FRONTIERS OF LAW IN CHINA
VOL. 12 MARCH 2017 NO. 1
DOI 10.3868/s050-006-017-0006-7

ARTICLE

CORPORATE GOVERNANCE WITH CHINESE CHARACTERISTICS: THE CASE OF STATE OWNED ENTERPRISES

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Abstract This article examines the reception of Western corporate governance models and standards into the Chinese system of corporate governance. It investigates how China has adapted these models to fit in with its political, economic, and cultural norms in relation to its state owned enterprises (SOEs), a large number of which are now listed in onthe Fortune Global 500 list. Overall, the study highlights that firstly, the importance of culture in the shaping and functioning of human behavior as well as that of institutions, and in their subsequent path dependence; and secondly the limited impact of property rights, minority shareholder rights, and financial markets as arbiters of the destination of investment funds.

Keywords China, state owned enterprises, governance, culture as a determinant

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INTRODUCTION

This article examines how politics, economics, and culture have shaped corporate governance in China. China's embrace of free markets and its adaptation of the Western model of governance structure to meet its specific economic growth and development needs has been made possible by the events and circumstances of its recent history in which its cultural traditions have had a significant role to play. As a result of these transformative shifts, China has emerged as the second largest economy in the world

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behind the US in terms of GDP,[1] and as the largest economy in the world by reference to purchasing power parity.[2] It is reputedly the largest creditor of the US, and its economy is characterized by high savings and low domestic consumption, as compared to the low savings and high domestic consumption economy of the US. China now has the second largest stock market in the world with a market capitalization of US$ 6 trillion, and is the world's largest investor in total fixed assets with a value totalling US$ 4.9 trillion as compared *e.g.* to estimates of US investments of US$ 3.4 trillion, and Japan US$ 1.1 trillion.[3] China is, at the same time, one of the largest recipients of inward foreign direct investment (IFDI), signifying the confidence with which it is viewed by the investment community. More importantly, China now has the second largest number (95) of Fortune Global 500 companies by revenue after the US,[4] with its economy characterized by the presence of a large number of listed state owned enterprises (SOEs) partly or wholly owned by the state alongside wholly privately owned listed enterprises (POEs).[5] This transformation of the Chinese economy, particularly its corporate business structure, has occurred in just over four decades — from around 1976.[6] These factors, combined with the enormous influence that China's business entities listed on Chinese and overseas stock markets now wield, makes it imperative to understand firstly, the forces that have helped transform Chinese business entities to the behemoths that they are now, and secondly the system of governance of these entities, particularly its SOEs, and how they compare with the US, UK, and Australian systems of corporate governance (hereinafter "the Anglo jurisdictions").

While institutional structure (such as two-tier versus single-tier boards, relational

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[1] The World Bank, *China Overview*, available at http://www.worldbank.org/en/country/china/overview (last visited Feb. 27, 2015).

[2] International Monetary Fund, *World Economic Outlook October 2014*, available at http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/weorept.aspx?pr.x=84&pr (last visited Feb. 27, 2015).

[3] Jennifer N. Carpenter, LU Fangzhou & Robert F. Whitelaw, *The Real Value of China's Stock Market*, NBER Working Paper 20957, available at http://www.nber.org/papers/w20957 (last visited Feb. 20, 2015).

[4] The Fortune Global 500 Companies List for 2014 Provides the following statistics for China: Two of the top five, three of the top ten, fifteen of the top one hundred, and ninety-five of the top five hundred are Chinese companies, available at http://www.erewise.com/current-affairs/fortune-500-2014-list-of-world-s-biggest-500-companies_art53bbb95640ff6.html#.VQkzfI6Ue2lwww.erewise.com (last visited Mar. 18, 2015). For a somewhat different view, see, *China Daily*, Jul. 8, 2014, Chinese companies fill 100 places on the Fortune Global 500 list for 2014 with Sinopec group taking third spot for the first time. The Fortune Global 500 released on Jul. 7 featured an unprecedented 100 Chinese companies, available at http://www.chinadaily.com.cn/business/2014-07/08/content_17673632.htm (last visited Feb. 27, 2015).

[5] Approximately 155,000 enterprises are still owned by the central and local governments, of which around 80,000 are "…in the economic lowlands: they run hotels, build property developments, manage restaurants and operate shopping malls." See *State-Owned Enterprises, Fixing China Inc*, *The Economist*, Aug. 30, 2014, available at http://www.economist.com/news/china/21614240-reform-state-companies-back-agenda-fixing-china-inc (last visited Feb. 27, 2015). There are approximately 600,000 foreign companies and more than 400 of Fortune 500 companies now operating in China.

[6] See discussions in Part II.

versus stock market financing, and employee participation in governance) and type of ownership (state, whether substantial shareholders are institutional investors, hedge funds and investment funds or families) help shape the conduct and performance of these entities, they do not by themselves help explain how and why they function in the way they do. Similarly, while institutional design and structure are generally potable, explanations on how they adapt to and function in the host jurisdiction have to be looked for elsewhere, namely, in the historical and cultural setting into which they have been transplanted. This is particularly so in the case of China. In this setting, the article examines the appropriateness of the use of the referents of ownership, control, management, supervisory structure, and executive remuneration as governance tools — standards commonly used to assess and evaluate the effectiveness of governance institutions and structure in the Anglo jurisdictions — to assess and evaluate the success of China's business enterprises and their governance structure, particularly its SOEs. The discussion in the article is structured as follows: Part I discusses the basic comparator of corporate governance, namely, the manager, the board and shareholder relationship;[7] Part II examines the recent evolutionary history of China's system of SOE governance system; Part III evaluates the management of China's system of SOE executive compensation; Part IV discusses the role of cultural norms in shaping the emergence of a Chinese form of corporate governance based on governance structure, institutional norms, and reward structure; and Part V concludes the key points of this research.

I. GOVERNANCE AND THE BOARD-MANAGER-SHAREHOLDER BALANCE OF POWER

The term corporate governance has its origins in the mid-1970's in the US, but has since become an international byword for the efficient management of companies. It requires boards to go well beyond their duty of good faith, loyalty, care, and due diligence, to also be proactive in the exercise of their duties. Good governance as now understood requires boards and managers to ensure that the entity they are managing is competitive and efficient both allocationally and operationally in its activities in an environment where the fittest survive. No longer can boards be content with being mere sounding boards for managers. It also contemplates transparent processes to enable monitoring of officers and employees on how they have discharged their duties and responsibilities. Listed companies are also required to act on the advice of specialist committees such as audit, appointments, risk management, and compensation committees, attend to the appointments of these committees, and monitor the disclosure and compliance requirements of the entity.

In Anglo jurisdictions, the shareholder-board-manager relationship has occupied center stage since Berle and Means articulated their concerns over the separation of

[7] See, Law of the People's Republic of China on the State-Owned Assets of Enterprises, Oct. 28, 2008 (in force from 1 May, 2009).

management and ownership in large public corporations with scattered shareholdings, and with it the problem of unaccountable managers pursuing their own agenda. Consequently, analysis of their relationship has been largely consumed by the self-dealing actions of managers and controlling shareholders ranging from the appropriation of corporate opportunity to the expropriation of corporate property; of actions by managers to game their compensation packages, and by boards and managers to protect their tenure of office; and of attempts by managers to make boards beholden to them for the positions they occupy. The attempt made by Jensen and Meckling's agency theory based executive compensation strategy[8] to motivate managers while at the same time make them more accountable to the shareholder body had the unintended effect of strengthening the ability of managers to game their compensation packages, leading to an overall explosion of these packages. The say-on-pay (SOP) legislation that followed in the Anglo jurisdictions was an attempt to address these excesses. However, the latter in turn has generated agency problems of its own, namely, a surge in shareholder power and with it the "controlling minority" shareholder problem. The experience has been that both agency theory based compensation as well as SOP has had the effect of swinging the pendulum to opposite ends of the spectrum.

Chinese corporate governance has to a large extent been able to avoid this somewhat unproductive battleground between boards, managers, and shareholders and the downside of the "controlling minority" problem, endemic to situations where blockholders[9] are able to influence managers to make corporate decisions that favor the interests of blockholders. While controlling shareholders in China range from the state in corporatized or partially privatized enterprises, to family and institutions, and more recently blockholders in non-SOE corporations, the aims and goals of controlling shareholders in the two situations appear to diverge widely. While the state as controlling shareholder of a corporatized entity will aim to import technology and attract external funding to transform the entity into a viable and competitive institution, private controllers of public corporations may opportunity permitting, aim to engage in the type of self-dealing transactions referred to earlier. As discussed in Part III below, Chinese corporate governance has also been able to avoid the problem of excessive managerial compensation. Stated differently, while the debate in respect of governance structure and compensation strategy remains largely inconclusive in the US and UK, this is less of a problem under the Chinese form for reasons discussed in Parts II and III below. Explanations for this lie at least partially in the governance structure of China's SOE

[8] B. M. Jensen & P. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics, 305 (1976).

[9] For example, hedge funds and other institutional investors, such as banks, insurance companies and pension funds.

system, and in this respect the role played by the state-owned assets supervision and administration bureaus,[10] with its preference for tournament theory based reward strategy. These features also explain the absence of a market for corporate control unlike in the Anglo jurisdictions. Another consequence of this extensive influence bearing interrelationship by state agencies over SOEs is that control by private blockholder funds of corporatized SOEs is an unlikely event. Additionally, given the relative newness of its entities laws and its opening up to private investment, there is no evidence as yet of asset stripping and transfers of corporate control by hedge funds and the like in China.

Nevertheless, SOEs present agency problems of their own, such as being uncompetitive if not also inefficiently managed. As losses are borne by the state, ample opportunities arise for SOEs within groups to cross subsidize each other, fulfil community service obligations (CSOs) that may not necessarily pay for itself, and in the furtherance of managerial interests such as the furtherance of philanthropic objectives and for that matter engaging in territorial disputes with one another so as to preserve or extend their existing empires and with it security and prestige. Common examples of CSO activity are the provision of power, communication, transport, health, and educational facilities to remote communities, which are often economically unviable. Moreover, partially privatized SOEs are saddled with problems of self-dealing of a somewhat different kind. Here, the appropriation and expropriation is for the benefit of the parent or related enterprise also related to the state. Where compensation packages are linked to that paid to managers in other entities or to bureaucrats of comparable standing, manipulation will be more of the key performance indicators (KPIs) and of their satisfaction, than of the amount itself.[11]

Looked at it differently, the observations show that while China's SOEs (CSOEs) are lacking in some key characteristics associated with Anglo jurisdiction notions of business entities, they at the same time have others that are, *e.g.* the ability to raise capital in competitive markets, share in the benefits of ownership (but not control) of the entity, and be market oriented in other respects.

II. A BRIEF SURVEY OF THE EVOLUTION OF SOE GOVERNANCE

China's SOE governance models have been through several radical restricting process since 1949, and several measures have been taken, such as making SOEs responsible for their own gains and losses in the marketplace, introducing financial variables including profits and taxes, transforming SOEs into limited liability companies and exploring new funding models, and seeking to access overseas foreign direct investment as well as to

[10] See discussions in Part II below.

[11] Martin J. Conyon & HE Lerong, *Executive Compensation and Corporate Governance in China*, 17 Journal of Corporate Finance, 1158–1171 (2011).

invest overseas through SOEs. For example, between 1949 to 1984, as part of a centrally planned economy, enterprises were fully owned by the state, the managers were selected from government officials and appointed by government agencies, and their performance was measured by reference to their ability to fulfil plans set forth by government agencies. With a view to opening up the Chinese economy to foreign investors including the sale of interests in SOEs, SOEs were made responsible for their own gains and losses in the marketplace from around 1984. Financial variables, including profits and taxes, were introduced for SOEs. The next phase of reform witnessed the establishment in 1990 of stock exchanges in Shanghai and Shenzhen; and in 1992 the China Securities Regulatory Commission (CSRC) to monitor and regulate the stock markets. The third phase followed the Third Plenary Session of the 14th Central Committee of the Communist Party of China (CPC) in 1993, endorsed the creation of a modern market economy "with Chinese characteristics." It saw the enactment of companies legislation in the form of Company Law of the PRC in 1993 (the most recently amended version being in 2013), whereby SOEs were transformed into limited liability companies and required to explore new funding models by being listed on the stock exchanges. This was followed by the Code on Corporate Governance for Listed Companies (Governance Code) in 2002. China's two stock exchanges have a total listing in excess of 1,500 firms.[12]

After 1976, China sought to access overseas foreign direct investment (OFDI) into China, as well as to invest overseas through its SOEs. Two great figures that loom large in China's economic transformation are DENG Xiaoping and JIANG Zemin. In a much quoted address made in 1992 in Shenzhen, DENG Xiaoping articulated the need to speed up the reform process of China's economic institutions and open up its markets to foreign investors. Special provision for the protection of SOEs were made through a series of Administrative Rules on Registration of Ownership of Overseas SOEs (State-Owned Assets Administration Bureau, 1992), Regulations on suspending of cross-border mergers and acquisitions, and strengthening of the Administration of outward investment (State Council, 1993). Following these changes, the Central Committee of the CPC implemented JIANG Zemin's recommendation in 1998 that a handful of competitive enterprises be encouraged and supported to invest "mainly in Africa, Middle East, Middle Asia, Middle Europe and Latin America," *i.e.* adopting a "going abroad" strategy to "explore international markets and take advantage of resources abroad and strengthen the development impetus and potential of the Chinese economy." The "going abroad" strategy later came to be embedded in the outline of the Tenth Five-Year Plan for the

[12] HOU Wenxuan, Edward Lee & Konstantinos Stathopoulos et al., *Executive Compensation and the Split Share Structure Reform in China*, available at http://ssrn.com/abstract=2060942 (last visited Oct. 11, 2013). As of 2006, there were 1,427 companies listed on China's two stock exchanges, with a total market capitalization of more than RMB 8.9 trillion, See Yan-Leung Cheung, JIANG P. & P. Limpaphayom et al., *Corporate Governance in China: A Step Forward*, 16(1) European Financial Management, 94–123 (2010).

National Economic and Social Development of 2001.[13]

SOEs may either be fully owned by the state or pass through an intermediary stage (but the state retains absolute voting control), or even fully transferred to private ownership (privatized). However, since the privatized enterprises were encouraged and helped by the state to be more internationally competitive, and some of them indeed reaped the benefits associated with various forms of state assistance and gradually have been getting much stronger, and even became national champions with such status as market monopoly power, in the context of privatization, government may still keep substantial control. Privatization of SOEs has taken one of four forms: (1) through share issues to the purchaser (SIP); (2) joint ventures with foreign firms; (3) management buyouts (MBO); or (4) or by way of a sale to outsiders.[14] About half of the privatization has been through MBOs and these have been the most successful.[15] Their success follows from the new owner-managers assuming control over decision making and in its restructuring. By contrast, governments still kept substantial controls over firms privatized through the other three methods. Privatization was officially banned by the central government till the 1990's, and such privatization as occurred at subnational government levels were done covertly. Subnational governments took the initiative in privatizing SOEs to alleviate the pressure on their budgets from the large losses made by some SOEs.[16] While such transfers and acquisitions came to be legally recognized, it shows the relationship of trust between transferor and transferee in entering into these transactions.

There are four types of shares on issue. "A" shares denominated in Renminbi, which

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[13] As part of this transformation process, China has adopted many of the institutions of Western capitalism. For a comprehensive review, see Vivienne Bath, *The Company Law and Foreign Investment Enterprises of the PRC — Parallel Systems of Chinese-Foreign Regulation*, 30 University of New South Wales Law Journal, 774 (2007). The current legal framework for corporate governance is based primarily on the following national laws and regulations: Law of the People's Republic of China on Certified Public Accountants as amended on Aug. 30, 2014, available at http://en.pkulaw.cn/display.aspx?cgid=233281&lib=law (last visited Jun. 21, 2016); Audit Law of the People's Republic of China as amended on Feb. 28, 2006, effective as of Jun. 1, 2006, available at http://en.pkulaw.cn/display.aspx?cgid=75164&lib=law (last visited Jun. 21, 2016); Company Law of the People's Republic of China as amended on Dec. 28, 2013, effective as of Mar. 1, 2014, available at http://www.fdi.gov.cn/1800000121_39_4814_0_7.html (last visited Jun. 21, 2016); Law of the People's Republic of China on the People's Bank of China as amended on Dec. 27, 2003, effective as of same day, available at http://en.pkulaw.cn/display.aspx?cgid=50973&lib=law (last visited Jun. 21, 2016); Law of the People's Republic of China on Commercial Bank as amended on Aug. 29, 2015, effective as of Oct. 1, 2015, available at http://en.pkulaw.cn/display.aspx?cgid=256594&lib=law (last visited Jun. 21, 2016); Securities Law of the People's Republic of China as amended on Aug. 31, 2014, effective as of same day, available at http://en.pkulaw.cn/display.aspx?cgid=233280&lib=law (last visited Jun. 21, 2016), and Accounting Law of the People's Republic of China as amended on Oct. 31, 1999, effective as of Jul. 1, 2000, available at http://en.pkulaw.cn/display.aspx?cgid=23550&lib=law (last visited Jun. 21, 2016). The key regulatory bodies involved in the lawmaking process are the CSRC, the former State Economic and Trade Commission, the Ministry of Finance, and the People's Bank of China.

[14] XU Chenggang, *The Fundamental Institutions of China's Reforms and Development*, 49(4) Journal of Economic Literature, 1076–1151 (2011).

[15] Id.

[16] Id.

originally could be traded only by domestic investors are now open also to qualified foreign institutional investors (QFII), and traded on China's domestic Exchanges. "B" shares denominated in US dollar, which at first could be traded only by foreign investors are now also open to domestic investors. The "H" shares denominated in US dollar and HK dollar, are listed on the Hong Kong Exchange. A fourth category of shares are of companies cross-listed in the New York and London stock exchanges. There are two categories of "A" shares: "restricted" and "freely traded" shares (so called split shares). Restricted "A" shares are those held by the central and local government agencies and affiliated SOEs, while "freely traded" shares are traded privately on the over the counter market and can be held by the above groups as well as by private investors.[17] While a significant proportion of CSOEs have now been corporatized or privatized, SOEs are still the means used to project China's foreign direct investment (FDI) strategy and industrial policy. At the same time new POEs have been contributing substantially to China's economic success.[18] The goal was to modernize the Chinese economy and make its business enterprises productive and internationally competitive through increased foreign investment, and with it access to much needed technology, management and marketing skills needed to operate businesses at home and abroad.[19]

SOEs, like other listed entities in China, have a two-tier board structure, *i.e.* a managerial first tier Board, and a supervisory second or upper tier Board consisting mainly of officials appointed from government agencies. Viewed through the lens of Anglo jurisdiction capitalism, Chinese entities have all the hallmarks of inefficiency in reference to how they are financed, managed, and controlled. Nevertheless, they have been the powerhouses that have propelled China to be the awakened economic giant that it is. Ownership and control of the SOEs can be by either the national (central) or sub-national governments.[20] Despite this fact, it is also clear that government at all levels are unable to wield real influence over them. More importantly, the system of management of SOEs has enabled China to deliver its own perspective to the Western world on how to manage economic affairs following the GFC of 2008, and to articulate more confidently its notion of The China Model, namely, "one-party rule, an eclectic approach to free markets and a big role for state enterprise being among its commonly identified ingredients."[21]

While management of SOEs is left by and large to professional managers, control over them is exerted through the appointment of senior managers of SOEs. SOEs

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[17] See HOU, Lee & Stathopoulos, fn. 14.

[18] Nicholas Lardy, *Markets over MAO, the Rise of Private Business in China*, Peterson Institute for International Economics (Washington, D.C.), (2014).

[19] See UNCTAD World Investment Report 2004, reasons for China's inward and outward FDI.

[20] See XU, fn. 16. It refers to government at the provincial, municipal (or prefecture), county, and township levels, and as used here.

[21] CHEN Duanjie, *China's State Owned Enterprises, How Much Do We Know? From CNOOC to Its Siblings*, SPP Research Paper No. 6–19, available at http://ssrn.com/abstract=2277938 (last visited Feb. 26, 2015).

typically take the form of vertically integrated corporate groups, with each corporate group having a holding company known as the "core" company overlooking it. Below the core companies are a large number of subsidiaries, including listed companies, finance companies, research institutes, and other entities.[22] Ownership and control over the core company is exercised by a state-owned assets supervision and administration bureau. state-owned assets supervision and administration bureaus operate at the central, provincial and local government levels. There is state-owned assets supervision and administration commission of the State Council (SASAC) at the central government level, thirty one at the provincial level, and three hundred and thirty one at the local government levels.[23] The core company acts as the intermediary between state-owned assets supervision and administration bureau and the other members of the group. Core companies include CSOEs such as China National Petroleum Corporation, China Mobile Communication Corporation, and China Datang Corporation which are Fortune 500 companies. The state-owned assets supervision and administration bureau exercises the shareholder control rights previously dispersed among the various governmental agencies. Following the enactment of the Law on the State-Owned Assets of Enterprises 2008[24], state-owned assets supervision and administration bureau is empowered to appoint the board of directors of SOEs as well as key personnel such as the CEO and CFO, (normally the province of the board of directors). SASAC was set up in 2003[25] following China's admission into the WTO in 2001 with a view to preventing state-owned assets from being transferred to non-state sectors, as well as to transfer the power of control over SOEs to the state through a single body. This is illustrated, for example, in the 2006 declaration[26] of the state's "absolute control" of seven industries and "strong control" of nine industries. What is important to note is that instead of wielding influence over the whole group, *i.e.* the core company and a large number of its subsidiaries, state-owned assets supervision and administration bureaus at different levels exercise ownership and control over the core company only. In other words, the core company plays the role of intermediary between state-owned assets supervision and administration bureau and the subsidiaries.

The SASAC was set up in 2003 to transfer the ownership and control of state enterprise shares under central control. Upon the establishment of the SASAC, about two dozen key industrial and technology sectors were brought under it. This was followed by

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[22] LI Wenlin & Curtis Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 Stanford Law Review 697, 707–716 (2013).

[23] Id.

[24] See fn. 7.

[25] See Main Functions and Responsibilities of the SASAC, available at ssac.gov.cn (last visited Nov. 18, 2016).

[26] See SASAC, 国有经济应保持对七个行业的绝对控制力 (*The State Economy Should Maintain Its Absolute Control of Seven Industries*), available at http://www.gov.cn/ztzl/2006-12/18/content_472256.htm (last visited Sep. 18, 2006).

a stimulus funding program of around $600 billion into SOEs in 2008–2009. There appears to be a pull-push factor in these developments. Rather than these actions being those of a controlling and domineering central government, there appears to be instead a pull from SOEs and POEs seeking government handouts and protectionism as well as a corresponding push from the central and local governments to encourage and nurture national champions from both SOEs and POEs.[27] Another example of this complementarity, though of a different kind, points to the influence wielded by the CSRC in shoring up investor protection and remedying the gap left in this regard by China's company and securities laws.[28] While some see these measures as being "a lurch backwards,"[29] others interpret these developments more sanguinely.[30]

With regard to China's goal to have national champions, the larger and more efficient SOEs have done the best. They have no doubt benefited by their power of incumbency. Likewise, the Chinese strategy has been to help encourage the more internationally competitive POEs to also become national champions and get the benefits associated with such status as market monopoly power and various forms of state assistance. This growth imperative has forced the CPC to look beyond SOEs in bolstering its claim to legitimacy, and enables private firms to capture state rents by demonstrating growth potential, particularly to local government officials. As a recent report notes, "[l]ocal leaders these days are assessed based on economic growth, and are increasingly agnostic about what type of firm provides that growth."[31]

The traditional notion of associating voting power with control of the entity has proven to be far from adequate in explaining the state and SOE relationship in China. Moreover, since SOEs may be transformed into other forms, and even be privatized, it becomes very difficult to draw boundaries between SOEs and privatized entities. As examples indicate, the control, though not obvious, has been made through holding shares. Besides, some managers of privatized entities may be members of the CPC. In short, even with privatization, there still may be the shadow of the government, with networking between them strongly supportive in the face of intense competition in the global business environment. In fact they become quite meaningless in the context of China and its business entities. A case in point is ZTE Corporation, China's second largest telecommunications equipment manufacturer which has been the subject of an investigation by the U.S. House Committee. Its shares are owned by a holding company,

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[27] Christopher Milhaupt & ZHENG Wentong, *Beyond Ownership: State Capitalism and the Chinese Firm*, available at http://ssrn.com/abstract=2413019 (last visited Feb. 10, 2015).

[28] Nicholas Howson, *"Quack Corporate Governance" as Traditional Chinese Medicine — The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle against State Political Economic Power*, 37 Seattle University Law Review, 667 (2014).

[29] James McGregor, *No Ancient Wisdom, No Followers: The Challenges of Chinese Authoritarian Capitalism*, Prospecta Press (Westport), (2012).

[30] See Milhaupt & ZHENG, fn. 27.

[31] Id.

51% of whose shares are in turn owned by two SOEs, and 49% by Zhongxing WXT, a POE. ZTE Corporation is at the same time a state designated "national key SOE." More importantly, the majority of the shareholders of ZTE Corporation have contractually authorized the POE shareholder to assume sole responsibility to manage the affairs of ZTE Corporation. Several reasons explain this blurring between SOEs and POEs. For a start, both SOEs and POEs hold shares in each other. Moreover, some POE managers like their counterparts in the SOEs are members of the CPC. Explanations for this include the desire of these managers to network with party members, ensure protection against local and overseas competition or conversely not be discriminated against, or establish claims of incumbency. SOEs and POEs alike also enjoy the privilege of being able to access finance from state agencies on liberal terms, as well as access patronage to render them national champion status. Examples of subsidies to POEs include those given to Geely Automobile and to Huawei (China's largest telecommunications equipment maker). As observed by one commentator, "[t]he irony that the SOE [ZTE Corporation] turned to equity markets while the private company [Huawei] relied on state funds indicates the blurred lines between the public and private sectors in China's creation of industries considered to be strategic."[32] Additionally, SOEs reputedly pay small or no dividends at all to the state, but instead use their funds to either subsidize their loss making subsidies or to plough them back into the enterprise. In addition to highlighting the difficulties in drawing a red line between SOEs and POEs, they also signify the inability of the state to exercise control over SOEs despite their substantial voting power The independence of SOE from state control is further evidenced in the inability of the state to persuade SOEs to conduct investment activity, which the state may find undesirable. Illustrations pointed by ZHENG include the lack of success of the state in attempting to restructure conglomerate SOEs to modernize them and make them more competitive in one instance, and the lack of success in preventing SOEs from investing in the real estate sector in another. Whatever influence the state has been able to wield over SOEs has been through indirect and oblique means. These have been through the exercise of its power to rotate senior personnel of the SOEs, and control of POEs through industrial associations such as the chambers of commerce staffed by former government officials, as well as its role as regulator of the conduct of corporations generally. Viewed from the perspective of agency theory, these enterprises appear to be replete with the free cash flow problem, and the exercise of extra-legal controls over these bodies. Yet, as Milhaupt and ZHENG observe:[33]

> *But the mechanism of capture in China differs from those of Eastern Europe in that the key currency by captor firms is not bribes, but growth potential. Because the Communist party is averse to establishing accountability through the political process, its primary*

[32] ZHENG Wentong, *Transplanting Antitrust in China: Economic Transition, Market Structure, and State Control*, 32 University of Pennsylvania Journal of International Law 643, 669–670 (2010).

[33] See Milhaupt & ZHENG, fn. 29.

claim to legitimacy in the reform era is the ability to deliver economic development and its hoped-for counterpart, social stability.

The structural dynamics of capture are enhanced by two other factors that provide special privileges to favoured firms without regard to public or private ownership. One such factor is industrial policy…Another factor is nationalist sentiment.

China's political power is centralized, and economic power decentralized to the subnational governments. The success of the system is attributed partly to its imperial history of over 2,000 years where local governments exercised power and responsibility.

III. MANAGING EXECUTIVE COMPENSATION

Executive compensation packages consist of a combination of basic salary, bonus payments, and incentive payments tailored to align the package with the aims and goals of the entity. Executive compensation payments have prompted debates and present difficulties on many fronts. Its advocates argue that it is useful in aligning the interests of managers and the corporation, of rewarding performance, overcome shirking and the underutilization of corporate assets, and in encouraging high risk investments. Its critics lament the harm caused by the overreliance on the extrinsic motivation of incentive based compensation to the almost complete exclusion of behavior prompted by intrinsic motivation to do what is appropriate and required of them in the circumstances. There is of course plenty of evidence of the negative aspects of incentive based compensation strategy. These range from the downside of excessive risk taking, lack of alignment between pay and performance, and the gaming of compensation packages. Moreover, the tournament theory offers an alternative explanation to agency theory as to what motivates managerial behavior, according to which the incentive is to progress to the next hierarchical grade than be focused on the compensation package itself.

The last decade or so has seen a substantial body of corporations law related legislation enacted in the Anglo jurisdictions to address the excesses of executive compensation payments. These include SOP, clawback, and two-strike. SOP provides a limited voice to shareholders by permitting them a non-binding vote on executive compensation packages placed for approval before a company meeting. Clawbacks require managers to justify their compensation package to avoid forfeiting it for failure to deliver. Clawbacks are provided for in the US and UK, but not in Australia. Moreover, UK corporate governance has required since 2010 that board members of the top 350 FTSE companies submit themselves for re-election every year, thus helping remove the board entrenchment problem through staggered boards, golden handcuffs, and over generous golden handshakes. The two-strike rule, introduced in Australia, threatens boards with dismissal by a simple majority vote that has been preceded by two successive votes of disapproval by at least 25% of shareholders voting at a meeting. This three-pronged strategy has as its broad aim to grant shareholders voice to convey displeasure, require managers to justify their compensation packages in the face of

clawbacks, and make boards (as ultimate gatekeepers) take the fall where shareholders express discontent with the packages awarded to managers. Their cumulative effect is to draw on all three constituent parts of the relationship triangle of shareholders, boards, and managers to prevent managers from self-dealing (wield overbearing influence if not decide on the compensation package they are to receive), and keep a check on boards from being rewarded for any misguided loyalty on their part to managers.

As observed earlier, SOP strategy has in turn generated its own agency problems, for though managers may have been made more accountable to shareholders, this has also had the unintended effect of strengthening blockholder power as against managers and the rest of the shareholder body.[34] For example, it has become commonplace now for hedge funds and investment funds to either singly or in combination acquire a substantial shareholding in an entity and bear influence on captive managers to implement changes to the business plans of the entity in line with the preferences of these funds. The latter may take the form of extra dividend payouts and share buy backs, require the restructuring of the entity, or in the ultimate facilitate the takeover of the entity itself. From a corporate governance point of view the problems presented by such behavior by the funds is that target managers may now well act in cahoots with the demands of these funds as a way of ensuring their own survival if not also share in the rents garnered for the funds. There is an irony here: Where once institutional shareholders were seen as the saviors against recalcitrant if not self-serving managers, these funds now as controllers appear to have perfected the art of getting managers to serve their ends at the cost of offering some protection to these managers. The result is that the task of holding managers and controlling shareholders to account to the general shareholder body has been made even more difficult. The result has been an almost exclusive focus on share price and to short termism in these jurisdictions.

SOE Compensation in China

China's recent experience on executive compensation packaging shows that it has been through a major transformation in the way it compensates its managers. Previously, compensation packages to SOE officers were generally linked to the salary of a bureaucrat and/or academic of comparable standing. For example, in the period between 1958 and 1978, there were no significant differences in the wages paid to managers and to employees.[35] Following the experience of this period, bonuses and other incentive payments were reintroduced in 1979, and more importantly required to be paid out of the retained profits of the entity.[36] This measure was perhaps the first move to orientate remuneration to performance of the entity itself. The series of changes thereafter show the

[34] Razeen Sappideen, *The Regulation of Hedge Funds*, 19 Journal of Business Law, 537 (2016).

[35] YU Guanghua, *The Regulation of Executive Compensation in China*, available at http://ssrn.com/abstract=1535660 (last visited Oct. 11, 2013).

[36] Id.

attempt to align the payment of bonuses to performance of individual managers. For example, by a proclamation of the State Council in 1981 only enterprises which fulfilled performance indicators in respect of quality, quantity, profit and supply could pay out bonuses. The existing cap on bonus payments not exceeding three months' salary was substituted by a maximum amount that could be paid out. In 1985, the linkage of managerial pay to the pay of academics and public servants was severed, and enterprises permitted to set payments within bands. The differential gap in payments to managers and employees was widened by a series of reforms in 1986 and 1988 from three times to five times. The next major reform was the Shenzhen experiment of 1994, following which the practice tested there was standardized in 1996.[37] Under this, managerial remuneration was to consist of a basic annual remuneration, performance annual remuneration, and bonus annual remuneration.[38] Importantly, bonuses could take the form of cash, in kind, or shares.[39] Managerial compensation packages based on this format was extended to the rest of the country in 1997. The move to introduce the annual salary system gained rapid acceptance, and was institutionalized by the state asset management bureau's decision to implement an incentive based annual salary system consisting of fixed base salary and performance salary in 189 SOEs directly owned by the central government.[40] More momentous, was the decision in 2001 that in enterprises where an annual salary was in place, managers were to be appointed by open market competition than from the bureaucracy.[41]

There has also been a move to require greater disclosure of shares held by managers and compensation paid to them. For example, a 1995 notice issued by the CSRC concerning the implementation of regulating the disclosure of information of listed companies" required listed companies to disclose in their annual report information regarding directors, supervisors, and senior managers' shareholding at the beginning and end of the year, changes in shareholding, and the annual compensation paid by the company including salary, bonus, benefits, and receipts of cash, kind, and securities.[42] This was followed by the Governance Code, Article 79 of which requires pay packages of

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[37] Art. 22 of Provisional Measures on the Work of Company Managers in the City of Shenzhen, issued by Shenzhen Municipal People's Government and the Regulation of Executive Compensation in China, available at http://ssrn.com/abstract=1535660 (last visited Oct. 11, 2013).

[38] Basic annual remuneration was based on the total value of assets, realized profit, sales volume, tax paid and foreign exchange earned. Performance annual remuneration had two components: 40% was to be based on growth rate of net assets, and 60% on growth rate of annual profits. Annual bonus was linked to the growth rate of the entity based on the above factors exceeded the industrial average. Id.

[39] Id.

[40] LIN Chen, SHEN Wei & SU Dongwei, *Corporate Tournament and Executive Compensation in a Transition Economy: Evidence from Publicly Listed Firms in China*, available at http://ssrn.com/abstract=1393507 (last visited Oct. 11, 2013).

[41] Id.

[42] See China Securities Regulation Commission (CSRC), Part IV Arts. 3(2) and 3(3), available at http://www. chinainfobank.com (last visited Oct. 11, 2013) now www.infobank.cn (since repealed by the CSRC in 1999).

senior managers to be approved by the board of directors, be explained to shareholders, and disclosed to the public.[43] However, since annual performance remuneration cannot exceed the basic annual remuneration, the difference in total remuneration between managers and employee continues to remain narrow.[44] Yet, from a tournament theory[45] perspective, these changes have been viewed favorably as motivating managerial aspirations and achievement. In testing a number of predictions of tournament theory using data of 34,701 executives in 450 publicly-listed firms in China for the period 1999 to 2006, CHEN Lin and others found that:

> *[O]verall, publicly listed firms in China as they become more market oriented, have adopted a market structure that is largely consistent with the predictions of Tournament theory, and that it is important to consider both ownership structure and corporate governance schemes in analysing executive compensation structure.*[46]

Additionally, a 2002 study by YIN Changlin[47] has found a positive relationship between executive compensation and firm performance in Chinese listed companies. The responsiveness of governance and compensation strategy to marketplace events is further evidenced in research done by Conyon and HE,[48] who found executive compensation payments in China firstly, to be positively correlated to firm performance; secondly, executive pay and CEO incentives to be lower in SOEs and firms with concentrated ownership; thirdly, firms with more independent directors on the board having a higher pay for performance link; and fourthly, non-SOEs and firms with more independent directors as more likely to replace the CEO for poor performance. This implies managerial entrenchment in SOEs and corporatized SOEs. In a related paper,[49] they

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[43] Art. 79 of the Code provides that the results of the performance assessment shall be approved by the board of directors, explained at the shareholders' meetings and disclosed.
Additionally, the Revised CSRC disclosure requirements of Dec. 22, 2003 requires disclosure of decision-making process concerning the compensation of directors, supervisors and senior managers, including basic salary, bonuses, welfare benefits, housing and other allowances, and the total compensation of the three highest paid senior managers. See Notice of the CSRC concerning the Amendment of Code 2 on the Content and Format of Information Disclosure by Listed Companies (The Content and Format of Annual Reports), Art. 26, Pt 5 of C 2 (Dec. 22, 2003), available at http://www.chinainfobank.com now www.infobank.cn (last visited Oct. 11, 2013).

[44] See YU, fn. 38.

[45] Iman Anabtawi, *Explaining Pay without Performance: The Tournament Alternative*, 54 Emory Law Journal, 1557 (2005).

[46] See LIN, SHEN & SU, fn. 41. The study also found that while state ownership of shares reduced executive compensation and the pay gap; the presence of more outside directors served to increase the pay gap; while the presence of more outside supervisors on the supervisory board tended to reduce the pay gap and the coefficient of variation in pay.

[47] YIN Changlin, *A Study on Executive Incentive Pay and Performance in Listed Companies*, 1 The Economist (in China), 125 (2004), cited from: YU Guanghua, *The Regulation of Executive Compensation: An Agency Perspective*, available at http://www.clta.edu.au/professional/papers/conference2006/2006GY_REC.pdf (last visited Apr. 19, 2007).

[48] Martin J. Conyon & HE Lerong, *Executive Compensation and Corporate Fraud in China*, available at http://ssrn.com/abstract=2292549 (last visited Oct. 11, 2013).

[49] Id.

found executive compensation to be lower in firms that commit more severe frauds, that CEOs of privately controlled firms and firms that split the posts of CEO and chairman as well as CEOs of firms located in developed regions suffer larger compensation penalties for committing financial fraud, and that CEOs at firms that commit fraud are more likely to be replaced compared to non-fraud firms. Finally, Conyon and HE found compensation payments to US executives to be about seventeen times higher than in China even after controlling for economic and governance factors.[50]

A more macro perspective on the issue is offered in the study by YANG Ruilong and YANG Jidong.[51] In investigating why top executive payments have increased so much in China, they found peer effects to play a significant role in this. For instance, while compensation committees designed packages by reference to peer groups in order to maintain competitive compensation, top executives wanted their packages to be above the average of their peer. The latter, coupled with the finding in some studies that in entities with a foreign ownership and a higher composition of outside directors higher compensation payouts are made, could escalate executive compensation packages in China. Whether this flow on effect will also extend to corporatized SOEs remains to be seen. The future outcome of this clearly depends on the remit of supervisory boards under China's Company Law, and state-owned assets supervision and administration bureau as the ultimate controller. However, given the nature of China's SOEs and the influence of the state on them, there is as yet no need to worry about runaway managerial compensation in SOEs. In other words, unlike in the US, for example, executive compensation payments in China have been restrained heavily for a variety of reasons. These include the fact that senior managers are still appointees of the state, are or have been members of the CPC, and/or previously held comparable positions in the government hierarchy prior to their appointment as "boss" of the enterprise. Furthermore, China's "two-tier" system of corporate governance requires compensation packages to be approved by the supervisory board (whose membership include members of the CPC), as well as explained to shareholders and publicized. This level of scrutiny has not surprisingly imposed restraints on managerial compensation packages despite official proclamations of independent wage setting for managers. The discussion in the next Part examines the role of cultural norms in shaping the emergence of a Chinese form of corporate governance based on governance structure, institutional norms, and reward structure.

IV. CULTURE, INSTITUTIONS, AND CORPORATE GOVERNANCE

Culture has been described as the software of the mind.[52] It is cognitive, bounded,

[50] Id.

[51] YANG Ruilong & YANG Jidong, *Why Has Top Executive Compensation Increased so Much in China: An Explanation of Peer Effects*, 14(5) Pacific Economic Review, 705–716 (2009).

[52] Geert Hofstede, *Culture's Consequences: International Differences in Work-Related Values*, Sage Publishing (Beverly Hills), (1980).

immutable, coherent, and unified.[53] Cultural analysis aims to capture what links groups within a society on the one hand, as well as societies generally on the other. Cultural practices may differ as between societies, as well as institutions, governance structures, and expectations therein. While human behavior is to a large extent shaped by cultural norms, culture is itself dynamic and receptive, and while universal is yet localized by events and circumstances. That is to say, institutions as well as their practices can all be conditioned by law and marketplace incentives. While the law and the marketplace are itself the product of cultural norms, in a globalized world they are as much exposed to and are influenced by other dominant strains of culture and universal norms.

Hofstede, an early pioneer in cultural research,[54] classified culture into four, and later six dimensions or value based analyses. His initial four-fold classification viewed national cultures by reference to whether they were individualist or collectivist in outlook, their attitude to uncertainty avoidance, the hierarchical distance between those who exercised power and those over whom it was exercised, and the rigor of the male-female task orientation divide adopted. The two dimensions he added on later were, long-term versus short term orientation, and indulgence as against self-restraint. This classification has been widely accepted as a theoretical basis for cultural analysis. It requires society to be viewed, analyzed and interpreted individually as well as collectively, and by reference to its institutions.[55] This is equally true of commercial and corporate law and culture, and of corporate governance for the reason that corporate governance is about interactive human behavior, and practices such as the balancing of competing interests and goal setting in the context of the issues and outcomes contemplated as well as the determination of reward for performance are manifestations of it. This is elaborated on below.

National cultures embody its institutions. Institutions spell out "the rules of the game" both formally and informally, and constitute "informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)."[56] Institutions refer to the social, economic, legal, and political organization of a

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[53] Cheryl Nakata, *Reflexive Considerations of Culture Theories in Global Marketing*, in Cheryl Nakata eds. *Beyond Hofstede: Culture Frameworks for Global Marketing and Management*, Palgrave Macmillan, (2009).

[54] See, *e.g.* Hofstede, fn. 53; Geert Hofstede, Gert Jan Hofstede & Michael Minkov, *Cultures and Organizations: Software of the Mind*, McGraw Hill, (2010); Michael Minkov & Geert Hofstede, *Cross-Cultural Analysis: The Science and Art of Comparing the World's Modern Societies and Their Cultures*, Sage Publications, (2013).

[55] Social anthropologists use the terms *emic* (where knowledge and interpretation within a culture is determined by local custom, meaning and belief, and best described by a native of that culture), and *etic* (generalizations about human behavior considered universally true such as economic or ecological conditions which cultural insiders may not consider relevant).

[56] Douglass C. North, *Institutions*, 5(1) The Journal of Economic Perspectives, 97–112 (1991); Douglass C. North, *The New Institutional Economics and Development*, available at http://www2.econ.iastate.edu/tesfatsi/NewInstE.North.pdf (last visited Sep. 5, 2016).

society. And as Ronald Coase has shown,[57] institutions do matter, as they impact on corporate governance at two levels: at the level of the individual entity, and as between entities, *i.e.* at the level of internal governance of the firm, as well as the firm in the marketplace and society. Internal governance and its participatory process include the formal structure of management, control, and accountability, namely, the board system (single versus two-tier) and the division of powers between shareholders, managers and the board; control–participation in the affairs of the entity (shareholders, creditors, and employees); and accountability to shareholders only or to shareholders and supervisory board. Impact as between entities is reflected in external constraints such as capital markets (stock market versus relational finance), market for managers, takeovers market, and the role of strategic investors such as hedge funds and investment funds. Supervening all of the latter are product and services markets.

Corporate governance institutional structures vary as between countries in at least six respects: their financing (stock versus bank/direct), management (single versus two-tier board, employee participation), ownership (state, banks, families, institutions, and individuals), control (CEO, board, shareholders), compensation strategy (intrinsic versus extrinsic),[58] and accountability (company meetings, capital markets, analysts). Clearly, these variations in governance prevail even amongst societies comparable politically, economically, and socially, given their different institutional and cultural trajectories. For example, while the Anglo jurisdictions have a market-oriented system of corporate governance, the Japan-German models have a network-oriented system, with the result that the former is shareholder-oriented whereas the latter is stakeholder-oriented. Under the shareholder model, shareholders nominally appoint managers, with managerial accountability thereafter being limited to the shareholder meeting and the marketplace. Neither employees nor creditors have a say in the affairs of a going concern corporation where managers, provided they observe the requirements of due diligence, can hide behind the business judgment rule. Consequently, the shareholder model is riddled with agency problems between managers, shareholders, creditors and employees, though adversity might bring about shifting coalitions between some of these groups.[59]

By contrast, employees whether as members of the supervisory board under the two-tier German board model (which model is also replicated in China), and through worker councils under the single-tier Japanese model, are an integral part of the

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[57] Ronald Coase, *The Nature of the Firm*, 4 Economica, 386 (1937).

[58] Whether economic incentives should be allowed to shape individual behavior to the exclusion of other considerations has been the subject of much debate. Behavioral theorists point to the damaging effects extrinsic rewards in the form of economic incentive payments have on human behavior and motivation and argue for greater emphasis to be placed on intrinsically desirable behavior. See Razeen Sappideen, *Corporate governance in Search of the Shareholder Manager Balance of Power*, 14 Richmond Journal of Global Law and Business, 91 (2015).

[59] John Coffee, *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 Georgetown Law Journal, 1495 (1990).

governing process in these countries resulting in a minimization of the agency problem between these two groups of claimants. Moreover in Germany and Japan, creditors (largely banks as both shareholders and financiers of the corporation — in Germany the hausbank, and in Japan the main bank), have a much closer interest in the corporation as a going concern entity than as outsider creditors, and consequently are able to reduce the exploitation of creditors and employees for the benefit of shareholders. In the Chinese context, state financing through its financing companies may well play a similar role in minimizing the agency problem between shareholders and creditors. The point to note here is that management under the shareholder model has much greater freedom of action in respect of the entity's investment, financing, and dividend decision, its risk profile, and its workforce. Moreover, where share ownership is more spread out, the successful engagement in hostile takeovers is possible. By contrast, such adventures are more limited under the stakeholder model given the close knit interest-relationship between managers, controlling shareholders, employees, and banks/state finance companies (in their capacity as both lender and shareholder), and in the case of China, the role played by state-owned assets supervision and administration bureau in influencing outcomes. Moreover, corporations under this model tend to commit their free cash flow to diversify their operations through cross shareholdings to ensure lines of supply and distribution, and to invest in research and development rather than distribute them as dividends, share buyouts, authorized reductions of capital and the like.[60]

This proximate relationship also makes it possible for German, Japanese, and Chinese businesses to avoid the downside of being short-term focused in their outlook. Commentators observe that the focus in Anglo American jurisdictions on earnings management with an eye on share price, avoid commitments that do not bring about immediate short-term results such as research and development. As observed by a US commentator:[61]

> *Short termism results in the deflection of capital needed for business survival and growth over the longer term. Growth can be defined in a number of different ways, such as meeting new customer demands or new competition...deflection can occur through dividend policy, stock buy backs, or simply pushing earnings earlier, among other things.*

Short-termism has the fundamental drawback of gains being short-term and harming investors as a class.[62] Investors for their part press for short term results while hedging against failure through diversification of shareholdings and derivative contracts. Short-termism has the result of abrupt job losses, and with that a reduction in the tax base

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[60] Milhaupt & ZHENG, fn. 29. See also Usha Haley & George Haley, *Subsidies to Chinese Industry: State Capitalism, Business Strategy, and Trade Policy* (1st edition), Oxford University Press (New York), (2013).

[61] Ira Milstein, *In Short-Term Thinking Linked to Compensation Problems by Justin Lahart*, *Wall Street Journal*, Sep. 29, 2009, available at blogs.wsj.com/economics/2009/09/29/short-term-thinking-linked-tocompensation-problems/tab/print (last visited Oct. 31, 2013).

[62] Id.

and a lowering in consumer demand, leading in turn to a closing down of businesses.

There are many explanations as to what causes short-termism. Ownership structure is one of them. Whereas shares are owned by families and institutional shareholders (banks in Japan and Germany, and by the state in China's SOEs), in the Anglo jurisdictions even institutional investors hold shares as an interchangeable part of their investment portfolio. Institutional shareholders in the Anglo jurisdictions also face the classic "liquidity versus control" dilemma identified by Coffee.[63] Moreover, they face the double agency problem, as they are themselves agents (managers) of entities on whose behalf the investment is being made. Both sets of agents are under pressure by their principals, to deliver.[64] Managerial incentive compensation packages which emphasize the short term, and the practice of regular turnaround of share portfolios may add to managerial uncertainty and insecurity. As observed by former Treasury Secretary Timothy Geithner:[65]

> *I think that although many things caused this crisis, what happened to compensation and the incentives in creative risk taking did contribute in some institutions to the vulnerability that we saw in this financial crisis. We need to help encourage substantial reforms in compensation structures particularly in the financial industry.*

By contrast, bank financing in Germany and Japan enable equity investments to be used for longer, and where necessary get failing entities on their feet by the transfer of additional investments into these entities.

Even more so, the concerns of China's form of corporate governance lie at the other end of the spectrum, namely, to ween away business enterprise dependence on the state by enabling SOEs to stand on their feet, be internationally competitive, but yet avoid the excesses of US-UK-Australian oriented model.

Viewed in terms of Hofstede's sixfold classification, therefore, Chinese corporate governance culture is seen to be characterized by high collectivism and hierarchical power distance relationships (based on notions of face, harmony, interpersonal connections or *guanxi* and compassion or *renqing*), paternalistic leadership, and a long term orientation.[66] Such culture may also be reflected in what was discussed previously — the level and the way of control, the background or experience of senior managers, and the comparatively low executive compensation in China — as compared to that in economies like the US and the UK. While these characteristics are to a large extent attributable to collectivism and the hierarchical power distance relationship, and their embedding in China's institutional structure through the influence wielded by bodies such

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[63] John Coffee, *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 Columbia Law Review, 1277 (1991).

[64] Patrick Bolton, Jose Scheinkman & WEI Xiong, *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 Review of Economic Studies, 577 (2006).

[65] See fn. 62.

[66] LEUNG Kwok, *Chinese Culture, Modernization, and International Business*, 17 International Business Review, 184–187 (2008).

as state-owned assets supervision and administration bureau, there is the argument that as societies become wealthy, the need for interdependence is lessened.[67] Whether this trajectory will set in and socialism with Chinese characteristics will converge with Western forms of capitalism becomes an open issue. It also highlights an aspect of the debate in cultural studies theory on the extent to which Hofstede's summation of culture as the "collective programming of the mind which distinguishes the members of one human group from another,"[68] holds true. Critics argue that Hofstede's dimensions are no more than values, and it is perception based on the application of these values by the beholder which is important, with individual responses to an event varying on the interplay of cultural values, occasion and context. Consequently, while an understanding of cultural differences may help in interpreting a particular action, it does not necessarily lend itself to prediction of human behavior or action with accuracy. Furthermore, change may be sudden and imposed by exogenous events. An example is the emergence of the labor-management-finance partnership in the reconstruction of the German and Japanese economies following World War II, and of employee or worker participation in the management of the larger industrial enterprises and greater reliance on bank finance as against capital markets finance in these countries. By contrast, the US and the UK have continued on with their almost hermetic seal separation of management and labor relationships. Less sudden, but as dramatic have been the changes necessitated, for example, to Chinese commercial, corporate, and contract enforcement laws following the decision by China to seek WTO membership as part of its accession agreement with the WTO members. More importantly, despite the new institutions/institutional values being introduced into these three countries, these institutions have in the course of their reception been heavily conditioned by the stamp of the jurisdictions normative values and societal culture. This is seen *e.g.* in the continuation of life long employment in Japan despite occasional murmurings to the contrary, the two-tier board in Germany, of diversified enterprises in these two countries, and of SOEs and state-owned assets supervision and administration bureau in China, as well as comparatively low executive compensation in all three countries as compared to that of the US and UK. In fact, this influence of culture on Chinese enterprise governance is nowhere better illustrated than in the context of the institutional constraints that bear on compensation packages to listed company SOE executives in China as discussed earlier. While executives appear to be awarded stock compensation as bonuses and incentive payments, research by CHEN and others shows that these awards are only for show and are almost never exercised by the executives, or if exercised the proceeds are made over to the entity for sharing by all of the employees. They are for show because of the received learning of Western capitalism

[67] Harry Trandis, *Individualism and Collectivism*, Westview Press (Boulder), (1995).

[68] Geert Hofstede, *Culture's Consequences: Comparing Values, Behaviours, Institutions, and Organizations across Nations*, Sage Publishing (Thousand Oaks), at 5 (2001).

that stock based incentive compensation is the best way of aligning performance and reward, and that parity and performance required that such payments be also made to executives of Chinese SOEs. However, given that almost all of the appointees to the senior ranks of SOEs are or were senior managers of the government, and whose positions are interchangeable, cultural norms and party political influence override individual desire for personal economic gain through managerial positions in SOEs.

CONCLUSION

China began the opening up of its markets to both national and international competition and to private ownership of business entities nearly four decades ago. Following this, it applied to become a member of the WTO, to which it gained admission in 2001. This required China to modernize its economic laws and the economy generally so as to benefit from, as well as comply with the WTO agreements. These changes in turn gave a further boost to its strategy to open up its markets and engage in international trade.[69] These initial developments, set in process by its political decisions, continue to reshape the country's legal, economic, and social development. As to what enabled these changes to take place, and take root, lies at least partially in China's historicity. The subsequent reforms to the country's economic, social and political fabric set in motion the framework of path dependence[70] for institutions to develop. The changes, as described by two noted commentators:

> *Under DENG Xiaoping, this meant reforming agriculture and unleashing entrepreneurship. Under JIANG Zemin, it meant officially enshrining a market economy, reforming state owned enterprises, and joining the World Trade Organization. Under HU Jintao and WEN Jiabao, it meant reforming social security.*

The present Chinese socialist market economy, therefore, straddles between three ideologies: Marxist-Leninst political ideology, market economy with SOEs within it operating in key economic and strategic sectors, and Confucianist thought emphasizing benevolent governance within its structure. Based on these, the CPC[71] has been able

> *to craft a coherent ideological narrative to legitimize its rule. In recent years, the CPC has emphasized nationalism and national unity as well as Confucian values…The political and social values are now associated with the statism and socialism of the single-party regime.*[72]

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[69] See Sappideen, fn. 57.

[70] Of winding roadways that were once pathways created to get from one valley to the next to avoid wolves and hostile groups that have been followed by others, even though the dangers have long since ceased to exist, and shorter routes can be worked out.

[71] KANG Youwei, *The End of Reform in China, Comment May/June 2015*, Foreign Affairs, available at http://www.foreignaffairs.com/print/140807 (last visited Apr. 26, 2015).

[72] Pan Jennifer & XU Yiqing, *China's Ideological Spectrum*, MIT Political Science Department Research Paper No. 2015-6, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2593377 (last visited Apr. 23, 2015).

This is not to ignore the ongoing ideological battles within the country and the Chinese Communist Party itself. As two noted authors comment:

> *...ideas of the conservative left include nationalism, a strong and powerful state, big government, Chinese identity, and cultural conservatism. On the liberal right, ideas include constitutional democracy, and its legal and societal foundations of legal order, protection of individual liberties, and governmental transparency. Promotion of a free market economy, which is considered conservative in the context of developed democracies, is on the right in China because it is the most significant rejection of the radicalism of the Maoist era.*[73]

While internal struggles as to ideas will continue, it can be said that it is unlikely that the CPC will fully privatize SOEs in areas considered to be of strategic concern to the country, or relinquish control of SOEs that may make the CPC politically vulnerable. As presently constituted, socialism with Chinese characteristics holds out the following as its hallmarks: (1) centralized political power alongside decentralized economic power to its provincial and municipal governments with the rider that they raise their own finances and be economically independent; (2) ownership/control of SOEs by subnational governments; (3) subsidies paid out to both SOEs and POEs with the aim of hosting national champions; (4) control of SOEs through managerial appointments by state-owned assets supervision and administration bureau; and (5) the prevalence of high levels of trust as seen *e.g.* in the transfer and operation of SOEs through MBOs, where neither the subnational government nor the transferee having legal authority for the transfer. These characteristics of China's system of corporate governance within its form of hierarchical norms make clear that while institutions matter, culture matters even more in that it acts as the mix which enables, channels, and restrains individual activity and relationships, substitute where formal institutions are lacking, and sometimes trumps even where institutions exist. It trumps in that it gives meaning to the institutions whether by deference to authority, or just doing what is expected of you.[74] China now boasts a flourishing private sector, and is one of the most favored destinations for foreign investors.[75] While these characteristics are emblematic of Chinese societal and organizational culture, its peculiar strength lies in its ability to be receptive to changes through the command structure residing at the various levels of political decision making. This perhaps helps explain why and how China has been able to blend centralized political control and regionalized economic power with SOEs and POEs integrated into the world economy.

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[73] Id. at 8 & 29.

[74] This partially explains why notions of strict property rights in respect of intellectual property are not observed as they should be. The element of monopoly power associated with it, and the extension of such privileges by developed economies to protect large corporate interests, are seen as containing elements of inherent unfairness.

[75] Alongside this trust, there is also resort to self-help where the trust is breached as is evident in the beating up of public officials, including medical and hospital employees.

These developments stand in high contrast to Anglo-American market theorists, particularly finance theorists with their almost exclusive emphasis on political stability and institutions to the almost total neglect not only of human foibles in decision making, but also of their cultural conditioning, and of the role culture plays on how these institutions are managed and made to operate.[76] Moreover, such a theory falls a long way short of explaining as to why even German capitalism is so very different from the Anglo jurisdiction systems, why employee participation and labor relations are such an inclusive part of *e.g.* German, Japanese and Chinese business enterprise. These unique qualities of Chinese and other cultures also explain why the view expressed by Hofstede and others that societal and institutional culture are quite different and separate may be flawed.[77] Finally, it also helps explain the paradox of culture in a globalized world — of both divergence and convergence — and of the strong presence of both in politically stable societies. In other words, while product and services markets as well as capital markets have adapted to fit in with the dominant Anglo jurisdiction form of capitalism, it is also clear that cultural and institutional norms can adapt but yet stay distinctive, and prevail in the global village. China's version of a modern market economy "with Chinese characteristics," including lower managerial compensation and state ownership of shares, seem to suggest that its culture and institutions can well prevail the challenges presented by international capital markets.

[76] LEUNG Kwok, *Globalization of Chinese Firms: What Happens to Culture?*, 10 Management and Organization Review, 391–397 (2014).

[77] Geert Hofstede, Bram Neuijen & Denise Ohayv et al., *Measuring Organizational Cultures: A Qualitative and Quantitative Study across Twenty Cases*, 35 Administrative Science Quarterly, 286–316 (1990), "After having done both a large cross-national and a large cross-organizational culture study, we believe that national cultures and organizational cultures are phenomena of different orders: using the term 'cultures' for both is, in fact, somewhat misleading."