whereas management's use of retained earnings is subject to no oversight.[58]

Banks may also be sufficiently dubious of a prospective borrower's financial health to refuse to lend at all, thus hastening the departure of a poorly run or otherwise inefficient company from the economy. And they may themselves be major shareholders, as in Germany or Japan,[59] although not in the United States.[60]

Chinese banks, however, have historically been incapable of playing this monitoring role. This is because they lacked both the ability to monitor and the incentive to do so.

As discussed above,[61] the traditional role of banks was that of cashiers for the state. Even after the reforms of the 1980s, lending decisions were based on political criteria and the perceived needs of SOE borrowers, not on the prospect of the loan being repaid from the proceeds of whatever project is was used to fund.[62]

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[57] *See generally* Cheryl Gray, *Creditors' Crucial Role in Corporate Governance*, 34 FINANCE AND DEVELOPMENT 29 (1997).

[58] *See* Michael C. Jensen, *Agency Cost Of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

[59] On the "main bank" system, see generally THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES (Masahiko Aoki & Hugh Patrick eds. 1984). For a skeptical view, see Yoshiro Miwa & Mark J. Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance* (Harvard University, John M. Olin Center for Law, Economics, and Business Discussion Paper No. 333, Sept. 2001), *available at* http://papers.ssrn.com/abstract=285254. For skepticism about the skepticism, see Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions* (Columbia Law School Center for Law and Economic Studies Working Paper No. 194, Nov. 9, 2001), *available at* http://papers.ssrn.com/abstract=290283.

[60] *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

[61] *See* Part II.B.1 *supra*.

[62] See Su Dongwei, *Corporate Finance and State Enterprise Reform in China* 6 (Nov. 18, 2000), *available at* http://ssrn.com/abstract=250802 ("If [a] political favor is deemed appropriate,

Bankers thus did not have the tools to understand whether a loan was being put to good use or not; that was not a question with which they were intended to concern themselves, and the accounting system at the time would not have provided an answer.[63] They were simply to supply the money when ordered to do so. Nor did they need to worry about defaults; profit was simply not the objective and played no significant part in the evaluation of bank executives.

Moreover, once profits did become important, it was book profits as reported to administrative superiors that mattered both to the bankers and to their superiors; thus, banks were forbidden to write off—i.e., declare a loss on—more than a portion of their non-performing loans. Attempting to put a defaulting debtor into bankruptcy would also have had the effect of forcing the bank to close the books on a bad loan, instead of keeping it on the asset side by lending the borrower enough money to make interest payments.

The result of all this is that banks have lacked what might be called a culture of monitoring.[64] Indeed, so weak is this monitoring culture that two scholars use Jensen's theory of free cash flows[65] to analyze the behavior of borrower SOEs, who treat the loan funds as free.

The very lack of a monitoring culture in banks has shaped corporate law significantly, as the state has tried to do through corporate law what the banks seem incapable of doing for themselves: protecting their interests as creditors.[66] In other

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subsidized loans, rescheduling of overdue debt or even outright transfer of funds can be arranged with SOEs [state-owned enterprises.]"). *See also* Part II.B *supra*.

[63] The Chinese accounting system in the pre-reform era was typical for a planned economy: it was about matching sources to uses to monitor the spending of funds as the funder intended. It was not about matching revenues to expenditures to ensure that investments were profitable. *See generally* ALLEN HUANG & RONALD MA, ACCOUNTING IN CHINA IN TRANSITION: 1949-2000, at 25-28 (2001).

[64] *See* Clement Kong Wing Chow & Michael Ka Yiu Fung, *Ownership Structure, Lending Bias, and Liquidity Constraints: Evidence from Shanghai's Manufacturing Sector,* 26 J. COMP. ECON. 301, 303 (1998); Jenny J. Tian & Chung-Ming Lau, *Board Composition, Leadership Structure and Performance in Chinese Shareholding Companies*, 18 ASIA PACIFIC J. OF MGMT. 245, 249 (2001).

[65] *See* Jensen, *supra* note 58.

[66] Of course, every mature legal system provides a range of protection for corporate creditors; in the United States, such protection is accomplished largely through state law restrictions on corporate distributions and state and federal rules on fraudulent transfers. In China, however, corporate law protection is viewed as necessary to save creditors from their own misguided lending decisions—and such decisions can be very misguided indeed. Consider, for example, the case of the man who received a bank loan of 3.4 million *yuan* for his shell company that had no assets. Had the bank done any due diligence—simply to the extent of visiting corporate headquarters—it would have discovered that there was an overgrown field with a few small

words, far from enlisting the help of active banks in monitoring corporations, China's corporate law sees them as passive victims that need protection.

Recent scholarship suggests that the monitoring value-added of banks in Germany and Japan is much less than was supposed during the eighties, when German and Japan corporate governance models were in vogue.[67] If German and Japanese banks find it difficult to monitor effectively, it is easy to see that it is unrealistic to expect Chinese banks to manage. And because banks are often still required to lend for political reasons,[68] the result is that corporate management has been subject to the discipline neither of the credit market when seeking a loan nor of lender monitoring after obtaining it.

4. Asset Management Companies

A possible substitute for banks as monitors has been the four asset management companies (AMCs), one corresponding to each of the Big Four banks, created in 1999 as part of a plan to recapitalize the state banking sector. The AMCs, organized as wholly state-owned non-bank financial institutions in corporate form owned (it appears) by the Ministry of Finance ("MOF"), were capitalized at ¥10 billion each by the MOF. They then purchased, at face value, some ¥1.4 trillion in non-performing loans from their corresponding banks, paying with ten-year bonds that they issued with a soft guarantee from the MOF.[69] The intent was that the AMCs would then use their position as

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buildings at the company's address. *See* Wu Jianzhong, *Yiqi Xubao Zhuce Ziben, Daikuan Zhapian An de Zhenpo yu Bianxi* [*The Breaking and Analysis of a Case of False Reporting of Registered Capital and Fraudulent Borrowing*], ZHEJIANG GONGAN GAODENG ZHUANKE XUEXIAO XUEBAO [JOURNAL OF THE ZHEJIANG PUBLIC SECURITY COLLEGE], No. 4, 2001, at 77-79.

[67] On the softness of German and Japanese bank monitoring, see Shliefer & Vishny, *supra* note 3, at 773, and the sources cited in La Porta et al., *supra* note 42, at 17-18.

[68] In April 2005, in interviews with *Caijing*, two senior bankers went public with complaints about the influence of the Communist Party in financial institutions. *See* Ling Huawei & Li Qing, *Zhang Enzhao Shijian Yinfa Gongsi Liangzhi Fansi* [*Thoughts on Good Corporate Governance Inspired by the Zhang Enzhao Affair*], CAIJING [FIN. & ECON.], May 1, 2005 (reporting remarks of Xie Ping); *Caijing Zhuanfang Zhongguo Jianshe Yinhang Xinren Dongshizhang Guo Shuqing* [*Exclusive Caijing Interview with Newly Appointed Construction Bank of China Chairman of the Board Guo Shuqing*], CAIJING [FIN. & ECON.], May 1, 2005 (reporting remarks of Guo Shuqing). According to Guo Shuqing, the chairman of the Construction Bank of China, under his predecessor the Party committee in the bank held "dozens of meetings" and even debated decisions over small loans; the board of directors, by contrast, met rarely and reported to the Party committee. *See* Richard McGregor, *China Bank Chiefs Hit at Communist Party Role*, FIN. TIMES, Internet ed., Apr. 28, 2005.

[69] Accounts differ as to whether the guarantee is soft or hard. Since the scheme requires AMCs to pay face value for assets that cannot possibly be worth that, it is evident that they are designed to lose money and are mathematically incapable of paying off the bonds from their

creditors (or as owners via debt-for-equity swaps) to force restructuring on the debtor enterprises.[70] The AMC could then sell its interest in the now valuable enterprise to an outside investor.

Unfortunately, some—not all—of the same problems that prevented banks from being effective monitors have also stymied the AMCs, most notably the political clout of the debtor enterprises and their government owners.[71] An account of the efforts of one of them, Huarong, is worth quoting in full:

> Monkey King Group (MKG), an industrial conglomerate from Yichang city in Hubei province, is one of the country's 512 key SOEs and one of the big SOEs to benefit from the debt-for-equity swap scheme put in place by the central government. In August 2000, China Huarong Asset Management Company bought 622 million RMB in MKG debt from The Industrial and Commercial Bank of China (ICBC). Since then, Huarong, the main creditor of the group, has been unable to press MKG into a drastic restructuring plan. On the contrary, with the approval of Yichang city officials, in December 2000, MKG started a huge asset stripping manoeuvre that has shrunk group assets from 2.42 billion RMB to 371 million RMB, according to Huarong. MKG then petitioned for bankruptcy to escape a restructuring plan coming from its main creditor Huarong, without informing the board of directors of its listed company. Last March, Huarong publicly questioned the fairness of the liquidation committee appointed by Yichang court, as it was composed only of representatives of local government agencies.[72]

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own revenues. *See, e.g.*, Richard McGregor, *Priceless Tales of Chinese Bank Lending*, FIN. TIMES, Internet ed., Mar. 21, 2002 (noting that the PBOC's original estimate, since shown to be vastly overoptimistic, was that the AMCs would recover 70 cents on the dollar). Indeed, with an aggregate capitalization of only 40 billion *yuan*, they are probably already incapable of paying even the interest on their bonds. Thus, the guarantee must for all intents and purposes be hard. On the AMC scheme generally, see David G. Pierce & Lawrence S. Yee, *China's Bank Asset Management Companies: Gold in Them Thar Hills?*, *in* TOPICS IN CHINESE LAW (O'Melveny & Myers LLP ed., 2001), *at* www.omm.com/webcode/webdata/content/publications/Topics_2001_07.pdf. The scheme is also discussed in Lo Chi, *Bank Reform: How Much Time Does China Have?*, CHINA BUS. REV., No. 2 (Mar. 2004), at 30, *available at* 2004 WL 11218673, but the author misstates the initial capitalization as 400 billion *yuan*.

[70] For a fuller description, see ASIAN DEVELOPMENT BANK, PRIVATE SECTOR ASSESSMENT: PEOPLE'S REPUBLIC OF CHINA 58-60 (2003); ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, CHINA IN THE WORLD ECONOMY, THE DOMESTIC POLICY CHALLENGES 179-81 (2002) [hereinafter CHINA IN THE WORLD ECONOMY].

[71] *See* JOE STUDWELL, THE CHINA DREAM: THE QUEST FOR THE LAST GREAT UNTAPPED MARKET ON EARTH 259-60 (Profile Books 2002); TENEV & ZHANG, *supra* note ?, at 63-64.

[72] CHINA IN THE WORLD ECONOMY, *supra* note 70, at 180 (citing Matthew Miller, *Real Monkey Business*, South China Morning Post, March 29, 2001, Business Post, at 14).

C. *Board of Directors and Board of Supervisors*

A key institution of corporate governance is an internal oversight body such as a board of directors and, in China, a board of supervisors. These function ideally as a committee of the shareholders, and represent an attempt to overcome the costliness of monitoring by individual shareholders. Needless to say, there are many obstacles to the effective functioning of the board in this way—management typically has a great deal of control over the election process, and thus can generally seat its preferred candidates when shareholding is widely dispersed.[73]

1. Independent Directors

Because a board of directors entirely beholden to management cannot be expected to represent shareholder interests, the hope for effective internal supervision lies in independent directors. In 2001, the CSRC issued a "Guidance Opinion" (*zhidao yijian*) calling for listed companies to have a one-third independent board by mid-2003, and virtually all have complied at least in form.[74]

Despite the attention devoted to independent directors, it is unlikely that they can play their hoped-for role. An important reason is that the Chinese independent director system does not provide for a good way of policing independence to ensure that it is genuine. The CSRC must vet candidates, it is true, but as a practical matter the CSRC cannot possibly know both before election and on a continuing basis whether directors meet the criteria, both in name and in fact, for independence.

Consider by way of contrast the American system of *disinterested* directors. In making their votes are highly desirable as a way of insulating conflict-of-interest transactions from substantive scrutiny, corporate law gives them a role that requires, in case of dispute, examination of the degree to which they actually were disinterested in the transaction in question. Chinese corporate law—in this sense like the New York Stock Exchange rules on independent directors, among others—simply requires that

[73] *See* Lucien A. Bebchuk, *The Myth of Shareholder Franchise*, (Oct. 2005), *available at* http://ssrn.com/abstract=829804 ("The power of shareholders to replace the board . . . is largely a myth.").

[74] For a full treatment of independent directors in China, see Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 36 DEL. J. CORP. L.125 (2006), on which much of this discussion is based. It is not clear that the CSRC actually has the legal power to require independent directors. The 2005 revisions to the Company Law delegate power to the State Council to make rules providing for independent directors in listed companies, *see* Company Law, *supra* note 39, art. 132; the intriguing corollary is that if the State Council did not already have such powers, *a fortiori* the CSRC could not have such powers.

directors meet some criterion of independence, but fails to provide a meaningful policing mechanism.[75]

The votes of independent directors in Chinese corporate law have no special significance. The CSRC has indeed attempted to legislate in this area by stating, in its Several Provisions on Strengthening the Rights and Interests of Public Shareholders,[76] that several matters must be approved by a majority of independent directors. Yet what will happen if they are not?

One requirement is for approval of the hiring or firing of an auditing firm; perhaps the CSRC can refuse to accept an audit from an auditor hired without independent director approval. But it cannot nullify a material transaction between a firm and an affiliate that was undertaken without the desired independent director approval, nor can it make rules giving shareholders grounds to sue for the same event. Thus, it is hard to imagine any event calling for a transaction-specific scrutiny of the actual independence of directors. Under such circumstances, it would not be surprising if they aligned their views with those of management despite meeting objective, *ex ante* tests of independence.[77]

In short, if independent directors are an institutional solution to vertical agency problems, China has gone only half way: it has provided the form of the institution, but has not provided the accompanying institutions that would give it life and significance.

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[75] I discuss the differences among independent, outside, and disinterested directors in Donald C. Clarke, *Setting the Record Straight: Concepts of the Non-Management Director*, 37 DEL. J. CORP. L. ___ (forthcoming 2007).

[76] *See* note ? *infra* and accompanying text.

[77] *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 921 (Del. Ch. 2003), for example, found the Special Litigation Committee directors insufficiently independent even though they would have passed any existing objective test of independence. Because they and the defendant directors shared ties with Stanford University, the court found "a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it[.]" *Id.* at 947. Similarly, Richard Breeden notes that the chairs of WorldCom's compensation committee and audit committee (like 80% of the board in the Ebbers era) both satisfied contemporary definitions of "independence," and would probably have satisfied the proposed NYSE and Nasdaq definitions. Nevertheless, they had both been involved in business with CEO Bernard Ebbers for years, and "seemed to be more solicitous of Ebbers' wishes than shareholder interests." RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. , at 28 nn.27, 30 (2003), *available at* http://www.thecorporatelibrary.com/spotlight/scandals/Restoring_Trust_Final-WorldCom.pdf.

2. Board of Supervisors

Another potential institutional solution to the agency problem is the board of supervisors (*jianshi hui*).[78] Chinese commentators often compare China's two-tier governance model to Germany's, where the law mandates a dual-board system for large publicly-held corporations, but the similarities in fact are few. In Germany, each corporation has an elected supervisory board (*Aufsichtsrat*), which appoints a managing board (*Vorstand*) composed of senior managers. The supervisory board's job is to oversee the management of the company,[79] and its major powers are the power to appoint and dismiss members of the managing board and the power to represent the company in its dealings with members of the management board.[80] The law explicitly allocates managerial power to the managing board.[81]

While German law gives real power to the supervisory board, the Company Law of China expects that the board of supervisors will perform a supervisory role essentially by simply saying that it will, without actually giving the board any significant powers[82] or providing structurally for its independence from those it

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[78] I treat the board of supervisors at greater length in Clarke, *supra* note 74, at 173-75.

[79] *See* AKTIENGESSELSCHAFTEN [LAW ON STOCK CORPORATIONS] § 111(1), *translated in* COMMERCIAL LAWS OF THE WORLD: GERMANY (rev. ed. 1995).

[80] *See* Walter Oppenhoff & Thomas O. Verhoeven, *Stock Corporations*, *in* BUSINESS TRANSACTIONS IN GERMANY ch. 24, § 24.03 (Bernd Rüster ed., Matthew Bender 2003).

[81] *See* AKTIENGESSELSCHAFTEN [LAW ON STOCK CORPORATIONS], *supra* note 79, § 76(1).

[82] The powers of the board of supervisors were set forth in Article 126 of the original Company Law as follows:

> The supervisory board shall exercise the following powers:
>
> (1) examine the finances of the company;
>
> (2) exercise supervision over the actions of directors or the manager when they are performing their duties, which actions violate laws, regulations or the articles of association;
>
> (3) request directors and the manager to remedy a situation when the acts of such directors or manager harm the interests of the company;
>
> (4) propose the convening of special shareholders' meetings; and
>
> (5) other powers stipulated in the articles of association.
>
> Supervisors shall attend board of directors meetings.

The October 2005 revisions to the Company Law brought a modest increase to these powers, but no qualitative change. *See Company Law*, *supra* note 39, art. 54.

As can be seen, the board of supervisors may criticize directors and officers and call on them to correct their errors, but has no power to require them to do so. *See* Liu Wen & Wu Man, *Shangshi Gongsi Jianshihui yu Duli Dongshi de "Gongsheng" Wenti* [*The Problem of the "Co-Existence" of the Board of Supervisors and Independent Directors in Listed Companies*], CAIJING KEXUE [FIN. & ECON. SCI.], ZENG KAN [SUPP.], July 2002, at 99; Wang Changbo & Feng Hualan, *Lun Duli Dongshi Zhidu yu Jianshihui Zhidu Xiang Jiehe de Jian Guan Moshi* [*On the Monitoring Model*

supervises. Like the board of directors, the board of supervisors is elected by shareholders.[83] There is no reason to expect that the interests that dominate director voting will fail to dominate supervisor voting. Moreover, in enterprises dominated by state ownership, supervisors are enterprise employees and are subordinate to the enterprise chief. Not surprisingly, they bend to his wishes.[84]

As a result of these problems, the board of supervisors appears to play no important role in corporate governance in China. Indeed, the impetus behind the independent director drive has been the hope that they will play the monitoring role that the board of supervisors has been unable to play.

D. *The Large Shareholder as Monitor: The State*

Large shareholders can often be reasonably effective in monitoring corporate managers; if they do not abuse their control rights, their efforts redound to the benefit of small shareholders as well. In China, the dominant shareholder in listed companies is often a state body. In principle, the state need not be an ineffective monitor of its agents—the absence of an ultimate human principal at the top of a chain of agents does not cripple many successful non-profit organizations, for example. But it is clear that in

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Combining the Independent Director System and the System of the Board of Supervisors], SHENGCHANLI YANJIU [RESEARCH IN PRODUCTIVE FORCES], No. 1, 2002, at 119; Wang Yuhong & Kang Jianhui, *Qianghua Jianshihui Zhineng, Jianquan Gongsi Zhili Jiegou* [*Strengthen the Functions of the Board of Supervisors, Improve the Structure of Corporate Governance*], XIANDAI QIYE [MODERN ENTERPRISE], No. 10, 2000, at 13, 13; Zhang Jianwei & Xiang Jing, *Jianshihui yu Duli Dongshi Zhidu de Gongneng Bijiao ji qi Jiazhi Qushe* [*A Comparison of the Functions of the Board of Supervisors and Independent Directors and an Assessment of Their Values*], LUOHE ZHIYE JISHU XUEYUAN XUEBAO (ZONGHE BAN) [J. LUOHE VOCATIONAL & TECH. INST. (GEN. ED.)], No. 1, 2002, at 52, 54.

[83] The Company Law provides that up to one third of the supervisors shall be elected by the employees of the company, *see 1993 Company Law*, *supra* note 39, art. 124; *Company Law*, *supra* note 39, art. 118, but such elections are dominated by management and the supervisors so elected cannot provide an independent check.

[84] *See* Jiang, *supra* note ?; Gao Yong, *Duli Dongshi Zhidu yu Shangshi Gongsi Zhili* [*The Independent Director System and Corporate Governance in Listed Companies*], JINGJI TIZHI GAIGE [ECONOMIC SYSTEM REFORM], No. 1, 2002, at 8, 9. Wang and Feng write:

> The actual situation is that the great majority of the supervisors are representatives of the union and of the congress of staff and workers, and the chairman of the union has the right to call meetings. Because the chairman of the union works under the leadership of the Party secretary and the Chairman of the Board of Directors, it is impossible for him to be independent. His livelihood and that of the staff and worker representatives is in the hands of management; if one day they should dare to offend management and exercise the sacred functions given to them by the law, perhaps the day after proposing to inspect the finances of the company they wouldn't even have their job at the company, and therefore wouldn't be able to continue to represent the staff and workers.

Wang & Feng, *supra* note 82, at 120.

fact the state often *is* ineffective; it is not collective action problems that prevent effective shareholder monitoring, since there is a large and possibly sole shareholder, but rather organizational problems internal to that shareholder.[85] The result is the phenomenon of the "absent owner" (*suoyouzhe quewei*). What are these problems?

First, the state often simply does not want to encourage the profit-maximizing behavior that minority shareholders value. But even when it does, it suffers significant disabilities as a monitor.

It may, for example, have inconsistent and incommensurable goals, such as full urban employment, efficient operations, and a bar on foreign ownership or control for reasons of national security. But even if the state as principal had mutually consistent and easily measurable goals, its agents—the monitors of the enterprise managers—might not monitor well for those goals. First, the monitoring individuals may well be locally employed and salaried, while the formal ownership of the shares is lodged in a higher level of government. A monitor responsible to local government will not object to corporate policies such as high employment that are beneficial to local government at the expense of the central state shareholder. Second, a monitor working in a government agency may be less able to distinguish good from bad corporate policy than a monitor in a business-oriented institutional shareholder.[86] Third, an individual monitoring on behalf of the state is much less likely to have someone at some point above him in the chain of command making a strong demand for good corporate performance in companies held by the state.

Finally, the devolution of managerial authority has occurred in tandem with economic reform measures that have legalized new forms of trade and new privately-controlled entities to which stripped assets can, by means of controlled transactions, be transferred. The complexity of property relations and ownership forms has outstripped the state's capacity to monitor, which remains designed for the simple structures of an earlier day, when private ownership of significant property was not allowed, and transfers between enterprises were physical and not financial.[87]

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[85] The same phenomenon has been noted among institutional investors in Western countries, who are often criticized for being unduly passive even when "they have strong reservations about strategy, personnel, or other potential causes of underperformance." DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS ¶ 15.22 (The Stationery Office 2003), *available at* http://www.dti.gov.uk/cld/non_exec_review.

[86] For a fuller discussion, see Qi et al., *supra* note ?, at 594-95. *See also* Mar & Young, *supra* note 20, at 282 ("[A]lthough Chinese SOEs [(state-owned enterprises)] have concentrated ownership (i.e., the state) the potential positive effect of such an arrangement is absent because of the dispersal of state representation . . . . In short, many SOEs are simply monitored inadequately or ineffectively.").

[87] *See generally* X.L. Ding, *The Illicit Asset Stripping of Chinese State Firms*, CHINA J., No. 43, 2000, at 1.

E. *Shareholder Coalescence Devices*

Corporate governance is enhanced by institutions that allow for the coalescence of shareholders and thus potentially overcome the monitoring problems of the small shareholder.[88] Such institutions include proxy fights and takeovers: while it may not pay a small shareholder to figure out how the company could be run better, it may pay an outsider to do so if he can buy up the shares and reap the benefit. This set of institutions has its own costs, of course: if concentrated shareholding were free, we would never see dispersed shareholding.

So far, at least, there is no hostile takeover activity to speak of in China. When listed companies were takeover targets, this was typically so that the acquirer could obtain a "backdoor" listing and thus have access to the stock market without having to gain approval itself. In addition, recall that typically only one third of listed company stock is actually available as circulating stock, with the rest held as state or legal person shares by a small number of shareholders. If they are contented with management, they will not sell to a hostile bidder. If they are not contented with management, they have the power to change it. In short, in the great majority of listed companies, a particular management team would not be in place if it were not performing to the satisfaction of the holders of a majority of shares.

Even if more shares were available on the market, one study found a negative correlation between performance and the proportion of shares traded on the market.[89] This suggests that management does not perceive a large number of circulating shares as a threat to its tenure.

F. *Management Compensation Arrangements*

A common method of tying management incentives to shareholder interests is through compensation arrangements, such as those that tie salary to stock price performance. Among those in China who recognize that the separation of ownership from control is an unavoidable problem, a frequently mooted solution is simply to make managers more like owners by giving them an equity stake in the firm. For example, Yang and Zhang suggest letting large stockholders take on management roles and letting some managers be large stockholders.[90] The first part of this solution is

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[88] *See* Roe, *supra* note 4, at 10.

[89] *See* Chen, *supra* note ?, at 68-69.

[90] *See* Yang Shuming & Zhang Ping, *Chongsu Gongsi Faren Zhili Jichu Xin Linian: Suoyou yu Jingying Fenli de Tongyi* [*A New Concept for Recreating the Basis of Corporate Governance: The Unity of the Separation of Ownership and Management*], XIANDAI FAXUE [MODERN LEGAL STUDIES], No. 5, 2000, at 18. The proposal to give a large block of equity to management is echoed by another informed commentator in Mike W. Peng, *Outside Directors and Firm Performance During Institutional Transitions*, 25 STRATEGIC MGMT. J. 453 (2004).

unexceptionable if understood to mean that corporate governance policy should not fear the role that can be played by large shareholders with an interest to protect.

The second prong of their solution is more problematic. Directors, for example, now typically own about 0.3 or 0.4 percent of their company's stock.[91] If they and other senior officers are not rich enough to own significant amounts of stock, should stock in such large amounts as to be significant be simply given to them? It might provide directors with more incentives, but would also involve a huge transfer of wealth to them.

Even a tiny percentage ownership stake in a listed company is a huge amount, given the amounts of money involved. A commonly suggested target for management ownership is one percent. If we value listed companies conservatively—at only the value of circulating shares—the total comes to about $160 billion, or about $116 million for each of the 1,381 listed companies. To give directors one percent means simply handing each of them over a million dollars. Surely monitoring can be purchased at a cheaper price than that.

Moreover, such a small stake cannot be expected to have an appreciable effect on management incentives. A manager holding a one percent interest who expropriates $100 from shareholders will still net $99. Yang and Zhang themselves note that a CEO with a 25 percent interest in the company still has a large incentive to engage in expropriating transactions. Yet giving CEOs a big enough stake to make a real difference—say, 50 percent—is not just unrealistic and unjust, but also unnecessary. Other institutions manage to procure reasonable performance from their agents for less than this, and there is no reason why Chinese corporations cannot manage to do so as well.

G. *Gatekeepers (I): Lawyers and Accountants*

Persons and institutions involved in information distribution and gatekeeping—including lawyers, accountants, securities analysts, underwriters, and the financial press—play an important role in corporate governance in many jurisdictions. The theory is that because they are repeat players whose income depends on reputation, the gains from maintaining that reputation will outweigh the gains from defecting and cooperating in fraud and mismanagement. Corporate insiders, it is thought, have the opposite set of incentives.[92]

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[91] *See* Peng, *supra* note 90, at 462. It is not clear to me that these amounts can be accurate. As the following paragraph shows, a conservative estimate of the average market capitalization of listed companies comes to $116 million; 0.3% of that number is $348,000. If this number is accurate, China's directors are very rich by Chinese standards.

[92] *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 595-607 (1984). *But see* John C. Coffee, Jr., *Understanding Enron: It's About the Gatekeepers, Stupid* (Columbia Law & Economics Working Paper No. 207, July 30, 2002), *available at*

To perform their function, all of these must of course be appropriately motivated. If lawyers and accountants bear no responsibility for their opinions, one cannot expect them to press their corporate clients to correct a state of affairs that damages shareholders. Similarly, one cannot expect much from the financial press if the rewards for providing accurate information are less than the rewards for not doing so.

Neither the legal nor the accounting professions in China are yet well equipped to play an effective gatekeeper role. The SEC has been able to farm out much of its supervisory burden to both professions in the United States because they are capable of handling the task. By contrast, China's lawyers are few in number and, like its accountants, not trained to handle complex financial matters.[93] The law schools do not teach such topics, and the modern legal profession has not yet accumulated enough experience to enable juniors to learn from seniors on the job.

The position of the accounting profession is even worse.[94] China suffers from an acute shortage of qualified accountants.[95] A 2001 study of 32 randomly selected audit reports found "gravely inaccurate errors" in 23 of them.[96] So bad did things become that then-Premier Zhu Rongji called for foreign auditing firms to conduct supplemental audits of all listed firms in China.[97] And the securities industry seems almost beyond redemption: a CSRC investigation revealed that in the notorious market manipulation scheme of Lü Liang, 125 securities firms actively assisted him.[98]

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http://ssrn.com/abstract=325240 (arguing that reputation is not as effective a policing mechanism as is commonly assumed).

[93] On the capabilities of the Chinese legal profession, see generally STANLEY LUBMAN, BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO 157 (Stanford University Press 1999); RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 343-393 (2002). On the accounting profession, see TENEV & ZHANG, *supra* note ?, at 120-123.

[94] *See generally* Brent Irvin, The Ecology of Corporate Governance in China (unpublished manuscript, 2005) (on file with author), to which much of the discussion and the citations in this subsection are owed.

[95] *See* Barney Jopson, *Beijing in Overseas Accountancy Deal*, FINANCIAL TIMES (Internet ed.), July 25, 2006 (describing plans for foreign training of Chinese accountants and teachers of accountancy).

[96] *See* Bei Hu, *Mainland Companies Are Reeling from a Year of Financial Scandals During Which the Audacity of Corporate Wrongdoers Has Put Their Western Counterparts to Shame*, SOUTH CHINA MORNING POST, Mar. 26, 2002, at 1.

[97] *See* Bei Hu, *Tough Audit Rules Eased After Outcry from Interest Groups*, SOUTH CHINA MORNING POST, March 2, 2002, at B3; Richard McGregor, *Creative Chinese Accounting Creates Work for Andersen*, FINANCIAL TIMES, Jan. 28, 2002, at 20.

[98] *See* WALTER & HOWIE, *supra* note 25, at 156-57.

As suggested above, lawyers and accountants cannot be expected to play a gatekeeping role if they bear little or no penalty for failing to do so. The system in China imposes few such penalties. While law firms and accounting firms may occasionally be sanctioned by the CSRC, I know of no lawsuits by misled investors against either. And firms seeking listings continue to use the same group of law and accounting firms without suffering any apparent penalty in the market.[99]

H. *Gatekeepers (II): The Financial Press*

A critical part of a healthy corporate governance system is information that is both demanded by and accessible to investors and other participants in the corporate enterprise. And a key institution in both creating or assembling information and making it accessible is an independent and competitive press.[100] The financial press should be independent of government for the same reason that central banks should be independent of government: even when direct corruption is absent, the temptations of short-term political gain at the expense of the long-term health of the polity are often irresistible, and governments will often want to suppress information that financial markets value.

A competitive press is necessary because information is necessarily imperfect. There must be some pressure on information suppliers to dig deeper and outdo their competitors if the supply of information is to be kept reasonably accurate.

The story of China's financial press in terms of these desiderata is a mixed one. On the one hand, the last several years have seen a mushrooming of newspaper, journals, and Web sites purveying information about economic and financial issues. In addition to the most well known journal, *Caijing* ("Finance and Economy"), these media include *21st Century Economic Report* (*21 Shiji Jingji Baodao*), *China Securities News* (*Zhongguo Zhengquan Bao*), *Economic Daily* (*Jingji Ribao*), *Securities Times* (*Zhengquan Shibao*), and *New Fortune* (*Xin Caifu*). There is no doubt that these media compete with each other, and *Caijing* in particular has produced some solid journalism with several exposés.[101]

On the other hand, these media all owe their existence to some kind of formal or informal government affiliation; one cannot simply decide to start a newspaper in China.[102] *Caijing*'s ownership structure is obscure—it is owned by an opaque entity of

[99] *See* Irvin, *supra* note 94.

[100] *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 798-99 (2001).

[101] On *Caijing* and its editor, Hu Shuli, see Clay Chandler, *China Moves: Business Magazine Thrives by Crossing the Party Line*, WASHINGTON POST, March 22, 2001, at E01.

[102] *See* Benjamin Liebman, *Watchdog or Demagogue? The Media in the Chinese Legal System*, 105 COLUM. L. REV. 1, ___ (2004).

uncertain organizational form known as the China Securities Market Research and Design Center (*Zhongguo Zhengquan Shichang Yanjiu Sheji Zhongxin*),[103] but it is commonly assumed in China that the key to *Caijing*'s ability to continue to operate the way it does is strong political backing. The *Economic Observer* is owned by a commercial enterprise linked to the Shandong provincial government. The enterprise obtained the right to publish a newspaper by purchasing the Jinan Academy of Social Sciences, which itself ran a newspaper and thus possessed the necessary license.[104]

Beyond the possible inhibiting influence of ownership ties, it must further be remembered that the state insists in principle on control over all information.[105] This control is a cornerstone of the Communist Party's system of political control and is unlikely to disappear before the Party itself. Its impact on the supply of financial information was underscored a few years ago by the ban on distribution to newsstands of the June 20, 2003 issue of *Caijing*,[106] perhaps because of its coverage of the corruption scandal involving Shanghai property developer Zhou Zhengyi or perhaps because of other articles criticizing, ironically enough, the government's control over information.

In the early days of China's financial press, it was regulated quite strictly by the CSRC[107]—in the interests not of accuracy but of stability:

> [T]he China Securities Regulatory Commission (CSRC) was comparatively strict in its regulation of the financial media from the early days of China's securities markets until the late 1990s. Indeed, the CSRC used to decide what could be reported and what had to be suppressed on the grounds of maintaining market stability. Media outlets that flouted these rules were subject to criticism and punishment. Before 1999 these restrictions were well-known both to the handful of state-run securities newspapers and to their readers.[108]

Following an exposé by *Caijing* of a scandal involving massive market manipulation by investment funds,[109] however, the CSRC under Zhou Xiaochuan began

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[103] The name of this body is commonly rendered in English as "Stock Exchange Executive Council".

[104] *See* Liebman, *supra* note 102, at ___.

[105] For an overview of Party and government controls over the media, see *id*. at ___.

[106] *See* Jonathan Ansfield, *China Stifles Curb-Defying Magazine*, REUTERS, June 23, 2003.

[107] The source of the CSRC's authority to regulate the financial press is not clear to me. Presumably it asserted this authority and for political reasons this assertion was not seriously challenged. As the financial press was in its own way quasi-governmental, no doubt conflicts were resolved through an opaque process of bargaining rather than simply through orders being issued.

[108] Hu Shuli, *Let There Be More Light*, 7 CHINA ECON. Q. 64, 64 (2003). Hu Shuli has been the editor of *Caijing* since its inception.

[109] Ping Hu & Li Qing, *Jijin Heimu* [*The Inside Story on Investment Funds*], CAIJING, Internet ed., No. 10, 2000.

to appreciate the positive role that could be played by the financial press and loosened the reins. This led to *Caijing*'s most famous scoop, the exposure of fraudulent dealings at Guangxia Corporation of Yinchuan (also known as Yinguangxia).

At present, however, *Caijing*'s successes are more exceptional than typical, and financial reporting remains hobbled in significant ways. Objective reporting is hampered by corruption: favorable press coverage can often be obtained, and unfavorable coverage suppressed, for a price.[110] Many financial reporters lack training in the field, resulting in superficial coverage. Journals that publish unwelcome stories may find themselves sued for libel.[111]

The picture is not completely bleak—in a recent libel case based on unfavorable press coverage, the court found that journalists should be immune from suit if their reporting is backed by a source that is reasonable and credible and not based simply on rumors.[112] Nevertheless, the overwhelming fact is continuing political restraints on what may or may not be published, a fact that is known and to some degree accepted by all in the industry.[113]

III. Conclusion

This paper has examined the non-state institutional environment for Chinese corporate governance. Several institutional approaches to corporate governance are possible, chief among them an ownership approach, a shareholder rights approach, and a market monitoring approach. A given jurisdiction will typically display a mix. The institutions of ownership can play a monitoring function when there is concentrated ownership and it pays the dominant shareholder to expend resources in monitoring because it will reap all or most of the benefit. This kind of monitoring need rely neither on minority shareholder rights nor on market signals in order to discipline management; the owner is already in charge and does not need the help of courts, and

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[110] *See* Donald C. Clarke et al., *The Role of Law in China's Economic Development* (George Washington University Public Law and Legal Theory Working Paper No. 187, Jan. 27, 2006), *available at* http://ssrn.com/abstract=878672.

[111] In 2002, for example, *Caijing* lost a defamation suit brought by Shenzhen Fountain Corporation, a company listed on the Shenzhen Stock Exchange, after it published an article that questioned the firm's accounting practices. The magazine was required to pay 300,000 *yuan* in damages. For a fuller account of the case with citations, see Benjamin Liebman, *Innovation Through Intimidation: An Empirical Account of Defamation Litigation in China*, 47 Harv. Int'l L.J. 33, 69 (2006).

[112] The case in question pitted the Guangzhou Huaqiao Real Estate Development Company against the journal *China Reform*. Excerpts from the text of the judgment as well as commentary by prominent attorney Pu Zhiqiang, who appeared for the defendants, can be found at http://www.epochtimes.com/gb/4/10/18/n694419.htm.

[113] *See* Liebman, *supra* note 102, at ___.

it can receive from its own analysis the signals that would otherwise be transmitted by the market.

Merely describing the ownership approach should, however, make it clear that does not come free. It cannot avail itself of the benefits of widely dispersed ownership; wealth must necessarily be concentrated in a single company and not held in a diversified risk-reducing portfolio of investments. Companies too large for any single owner to control cannot use this governance method. And to the extent the owner undertakes its own analysis instead of relying on market signals, it must expend resources instead of free riding on the activity of others.

Finally, while concentrated ownership can mitigate one set of agency costs—vertical, between managers and shareholders as a body—it can exacerbate another set—horizontal, between dominant shareholders and minority shareholders. As the former decrease, the latter may increase. Which effect will outweigh the other cannot be known *a priori*.

The shareholder rights approach attempts to solve the problems of minority shareholders who cannot avail themselves of ownership rights—not only do they not have the right of owners, but they also do not have the same incentives as owners. If minority shareholders can enlist the aid of the legal system at an acceptable cost, however (including the cost of informing themselves), they can protect their interests and both correct and deter management misbehavior.

Like the ownership approach, however, this approach has its characteristic costs. The more power minority shareholders have to protect their legitimate rights, the more power they have to pursue illegitimate claims as well for their nuisance value. A corporation whose shareholders enjoy the fullest complement of rights is a paralyzed corporation. People rationally choose to hold a security that does not grant all the rights they might like for themselves because they know that other investors are similarly constrained. The key, therefore, is to strike the right balance.

Where that balance should be struck, however, will differ across jurisdictions, because the availability of substitutes will differ. If there is a good substitute for minority shareholder rights, then there is little reason to pay the cost of an extensive panoply of rights because the marginal benefit thereby purchased will be small.

This consideration leads to the third approach to corporate governance: the market monitoring approach. As discussed above, a firm operates in a number of markets that impose objective constraints on its management. At the most obvious level, the stock market and not management has the final word on the appropriate value of a company's stock. When markets are functioning well, monitoring is much simpler. If stockholders wish to judge whether the CEO's salary is excessive, they can look at salaries in comparable companies.

Needless to say, knowing that a CEO is paid too much is not the same as being able to do something about it, so the existence of a managerial labor market is not a complete corporate governance solution. But if the stock market shares this knowledge, then the stock price is discounted accordingly, and those who buy after this knowledge is incorporated into the stock price are not harmed by it. Thus, the small investor can free-ride off the valuation efforts of market professionals, and to the extent that the stock market effectively disciplines managers (and dominant shareholders if management does their bidding), the small investor needs no special protections.

Where does China fit into all this? For all the attention it receives, the shareholder rights approach—indeed, any approach that relies upon formal legal institutions—cannot be expected to form the mainstay of an effective corporate governance regime. The courts have neither the power nor the inclination to play a major role, and government agencies such as the CSRC do not have the resources to serve as a substitute.[114]

Nor does the ownership approach hold out much hope. At present, dominant shareholders seem either to abuse their control or to fail to exercise it entirely. There are two possible ways in which these problems could be remedied. The state could improve its internal management system so that it became a more effective monitor in the companies it dominated. Such a reform is imaginable, but fails to address the issue of abuse of control. The control of abuses rests ultimately, like the shareholder rights approach, on legal institutions—and as argued above, legal institutions are a weak reed on which to rely.

Unfortunately, the best available substitute approach, that of market monitoring, is disfavored by the state. The Chinese state prefers direct regulation by government agencies first, and indirect regulation by private litigation in the state's courts next. Regulation by the uncontrolled institutions of the market comes a distant third, and indeed it is hard to find such institutions in China. The stock markets are creatures of the state and exist only upon its sufferance; securities firms are established and owned by various governmental bodies; banks are either directly owned or else highly controlled by governmental bodies; the financial press is subject to significant state influence, both through ownership channels and through the state's pervasive regulation of the media.

In a state with limited administrative resources, it would make sense to rely as far as possible on the contributions of non-state actors. But Chinese corporate governance institutions are tilted toward the legal because the government generally suspects the institutions of the market and civil society in general. It wants rules, not incentive structures. There is an excessive emphasis on getting the rules right, and an

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[114] There is not space here to make this argument in detail; I do so in another unpublished paper, *Corporate Governance in China: Dilemmas of Reform and the Institutional Environment* (2006).

inadequate attention to institutions that could be flexible in creating and enforcing rules as the situation warranted.[115]

The Asian financial crisis of 1997-1998 gave governments of the region good reason to be concerned with corporate governance issues. Weak corporate governance, insofar as it saps the confidence of investors in their ability to forestall managerial expropriation, can exacerbate such crises.[116] When times are good, insiders refrain from excessive expropriation of outsiders because they desire future financing and care about their reputation. As future prospects deteriorate, however, an end-game situation appears, and insiders step up their expropriation. This is perceived, and perhaps even foreseen, by investors, who attempt to liquidate their positions as soon as possible (calling loans that can be called in the case of banks and selling stock in the case of equity investors). This pushes the firm nearer to collapse and the stock price further down. As the lack of sound corporate governance is a national problem, there are no attractive alternative investments domestically, so the withdrawn capital flees, exacerbating the collapse of the currency as it goes.

That corporate governance is a matter of public as well as private concern, however, does not mean that the only or best solution to corporate governance problems is a public one initiated by the state. An important part of any solution to China's corporate governance problems, given its current set of administrative and legal institution, lies not in the state's actively beefing up those institutions, but simply in its relaxing its hostility to civil society institutions and understanding that corporate governance is too important a matter to be left solely to the state.

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[115] In the words of Ronald Gilson,

> the goal is not necessarily to seek the optimal governance institutions for existing industrial conditions. Rather, reform of national governance systems should strive to assure that institutional structure facilitates prompt and low-cost organizational responses to changes in industrial technology.

Ronald J. Gilson, *Path Dependence and Comparative Corporate Governance: Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 343 (1996).

[116] *See* Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141 (2000). According to Johnson and his colleagues, governance variables such as investor protection indices and the quality of law enforcement are powerful predictors of the extent of market declines during the Asian financial crises, and explain the decline better than the macroeconomic variables that have been the usual focus of the policy debate. *See id.* at 184.