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Venture Capital and the Corporate Governance of Chinese Listed Companies

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Preface

State-controlled listed companies have always dominated Chinese stock markets. As a result of the rampant scandals related to them, there have been voluminous academic efforts to explore their corporate governance, underpinned by agency costs. However, the attempt to examine it from the perspective of venture capital and adaptive efficiency is still absent. Therefore, this is the research gap filled by this dissertation.

During the last 10 years, China has made remarkable progress in the development of its venture capital market. However, the striking expansion of China's venture capital market cannot cover the embarrassing fact that Chinese domestic venture capital has been marginalized by American competitors. Given the different performance between them, this book hypothesizes that the corporate governance system of Chinese state-controlled listed companies has hampered the presence or the full functioning of the institutional factors which are responsible for the prosperity of American venture capital in Chinese domestic venture capital.

With the practice of American venture capital as the mirror, this book empirically demonstrates that Chinese domestic venture capital lacks the four factors related to the success of their American counterparts – large and independent funding, application of incentive mechanisms, efficient exit channels and high-risk tolerance level. More importantly, these defects as a whole are closely linked to the corporate governance of state-controlled listed companies.

The findings that the corporate governance of Chinese state-controlled listed companies imposes negative effects on the healthy development of Chinese domestic venture capital and in turn the increase of adaptive efficiency of Chinese society tell us that the efficient proposal for the improvement of the corporate governance of Chinese state-controlled listed companies must harmonize agency costs and adaptive efficiency.

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Chapter 1

An Introduction to Adaptive Efficiency and Corporate Governance

The issue of corporate governance has gained unprecedented attention in the international community after the ravages of the Asian financial crisis. In recent years, laying down the more sophisticated governance guidelines has become a vibrant campaign with the favour and participation of various interested groups: academics, media, regulatory authorities, legislatures, companies, institutional investors, international organizations, intermediaries, etc.¹ For instance, the government of South Korea has taken a series of steps to reform the corporate governance of Chaebol since 1998.² The Organization of Economic Cooperation and Development (OECD) also released “OECD Principles of Corporate Governance” in 1999 in order to provide member and non-member countries with specific guidelines to improve the legal, institutional and regulatory frameworks that underpin corporate governance.³ In addition, intermediaries, such as McKinsey & Company, are also urging the overhaul of corporate governance in emerging and transitional economies.⁴

Given the ongoing lacklustre performance of its state-owned enterprises (SOEs) and the substantial competition from its entry into the World Trade Organization

¹ Bai C-E, Liu Q, Lu J, Song FM, Junxi Z (2004) Corporate governance and market valuation in China. *J Comp Econ* 32:600.

² Black B, Metzger B, O’Brien TJ, Young Moo Shin (2001) Corporate governance in Korea at the millennium: enhancing international competitiveness. *J Corp Law* 26:537–608. In this report, with the request of the South Korean government, Professor Black and his colleagues proposed a systematic legal reform framework to the Ministry of Justice of South Korea for the purpose of improving the porous governance structure of Chaebol.

³ OECD (2008) Principles of corporate governance. <http://www.oecd.org/dataoecd/32/18/31557724.pdf>. Accessed on 29 Feb 2008. Since its first issuance, this document has been revised in 2003 and 2004. The above hyperlink leads to the 2004 revised version.

⁴ McKinsey & Company (2002) Corporate governance in emerging markets. *McKinsey on Finance* 3:15–18.

(WTO), China has also put considerable emphasis on corporate governance in recent years.⁵ At the core of such attention is the debate on how China can design an effective corporate governance system for its listed companies through the perspective of agency theory.⁶ The Chinese government opened stock exchanges in the early 1990s in order to raise capital for its moribund SOEs.⁷ At the very beginning, there were only eight companies listed on the Shanghai Stock Exchange.⁸ However, in the following less than 20 years, the total number of listed companies on the Shanghai Stock Exchange and the Shenzhen Stock Exchange has increased to 1,633 with a market capitalization of RMB28,173 billion yuan.⁹ In addition, according to the statistics of the Chinese Securities Depository and Clearing Corporation Limited, 94,976.6 thousand valid accounts had been set up in the above two stock exchanges by the 22nd February 2008.¹⁰ Notwithstanding that the aforementioned data is sanguine, poor governance practices are rampant in Chinese listed companies. For example, in 2001, the largest shareholder of Mailyard and other related parties conspired with one another and embezzled \$44.6 million or 41% of the listed company's total equity. In the same year, the largest shareholder of Sanjiu Pharmacy illegally transferred \$301.9 million or 96% of the total equity out of the listed company.¹¹ The consecutive corporate scandals in 2001 severely undermined investors' confidence in the next 4 years. Consequently, as vivid reflection of the tremendous decrease of public investors' confidence, the Shanghai Composite Index once slumped to less than 1,000 points on the 6th June 2005.¹² China's stock market was criticized as being worse than a casino.¹³ In order to restore investors' confidence and rescue the stock market which was on the brink of collapse, the China Securities Regulatory Commission (CSRC) launched the equity division reform among Chinese listed companies at the end of April 2005.¹⁴ To some degree, this reform

⁵Li S (2003) Company control of China and the reform in its transition. *Trib Polit Sci Law (J China Univ Polit Sci Law)* 21:3.

⁶Liu Q (2006) Corporate governance in China: current practices, economic effects and institutional determinants. *CESifo Econ Stud* 52:415–416; Clarke DC (2003) Corporate governance in China: an overview. *China Econ Rev* 14:494.

⁷Luo P (2004) The contractual perspective of the company law and the legitimacy of Chinese company law rules. *CASS J Law* 26:80.

⁸Xinhuanet (2008) The Shanghai stock exchange has become the third biggest bourse in Asia. http://news.xinhuanet.com/fortune/2002-08/10/content_519167.htm. Accessed 1 Mar 2008.

⁹The data is available at <http://www.hkex.com.hk/csm/highlight.asp?LangCode=en>. Accessed 1 Mar 2008.

¹⁰These statistics are available at <http://www.chinaclear.cn/>. Accessed 1 Mar 2008.

¹¹See footnote 1 above, p 600.

¹²Xinhuanet (2008) Witnessing 998 points of the Shanghai composite index on 6 June. http://news.xinhuanet.com/stock/2005-06/06/content_3051529.htm. Accessed 2 Mar 2008.

¹³In an interview, Jinglian Wu, a famous Chinese economist, sharply pointed out "China's stock market is worse than a casino. At least in a casino there are rules", available at <http://202.99.23.223/BIG5/jinji/35/160/20010213/394537.html>. Accessed 2 Mar 2008.

¹⁴CSRC (2008) Notice regarding the Equity Division Pilot Reform among listed companies. <http://www.csrc.gov.cn/n575458/n776436/n804935/n2466682/2652975.html>. Accessed 2 Mar 2008.

Table 1.1 The annual numbers of administrative penalty decisions made by the CSRC from 2002 to 2007

The pre-reform period			The reform and post-reform period			
Year	2002	2003	2004	2005	2006	2007
No.	20	42	20	46	40	31
Total: 82			Total: 117			

Source: The China Securities Regulatory Commission (CSRC) (These statistics are available at <http://www.csrc.gov.cn/n575458/n575742/n576221/index.html>. Accessed 2 Mar 2008)

has rekindled investors' interests in China's stock market and temporarily alleviated the public antagonism towards regulatory authorities and supervised enterprises.¹⁵ However, its effects cannot be overestimated. The corporate governance of Chinese listed companies has not yet been fundamentally changed. Fraudulent disclosure, insider trading and controlling shareholders' tunnelling are still common. Table 1.1 is a summary of the annual number of administrative penalty decisions made by the CSRC from 2002 to 2007. According to the data in Table 1.1, the total amount of penalty decisions was 82 during the 3 years before the equity division reform and this number increased to 117 in the 3 years amid and after that reform. On the one hand, the change reflects the greater efforts of the CSRC to purify China's stock market which was riddled with fraud and speculation. On the other hand, it also shows that the corporate governance of Chinese listed companies is still badly conducted.

Confronted with the torrent of corporate scandals, it is not difficult to understand that the concern of legal scholars with the corporate governance system of Chinese listed companies is to minimize agency costs through the improvement of legal rules and other institutional settings. In terms of the subjects that they deal with, their discourses can be classified into two groups: the group focusing on the whole governance framework of Chinese listed companies and the group concentrating on some specific governance institutions of Chinese listed companies.

In the first group, the intellectual contributions by legal scholars are not as abundant as the ones in the second group. Shuguang Li drew a general picture of the Chinese listed companies' governance framework. First, he analyzed the status quo of financial markets, product markets, political and legal environments, social governance, company law and the market for control in China. Then, he pointed out the shortcomings of these factors and proposed the reform suggestion for them. Finally, he concluded that the key point of the improvement of China's listed companies' corporate governance was to achieve the transition from the state-oriented pattern to a market-oriented pattern.¹⁶ Along a similar path, Layhong Tan and Jiangyu Wang

¹⁵Cao G, Li H, Lai P (2006) Positive research on the market reaction of the execution of the shareholder structure reform scheme. *J Chongqing Univ (Nat Sci Ed)* 29:122–135; Xinhuanet (2008) The Shanghai composite index overpassed 5000 points for the first time. http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune/2007-08/24/content_6595444.htm. Accessed 2 Mar 2008.

¹⁶See footnote 5 above, pp 3–15.

explicated the practice of internal governance mechanisms and external governance mechanisms in Chinese listed companies. Then they compared the outsider-based model in the Anglo-Saxon jurisdictions, and the insider-based model in Japan and Germany. Lastly, they considered the German model to be the most suitable one for China to transplant and localize.¹⁷ Guanghua Yu proposed a unique insight into the search for the optimal governance framework for Chinese listed companies. On the basis of persuasive evidence, he moderately criticized the efforts to seek the best corporate governance model for large public companies and to connect one country's existing governance practice to its economic performance. Then he suggested that a more pragmatic way to promote the quality of corporate governance in Chinese listed companies and their counterparts in other countries would be to encourage competition between equity financing and debt financing.¹⁸

The literature in the second group accounts for the overwhelming majority of extant academic papers by legal scholars on the corporate governance of Chinese listed companies. According to the findings of literature review, they are principally concerned with four governance institutions of Chinese listed companies as follows:

1. State shares are concentrated in Chinese listed companies. Leping Shen argued that the central government and local governments were the controlling shareholders in most Chinese listed companies. Consequently, the separation of ownership and control in those companies was incomplete. Then he pointed out that the controlling position of the state directly led to the absence of the ultimate principal and the bureaucratic interference in the operation of those companies.¹⁹ Likewise, Peizhong Gan also recognized the harms of concentrated state shares to the performance of both Chinese listed companies and China's economy. After that, he analyzed the flaws of the method to reduce state shares in Chinese listed companies designed by the State Council in 2001 and proposed his own advice to redress them.²⁰
2. The board of directors of Chinese listed companies is just a "rubber stamp". Clarke thought that the board of directors was manipulated by controlling shareholders in Chinese listed companies. Therefore, it was necessary to bring in the mechanism of independent directors to monitor and curb controlling shareholders and to protect minority shareholders from expropriation. Then he illustrated the practice of independent directors in the USA for Chinese authorities' reference.²¹

¹⁷ Tan L, Wang J (2008) Proposing a model of corporate governance for China's listed companies: problems and prospects. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=526942. Accessed 5 Mar 2008.

¹⁸ Yu G (2006) Toward an institutional competition model of comparative corporate governance studies. In: Yu G (ed) *The essence of company law*. Law Press, Beijing, pp 114–146.

¹⁹ Shen L (2003) Analysis of the current situation of enterprise group corporate governance structure and counter-measures. *J Jinan Univ (Philos Soc Sci Ed)* 25:28–29.

²⁰ Gan P (2002) Government and market in the reduction of state shares – the analysis of this failed reform through the perspective of economic law. *Jurists Rev* 4:87–90.

²¹ Clarke DC (2006) The independent director in Chinese corporate governance. *Del J Corp Law* 31:125–228.