Research Brief

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The Evolution of Corporate Governance in China

China's economic reforms have fueled rapid economic growth in the past three decades. At the same time, the Chinese have developed policies to create Western-style oversight mechanisms and corporate governance, in an effort to improve public confidence in their markets at home and abroad. Despite this progress, however, corporate governance mechanisms in China remain weak. A 2003 study by the World Economic Forum ranked China 44th out of 49 countries surveyed in terms of quality of corporate governance.

A 2008 RAND report titled *Chinese Corporate Governance: History and Institutional Framework* describes the recent history of corporate governance institutions in China, identifies obstacles to the evolution of best practices in this area, and recommends policies to promote improvement.

Abstract

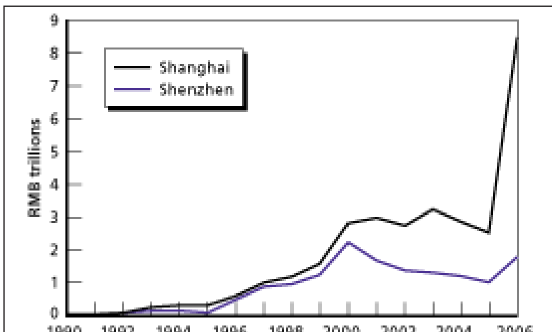
Although China's economy has grown rapidly in recent years and investment in its stock markets has soared, corporate governance institutions remain nascent. A RAND report analyzes the evolution of Chinese corporate governance, describing recent reforms that have created Western-style oversight mechanisms. It also identifies obstacles to reform that stem from the continued prevalence of state ownership, and recommends policies that will help address those obstacles so that China can move toward international standards of corporate governance.

Emergence of Corporate Governance

Until recently, the government controlled almost every aspect of China's economy, and most enterprises were state-owned. In the 1990s, China took the first steps toward modern corporate governance by establishing the Shanghai and Shenzhen Stock Exchanges and by creating a new government body—the China Securities Regulatory Commission (CSRC)—to regulate its new stock market. The next 10 years saw the emergence of a modern enterprise structure, as China passed its first Company Law, delineating the rights and responsibilities of corporations. Notably, investments in Chinese stock markets surged during this period (see figure). But despite these reforms, state shareholders still enjoyed overwhelming favoritism over individual investors. In 2006, China implemented the first of several new policies intended to address the continuing power imbalance between state and individual shareholders.

To describe the current status of corporate governance in China, the report identifies two sets of institutional entities: those internal to companies and those external to them. The inner circle of governance consists of shareholders' general meetings, boards of directors and boards of supervisors, and management personnel. The outer circle includes regulators (primarily the CSRC), the stock exchanges, the Chinese legal system, the auditing system, and institutional investors. The report describes the roles of each of these entities in shaping corporate governance in modern China.

Market Capitalization of the Shanghai and Shenzhen Stock Exchanges



SOURCE: Wind Data, one of the largest providers of data on Chinese financial markets. See http://www.wind.com.cn/en/home.html.
NOTE: RMB=renminbi, the Chinese currency.

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Obstacles to Progress

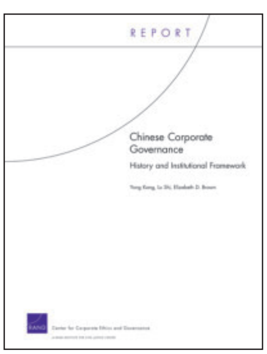
1. ***Overwhelming concentration of state ownership.*** Two-thirds of companies listed in the Shanghai Stock Exchange are state enterprises, a legacy of the state-controlled economy. This problem is the source of many of the other obstacles to progress listed here, such as lack of independence of boards of directors and insider trading. It also has the effect of diverting resources away from companies, reducing the liquidity of the capital markets, and discouraging minority investors from engaging in long-term investment. Recent reforms have improved protection of minority shareholders, but it remains difficult for them to disagree with state shareholders.
2. A direct result of ownership concentration is the ***lack of independence among boards of directors***. Members of both corporate boards of directors and boards of supervisors are typically selected and removed by the dominant owner of the company, which is often the Chinese government. As a result, directors are likely to be impeded in carrying out fiduciary duties, and supervisors are less likely to be able to exert independence from the board of directors and senior managers.
3. ***Rampant insider trading.*** Because so many Chinese enterprises are state-owned, with nontradable shares, insiders at many of these companies have made fortunes on stock offerings. This problem is so widespread that one well-known Chinese economist once called the stock markets “a casino without rules.”[1] The problem is exacerbated by the absence of a well-defined concept of “fiduciary duty” and by weak enforcement provisions under Chinese law.
4. ***Weak mechanisms to control false financial disclosures.*** Corporate fabrication of financial reports is a serious problem in China. Although steps are being taken to change a business culture that has long tolerated corruption, weaknesses in the accounting profession, the media, and the courts undermine reform. The accounting profession has little independence from management and suffers from a severe shortage of qualified auditors. Although the media has made progress in exposing corporate fraud, journalists are often hired through a process that is influenced by senior corporate officials. Securities litigation did not appear in China until 2001, when the Supreme People’s Court of China developed a framework for investors to sue listed companies for losses caused by false financial disclosures. But even today, the process is slow and cumbersome. About 1,000 suits have been filed against 14 companies, but most remain in legal limbo and none has yet been settled by the court in favor of investors.
5. Finally, China continues to suffer from ***immature capital markets***, characterized by the Chinese banks’ preferential treatment of state-owned enterprises, difficulties in issuing corporate bonds, and the absence of an over-the-counter securities market and corporate debt market.

Future Prospects and Recommendations

Despite these problems, the report’s authors are optimistic about the evolution of corporate governance in China. They point to the increasing globalization of listed companies, such as those listed in Hong Kong, as a trend that has helped align those companies with international standards of governance. They also point to the new government policy allowing mainland Chinese citizens to invest in non-mainland stock markets, a move that will force mainland enterprises to compete with their Hong Kong counterparts for investors. Also, as China’s market economy matures, it will stimulate the development of more experienced personnel who are badly needed to serve as company managers, independent directors, and certified public accountants.

To overcome the obstacles to better corporate governance, the authors recommended a number of policy options. These include better defining the functions of supervisory boards, making it easier for investors to sue management, and toughening the punishment for insider trading—all steps that have been recommended by other experts. The authors also suggest reviving the now-banned regional over-the-counter markets, establishing an incentive mechanism to encourage reporting of insider trading, and promulgating the concept of fiduciary responsibility. ■

[1] “Wu Jing Lian Nu Chi Gu Shi Hei Zhuang” [“Wu Jing Lian Denouncing Market Manipulation”], *Economy 30 Minutes*, January 14, 2001. As of October 22, 2008: http://finance.sina.com.cn/t/32603.html



This research brief describes work done for the Center for Corporate Ethics and Governance within the RAND Institute for Civil Justice and documented in *Chinese Corporate Governance: History and Institutional Framework* by Yong Kang, Lu Shi, and Elizabeth D. Brown, TR-618-RC (available at http://www.rand.org/pubs/technical_reports/TR618/), 2008, 60 pp., $24.00, ISBN: 978-0-8330-4611-6. This research brief was written by Laura Zakaras. The RAND Corporation is a nonprofit research organization providing objective analysis and effective solutions that address the challenges facing the public and private sectors around the world. RAND’s publications do not necessarily reflect the opinions of its research clients and sponsors. **RAND**® is a registered trademark.

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