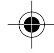

6
Building a Modern Governance System

The institutional mechanisms of corporate governance discussed in the previous chapters comprise a system that can employ alternative instruments of control to effectuate changes in companies' behavior. The various instruments of corporate governance may be imperfect in isolation, but in combination they can constitute a powerful architecture. At the same time, fundamental weaknesses in individual instruments can undermine the effectiveness of the entire structure. For example, weak creditor rights will inevitably be reflected in the cost of equity capital and share prices, and will undermine the disciplining role of stock markets.

The effectiveness of the various instruments of corporate governance depends largely on the incentives of market players to use them. Effective regulation builds on their incentives, strengthening some and weakening others, thereby establishing an effective system of checks and balances. Without the support of markets and incentives, an overemphasis on regulations and rules may be a triumph of form rather than of substance.

Establishing Credible Penalties for Failure

The effectiveness of the modern corporate governance system rests ultimately on rigorous market tests of success or failure. Without a credible threat of failure in the form of loss of market share, bankruptcy, delisting, or hostile takeover, most instruments of corporate governance will remain unused or their effectiveness will be limited.

The strength of creditors' rights in bankruptcy, for example, underpins all other instruments that banks and other creditors have at their disposal to affect companies' behavior. Without a real threat of

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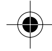
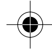


bankruptcy, banks are likely to lend only to prime customers or to resort to short-term financing. As a result, their role in corporate governance will remain limited. Weak creditors' rights will in turn be reflected in stock prices, resulting in excessive valuations. Other things being equal, this will lead to excessive demand for listing and share issuance and a distorted capital structure. Excessive valuations will create stakeholders that are likely to oppose strengthening creditors' rights and imposing discipline on the stock market. With weak creditors' rights and without a credible threat of delisting, stock market participants will not have the incentives to base their investment behavior on information on companies' business fundamentals, including corporate governance practices. As a result, stock prices will not be able to serve as useful market signals in designing compensation contracts, assessing managerial performance, and guiding takeover activities.

The threat of failure (and actual failure) has the unique capacity to focus the attention of investors, regulators, lawyers, and so on on taking corrective action, on discovering wrongdoing, and on ascertaining what their respective rights are and how they can use them to protect themselves. It will therefore activate the use of the various mechanisms of corporate governance, thereby triggering an evolutionary process of further improvement and fine-tuning.

Addressing the Agency Costs of Government Ownership

The threat of failure cannot become fully credible in China given the dominant role of state ownership. The government, and local governments in particular, is likely to continue to rely on noneconomic considerations and use its powers to affect decisions on bankruptcies, delistings, and takeovers of firms under its control. As owners local governments are more likely to continue to extend support to failing firms in ways that run counter to the principles of market order, such as providing explicit or implicit subsidies, engaging in local protectionism, and lobbying. As owners they are also more likely to interfere with the application of the rule of law when they have to enforce laws, regulations, and court decisions against companies under their control. The tools available to address some of these issues can be divided into three broad groups: aligning incentives and building regulatory capacity, separating government control rights from cash flow rights, and reducing state ownership.



Aligning Incentives and Building Regulatory Capacity. For managers and company directors to pursue any legal means to advance the fortunes of their companies, including seeking the support of local governments, is not inconsistent with the principle of fiduciary duties. In the same vein, a responsible local government is expected to use its powers legitimately to advance the prospects of firms under its jurisdiction. Indeed, local governments' incentives to promote regional development, and in this context, the support they have extended to local firms, have been a key factor in China's economic dynamism, as discussed in chapter 2. Over time, the evolutionary dynamics of the development process inevitably tend to generate tensions and conflict between incentives at the company, regional, and national levels. China's regulatory challenge is how to align these incentives better while preserving the positive forces at the company and local government levels that are consistent with the operation of market forces.

At the company level, national regulations related to the fiduciary duties of directors, managers, and controlling shareholders are intended to align the interests of directors and officers more closely with those of shareholders, and in the process to affect the capacity of government agencies as significant shareholders to use control for the production of political goods and to abuse the interests of independent (minority) shareholders. China has borrowed concepts from the Western corporate law tradition that had been developed to protect absentee, "inactive, and irresponsible" shareholders (Berle and Means 1999, p. 311) by, in effect, shifting the costs of monitoring from the principal (shareholders) to the agent (management and controlling party) and to the regulator and the courts. According to Berle and Means (1999, p. 242), the global trend is for corporate law "to become in substance a branch of the law of trusts." Having been designed with the interests of passive and absentee owners in mind, the principles of fiduciary duty, if successfully enforced, tend to make the identity of the owner and the ownership structure in general less important in terms of their impact on economic efficiency.

In addition, complete separation of listed companies' managers from the civil service system will reduce the scope of political and government control over managerial appointments and will promote the development of a managerial labor market. Better alignment of the incentives of managers and minority shareholders through stock options and compensation based on stock performance will make

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managers more likely to resist requests from state shareholders to promote noneconomic objectives.

At the local level, many of the central government's regulatory initiatives and ideas have been directed at reducing local governments' incentives and capacity to engage in protectionist practices, and in the process usurping the controlling functions of markets. In April 2001 the State Council issued regulations that outlaw regional protectionism and establish penalties for government officials engaging in protectionist conduct. Price deregulation has not been extended to the subnational levels; however, steps are under way to strictly implement Article 18 of the Price Act to limit subnational governments' discretionary power to fix prices. Legal scholars have proposed the passage of an interstate commerce clause like that in the U.S. Constitution. These measures are expected to hasten the development of a unified national market and reduce the scope for local protectionism. Important initiatives are also under way in the area of taxation. The Tenth Five-Year Plan envisages major improvements to the tax system. The goal is a unified system and a reduction in the numerous taxes and surcharges levied by local governments. In October 1999 the Supreme People's Court introduced a five-year plan for comprehensive court reforms. The reform plan notes that China's legal institutions and mechanisms face a severe test because of, among other things, the rise in local protectionism. The five-year plan emphasizes that the lower courts belong not to the localities but to the state. The Supreme People's Court has also started to study reform of the funding system so that the lower courts can be funded through the central government.

These regulations and initiatives are intended to build a unitary, fair, and orderly market system, and if successfully implemented will increase the costs for local governments in using ownership control for the production of political goods. They are also expected to strengthen the state's regulatory and implementation capacity. However, while well intentioned, some of the reform proposals may run against the natural incentives and interests of market players. For example, the State Planning Commission has suggested revamping the fiscal system so that local officials do not collect tax payments directly from local branches of state enterprises as a way to curtail the incentives for local protectionism. This proposal, in addition to implicitly assuming that taxation rights create stronger incentives for local protectionism than ownership, raises the important issue of how such a revamping of the fiscal

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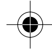

system would affect local governments' incentives to use ownership to derive noneconomic benefits. Another idea has been to stop linking the promotion of local cadres to the economic growth of their localities (World Bank 2001b). Regulations often rely for enforcement on signals from agents that may be conflicted about the very issue they are asked to help regulate and enforce. Recent regulations on independent directors, for example, in effect create two different classes of directors and the opportunity for antagonism in the board room. In many areas regulations amount to no more than prohibitions, and this is insufficient to make them effective given the powerful forces working in favor of maintaining the status quo.

The complexity of the issues and the magnitude of the task pose significant challenges to the government's regulatory capacity, especially at the national level. The government will have difficulties meeting these challenges if it relies only on its own resources and on direct methods of regulation. Box 6.1 illustrates the successful experience of the U.S. Securities and Exchange Commission (SEC), which is based on self-regulation and on extending support to the "right" party that has an interest in regulations being enforced. China has made some progress in self-regulation and in mobilizing civil society to participate in the enforcement process, but the unrealized potential in this area is enormous. In the Chinese context, empowering the "right" party in relation to specific regulatory issues will often mean enhancing the independence of associations, the media, self-regulatory bodies, and other members of civil society. In the future, China's trading partners are likely to play an important role in the enforcement of some of these regulations by seeking to bring WTO discipline to bear on local internal barriers to trade and other forms of local protectionism. On a more fundamental level, building a strong regulatory capacity is likely to enhance the government's confidence that it can manage the economy effectively without the tools of direct ownership.

Separating Government Control Rights from Government Cash Flow Rights. China could move more aggressively in experimenting with various mechanisms for separating control from cash flow rights as a way to reduce political control over companies' behavior. Regulations along the lines discussed earlier are likely to reduce the benefits of control associated with government ownership. As a result, the

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BOX 6.1
The Early, Indirect Approach of the U.S. Securities and Exchange Commission

An important constraint that shaped the SEC's strategy in its initial years was the resource constraint: if the SEC had decided to do its job entirely on its own, its resources would have had to be enormous. Just the policing of corporate financial reporting would require thousands of auditors and accountants, each under some form of supervision. Thus the strategy of direct control had obvious drawbacks.

Instead, the SEC decided to work through existing private structures and, where necessary, to create new ones. Its philosophy was to manipulate private incentives to serve public ends, while preserving its independence and not being manipulated to serve private interests. The SEC's strategy would be presented to accountants, bankers, and brokers as an attractive plan for "self-regulation." The heart of the regulatory system would be a careful shaping and bending of the incentive structures so that each of the major players would voluntarily carry out SEC policies. This was based on an appreciation of the need to manipulate incentives implicit in the industry, so as to give those involved a self-interest in obeying and strengthening the law. As a result of its efforts the SEC was able to obtain the cooperation not only of the exchanges but also of brokerage houses, investment bankers, and corporation executives, who in turn recognized that their efforts to improve financial practices were now buttressed by the strong arm of the government.

The SEC's first major success in co-opting interest groups was with accountants. Accountants had an obvious interest in cooperating, because the SEC's regulations and laws were creating a huge demand for accounting services. Regulation built along these lines welded together existing self-regulation and direct control by the government. The philosophy of the SEC's interventions was to restore checks and balances by the government's adding its weight to the right party rather than substituting for private parties.

Source: McCraw (1984).

government will increasingly begin to associate ownership with cash flows and monetary values. This will increase the incentives to trade shares and will make various mechanisms for separating control from cash flow rights more attractive.

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For example, the government could conduct experiments to determine whether having private (including foreign) institutional investors manage listed state shares would promote a more market-based and value-maximizing approach. One way to do this would be to transfer state shares to trusts administered by trust investment companies. In this way state shares would be allowed to circulate without putting them directly into private hands. This may help demonstrate an important point: a portfolio approach may achieve value preservation and enhancement more successfully than holding controlling, but illiquid, packets of shares in specific companies. The recently adopted Trust Law and Trust Investment Companies Measures creates a legal framework for this.

Another method for separating control from cash flow rights could be to modify the nature of government equity claims by, for example, transforming government equity claims into preferred nonvoting shares. This would transform the nature of the government's cash flow rights so that they would become more like some forms of tax liabilities, thereby promoting greater consistency between the different roles the government is playing with respect to government-owned firms. A wide variety of preferred nonvoting shares is available, some of which allow for conversion back into voting shares under certain circumstances.

Both these measures—making the government a beneficiary owner and transforming the nature of the government's equity claim—could be useful transitional mechanisms, as they could send a powerful signal that the government is committed not to interfere with market forces.

Reducing State Ownership in a Gradual Fashion. The government should not view the aforementioned measures and approaches as a substitute for further ownership reform. The government realizes that despite the significant progress it has made to date in developing the various instruments of corporate governance, fundamental and sustainable improvement cannot be achieved without reducing state ownership.

A number of different methods are available for gradually reducing state ownership. China has been considering different mechanisms for liquidating state assets in the capital market, both to help support the social security system and to fulfill conditions for SOE reform. In September 2000 the government unveiled a plan to reduce the proportion of state-owned shares from 68 to 30 percent in two stages. The plan specified five ways to reduce the amount of state-owned

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shares: state share placement, share repurchase, negotiated transfer, auctioning, and debt-equity transfers. Other proposals for reducing state shares include transferring state shares to employees and to institutional investors. Some experiments have already taken place. All existing plans agree that the process of divesting state shares has to be gradual. The process is likely to be influenced by changes in ideological thinking, concerns about market stability, pressure to restructure, and social safety net needs.

Perhaps the most appealing way of reducing state shares is through institutional investors. Institutional investors, including foreign-invested institutions or those under foreign management, can provide the liquidity and sophistication to absorb a large supply of government shares without disrupting market stability. Disposing of state-owned shares in the form of an index fund, for example, has some attractive features. An index-linked fund, similar to the Tracker Fund of Hong Kong (China), could be established to sell state-owned shares. Along with the development of a domestic pension fund, this would reinforce the development of the Shanghai main board market and would also facilitate the creation of other index-driven products. An attractive feature of an index fund is that it is likely to have a relatively small destabilizing effect on the market. Ideally, the fund would be expected to issue units to tap cash from retail and institutional investors, including insurance firms and pension funds.

The ownership structure is likely to undergo fundamental changes as a result of new share issues and new listings, which are likely to be the dominant approach in the near to medium term. For example, a provision already exists for selling up to 10 percent of the state share in an IPO to replenish the social security funds. The July 1999 CRSC Circular on Further Improving Methods of Issuing Shares, which applies to companies with registered capital of more than RMB 400 million (US$48.3 million), is likely to have a significant impact on the liquidity of legal person shares. Under the circular the prices of shares in private placements are equal to those in public offerings, and private placements are also subject to similar disclosure requirements as public placements. Legal person shares issued under the circular can be publicly traded subject only to a six-month or three-month holding restriction. As more state and legal person shares become tradable, market forces and corporate governance institutions will begin to shape the ownership structure of listed companies.

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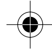

Strengthening Boards of Directors

Chinese regulators have emphasized strengthening boards of directors as part of their efforts to improve corporate governance practices in listed companies. However, many of the aspects of good board of director practices are part of the internal operations of a company and may fall outside the domain of laws and regulations. Therefore promising approaches might combine regulatory initiatives with peer pressure mechanisms to disseminate good practices. To this end China has adopted the Code of Good Corporate Governance Practice for both listed and nonlisted companies.

Assessing Whether Independent Directors Add Value. International evidence suggests that corporate boards need directors who are not just independent of management, but who are accountable to shareholders. A rapidly growing literature focuses on the relationship between board composition, governance, and performance; however, empirical evidence broad enough to cover all the major issues is available only for the United States. Thus the literature reflects relationships in a highly developed and sophisticated market economy populated by large firms that already have a significant number of independent directors on their boards. While we believe that many of the results have some general validity, they do not emphasize absolute relationships, but rather whether existing average board structures in U.S. companies are efficient, and whether small changes from the status quo would help or hinder corporate governance and performance.

A number of studies look at the relationship between board independence and observable board actions, such as firing a poorly performing CEO, setting the level of CEO compensation, and committing financial fraud. Weisbach (1988) reported that boards with more than 60 percent independent directors are more likely than boards with fewer independent directors to fire a poorly performing CEO. He also found that boards independent of a majority stockholder are faster in firing the CEO if observable performance measures such as stock price and earnings are poor. Other studies (Bhagat and Black 1999; Bhagat, Carey, and Elson 1999) have found that firing a CEO under such circumstances increases the firm's value. Critics have questioned these findings on the grounds that they may be limited to a particular period in U.S. corporate history when takeover activity was exceptionally high.

If that were the case, the results suggest that boards independent of majority stockholders are faster in taking disciplinary action when the threat of a takeover is real. Taken together, the various findings seem to confirm that independent directors behave differently than inside directors in the decision of whether to replace a poorly performing CEO, but that the differences are marginal.

Regarding CEO compensation, little evidence suggests that independent directors do a better job of setting CEO pay than inside directors. Several studies (see, for example, Borokhovich, Parrino, and Trapani 1996) report that the higher the proportion of independent directors, the more the CEO is paid. Independent directors in U.S. companies are not doing a good job of developing incentive compensation to induce better performance. This could be because many independent directors are current or former CEOs who are prone to compensate the CEO in the manner they would like to be compensated themselves.

With respect to the likelihood of committing financial fraud, Dechow, Sloan, and Sweeney (1996) reported that firms with a majority of inside directors and without an audit committee are more likely to commit financial fraud than a control group matched by industry and size. Overall, findings seem to suggest that independent directors help to control financial fraud, but the reverse causality is also possible, that is, that managers prone to financial fraud resist oversight by independent boards.

Finally, a number of studies explore various aspects of the relationship between board composition and performance. Rosenstein and Wyatt (1990) found that, on average, stock prices increase about 0.2 percent when companies appoint additional outside directors. Kline (1999, as quoted in Bhagat and Black 1999) examined whether the existence and staffing of board committees affected performance and found little evidence that monitoring committees dominated by independent directors affect performance. Companies with inside director representation on a board investment committee tend to exhibit superior performance. This suggests that companies with a large majority of independent directors may perform worse because they have too few inside directors to perform this role.

Looking at the direct link between performance and board composition, a number of recent studies, the most influential of which is Bhagat and Black (1999), find a negative correlation between the proportion of independent directors and firm performance—the exact

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opposite of conventional wisdom. This may indicate that U.S. boards have too many outside directors.

One implication of these findings is that favoring independent directors regardless of their backgrounds may not be the best approach. Firms need boards capable of balancing independent directors' lack of in-depth knowledge about the business with the combination of knowledge and conflict of interest that is characteristic of insiders. Above all, corporate boards need directors who are not merely independent of management but are accountable to shareholders.

Making Directors More Accountable to Shareholders. Directors' rights and responsibilities need to be clarified and their enforceability made credible. Existing laws and regulations do not set out directors' exact rights and responsibilities clearly enough. The Company Law does not stipulate any disclosure obligation on the part of directors or any specific liabilities assumed by directors who fail to perform their obligations. Regulations such as the new guidelines on independent directors provide more details, but still fail to clearly describe directors' main duties and responsibilities. China could follow the examples of countries like Australia and New Zealand, which have translated duties related to company loyalty into statutes.

Increased legal liability often follows on the heels of increased responsibility. Thus directors also need a reasonable degree of assurance that if they follow established standards of behavior, they will be relatively protected from litigation. Protection under the business judgment rule should be an integral part of the system of rights and responsibilities, translated into statutes as some countries are currently doing. One change in Australia has been the introduction of a statutory business judgment rule, which provides a "safe harbor for honest business decisions that turn out badly providing they satisfy certain criteria" (Hockey 2001). The statutory formulation should provide a clear presumption in favor of directors' judgment. Protection under the business judgment rule should be linked to directors' qualifications; functional responsibilities on the board; and the procedures that govern board functioning, such as the use of experts.

With sufficient clarity concerning directors' rights and duties complemented by corresponding shareholders' rights, legal action could become a way to monitor and enforce regulations. Lack of compliance with regulations by boards of directors and directors' failure to live up to their obligations could result in legal action against a company and

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its board. In China, enforcement emphasizes administrative and criminal processes rather than derivative civil actions. According to Article 166 of the Criminal Law, any employees who take advantage of their positions, turn management of their units over to their relatives or friends, purchase commodities from units managed by their relatives or friends at prices higher than the market price, sell commodities to such units at prices lower than the market price, or purchase commodities that are not up to standard from units managed by their relatives or friends face up to seven years in prison. However, these regulations do not apply to the directors and managers of non-SOEs, thereby creating an uneven playing field. A major reason for China's emphasis on criminal sanctions is because under current conditions, few company officers or directors could afford to pay a substantial civil judgment for breach of fiduciary duty.

Thus under current conditions, directors' liabilities are not credible, and legal action as a controlling mechanism will not emerge without some sort of liability insurance for directors and officers (D&O). The D&O insurance market has expanded and evolved rapidly in the last few years at the same time that directors' obligations have increased (see box 6.2). With globalization, the directors of some Chinese companies will be exposed to litigation under U.S. securities laws, as they increasingly seek to raise capital in the United States.

One objection to D&O insurance is that it introduces moral hazard and does little to improve corporate governance. However, standard techniques developed in the insurance industry to tackle the issue of moral hazard are applicable in the case of D&O insurance, for example, deductibles, coinsurance, and policy conditions to restrict the coverage of high-risk individuals. In effect, the incentive for taking care is provided by the insurer rather than by the threat of having to pay compensation, a risk that is now largely transferred to the insurer. Insurers, while diversified and with few incentives for close monitoring, can be powerful forces in introducing standards and ratings. The price of D&O insurance can be a barometer of corporate governance. In addition, the presence of D&O insurance may influence the likelihood of legal action taken, for example, by shareholders. The presence of D&O insurance will certainly make directors more likely targets of shareholder activism.

Promoting Board Independence. Board independence could be promoted through a more flexible approach that focuses on procedures,

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BOX 6.2
Directors' and Officers' Liability Insurance

D&O liability insurance is a form of malpractice insurance for corporate boards of directors. It provides coverage for acts, errors, and omissions by individual company D&O to the extent those acts are committed during the course of their employment. Such insurance does not provide coverage for the company itself. D&O insurance is a key component of the protection that every director and officer should have. Some developed markets have statutory schemes permitting corporate indemnification. The overriding goal of these statutes is to encourage capable individuals to serve as D&O secure in the knowledge that they would be insulated from personal liability if corporate actions, taken in good faith, were attacked by way of legal proceedings. For many years D&O policies have been structured to insure not only the directors but also the companies when the latter have indemnified directors. Such indemnification may arise by virtue of a contractual right of the directors, by order of a court, or by means of a voluntary payment that the company has the power to make and the funds to support.

North America remains the biggest market for D&O insurance, accounting for about 83 percent of premium income compared with around 13 percent for Europe. Research (Monteleone and Conca 1996) reveals that the tendency to buy D&O coverage increases with firm size, as do the size and frequency of D&O claims. In the United States around 90 percent of major industrial corporations carry D&O insurance, and coverage is almost universal (97 percent) among utilities, large banks, and insurance companies, which seem especially risk averse. In the United Kingdom about 55 percent of companies with annual turnover in excess of £100 million buy D&O insurance, but only about 1 in 10 companies with an annual turnover of less than £5 million do so. In general, firms more likely to encounter financial distress are more likely to purchase D&O coverage.

rights, and responsibilities. The CSRC's current approach is to prescribe a somewhat rigid board structure. Rigidity inevitably implies some degree of arbitrariness in the prescribed number of independent directors. Companies differ tremendously in terms of their size, their affiliations with other companies, the contestability of their market positions, and so on. These are all factors that affect the potential for

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conflict of interest and the need for board independence. Thus an alternative approach would be to regulate board composition and independence indirectly through regulations on, for instance, related party transactions and boards' and directors' duties and responsibilities. For example, mandating the approval of large related party transactions by noninterested directors (suitably defined) implicitly restricts board composition while leaving companies the flexibility to adjust their board structures to their unique circumstances. Similarly, imposing requirements on the functions and responsibilities of auditing, nomination, and compensation committees has direct implications on the composition of boards of directors.

Additional measures, such as disclosure by directors and specific board procedures, can also improve a board's independence. For instance, some directors may be obliged to the company or to its current CEO in ways too subtle to be captured by customary definitions of independence. This possibility is consistent with the evidence that directors who are appointed during the current CEO's tenure are more generous in determining the CEO's compensation. One way to improve transparency would be for the CSRC to require the disclosure of financial and personal ties between directors (or the organizations they work for) and the company and its CEO.

Procedures may be more important than exactly specified board composition. Measures for improving board performance focus on procedures that facilitate monitoring, such as holding an annual meeting of outside directors without the presence of inside directors, periodically reviewing the performance of the CEO and the directors, or appointing a lead director. Examples of good board practices adopted in some of the economies in the region include reducing the number of principal directorships (up to six in Singapore); setting new performance benchmarks based on shareholder value added (economic value added), especially for government-sponsored companies; requiring that boards meet no less than once a quarter (Republic of Korea); evaluating the performance of management; making board and outside directors' reports public; and requiring directors to be accredited (Hong Kong Institute of Company Directors).

Providing Independent Directors with Incentives. Independent directors need the direct economic incentive of substantial stock ownership to actively monitor management. However powerful a disciplining device the threat of regulatory and legal action may be, it cannot substitute for the power of positive incentives. Independent directors have

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little incentive to actively monitor management without the direct economic incentive of substantial stock ownership, and should therefore be required to purchase significant amounts of stock before serving on the board. High fixed compensation that does not depend on stock performance can act as a disincentive for management monitoring. The stock ownership will serve as a performance bond. For example, Bhagat and Black (1999) found that the greater the amount of stock individual outside directors owned, the better the company performed and the higher the likelihood of management turnover based on disciplinary grounds.

Professionalizing Corporate Directors. Continued training and education constitute an essential component of any measures supporting improvements in the functioning of boards of directors. Internationally, a growing trend toward professionalizing corporate directors has become apparent. The U.K.'s Institute of Company Directors, for example, is introducing a chartered director qualification that it claims will be the world's first professional standard for directors (see box 6.3). This may eventually bring directors in line with practitioners in other professions, such as the law and accounting. Thus in the future directors will increasingly be expected to have completed some form of training, passed certain examinations, and achieved a required level of competence.

In this regard, China needs an institute of company directors independent from the regulator. This institute would provide training for directors; maintain a database of individuals who are potential

BOX 6.3
Chartered Director Qualification in the United Kingdom

The candidates are required to be at least 28 and have at least three years of board experience. They are expected to take a three-hour examination in addition to other tests. On successful completion of the assessments, candidates will receive chartered director status, which will give them the right to put the letters "C. Dir." after their names. Chartered directors are expected to subscribe to a code of professional conduct and agree to 30 hours of training a year. The introduction of the chartered director qualification is expected to put board membership on a level playing field and detach it somewhat from the use of criteria based on titles, connections, and so on.

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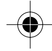

candidates for directorships and help companies fill directorship positions; accredit directors; and disseminate information to establish useful benchmarks for remuneration, functions of boards of directors, and so on.

Moving toward a Single-Tier Board Structure. The original intent of Chinese legislation was to limit the power of directors through the presence of supervisory boards: the main function of the supervisory board seemed to be to ensure directors' accountability. Shortly after the promulgation of the Company Law, some scholars expressed the view that supervisory boards are providing ex ante director accountability more effectively than any equivalent regime under company law elsewhere. They claim that supervisory boards are even more important in the Chinese context, because the enforcement of court judgments is comparatively weak in China (Ong and Baxter 1999).

However, in recent years, countries have tended to move toward a legal regime that strongly favors a single-tier board that is relatively small, and that contains some insiders as well as a majority of outside directors. Mandatory two-tier board structures seem to be going out of favor with companies and regulators based on the argument that they promote weaker and less responsive boards. According to Cha (2001):

> It is sometimes argued that more authority should then be given to the supervisory board, which sits on top of the boards of our listed companies. However, experience has shown that this system of supervision is not effective as it is often unclear whose interest is being represented by the supervisory board. In many cases the supervisory board duplicates the authority of the board itself but without corresponding responsibilities. In fact the presence of a supervisory board may give the illusion of certain checks and balances in the listed company when none existed.

China seems to be moving in this direction. Recent measures strengthen the power and independence of boards of directors, which has the effect of further emasculating supervisory boards.

Empowering Shareholders

While regulatory activism and more independent boards can play an important role in protecting minority investors, they cannot substi-

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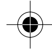

tute for directly empowering small and independent shareholders to protect and further their own interests.

Stipulating and Enforcing the Fiduciary Duties of Controlling Shareholders. Recognizing that existing ownership structures and IPO practices have made related party transactions a critical issue for corporate governance, the regulator has made significant progress in improving disclosure; introducing various internal procedural mechanisms, such as disclosure of interests and disinterested voting; and strictly prohibiting certain activities, for example, guarantees for other companies. However, further progress is needed to align definitions of related party transactions with international practice. More important, as the fiduciary duties of controlling shareholders are not stipulated, their liabilities in relation to losses incurred by minority shareholders are not clear.

Over the last 25 years corporate law has come to recognize that shareholders in a corporation owe fiduciary duties to each other akin to those partners in a partnership owe each other. One of the most important developments of the concept of fiduciary duties has been the recognition of the duty of fair dealing by majority shareholders in relation to minority shareholders. Recent regulations implicitly introduce this principle without, however, spelling out liabilities, penalties, and procedures. In a fiduciary duty context those in control carry the burden of proof in establishing that their actions were taken in good faith and were fair to the minority shareholders' interests. Given the lack of sophistication in fiduciary duties matters, the appropriate approach for China seems to be the paternalistic one, where statutes should set out the full range of fiduciary obligations. The statutes could ensure flexibility by specifying the types of duties that shareholders could opt out of, or these could be specified in individual operating agreements.

The doctrine of piercing the corporate veil is not well established in China, but if developed and applied could be effective in discouraging certain forms of abuse by controlling shareholders.[1] Although this

1. The Company Law is piercing the corporate veil with respect to the ownership rights of the state as shareholder when declaring in Article 4 that "the ownership of state-owned assets in a company shall reside with the state" (see Howson 1997). This provision creates legal uncertainty as to the real rights of a corporation and the validity of the corporate form in the presence of significant state ownership.

doctrine is primarily directed at providing a remedy for creditors, it has the effect of protecting minority shareholders because of its deterrence effect on large shareholders. China has seen some cases where the courts have demonstrated that under certain circumstances, typically related to inadequate capitalization, they are willing to pierce the corporate veil (Feng 2001). In developed marked economies the factors determining courts' decisions about whether to pierce the corporate veil are quite broad and may include (a) a failure to observe corporate formalities, (b) the siphoning off of corporate funds by the dominant shareholder, (c) the nonfunctioning of officers or directors, (d) the use of the corporation as a facade for the operations of the dominant shareholder, (e) the mixing of the parent company's assets with the assets of a newly established firm, and (f) the exercise of direct control by the parent company by ignoring the subsidiary's corporate structure. Such practices are quite common in China today and tend to hurt creditors and minority shareholders. A broader application of the doctrine of piercing the corporate veil may be an effective approach to discouraging them.

Conglomerates pose special issues with respect to related party transactions. The duties and restrictions placed on controlling shareholders in conglomerates should be clearly spelled out and the appropriate checks and balances should be implemented. The disclosure of interested director contracts is not enough. German corporate law has developed mechanisms designed to protect the minority shareholders of subsidiaries in corporate groups or conglomerates.

Strengthening the Rights of Minority Investors. Shareholders' meetings are a corporation's most powerful authority; however, Chinese laws and regulations do not specify shareholders' rights clearly. The power to elect and remove directors is one of the indirect methods whereby shareholders can influence a company's behavior, but Chinese minority shareholders have limited capacity to ensure that they are represented on the board. Reportedly, a small number of listed companies have tried the cumulative system—a complicated procedural mechanism that is designed to facilitate minority shareholder representation on boards, but one that is open to abuse if not properly regulated—however, the lack of enabling regulations limits its applicability to listed companies.

The new system of independent directors stipulates that they should pay special attention to the rights of medium and small share-

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holders. However, the stipulation of a 10 percent minimum shareholding for nomination means that minority shareholders are unlikely to be in a position to nominate independent directors, much less appoint them. Without this, expecting independent directors to have a special duty of loyalty to minority shareholders, as stipulated in the regulations, is unlikely. Under the current ownership structure, the right to nominate independent directors is worth little if not supplemented by methods that enhance the chances of minority shareholders to elect directors, for example, cumulative voting. However, a better approach might be that proposed in Brazil, where minority shareholders holding a certain percentage, for instance, 15 percent, would have the right to appoint a board member.

Company law and related regulations make removing directors difficult, primarily to strengthen their independence in relation to controlling shareholders. The Company Law provides that before directors' terms of appointment expire, shareholders' meetings shall not be permitted to remove directors from their post without due cause. The law does not specify what reasons could lead to their removal, although the CSRC's guidelines in the Articles of Association include the provision that directors who fail to attend two successive board meetings, whether in person or by delegating their duties to other directors, are deemed incapable of performing their duties, and at the shareholders' meeting the board of directors can propose removing such directors. The law and regulations do not specify removal by court order. Removal of directors by court order for a specific reason can be an important device for protecting minority investors in cases where a director is also an important shareholder.

The provision that shareholders' meetings cannot remove directors without a cause before their term expires acts as an antitakeover device, in that it limits the capacity of a new controlling owner immediately to effect changes in the board of directors. However, the provision may cause less resistance to changes in control on the part of management. Modern statutes in other countries have dramatically expanded shareholders' powers to remove directors without cause.

Provisions governing the removal of directors should be drafted so as to prevent the majority from undermining the outcome of cumulative voting or other devices designed to protect minority shareholders. For instance, if a corporation uses cumulative voting, then the statutes will normally provide that directors cannot be removed if the

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number of votes cast against their removal would have been enough to elect them.

A quorum requirement could be a powerful protection device for minority shareholders and should be strengthened in the case of shareholders' meetings. It could be a simple majority or some other minimum percentage of outstanding shares. Specific, usually stricter, quorum requirements for specific issues, such as amending the articles of association, should also be based on outstanding shares. The current system, which requires a simple or qualified majority of shareholders in attendance, significantly strengthens the power of controlling shareholders.

The development of a proxy system, essential for the exercise of shareholders' rights, will have to accompany the adoption of a quorum requirement. A proxy system provides shareholders with the means of submitting proposals to fellow shareholders and regulates the nature and content of information flows between management and shareholders. For example, annual reports are not currently sent to shareholders, but will have to be if a quorum is required and all shareholders are given equal chances to exercise their voting rights. Thus the focus of a proxy system is to provide investors with adequate information before they exercise their rights. Proxy contests are an important complement, and in some sense a substitute, for the takeover process. They permit partial changes in corporate governance practices without necessarily undergoing changes in control. They also allow a competitive process in deciding on specific proposals and issues. In theory, a proxy contest is cheaper than a hostile takeover bid and makes obtaining control without owning a majority of the shares possible by simply winning a majority of the board seats.

A critical factor for the functioning of a proxy system is the cost of interactions of listed companies with their shareholders. Given China's predominantly retail and fluid investor base, this could present a serious obstacle to a functioning proxy system. At least initially, regulations could provide for extra time for vote solicitation in the case of large, dispersed firms and highly liquid stock. However, the advent of the Internet has provided more options for maintaining accurate shareholder lists and reducing the costs of interaction with shareholders. Institutional investors can greatly facilitate the implementation and enforcement of proxy regulations.

The power to request a meeting is a key shareholder right. Currently, only shareholders holding 10 percent or more stock have this

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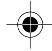

right. This could be expanded to shareholders that together represent 10 percent or more stock, thereby giving trustees, institutional investors, and individual investors the opportunity to solicit representation through the proxy system. With respect to shareholders' rights to propose agenda items for shareholders' meetings, the CSRC's guidelines in the Articles of Association specify that a shareholder or shareholders holding an aggregate 5 percent or more of the voting rights of the company may propose agenda items.

Many jurisdictions impose restrictions on shareholders' preempting or challenging management, for example, in putting forward shareholder proposals, calling meetings, requesting information, or taking certain kinds of legal action. These restrictions are usually in the form of a percentage shareholding threshold. Given the difficulties facing any shareholder initiatives in China and the impracticalities of litigation, such restrictions are probably unwarranted. In the interests of curtailing excessive management power, some observers have suggested that shareholder approval be required for a wider range of activity. In situations with a controlling shareholder and an alignment of interests between this shareholder and management, requiring the approval of a majority of the minority shareholders may be advisable. This runs counter to the doctrine of majority rule in corporate law matters, but has been invoked in some countries, and may be justified in China under certain circumstances.

The right to inspect the company's books and records is a fundamental shareholder right. For shareholders to be able to decide intelligently whether to continue to be shareholders of the company; to bring legal action against the company, a controlling shareholder, or a director; or to take other action in relation to their investment they need information. Article 110 of the Company Law gives shareholders the right to consult the company's articles of association, minutes of shareholders' meetings, and financial and accounting reports, and also the right to make inquiries about the company's business operations. However, these rights are not codified and are at best rudimentary. The types of records to which shareholders have an automatic right of access is not broad enough and does not include all written communications to every shareholder, the names and addresses of current officers and directors, and annual reports or financial statements. No provisions allow for qualified rights, based on a definition of a proper purpose, for shareholders to inspect more sensitive information, such as the list of shareholders. The law also does not specify

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if the beneficiaries of shareholders can inspect company materials. Shareholders' rights in relation to information access are significantly less than the information listed companies are required to give the government. The information parity of minority shareholders with respect to the government, major shareholders, and analysts is important for the existence of a proper system of checks and balances.

Existing laws and regulations do not specify penalties for corporations and officers that obstruct shareholders' rights to access information. To encourage more stable shareholdings, the rights of inspection could be strengthened for shareholders who have held their shares for a certain time or for larger shareholders.

One area of weakness in the present legal structure is the lack of civil remedies for investors (Neoh 2000). The only remedy the Company Law provides to minority shareholders is that they may apply to the courts to prevent the continuation of unlawful conduct by directors and majority shareholders. At the same time, the Securities Law is unclear as to whether investors can take civil action against directors and investment professionals for false or negligent disclosures that resulted in losses. The Civil Procedure Law allows collective action, but so far none has been taken in the securities field because of the uncertainties about remedies. The authorities need to clearly establish these rights and introduce the necessary procedural laws.

Chinese shareholders have the right to sue for an injunction and damages if a board decision violates laws and administrative rules. In such cases the law does not stipulate a threshold in terms of minimum shareholding. How the court determines who the defendant is in cases of this sort—the shareholders' general meeting, the board of directors, an individual, or the company—is not clear.

Often individual investors do not wish to incur the expense of a complex lawsuit to recover small, private losses. The need for broad civil discovery and class action suits is especially critical in this respect. The judicial system must also permit proof of wrongdoing to be based on circumstantial evidence. Rules that shift the burden to insiders to prove or disprove fairness once suspicious circumstances have been established can be highly valuable. Class actions or other ways to combine many individual small claims are important. Contingent fee arrangements are a useful supplement to class action procedures, but are probably not essential. Institutional investors can play an active role in securities class action suits by representing and organizing individual shareholders. In the United States, for example, the pas-

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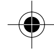

sage of the Private Securities Litigation Reform Act in 1995 increased the frequency with which institutional investors serve as lead plaintiffs in securities class action lawsuits. U.S. courts and legal scholars generally agree that as fiduciaries, investment managers have an affirmative duty to determine whether pursuing litigation is in investors' interests (see Fried and others 1996).

Shareholders' rights would be significantly enhanced if derivative suits were permitted, that is, if shareholders or directors were allowed to commence proceedings on behalf of the company when the company is unwilling or unable to do so. Current law does not make the distinction between direct or derivative action by shareholders.

A number of countries that did not previously permit suits initiated by shareholders against directors and managers are now doing so. Germany recently reduced the ownership threshold that qualifies shareholders to demand legal action (to be brought by the supervisory board or special company representative against managing directors) from a 10 percent equity stake to a 5 percent stake or DM 1 million stake, whichever is smaller, if dishonesty or illegality is suspected. Meanwhile Japan has altered its rules on posting bond to remove disincentives for litigation, while the United States is moving back the other way by beginning to rein in the strong incentives for potentially opportunistic litigation.

Mobilizing Civil Society to Enhance Protection for Minority Investors. The recent publication of a report on widespread market manipulation and cheating by China's 10 fund management companies in the country's respected business magazine, *Caijing Monthly*, illustrates the enormous social benefits of independent public monitoring of stock market practices by the media. Some interesting proposals to encourage such practices are circulating, some of them modeled after successful experience in Taiwan (China), including establishing associations of minority shareholders with the powers to monitor company behavior and bring legal action in the case of malpractice.

Assessing Whether Institutional Investors Can Be Active Minority Shareholders. The literature has described the increase in monitoring by traditionally passive minority investors, such as institutional investors and individuals, as shareholder activism. Theoretical (Admati, Pfleiderer, and Zechner 1992) and empirical (Smith 1996) evidence supports the thesis that large and diversified shareholders may have

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the incentives to expend resources on monitoring despite the presence of free-riding by other shareholders. Institutional investors may have incentives to engage in monitoring when the expected benefits exceed the costs (see box 6.4).

Investigators have found that the level of shareholder activism by institutional investors depends on whether they behave like affiliated or unaffiliated investors. When institutional investors have other links with a company, for example, an insurance company that holds a significant portion of a corporation's stock and concurrently acts as its primary insurer, they are unlikely to be active shareholders (Pound 1988). Because of conflict of interest, institutional investors are likely to vote with management.

Furthermore, empirical surveys (for example, Ayres and Cramton 1993), have found that institutional investors are more likely to target larger firms, firms that underperform the market, and firms with significant outside ownership. Institutional investors that commit to holding a firm's equity have increased credibility and influence in monitoring that firm's management. Other factors that influence the level of activity and the rate of success are ownership levels and stock liquidity. The higher the ownership share, the more seriously management and other shareholders take proposals by an institutional investor. By contrast, higher stock liquidity makes it more difficult for an institutional outside investor to identify shareholders and solicit their support in a proxy fight.

Several factors seem to be important in determining the level of shareholder activism by institutional investors and their role in corporate governance. Other things being equal, limiting opportunities for conflicts of interest by institutional investors, especially pension funds and insurance companies, is likely to result in a higher level of involvement in corporate governance. The corporate governance of the institutional investors themselves could affect their incentives to exercise shareholders' rights. For example, introducing higher disclosure requirements for institutional investors, such as a provision for fiduciaries to disclose how they vote, may increase the cost of collusion with managers.[2] The efficiency of the proxy system could be an important factor, because it allows reputable institutional shareholders

2. The lack of such a provision creates an imbalance between the information available to management, who typically know how major shareholders vote, and beneficial owners, that do not.

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BOX 6.4
California Public Employees' Retirement System and Shareholder Activism

The leader in shareholder activism in the U.S. equities market is the California Public Employees' Retirement System (CalPERS). CalPERS is one of the largest public pension funds in the United States and has had an organized shareholder activism campaign since 1986. To encourage shareholder activism by interested institutional investors, in 1984 CalPERS helped found the Council of Institutional Investors and has been involved in public policy formation at the federal and state levels.

Firms that CalPERS considers targets for activism are in its internally managed portfolio. In 1986 CalPERS identified 47 firms held in its portfolio that had implemented poison pills without shareholder approval. Of those 47, CalPERS identified a subset in which it was one of the largest shareholders and in which the level of institutional ownership was high, typically greater than 60 percent. Ten firms met these criteria and were selected to be targets of shareholder resolutions requesting the rescission of the poison pills.

During the 1987 and 1988 proxy seasons CalPERS targeted firms based primarily on their corporate governance structures. In 1987 CalPERS expanded its governance structure criteria to include firms making greenmail payments and firms not using confidential shareholder voting systems. Based on these criteria CalPERS identified seven target firms for the 1988 proxy season. The target selection process changed in 1988 when the primary selection criterion shifted from governance structure to firm performance and the selection process became more sophisticated. The process now begins in June of each year when CalPERS ranks firms based on their last five years' stock returns. It then takes the bottom quartile of approximately 250 firms for further analysis. Firms in the "Bottom 250" are eliminated as potential targets if they have high levels of inside ownership, large ESOPs, or low levels of institutional ownership, or if CalPERS is not one of the largest shareholders.

The result of this filtering is an annual list of approximately 50 firms, referred to internally as the "Failing 50." Firms in this group are then analyzed further and the Investment Committee identifies approximately 12 targets and 1 corporate governance structure issue for each target that it will pursue in the form of a shareholder resolution. Shareholder resolutions have included creating shareholder advisory committees, changing

(Box continues)

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BOX 6.4
(CONTINUED)

the composition of the board of directors and its committees, and restructuring executive compensation. The first step in notifying targets is to file shareholder resolutions with the target firms.

In 1992 CalPERS tested what it considered to be a less adversarial approach, in which it did not file resolutions with target firms. CalPERS sends a letter to the chairman of the board, the CEO, or both requesting a meeting with CalPERS officials to discuss ways in which the company can meet CalPERS' governance structure goals without a shareholder resolution. If management adopts the proposal or reaches a suitable compromise, CalPERS withdraws the resolution, it does not appear in the proxy statement, and hence it is not voted on. CalPERS prefers settlements, because even if shareholder resolutions receive a majority of votes they are often nonbinding.

During the first two years, when CalPERS was selecting targets based on governance structure, only 1 of the 15 targeted firms adopted the resolution or made changes sufficient to warrant a settlement. During this period, surveys have found that CalPERS activism had a negative impact on firm market value, possibly because CalPERS may have produced information that had not been incorporated in the stock price prior to targeting. During 1989–93, 26 of the 36 targeted firms either adopted the resolution or settled the first year they were targeted. During this period successful targeting was associated with a positive impact on the stock price and vice versa. This suggests that activism is beneficial for shareholders if the activist is able to change the organizational control structure of targeted firms. During the period the total wealth increase for CalPERS was approximately $19 million while the estimated cost of activism was about $3.5 million. Thus activism appears to have resulted in a net benefit.

SOURCE: Smith (1996).

to garner the support of other shareholders relatively easily. Allowing institutional shareholders to make pledges to purchase additional shares contingent on the passage of proposals may increase the credibility of their stated intentions and the chances of successful proxy contests. Factors such as making voting an integral part of institutional investors' fiduciary duties and facilitating coalition building among institu-

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BOX 6.5
The Factors behind the Rise in U.S. Shareholder Activism

In the United States, several factors seem to have contributed to the more active role that institutional investors are currently playing in the corporate governance of investee firms. Perhaps the most important was the 1988 ruling by the U.S. Department of Labor (the so-called Avon letter) stating that decisions on voting by pension funds were fiduciary acts of plan asset management under the Employee Retirement Income Security Act, which must either be made directly by trustees or delegated wholly to external managers. Yet despite the growing importance of mutual funds, no such requirement is in effect for them. In the early 1990s, a ruling by the SEC liberalized coalition building among institutional investors. This has encouraged activism among U.S. shareholders, because institutional shareholders were able to gain influence by acting together without the need for each to amass significant shareholdings. Under the lead plaintiff provision of the U.S. Private Securities Litigation Act of 1995, large shareholders can seek to be named controlling parties in class action shareholder lawsuits against company management.

SOURCE: Davis and Steil (2001).

tional investors can also play an important role, as evidenced by the U.S. experience (see box 6.5).

Clearly the degree of shareholder activism by institutional investors will depend on the size of their shareholdings. The larger the size the more difficult exit becomes and the stronger the incentives to assume an active role in corporate governance. The investment policies of institutional investors are among the most important factors determining their approach to corporate governance. In most countries institutional investors have been adopting investment policies based on passive indexation to measure performance, achieve diversification, and lower transaction costs. However, passive indexation strategies have reduced institutional investors' incentives and capacity to affect the behavior of poorly performing companies.[3] Some have ar-

3. Monks (1997) has argued that indexation strategies have actually encouraged activism by, in effect, forcing institutional investors to hold shares in large companies that form the index, thereby restricting the exit option.

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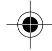


gued that the use of cumulative voting for board elections is the most powerful tool for allowing institutional shareholders to elect directors that are truly independent and to play an active role in protecting the interests of minority investors (Vittas 1998).

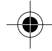
Institutional investors have been also active in using the media as a disciplining mechanism in corporate governance. Open public criticism of such corporate practices as empire building, excessive managerial compensation, and adoption of antitakeover defenses by institutional investors has been instrumental in mobilizing action by other shareholders and regulators. Collective action by large institutional investors through informal groups or associations has proved to be an effective tool of corporate governance.

Developing Capital Markets That Reward Good Corporate Governance

Chinese capital markets should develop the capacity to create pressure and incentives for improvements in corporate governance practices. To this end it is critical to establish a credible threat of market failure and to introduce market players that demand better governance and can contest control.

Giving Institutional Investors a Stronger Role in the Future. Institutional investors are key to developing a Chinese capital market that rewards companies with good corporate governance practices. Institutional investors operating in a global environment should be able to develop the capacity to recognize, demand, and expect good corporate governance in the form of reputable auditors, timely disclosure of material events, composition and quality of boards, and so on. The development of an institutional investor base will also encourage the development of the investment analyst profession.

In addition, institutional investors are expected to play a direct role in improving corporate governance by making available shareholders' rights effective, using the proxy system, and assisting the takeover mechanism. Institutional investors are also expected to provide the extra liquidity needed for the gradual disposal of state-owned and legal person shares. Most important, their presence will allow the regulator to adopt and apply a multilayered system of regulations and to enforce regulations more efficiently and effectively through the institutional investors rather than interacting directly with the listed com-



panies. In this way, the hope is that overspeculation and volatility will be reduced.

Development of a strong institutional investor base has obvious synergies with other reform objectives, such as reforming SOEs, deepening and broadening capital markets, and establishing a social safety net. China could make relatively rapid progress in increasing the role of institutional investors in its capital market development simply by opening up its markets to foreign institutional investors. A plan to liberalize various aspects of the capital account, unify stock markets, and allow greater foreign presence in financial services is gradually emerging.

Developing a Market for Corporate Control. Institutional investors can play another important role in corporate governance indirectly through their financing of M&As. M&A activity should help eliminate some of the more notable mispricing in the stock markets. For example, striking differences are still apparent between the valuations of H shares and their corresponding A shares and between B shares and their corresponding A shares. These unjustified differences might be substantially reduced, and even eliminated, through M&As. In this way, M&A activities could be an instrument for a gradual convergence and unification of China's segmented capital markets.

China's legal regime has been evolving in the direction of reducing the costs of acquisitions. For example, the section on acquisitions in the 1993 Stock Trading Provisional Regulations requires anyone who acquires control to offer to buy the shares of all shareholders at the average trading price of the stock in the last six months prior to the acquisition. Because the acquisition of control has invariably involved listed companies with state-owned majority shareholders, and because these listed companies invariably need injections of capital by a new majority shareholder, to date the CSRC has waived the need to make a general offer. The Securities Law, which came into effect on July 1, 1999, has cut the cost of M&As by allowing partial bids when more than 30 percent of the shareholdings of a listed company are acquired through trading in the stock markets. The regime will rely strongly on disclosures by the incoming majority shareholders. This focus on transparency will help the market take a more informed view of listed companies and their controlling shareholders. The CSRC is currently preparing a takeover code that is expected to be made public soon.

However, the M&A regime will always be imperfect and ineffective if two-thirds of the shares are nontradable. Thus improving the tradability of shares is an essential precondition for developing an effective M&A regime. Furthermore, the existing ownership structure hinders the growth of M&A activities. As powerful owners of listed companies, local governments often oppose M&As that could be associated with a loss of their tax base, layoffs, and closings. However, M&A activity should help break the old model of local government ownership. As a result, even without the rapid divestiture of state assets, the industry landscape should become more business oriented than government oriented. M&As will inevitably lead to higher participation in business by private and foreign investors, thereby introducing management discipline and incentives.

The Company Law has several legal provisions that make M&As costly. One is the requirement that all creditors have the right to request to be paid out in the event of a merger or division. In most other markets creditors do not have the automatic right to call for repayment if the merged entity can clearly show that it can pay all debts when they come due. In the event that the merged entity cannot pay its debts in full, then most markets adopt an absolute majority rule subject to approval by a judicial or regulatory authority. A mature capital market requires company law that enables M&As to be undertaken efficiently and fairly. Another inhibiting factor is the requirement in the Company Law that directors cannot be replaced without cause prior to the expiration of their terms. As mentioned, international practice has moved in the direction of allowing shareholders to replace directors without cause.

Improving Disclosure

A strong disclosure regime can have a powerful effect on companies' behavior. To improve disclosure by Chinese listed companies, developing a more investor-oriented accounting and disclosure system and strengthening the accounting profession are important.

Developing a More Investor-Oriented Accounting and Disclosure System. Accounting rules and disclosure requirements should strike a sensible balance between users' needs for information, the cost of providing the information, and companies' concerns that giving detailed information to investors also means giving valuable information to com-

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petitors. Good accounting rules should be designed so as to provide information in a form that is helpful to such users as tax authorities, regulators, and different types of investors, whereas in China they are heavily influenced by the information needs of the tax and regulatory authorities, whose information needs take priority at the expense of investors. Examples relate to provisioning rules and the lack of flexibility for using professional judgment, which often results in overstated profits, and consequently in excessive tax payments.

As the Chinese accounting and auditing profession continues to develop its expertise and sophistication, greater flexibility and use of professional judgment within an international accounting framework will increasingly be needed. The need for flexibility is also related to the costs of information disclosure and the different and evolving needs of various users. For example, abundant evidence suggests that individual investors, even in developed financial markets, do not base their investment decisions on financial disclosures made in registration or other statements. Analysts and institutional investors are heavy users of financial and accounting information, but their requirements are often different from those mandated by securities laws and regulations.[4]

With the rapid evolution of China's economic environment, important new economic actors are likely to emerge with different information needs. For instance, the continued liberalization and sophistication of China's capital markets would, over time, increase the importance of risk factors related to movements in interest and exchange rates. Institutional and portfolio investors will become more important. M&As are likely to assume a more prominent role as restructuring accelerates following entry into the WTO. Intangible assets will become more important determinants of overall firm value. These changes will create demands for different types of information. For example, institutional investors attribute significant weight to indicators of volatility. Disclosure about derivative and off-balance-sheet

4. Analysts develop their own ways of analyzing and interpreting financial statements. For example, according to an ING Barings analyst based in Hong Kong (China), the best valuation tool for companies in China is to focus on their debts, which means disregarding not only their share prices but also their income statements, and instead focusing on the ratio of current assets to current liabilities (*The Economist*, May 24, 2001). In Taiwan (China) the information on research and development expenditures is most valuable (*The Economist*, May 24, 2001).

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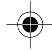

positions will become important. Reporting on good will, brand value, and so on will provide valuable information. Reporting on business combinations is likely to assume increasing importance in an environment where M&As are the main form of restructuring. Many of these standards are not well developed or are lacking in China.

With the increased emphasis on flexibility and professional judgment, incentives for disclosure will become more important. Listed companies already provide a significant amount of disclosure on a voluntary basis. Understanding the motivation for such practices is critical in order to build on them.

Strengthening the Accounting Profession. Perhaps the single most important requirement of all professions is the ability to perform their jobs independently. Prior to 1998, government authorities owned or managed most local firms, and these firms are still struggling to become independent business entities and improve their quality. Accounting firms should make an effort to improve their staff quality, increase risk control, and establish control procedures within the firm. Accounting firms should assume modern corporate or partnership forms of business organization. Private ownership is a necessary condition for real independence. The firm's legal form and ownership would have significant implications for its accountants' professional conduct. For instance, current practice is that the CPA who signs the report takes nearly the entire responsibility in the case of litigation. Such a practice reduces senior management's incentives to focus on improving quality control.

The Chinese Institute of Certified Public Accountants should gradually weaken its monitoring function while at the same time strengthening its self-regulation function. It should increase the services it provides to its members, such as training on audit ethics and continuing education on accounting updates and auditing techniques. It should lead the development of the auditing industry and promote the establishment and improvement of relevant laws and regulations to provide a healthier environment for the auditing industry. This professional, self-regulated body should set up its own code of ethics and conduct to regulate its members and enforce the code strictly. Good self-regulation will not only enhance the independence of its members but will also strengthen the public perception of professional independence. In China the Ministry of Finance tends to write accounting rules, which primarily reflect the need to provide the information required to collect taxes. Writing good accounting rules requires good

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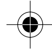


knowledge of how companies operate and how they use loopholes in the rules to portray their performance as better than it really is. This offers some reasons to vest rule writing in a quasi-public organization run by accountants rather than in a government agency.

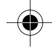
Unlike in other countries, communication and cooperation between external and internal auditors at the time of auditing are minimal in China. This is mainly the result of the perceived lack of independence of internal auditors. Various measures could be adopted to strengthen the independence of internal auditors. A minimalist approach would include, for instance, audit committees composed of independent directors with good skills in finance and accounting. Expanding the scope of the internal audit function is also important to focus not only on protecting the interests of shareholders and ensuring compliance with legal requirements, but also on reviewing and improving business performance and internal control functions.

The legal system should play an important role in promoting good accounting practices; however, current practices do not promote such a role. The Ministry of Finance approves all standards for the purpose of enhancing their legal binding power, but as Chinese Independent Accounting Standards are considered to apply only to the accounting profession and the Chinese Institute of Certified Public Accountants is not a government agency, other government entities do not comply with these standards. In lawsuits where accounting firms and CPAs are involved, Chinese Independent Accounting Standards are typically not regarded as legal evidence or common acceptable practice from the legal perspective, and therefore cannot be referred to. Accounting and auditing professionals are generally not invited to participate in legal proceedings. Developing a liability insurance system for accounting and legal firms would greatly enhance the use of the legal system as a controlling mechanism.

At present, the market for accounting services does not promote better accounting practices and accountants' independence in relation to their clients. A more rigorous licensing system might assure quality while at the same time creating franchise value and increasing the risks resulting from corrective actions.

Activating the Use of Various Corporate Governance Mechanisms

Boards of directors, shareholders' rights, well-functioning capital markets, and disclosure are the necessary ingredients of a modern corporate governance system. However, without the existence of



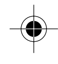
agents with the need and incentives to use them, these mechanisms are likely to remain mere formalities. Institutional investors can play a catalytic role in activating the use and further development of these instruments.

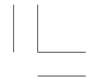
Institutional investors can play an important role in promoting an efficient capital market by providing the depth, the liquidity, and the incentives to discover and exploit arbitrage opportunities. A strong institutional investor base is likely to make the job of the stock market regulator somewhat easier by enhancing its capacity to supervise market players and promote market stability. Institutional investors are in the best position to develop an investment culture that expects, demands, and rewards good corporate governance. The development of an institutional investor base is intrinsically linked to the development of the investment analyst profession and the associated demand for transparency and disclosure. Under a plausible set of conditions, some types of institutional investors are likely to be active shareholders that make active use of their shareholder rights, and in the process provide some protection to other minority shareholders.

China is making progress in developing an institutional investor base by drafting enabling legislation, establishing a pension system, licensing closed and open-end investment funds, reforming its investment trust sector, promoting the insurance industry, and making commitments to open up its capital markets to foreign institutional investors. Key factors for building institutional investors' potential to play a strong role in corporate governance are the regulator's capacity to supervise institutional investors and the corporate governance of institutional investors themselves. The pace of building these capabilities will determine the speed at which institutional investors will be allowed to enter the market. China has the option of importing many of these ingredients by opening its capital markets to foreign institutional investors, and by promoting cooperation between foreign and domestic institutional investors in the form of joint ventures and technical assistance arrangements.

Conclusion

The role of honest and capable courts and regulators is critical to the evolution of corporate governance in China. However, without the support of markets and incentives, the overemphasis on regulations and rules carries the risk of a triumph of form over substance. Laws





and regulations should focus on giving content to procedural rights and establishing credible liabilities and penalties and effective incentive structures so that an evolving system of corporate governance is established that is capable of generating selection pressure for improved corporate governance. This would involve parallel emphasis on incentives, markets, and the legal system in addition to regulations. The implementation of regulations should itself rely on the proper alignment of incentives and be based on existing or newly created agencies and associations of accountants, analysts, directors, and others. However, fundamental and sustainable improvements in corporate governance will not take place without fundamental changes in the ownership structure of listed companies.

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