

Understanding Corporate Governance in China

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Introduction

The advent of corporate governance in China

In the 1980s, the People's Republic of China (PRC) began to introduce a market-led economy. The Chinese Communist Party's Central Committee made the decision to bring in a modern enterprise system, the state withdrawing from the central control of state-owned enterprises (SOEs). A new companies law was enacted in 1994 permitting the formation of companies. Many SOEs were subsequently corporatized and their management given greater autonomy. New companies were created; some family firms, others reflecting national, provincial, or local interests.

Among the SOEs were some vast companies in oil, telecom, steel, and finance. In many cases a minority of their shares were floated on stock exchanges in Hong Kong, Shanghai, and Shenzhen (a vast new city close to Hong Kong). A few were floated in London or New York. But governance was needed to oversee those emerging corporate enterprises.

Experts from Hong Kong and the Organisation for Economic Co-operation and Development (OECD) helped to produce a set of corporate governance guidelines. Inevitably, OECD drew on corporate governance practices in countries such as the US, the UK, and Germany. But these countries are democracies with independent judiciaries and a culture of business integrity.

Individual accountability, transparency, governance regulations, or code with regulatory bodies ready to cite non-compliance, which are taken for granted in the West, were not the norm in China. The Chinese culture is one of collective and shared accountability. Opaqueness has been the working norm for many SOEs.

China stands out as a case on its own. Government is an oligarchy, exercising significant central administrative control, with the judiciary serving the state. Nevertheless, the PRC has developed an innovative corporate governance regime, with supervisory boards reflecting the German two-tier board model, but also boards of directors with independent outside directors, somewhat similar to the US and UK unitary board model.

For years governance was left to companies, under the overall supervision of the State-Owned Assets Supervision and Administration Commission (SASAC)

and the China Securities Regulatory Commission (CSRC). State involvement at a higher level tended to be distant. Some felt that the Communist Party's leadership had been undermined, so central authorities have recently sought to reassert party influence over the SOEs.

However, corporate governance involves more than company law, governance guidelines, and the rules of the stock exchanges and regulatory authorities. Culture and ethics lie at the core of corporate governance—the culture of the country, the culture of each company, and indeed the culture of every board. In China, the corporate governance culture is still emerging, the ethics underpinning business activity are evolving, and business-government relations continue to change.

Corporate governance in Hong Kong was different. Hong Kong became a Special Administrative Region of China in 1997, after nearly 200 years as a British Protectorate under a lease from mainland China. The roots of corporate governance in Hong Kong were different and deep. Under the British influence, Hong Kong developed its own legislature, an independent judiciary based on English-style common law, and its own currency linked to the US dollar. The Hong Kong Stock Exchange dates from 1891. Institutions for company registration and regulation were created, and strong professions were formed: legal, audit, accountancy, finance, and company secretarial. This infrastructure and these institutions remained after the 1997 handover; as the Joint Agreement between the PRC and Britain put it: “one country, two systems.” But as the business worlds of China and Hong Kong grow together, some Hong Kong institutions are coming under China's influence.

To reach its present economic and political significance in the world, China has traveled a unique road. This historical and cultural context means that China has developed corporate governance with a distinct “Chinese face.” Exploring and understanding the special features of corporate governance in China and the challenges ahead is the theme of and rationale for this book.

When the authors worked together in Hong Kong, around 20 years ago, they did not imagine that within two decades, China would:

- become the second largest economy in the world
- have some of the most significant companies on the New York Stock Exchange board
- create an affluent, car-owning middle class able to travel to Hong Kong, Europe, and North America
- build many “smart cities” using virtually cashless information technology for their activities
- develop a modern transport network of motorways and railways, and
- formulate a “belt and road” strategy to link China with Europe.

Corporate governance was recognized, at the outset in China, as fundamental to such developments. China has been and continues experimenting with its governance systems. In the process, unlike the West, which tends to think of corporate

governance as the method of regulating business, China sees corporate governance as a means of contributing to economic growth for the benefit of the people and the state. This book tells that story.

The basis of this book

To understand corporate governance in China, it is not enough to know the policies and procedures, rules and regulations involved; it is vital to understand how businesspeople and officials act in practice. This book is based on a research project by Gregg Li in 2016 and 2017, in which he conducted in-depth interviews with business leaders, auditors, bankers, lawyers, and others closely involved in corporate governance in China. Some interviewees contributed material based on their unique experiences and insights. The background of interviewees and contributors appears in Appendix IV, although some interviewees preferred anonymity.

This book attempts to understand reality but recognizes that it is only possible to capture slices of the past. Corporate governance practices are evolving rapidly in China. There are many negatives and many positives. What worked in one situation weakened the governance infrastructure of another firm.

The two authors, Gregg Li and Bob Tricker, have extensive knowledge of corporate governance through research, writing, trouble-shooting, and teaching in the subject and through long-standing coaching and consultancy for directors and boards. More biographical information appears in Appendix IV.

What the book covers

The main intention is to provide a practical guide to current corporate governance issues and practices in mainland China and Hong Kong, with an insight into possible futures. Companies involved include private companies and those owned by regional, municipal, or other official bodies such as the People's Liberation Army (PLA), SOEs and their subsidiary companies, and companies with overseas ownership. The governance of companies listed on the Hong Kong, Shanghai, and Shenzhen stock markets, including SOEs, is included. The governance of H-share companies, incorporated in mainland China but increasingly important to the Hong Kong market, is also covered.

Who the book is intended for

The book will interest board chairpersons, company directors, and senior executives, PRC officials at state, regional, and municipal levels, and practicing governance professionals in the, law, and company secretarial fields. Masters-level students studying for an MBA or similar degree, and students working on professional examinations

in the accountancy, auditing accountancy, auditing, legal, and company secretarial professions will also find the book useful. Some case studies of actual governance situations have been included for use in courses although practitioners may also find them interesting. Indeed, the book will be valuable to all those around the world who have an interest in China. It is particularly relevant to those sitting on the boards of Chinese companies or foreign companies owned by the Chinese: they need to appreciate the reality of corporate governance in China and the potential for cultural differences.

1

Corporate Governance: The Basic Ideas

Bob Tricker

In this chapter we consider:

- ❖ what is corporate governance
- ❖ that corporate governance is not management
- ❖ the limited liability company
- ❖ membership of the board of directors
- ❖ the role of the board of directors
- ❖ classic approaches to corporate governance around the world
- ❖ the Western approach
 - the United States unitary board, rule-based model
 - the UK/Commonwealth unitary board, principles-based model
 - the continental European two-tier model
- ❖ the Eastern approach
 - the *keiretsu* model of corporate governance in Japan
 - the *chaebol* model of corporate governance in South Korea
 - China's approach to corporate governance

What is corporate governance?

The term “corporate governance” first came into use during the late 1980s¹ and the phrase was soon adopted worldwide. In 1988, Cochran and Wartick, two American academics, published an annotated bibliography of corporate governance: it had 74 pages. Today, Google notes over 57 million references to the phrase. The world's first corporate governance code, Sir Adrian Cadbury's code for the UK, was published in 1992.

But the only thing that is really new about “corporate governance” is the phrase. The practice of corporate governance is as old as trade. Whenever the owners or the members of an organization delegate the responsibility for its running to managers,

1. The first book with the title “Corporate Governance” was published in 1984, reporting five years' research at Nuffield College, Oxford, into the practices and procedures of British boards of directors. See Tricker, 1984.

they need a means to ensure that those managers do their job properly and meet the enterprise objectives.

Essentially, corporate governance is about the way power is exercised over corporate entities.² It ensures those organizations meet the needs of their members.

All organizations need governing: educational institutions, sports clubs, hospitals, cooperatives and, of course, businesses. In this book we focus on companies incorporated to do things for a profit. We will explore what goes on in and around the boardrooms of businesses in modern China.

Corporate governance is not management

Corporate governance is not the same as management. The management of an organization is in the hands of the corporate executives and other managers who run the enterprise. Management involves planning, controlling, and taking managerial decisions. It is an analytical and logical process. Corporate governance, in contrast, is principally a political process. The governing body is responsible for overseeing the management, ensuring that the enterprise is running in the right direction and meeting its members' objectives. The governing body provides the moral compass for the enterprise, sets its standards, and oversees its ethical approach.

The governing body is frequently called the board of directors though many other names are used—committee, council, or even just the “governing body.” For simplicity, we will refer to the board throughout.

The limited liability company

Limited liability companies were a brilliant development of mid-nineteenth-century Britain. To raise capital, company law allowed the incorporation of corporate entities with the powers of an individual trader to do business but limiting the liability of their investors to their shareholding stake. The notion quickly spread around the world, allowing the creation of employment, wealth, and economic growth. The limited liability company now underpins world trade.

Crucial to the concept of the limited liability company is that ownership is the basis of power over that company, allowing shareholders to nominate and elect the directors, appoint the auditors, and receive information about their directors' stewardship of the company. Predictably, over the years, the success of the concept led to immense complexity. In the early days, shareholders were individuals. In most listed companies today, individual “retail” investors are in a small minority, overshadowed by institutional investors, hedge funds, private equity investors, and

2. Only a brief insight into corporate governance can be provided in this chapter; for a fuller discussion see Tricker, 2015.

others, including sovereign funds and nationalized state ownership (both relevant to corporate governance in China, as we will see).

Membership of the board of directors

Essentially, there are two distinct types of board member:

- *executive directors*, who are also senior members of the management
- *non-executive directors*, who are not part of the management.

Non-executive directors are often referred to as outside directors. These non-executive directors fall into two significant categories:

- *independent non-executive directors* who have no ties with the company, other than their directorship, who can thus bring independent insights and judgment to board deliberations
- *connected non-executive directors*, who are not members of the management but who do have some connection with the business, such as being a major shareholder, having connections with significant suppliers or customers, or previously being executives of that company and therefore not seen to be able to exercise independent judgment.

Boards vary in size and structure, affecting their operational characteristics. Four possible structures are possible:

The executive board is made up entirely of directors who are also managers in the company. These boards are often found in family businesses, particularly in the first generation, private companies, and on the boards of subsidiary companies within a group of companies.

The majority executive director board has non-executive directors to give advice but they are in a minority, executive directors holding the power. Such structures used to be quite common in companies listed on stock markets around the world. But many corporate governance codes today call for a majority of independent outside directors, so these boards are rarer, except in private companies and some family firms.

The majority non-executive board is now the norm in listed companies, because of corporate governance code and stock exchange listing requirements. Such structures are seldom found in private companies because top management prefers to keep the power over the company in their own hands.

The all non-executive board composed entirely of outside directors is symptomatic of the supervisory board in the two-tier board model, to be discussed shortly. It is also frequently found in the governing bodies of not-for-profit organizations.

The role of the board of directors

The essential role of the board of directors is to direct the company. As we have seen, this is not the same as managing it.

Boards need to look forward and outward at the company in its commercial, competitive, market setting as it *formulates corporate strategies*, in the light of the economic, political and social context. Clearly the board works closely with top management in formulating these strategies although boards vary in the extent to which they initiate strategic changes themselves or discuss and approve strategies proposed by their management.

The board then needs to look inwards to *ensure that policies are in place* for these strategies to lead to appropriate management action. The board *sets the standards* for the entire organization: corporate ethics begins in the boardroom.

Boards also need to look at past and present performance to fulfill their responsibility *to oversee and supervise management*. Reporting on performance against key performance indicators (KPIs) and financial budgets are crucial board information.

Finally, boards have a fundamental duty *to be accountable to their shareholders* and other legitimate stakeholders. Corporate reporting is a fundamental duty of the board, in compliance with company law and other regulations. The classical financial accounts are increasingly being expanded to include integrated reports covering many other aspects of the company's performance, including employee policy, environmental concerns, and social responsibility to stakeholders affected by corporate activities.

Classic approaches to corporate governance around the world

Although the basic intentions of corporate governance around the world are similar, the means of achieving them vary considerably. Evolving history, culture, company legislation and corporate regulation affect the principles and practices of corporate governance in different countries.

Two rather different approaches have emerged in applying corporate governance principles and practices. The Western approach can be divided into three distinct models:

- The United States rule-based model
- The UK/Commonwealth principles model
- The continental European two-tier model

The Eastern approach falls into three basic models:

- The Asia family-based model
- The *keiretsu* model in Japan
- The *chaebol* model in South Korea

As we will see, China has created a unique model, drawing from both the Western and Eastern models. Let us now consider now the basic models of corporate governance that have provided the major influences.

Western approach

The United States unitary board, rule-based model

Companies in the US are incorporated in individual states and are subject to those states' company law and corporate regulation. Investor protection, auditing requirements, and financial disclosure of public companies, however, are federal responsibilities, predominantly overseen by the US Securities and Exchange Commission (SEC), which was created in 1934.

The basic governance model for public companies in the US is the unitary board, with a predominance of independent outside directors. SEC and stock exchange listing requirements also call for mandatory audit, nomination, and remuneration committees of the Main Board.

In the US, governance is regulated by legal statute and mandatory rules, which are inherently inflexible. Litigation levels are high. Directors face legal penalties for non-compliance. The 2002 Sarbanes-Oxley Act strengthened this emphasis on governance under penalty of law, with disclosure requirements that proved more expensive and burdensome than expected. The US financial markets are still among the best regulated, as well as being the largest and most liquid in the world; but that lead is being eroded.

The UK/Commonwealth unitary board, principles-based model

The law that recognized the incorporation of the joint-stock shareholder limited-liability company originated in the United Kingdom in the mid-nineteenth century. Membership of the old British Empire, in the later nineteenth and early twentieth centuries, meant that UK company law influenced the development of company law in Australia, Canada, Hong Kong, India, New Zealand, South Africa, Singapore, and indeed throughout what is now known as the Commonwealth.

Company law in the UK/Commonwealth model is based on common law, rooted in legislation, which is reinforced as the courts decide specific cases. However, by contrast with the US model, in the UK and in Commonwealth countries, corporate governance is "principles-based." Codes of corporate governance principle or good practice determine board responsibilities, not legal doctrine. Companies are required to report that they have followed the governance principles laid down in the codes or to explain why they have not. Consequently, this model is often referred to as the "comply or explain" approach to corporate governance. Self-regulation by each company, not the rule of law, is the underlying theme.

Compliance is voluntary, the sanctions being the exposure of corporate governance failings to the market and, ultimately, delisting from the stock exchange. Stock exchange regulations and company regulators ensure that investors and potential investors have accurate information on which to base their judgments.

Throughout the Commonwealth, corporate governance codes for listed companies; although differing slightly in detail, all call for independent non-executive or outside directors, audit, remuneration, and nomination committees of the board, and high levels of transparency and accountability. The codes also call for a separation between chairperson and CEO.

The Hong Kong approach to corporate governance mirrors the UK's unitary board, principles-based model, as we will explore in Chapter 3.

The continental European two-tier model

In the two-tier board model a supervisory board, with no management members, sits above the executive board, which comprises entirely executive (management) members. As the name suggests, the supervisory board oversees the work of the executive board and can hire and fire its members. Two-tier boards are required in Germany and The Netherlands and are found in France and Italy. In Germany, large companies are seen as a quasi-partnership between capital and labor. Reflecting this idea of social democracy, German co-determination laws require one half of the supervisory board to represent labor, the employee representative directors elected through the workers' trades unions; the other half, representing capital, is elected by the shareholders.

Typically, members of top management attend and report to their supervisory board. Critics of the two-tier model of corporate governance argue that the supervisory board is often dominated by top management and lacks the information inputs, advice, and wise counsel that can be provided by outside independent, non-executive directors in unitary boards. Other critics question the effectiveness of supervisory boards, their lack of real power, and their ability effectively to control the management board. Some also argue that the representative character of the supervisory board produces conflicts of interest.

For a while, countries that employed the two-tier board believed that this was a superior model to the unitary board. Indeed, the European Union once tried to impose the two-tier model on all companies in member states—a proposal that was strongly resisted in the unitary board countries.

Eastern approach

- The Asia family-based mode
- The *keiretsu* model in Japan
- The *chaebol* model in South Korea

*The Asian family-based model*³

Chinese businesspeople play a fundamental part in the business life of Southeast Asia, as a result of the Chinese diaspora from the Mainland over the years. Many companies in the significant Asian economies—Singapore, Taiwan, Malaysia, Thailand, Indonesia, Hong Kong, and the Philippines—are in the hands of Chinese families. For example, nearly half of the share capital invested in Malaysian companies is owned by Chinese residents.

In the governance of overseas Chinese companies, the board tends to play a supportive role to the real exercise of power, which is exercised through relationships between the key players, particularly between the dominant head of the family and other family members in key top management positions. Some of these companies are quite diverse groups with considerable delegation of power to the subsidiary units, but the owner-manager, or a family-orientated small group, still holding a strategic hand on the tiller.

Research into the management of companies owned by overseas Chinese has suggested some distinguishing characteristics about their management and governance. Such firms tend to be:

- family-centric with close family control;
- entrepreneurial, often with a dominant entrepreneur, so that decision-making is centralized, close personal links emphasizing trust and control;
- family inclusive with family members working in the family business;
- paternalistic in management style, in a social fabric dependent on relationships and social harmony, avoiding confrontation and the risk of the “loss of face”;
- strategically intuitive, the business seen as more of a succession of contracts or ventures, relying on intuition, superstition, and tough-minded bargaining rather than strategic plans, brand creation, and quantitative analysis.

Where such companies are floated on the stock market, the outside shareholders are often in the minority. Consequently, regulatory authorities tend to emphasize the importance of disclosure and the control of related-party transactions. Although many corporate governance codes require independent non-executive directors, the independence of outside directors is less important to the owner than are their character, trustworthiness, and overall business ability. Of course, corporate governance problems exist in Chinese and overseas Chinese companies: corruption, insider trading, unfair treatment of minority shareholders, and domination by company leaders, to name a few. But these are unfortunate attributes of corporate governance that reflect human behavior everywhere.

3. For more information on the business methods of overseas Chinese, see Redding, 1993.

The keiretsu model of corporate governance in Japan

In Japan, the *keiretsu* are networks of companies connected through cross-holdings and interlocking directorships. Member companies tend to inter-trade extensively. Frequently, the network includes a financial institution. The classical model of the *keiretsu* reflects the social cohesion within Japanese society, emphasizing unity throughout the organization, non-adversarial relationships, lifetime employment, enterprise unions, personnel policies that encourage commitment, initiation into the corporate family, decision-making by consensus, cross-functional training, and promotion based on loyalty and social compatibility as well as performance.

In the classical *keiretsu* model, boards of directors tend to be large and are, in effect, the top layers of the management pyramid. People speak of being “promoted to the board.” The tendency for managers to progress through an organization on tenure rather than performance means that the mediocre can reach board level.

Japan’s 2016 Corporate Governance Code overcame decades of resistance to the inclusion of independent outside directors on Japanese boards. The code took a pro-investor stance and emphasized that corporate governance should add to the long-term growth of the company. Two governance models were offered—one with a supervisory board, the other with an audit committee of a unitary board—both to have independent outside directors. A nomination committee and a nomination committee of the main board were also required.

Many Japanese still do not see the need for such intervention. Indeed, they have difficulty understanding how outside directors operate. How can outsiders possibly know enough about the company to make a contribution, they question, when the other directors have spent their lives working for the company? How can outsiders be sensitive to the corporate culture? They might even damage the harmony of the group.

The chaebol model of corporate governance in South Korea

Chaebol groups in South Korea developed following World War II, when the government advanced loans on attractive terms to family-based firms to stimulate economic revival. Over time, some of these family firms prospered and became large groupings of associated companies. Even *chaebol* companies that are listed are often still controlled by the dominant owner-family interests. Even though companies attracted outside capital, family domination was maintained predominantly through insider boards and cross-ownership with subsidiary companies.

Attempts to introduce independent outside directors into South Korean boards have had only limited effect against the entrenched power of the existing block owners. At times, this has led to protests from employees and social unrest. In recent years, the South Korean government sought to reduce the power of the *chaebol* by requiring them to divest some of their interests. But before the financial

and economic crisis of 1997, success was limited. Subsequently, the *chaebol* found it increasingly difficult to compete with other Asian producers, because of their tradition of lifetime employment and militant trade unions, and governance changes were forced on them.

The governance of companies in Southeast Asia has its own distinctive characteristics. The significance of the cultural context—the history, traditions, business methods, and law—is apparent. This is a key feature in understanding corporate governance in China.

China's approach to corporate governance

The Chinese approach to corporate governance is different. China has evolved a unique form of governance for both its SOEs and independent companies, as we will see in the following chapters. In the early stages of the market-orientated reforms, ideas were borrowed from the experience of Western countries, encouraged by the World Bank, the OECD, a club of mainly rich countries, and well-meaning US institutional investors.

But over the past 20 years, China has developed its own form of corporate governance, appropriate to a country in which the law, the judiciary, and the courts serve the state and are not an independent check on the legislature as in most democracies, as will be explored in depth in Chapter 3. Moreover, Chinese corporate governance has become a fluid learning system, not a set of laws, rules, and voluntary codes as is typical in many other countries. We will argue that the West now has something to learn from China.

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Case study

Alibaba China and investor relations

Alibaba Group Holding Ltd. is China's largest e-commerce group and processes more transactions each year than Amazon and e-Bay combined. Alibaba is a global leader in Internet-based businesses, offering advertising and marketing services, electronic payment systems, cloud-based computing, network services, and mobile communications. The group also provides wholesale and retail online markets. Gross revenues (excluding investment income) for the year to March 31, 2016 was RMB 10,143 million, or US\$15,686 million.

The Alibaba Group was listed in New York in 2014 raising US\$22 billion, the largest initial public offering on record; bankers handled the float claiming they had orders for more than 10 times that amount.

Alibaba has a strategic alliance with Ant Financial Services Group, to provide MYbank, one of China's first privately owned online banks; Sesame Credit, a credit-scoring service; and Koubei, which provides financial services to the China market. The Alibaba Group also has a strategic alliance with Suning to build on synergies in e-commerce, logistics, and online-to-offline (O2O) commerce, which draws potential customers from online channels to physical stores. Alibaba also runs DingTalk, a mobile group messaging tool for SMEs, and owns the Hong Kong English language newspaper *The South China Morning Post*. The hub of the group's European operations is in London. The international headquarters of Alibaba Cloud is in Singapore.

Cainiao is the Alibaba Group's logistics company, formed in 2013. It provides a China-wide parcel delivery system and offers next-day delivery in 50 cities for goods ordered from Alibaba's online marketplaces.

For more detailed information on the businesses of the Alibaba Group, see www.Alibaba.com.

The origins of Alibaba

Alibaba was founded in 1999 by Jack Yun Ma, a teacher of English from Hangzhou, the capital of Zhejiang Province on China's east coast. Ma created a website for the rapidly growing number of entrepreneurial, but relatively small, Chinese manufacturers, retailers, and exporters to sell their goods around the world. At the time Alibaba had 18 employees.

The founders saw that that the Internet could be used by smaller enterprises to compete in the global as well as the Chinese market against larger companies with well-established supply chains, distribution networks, and marketing outlets. Users of the Alibaba Internet services could apply their innovation, technology, and entrepreneurial skills more effectively.

In 2005, Alibaba acquired the China operations of US-based IT company Yahoo for a 43% stake in Alibaba. Prior to the New York listing in 2014, 43% of Alibaba shares were held by Yahoo, 28% by a Japanese IT company, Softbank, and 29% by Jack Ma and colleagues in top management.

At the time, Yahoo was losing market share in its American and other world-wide operations, so Alibaba became a jewel in its crown.

The Alipay saga

A significant component of the Alibaba Group was a business called Alipay, which was launched in 2004, to provide the online payment portal for transactions on Alibaba.com. It became the world's largest online payment system.

But in 2010, the Chinese government ruled that all Internet payment systems should be wholly owned by Chinese interests. Alipay did not qualify, because Alibaba was 71% foreign owned. Alipay risked losing its license to operate, which would destroy its business. Jack Ma then made a unilateral decision to transfer ownership of Alipay to a new entity—Zhejiang Alibaba e-commerce Ltd—which he and Shihuang Xie, his co-founder, controlled. Apparently, neither the Alibaba board nor Yahoo was informed at the time.

In March 2011, Yahoo and Softbank were told officially that Alipay had been spun off from Alibaba. Yahoo shareholders found out in May 2011 from an SEC filing, and the share price fell 10%.

When asked why he had bypassed the board, Ma apparently said that the Alibaba board seldom met formally and taking the matter to the board might have meant a delay, the loss of the license, and the end of Alipay. Alipay did obtain a license to operate as a Chinese-owned company in May 2011.

A formal agreement was ultimately signed between Alibaba, Yahoo, and Softbank for the transfer out of the Alipay business, involving a capital sum, an agreement on sharing profits, and licensing agreements.

The Alibaba Group's mission, vision, and values

Today the company has a clear mission statement:

To make it easy to do business anywhere

Which it achieves by providing:

the fundamental technology infrastructure and marketing reach to help merchants, brands and other businesses that provide products, services and digital content to leverage the power of the Internet to engage with their users and customers. Our businesses are comprised of core commerce, cloud computing, digital media and

entertainment, innovation initiatives and others. Through investee affiliates, we also participate in the logistics and local services sectors.

The company reinforces its mission statement with its vision that:

We aim to build the future infrastructure of commerce. We envision that our customers will meet, work and live at Alibaba, and that we will be a company that lasts at least 102 years [thus covering three centuries since its creation in 1999]. We enable hundreds of millions of commercial and social interactions among our users, between consumers and merchants, and among businesses every day. We empower our customers with the fundamental infrastructure for commerce and data technology, so that they can build businesses and create value that can be shared among our ecosystem participants. We strive to expand our products and services to become central to the everyday lives of our customers.

The group emphasizes the importance of its values and publishes a code of ethics, stating that “the conduct of all employees should reflect Alibaba Group’s values and promote a work environment that upholds and improves Alibaba Group’s reputation for integrity and trust.” For details of the code of ethics, go to: <http://alibaba-group.com/en/ir/governance>.

Corporate governance of the Alibaba Group

Alibaba is today a leader in its approach to corporate governance, not the least because it has to meet the demands of the US SEC and the listing rule of the New York Stock Exchange (NYSE). (For the latest SEC filing, go to http://www.alibaba-group.com/en/ir/pdf/agm160524_ar.pdf.)

The board has established corporate governance guidelines describing the principles and practices that it follows in carrying out its responsibilities. The corporate governance guidelines cover:

- The role and responsibility of the board
- Board composition, structure and policies
- Board meetings
- Committees of the board
- Expectations of directors
- Management succession planning
- Evaluation of board performance
- Board remuneration
- Approval of related-party transactions
- Equity incentive plans
- Communications with shareholders

To explore these guidelines more fully, go to: http://alibabagroup.com/en/ir/governance_1.

The **Board of Directors** currently has 11 members:

six executive or connected directors:

- Jack Yun MA Executive Chairman
- Joseph C. TSAI Executive Vice Chairman
- Daniel Yong ZHANG Director and Chief Executive Officer
- J. Michael EVANS Director and President
- Masayoshi SON Director
- Eric Xiandong JING Director

and five independent directors:

- Chee Hwa TUNG
- Walter Teh Ming KWAUK
- Jerry YANG
- Börje E. EKHOLM
- Wan Ling MARTELLO

Detailed biographies of each of the directors can be read at: <http://alibabagroup.com/en/ir/governance>.

The board has three standing committees:

- audit committee
- compensation committee
- nominating and corporate governance committee

Each committee has a published charter, which can be read together with details of the committee membership at: <http://alibabagroup.com/en/ir/governance>.

The corporate governance guidelines are reviewed periodically by the nominating and corporate governance committee to ensure that they continue to promote the best interests of the company and its shareholders and that they comply with all relevant laws, regulations, and stock exchange requirements and are in line with the company's memorandum and articles of association.

The Alibaba Group held its 2017 annual general meeting in Hong Kong to elect three directors and auditors. To encourage shareholders around the world to participate, the company provided a virtual shareholder meeting over the Internet. The company explained to its shareholders: "you can attend the meeting, view materials, and ask questions without leaving the comfort of your home."

Exercising governance power over the Alibaba Group

Shareholders do not own Alibaba directly. Ownership is covered by legal agreements with a company incorporated in the Cayman Islands. Power over that company is exercised by a somewhat opaque entity called the Alibaba Partnership.

Shareholders in Alibaba Group Holding Ltd. have few powers over the governance of their company. Their interests are sidelined; in the words of the *Economist*: “ordinary shareholders are supine.” The Hong Kong Stock Exchange (HKSE), which was approached first to list Alibaba, turned down the opportunity because of its listing rules, which require all shares to carry equal voting rights. Dual-class shares, one class able to maintain control even though they represent a minority of the equity, are not allowed.

New York has no such restriction. Indeed, many prominent US public companies, including some in Silicon Valley, have dual-class shares, with the founders owning shares with enhanced voting rights to maintain their control.

The Alibaba Group justifies the use of the Alibaba Partnership as the vehicle for exercising governance power over the company as follows:

Our partnership is a dynamic body that rejuvenates itself through admission of new partners each year, which we believe enhances our excellence, innovation and sustainability.

Unlike dual-class ownership structures that employ a high-vote class of shares to concentrate control in a few founders, our approach is designed to embody the vision of a large group of management partners. This structure is our solution for preserving the culture shaped by our founders, while at the same time accounting for the fact that founders will inevitably retire from the company.

The company further explained that, in the early days of Alibaba, the directors realized that their new business, built on innovation, technology, and harnessing of the Internet, had also created a distinct culture. As the company grew larger, more complex, moving into new businesses, the directors wanted to maintain this distinctive culture, because they felt it was fundamental to the group’s success.

From the outset, the company explained, directors and management had acted in a spirit of partnership, to serve their customers, develop their employees, and deliver long-term value to their shareholders. To preserve this spirit of partnership and to ensure the sustainability of the group’s mission, vision and values, the founders formalized the Alibaba Partnership.

The Alibaba Partnership currently has 32 members: 24 members of senior management, 7 members of management from Ant Financial Services, and 1 member of management from Cainiao Network. The number of partners is not fixed and can change from time to time. All partnership decisions are made on a one-partner-one-vote basis. The partnership is governed by a partnership agreement and operates under principles, policies, and procedures that have evolved with the business.

The group believes that the peer nature of the partnership enables senior managers to collaborate and override bureaucracy and hierarchy.

Questions for discussion

1. The Alibaba Group appears to meet the norms of good corporate governance, with one exception: shareholder rights. Is the Alibaba arrangement using the Alibaba Partnership to exercise governance control acceptable?
2. Do you believe that “one share one vote” should apply to investment in all companies listed on stock markets?
3. The HKSE does not allow companies with dual-class, different voting rights to list. Discussions continue on whether allowing companies with dual-class shares to list would encourage founders of successful start-up companies to make an IPO (initial public offering). Should the HKSE change its rules?
4. Is a shift towards protected insider rights likely to be a trend?
5. If you were on the board of the HKSE, how would you introduce dual-class shares in Hong Kong? (The HKSE introduced a trial of the weighted voting shares in latter 2018. Please refer to their latest webpage for more information. http://en-rules.hkex.com.hk/en/display/display_main.html?rbid=4476&element_id=5103.)

2

The Chinese Political and Economic History in Post-1980s and Corporate Governance

Gregg Li

In this chapter we consider:

- ❖ an aging population, migration to urban areas, a coastal nation
- ❖ domestic drivers of modern corporate governance practices in China
 - leadership and the direction of the political wind
 - sense of urgency and fear of the loss of control
 - a reference for history, culture, religion, philosophy, and ethics
 - the uncompromising drive against corruption
 - the strong push for innovation, entrepreneurship, and smart cities
- ❖ Deng's drive for modernization of the enterprises in the 1980s
- ❖ The birth of private firms
- ❖ The Chinese modern enterprise system

To understand China one has to begin with an appreciation of the rich and long history of China. Today, Chinese bureaucrats think in decades, not years, and in systems that can cater to billions of people, not thousands. Chinese leaders, made wiser with an understanding of history, also have realized that nothing is everlasting and anything can be changed with time and patience. A history of turbulence, politically and economically, since 1949 and leading up to the 1980s, has refined a leadership rank that favors political stability and continual economic growth over other priorities. Central to this is a working system of sound corporate governance for their modern Chinese enterprises because those systems can properly answer and balance authority, decision rights, incentives, and ownership; but China is still a communist country, or a socialist country with Chinese characteristics for that matter. Shared ownership is still the spirit, and decisions and accountability should be determined collectively, not individually. Chinese leaders see and understand interdependency and interconnectedness. That is why the discussions and feasible practices of corporate governance are so important, and different, and why the authorities are willing to experiment.

China is a land of contradictions, mystery, paradoxes, and inconsistencies. Politics and political awareness underpin nearly all facets of life, and sometimes,

3

The Evolution of Corporate Governance in China

Bob Tricker

In this chapter we consider:

- ❖ the political history behind the advent of modern China
- ❖ the corporate governance of SOEs in China
- ❖ the Chinese government's attempt to reassert control over SOEs
- ❖ the governance of private companies in China
- ❖ the development of corporate governance in Hong Kong
- ❖ one country, two systems of corporate governance

The political history behind the advent of modern China

As we saw in Chapter 2, the history, culture, and politics of mainland China created a unique context for the development of corporate governance with “Chinese characteristics.” In this chapter, we review the evolution of corporate governance in SOEs and private companies in China and contrast that with the development of corporate governance in Hong Kong. In subsequent chapters we will explore the reality of governance practices, review the state of play in all types of corporate enterprise in China, recognize the significance of board-level abilities and attitudes, and identify some ethical challenges. But first, we need to remember the immense political and economic changes that have occurred in China in just half a century.

The PRC was established in 1949, by Mao Zedong following the defeat of the Nationalist Army under Chiang Kai-shek and its retreat to Taiwan after the civil war of 1946 to 1949. Mao founded the PRC and remained chairman of the CPC from 1949 until his death in 1976.

Over that period, the state proclaimed ownership of the means of production, prohibited private property, and banned incorporated companies. In 1958, Chairman Mao initiated the Great Leap Forward, relocating millions of farmers, peasants, and city workers. Massive economic dislocation and famine resulted. The Cultural Revolution began in 1966 and lasted a decade. Communes were reorganized and SOEs were created, most relying on state subsidies.

Culture and Ethics in Chinese Corporate Governance

Bob Tricker

Gregg Li

In this chapter we consider:

- ❖ what culture is and why it is relevant to corporate governance
- ❖ Modern business ethics in China
- ❖ the essence of contemporary Chinese business culture
- ❖ corporate social responsibility with a Chinese face
- ❖ the effect of culture in overseas Chinese businesses
- ❖ insights into business ethics in modern China
- ❖ the influence of religion on the development of corporate governance
- ❖ the proliferation of Buddhist, Confucian, and Daoist thoughts in modern China
- ❖ comparison of Buddhism with Confucianism and Party ethics
- ❖ Communist Party ethics
- ❖ the need for a moral compass in Chinese corporate governance

What culture is and why it is relevant to corporate governance

Culture can be thought of as the social heritage of beliefs, expectations, and values that people share. Over the years, the culture of a country is influenced by its geography; its history of social, economic, and political change; and its religion. Culture is molded by situations that affect relations between individuals, institutions, and the state. Culture influenced by experience, education, and law, is reflected in the language, and is passed on by life in families and organizations. The culture of a country influences what is thought of as acceptable, important, and right or wrong. It affects how people think and act. It is fundamental to understanding corporate governance. For companies, culture means the way things have been done around the company. Often nebulous and unclear, culture would come to reinforce or slow down any corporate governance practices introduced by a board of directors.

In the late twentieth century, when ideas about corporate governance began to be discussed, much of the thinking and practice was influenced by countries that shared Anglo-American culture: a belief in the rule of law; the importance of the rights of individuals to personal freedom and ownership of property; individual

The Ecosystem and Regulatory Framework of Corporate Governance in China since 1978

Gregg Li

In this chapter we consider:

- ❖ the general ecosystem and the various participants since 1978
- ❖ the roles and interlinkages among these participants
- ❖ other forces that are shaping the governance of companies
- ❖ the first Code of Corporate Governance of 2002
- ❖ the 2006 Company Law and Securities Law¹
- ❖ other relevant legislation

Corporate governance has been completely rewritten since the reintroduction of the Four Modernizations in 1978 in China.² Over time, new institutions have been set up to regulate commerce and corporate governance.

China is still changing rapidly indeed, and its perception of good practices is being molded every day by local conditions, foreign ideas, and government policies but also by the Chinese government and the party. Many foreign investors have questioned the sanity and existence of corporate governance in China. Does it exist at all? The unequivocal answer is yes but unlike the way most from the West would understand it. Corporate governance has taken on a Socialist and a Chinese characteristic.

But corporate governance practices are quite different between that of an SOE and a non-SOE. Conversely, between a family-run private firm and one that is recently listed. As China evolves, we believe eventually there will be many different forms of corporate governance to reflect the many different types of institutions. The current Chinese institutions in place have helped to draw and attract organizations to acceptable norms and practices. Correspondingly, there isn't one best practice in corporate governance in China today but many, and eventually over time, each type of organization will find its own niche in its myriad forms.

1. Zhengquan Fa (证券法), 2007.

2. The Four Modernizations was introduced in government policy by Zhou Enlai in 1964 and reemphasized by Deng Xiaoping in 1978, stating that the top priority was to realize Four Modernizations.

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The Regulatory Framework of Corporate Governance in Hong Kong

Bob Tricker

In this chapter we consider:

- ❖ the evolution of corporate governance in Hong Kong
- ❖ corporate governance institutions
- ❖ the Independent Commission Against Corruption (ICAC)
- ❖ relevant professions
- ❖ nominated advisors (NOMADS)
- ❖ some classic corporate governance cases
- ❖ the Hong Kong Companies Ordinances
- ❖ Hong Kong Corporate Governance Code
- ❖ Hong Kong Stock Exchange Listing Rules
- ❖ Hong Kong Financial Reporting Council (FRC)
- ❖ core competencies for an effective director (HKIoD)
- ❖ influences for the future

The evolution of corporate governance in Hong Kong

We briefly mentioned Hong Kong's history in Chapter 3. That history proved to be fundamental to the development of corporate governance. Following their defeat in the First Opium War in 1842, China's Qing dynasty government was forced to cede Hong Kong Island to Britain. In those days Hong Kong was a barren place, known for its fishing and its pirates. The establishment of trading companies, known as the "hongs," led to the development of trade. Subsequently, China granted a further lease to the peninsula north of Hong Kong Island (Kowloon) and then further land (the New Territories) up to the border with China. At the time Britain was ruled by Queen Victoria, and Hong Kong became part of the British Empire.

Consequently, as Hong Kong developed, it came under the influence of British law, British commercial and banking practices, and British traditions. It had its own government bodies, its own law courts, and its own currency. By the later part of the twentieth century, after its liberation following the World War II, Hong Kong

Corporate Governance of Chinese Family Businesses

Gregg Li

In this chapter, we consider:

- ❖ the governance of family businesses in China
 - number of family businesses
- ❖ key challenges
- ❖ growth and succession
 - the mindset and psyche of the early founders of modern China
 - limited gene pool
 - government partnership or administrative control
 - succession: transferring power to the next generation
- ❖ characteristics of Chinese family businesses and family values
 - paternalistic governance
 - characteristics of enduring family businesses
- ❖ the East Asian experience: ownership, control, and dilution
 - the return of the sojourners outside China
 - successful multigenerational Chinese family businesses

The governance of family businesses in China

Family businesses have been a core contributor to the economic dynamo of China and bring a special challenge to the governance of these entities. As in other parts of the world, family businesses and entrepreneurs with family backing play a critical part in strengthening and stabilizing an economic ecosystem. Family provides the first source of finance and labor. But family businesses in China also bring different challenges, including potential nepotism, sibling rivalry, acrimonious fighting for inheritance, the need for family legacy and control, or the forced sale of businesses due to the death of the founder. These days it is very much about succession, as nearly 80% of the next generation has indicated their unwillingness to join, according to a Jiaotong University study. How power is distributed, shared, groomed, and

The Functions and Practices of the Board of Directors in China

Gregg Li

In this chapter we consider:

- ❖ what boards do: performance and conformance
- ❖ strategy formulation in Chinese companies
- ❖ policymaking in Chinese companies
- ❖ supervising executive activities in Chinese companies
- ❖ ensuring accountability in Chinese companies
- ❖ succession planning in China

What boards do: Performance and conformance

In Chapter 1, we saw that corporate governance involves overseeing management, ensuring that the enterprise is meeting its objectives, and running in the right strategic direction. In fact, governance has two basic complementary elements: overseeing performance and ensuring conformance. These two wax and wane based on the changing nature of the firm's business model.

The performance role involves working with senior management to formulate corporate strategy and develop corporate policy. The conformance role supervises management activities and ensures compliance with corporate governance norms, providing accountability to legitimate stakeholders.

In a unitary board, which has both executive directors and independent outside directors, the board is responsible for both performance and conformance activities. In the two-tier board system, the executive board is responsible for mostly management performance, while the supervisory board ensures mostly conformance. The degree of intensity and separation of functions between the executive board and the supervisory board has depended more on the maturity of the firm and the speed of change in the industry that provides the ecosystem.

In the system of governance designed for Chinese SOEs (described in Chapter 3), the responsibilities of the board of directors and the board of supervisors can be ambiguous and fluid. The main board, which has both executive directors and

The Governance of Chinese Companies Abroad

Bob Tricker

In this chapter we consider:

- ❖ the development of Chinese business abroad
- ❖ some classic cases of China's investment abroad
- ❖ China's experience of acquisition and merger
- ❖ China's investment in developing countries
- ❖ China's Belt and Road Strategy
- ❖ keeping governance control
- ❖ the governance of corporate groups
- ❖ board-level information for diverse groups
- ❖ transfer pricing, cost allocation, and tax planning
- ❖ balancing the needs of companies and the state

The development of Chinese business abroad

When China began its market-orientated reforms in the 1980s, no Mainland-owned companies were incorporated abroad. SOEs responded to demands from the state. Private companies were not allowed in mainland China.

In Hong Kong things were different. Many of the companies listed on the HKSE were incorporated in overseas tax havens. The major trading houses, such as Jardines, Swire, and Hong Kong Land, had interests abroad, as did other local companies. These subsidiaries offered products or services in the same line as their parent company, or were entrepreneurial attempts to make money, often in property. Two of the tallest skyscrapers in London,¹ for instance, are owned by Hong Kong companies.

Many of these subsidiaries operated in Singapore, Australia, or the UK, where English is spoken and company law was similar to Hong Kong's British-influenced law; many others were in countries in East Asia. None of them had a global brand, nor could they really be classified as multinational.

1. Nicknamed the "Cheese grater" and the "Walky Talky."

Corporate Governance in China in the Years Ahead

Bob Tricker

Gregg Li

In this chapter we consider:

- ❖ the context for change in corporate governance
- ❖ the basis of power in modern China
- ❖ the future control of Chinese enterprises
- ❖ drivers of change in corporate governance
 - the impact of changes in corporate financing
 - the impact of corporate restructuring
 - the impact of changes in the labor market
 - the impact of technological change
 - the impact of changes in societal expectations
- ❖ forces for change in Chinese corporate governance
- ❖ what the West might learn from Chinese corporate governance
 - let the bullets fly
 - The Chinese market is vast
 - explore, experiment, innovate
 - practical results not regulation in governance
 - enthusiasm but slow and consensual decisions
 - high-quality directors needed
 - treat CEOs as state employees
- ❖ corporate governance as a catalyst for economic growth
- ❖ the new “Xi” era of corporate governance

The context for change in corporate governance

For the first time in recent history, large and robust Chinese companies have the opportunity to extend their influence simultaneously eastward and westward: eastward into the North American markets, as Chinese companies become richer, stronger, and able to acquire multinational competitors; westward to Europe but also to the 65 other countries between China and Western Europe, now connected by China’s One Belt, One Road Initiative.

The future of corporate governance in China depends, obviously, on the future of China itself, and there lie many uncertainties—economic, political, and cultural. As China is a land of experimentation in the realm of corporate governance, we expect to see major changes and innovation in corporate governance that other countries just talk about.

The economic future depends on levels of economic growth, productivity, and the balance of trade—all of which hinge not only on what China can achieve but also on economic factors around the world. In China, the availability of an educated labor force given an aging population, the use of robotics in production, and the need for continuing development of technology, will be important. As of 2017, China has earmarked more money to spend on artificial intelligence than has any other nation in the world.¹ According to Accenture, China has filed more than 8,000 AI patents in the five years leading up to 2015, which represented a growth rate of 190% and which outpaced all other leading markets. Plans are in place to predict crimes, lend money without banks, provide credit based on a person's travel patterns, install driverless cars, and track citizens better with more powerful facial recognition software.

The political future is likely to be even more significant. Economic success needs political stability. Maintaining China's centralized one-party system of national governance calls for a subtle balancing of the changing expectations of a populace which is increasingly educated, affluent, and informed. "Smart city" policies provide ready access to information and ideas even though strictly regulated. Overseas education and travel also expand the knowledge base.

Central Government policymakers also have to balance regional calls for more local influence, for example, in Hong Kong and Western border territories. The success of the new Belt and Road Initiative also depends on stable relations with neighboring countries to the west and in the seas of South China and Japan.

Underpinning both the economic and the political future of China lies its cultural context: the way people think, their beliefs and their values. These are changing. The underpinning set of beliefs affects the way businesses are perceived and the way they are run. This is the relevance for corporate governance.

Inherent in a culture are beliefs about human values and behavior. In the past, Western thinking tended to place more emphasis on individual rights and duties, whereas in Eastern countries greater emphasis was put on the responsibility to the family, the community, and society. More recently, Western thinking shows signs of shifting in the Eastern direction, with more emphasis on a socially responsible society, as seen in the growing emphasis on corporate social responsibility, sustainability, and business ethics.

1. Daugherty (2017, July 30).

The basis of power in modern China

The governance of companies and other corporate entities in a country must be consistent with and form part of the overall governance of that country. In the United States, corporate governance is rooted in law and regulation, reflecting the vital underpinning that law provides in the US Constitution. The UK, by contrast, has no written constitution and corporate governance involves voluntary adherence to a corporate governance code, which is consistent with company law and embedded in the stock market rules.

In China, the law serves the people, represented by the Communist Party. The underlying philosophy, reflecting Lenin's concept of "democratic centralism," holds that the leaders of the party should not seek to dictate or lead, rather to provide guidance, direction, and influence in responding to the needs of the people who are represented by the party. The aim of corporate governance is **not** really about enhancing "shareholders'" value but about enhancing "societal values." It is indeed capitalism with a Chinese social characteristic.

The head of the party and the state is Xi Jinping, general secretary of the Communist Party of China, president of the People's Republic of China, and chairman of the Central Military Commission. The president works with the Politburo, whose members are drawn from the Central Committee, which is elected by the large National Congress of the Chinese Communist Party.

Xi Jinping operates with a group of colleagues organized into "small groups" or committees. There are, for example, small groups covering economics and finance, cyber security, anti-corruption, party-building, and Hong Kong and Macau affairs. There is also a small working group for "comprehensively deepening reform." Subsets of the small groups operate at the provincial level. In his book, *The Governance of China*, Xi Jinping describes the governance of China to be a "work in progress."

Below this summit sit the heads of the provinces, the top brass of the PLA, the judiciary including the law courts, government ministries, and government regulatory agencies, such as the bodies overseeing corporate governance: CSRC and SASAC.

Early approaches to corporate governance in China sought to maintain the state's overall power through command of the political agenda and the economy, while facilitating markets, innovation, economic growth, and the acquisition of personal wealth. This was communism with a Chinese face.

The future control of Chinese enterprises

If we adopt a simple definition of corporate governance as the way power is exercised over corporate entities, how is power currently wielded over Chinese businesses? Independent companies incorporated under the Companies Act face regulation by the CSRC. SOEs are supervised by SASAC. Other organizations relevant

to corporate governance in China include the Asset Management Association of China (AMAC), the China Association for Public Companies (CAPCO), and the China Institute of Finance and Capital Markets (CIFCM).

Companies listed on a stock market must also meet the listing rules of that exchange whether in China, Hong Kong, or abroad. Other laws and regulations, for example, on taxation, anti-corruption, and pollution, also affect business entities at the national, state, province, and local levels.

Owners of a business may also exercise considerable power; for example, in the case of a dominant founder owner. In SOEs, obviously, the state wields the ultimate power. When an SOE is listed, other investors, typically in a minority shareholder position, wield little influence. Powerful block holders or significant groups of institutional investors, frequently found in the West, do not yet exist in China.

In recent years, authorities in Beijing have felt that the corporate sector, though dramatically successful in building the economy and contributing to the restructuring of society, was increasingly running outside their control, which was not consistent with the country's underlying governance philosophy.

This was not surprising, given that China's companies acts and corporate governance procedures, including executive boards with independent directors and supervisory boards, were modeled on corporate governance practices in the US, the UK, and Germany, with advice given by the OECD.

The early days of corporate governance in China were influenced by Western practices. Those days are almost certainly over. Corporate governance in China is developing a distinctive Chinese face, reflecting the unique economic, political, and cultural situation. In the past, a company's allegiance to the state and the party were often maintained by having the local party secretary serve on the supervisory board, sometimes as its chairperson. But in practice, if the executive board was powerful and the company successful, the supervisory board may have had little influence.

An ongoing development is to give each company's Communist Party Committee (PC) a formal role in corporate governance. This is an attempt to re-exert state supervision of the corporate sector. In this model, each PC has a formal role in overseeing the performance of the company, to ensure that the state's needs as well as those of the shareholders are being met. The PC is appointed through the party's organization and is responsible upwards through the party hierarchy.

The PC represents the party within the company and monitors its activities. This broadens PCs' previous involvement in personnel matters and senior employee appointments. In SOEs the PC will be responsible for corporate governance matters.

The slogan "four meetings: one team" was coined to explain the workings of this new structure; the four meetings being: the PC, the executive board, the supervisory board, and the management team responsible for running the business. One significant policy suggestion was that board resolutions should be approved by the PC before being formally ratified by the board. But this idea was followed by the suggestion that the executive members of the executive board would also be

members of the PC. These ideas are still evolving. The intention is for the state to exercise oversight and, if necessary, control for the benefit of the people, without adversely affecting the raising of capital, the successful operation of the business, or the generation of wealth.

This structure for the governance of companies differs from that in the present companies act, as described in Chapter 3. In this model, the executive board, with at least one-third independent non-executive directors, is elected by the shareholders and the supervisory board with input from the employee representatives' meeting. The supervisory board is elected by the shareholders and the employee representatives' meeting. The executive board is then responsible for running the business. The new structure returns power to the party.

An updated corporate governance code is likely to be written reflecting this new reality of Chinese corporate governance. In due course, there may be calls for a rewrite of the Chinese companies act. In the future, China's approach to corporate governance might influence other countries where the state wants to maintain control of the business sector and restrain unfettered market freedom.

Drivers of change in corporate governance

A number of factors can drive changes in corporate governance policies and practices.

The impact of changes in corporate financing

The next decade or two are likely to see some significant changes to the way Chinese companies are financed, with some interesting corporate governance implications. The new listing boards of the Shanghai and Hong Kong exchanges that cater more to growth companies in the Fourth Industrial Revolution will inevitably enrich the ecosystem.²

China's stock markets are emergent. Unlike developed markets, they are principally retail, with individuals as customers who have no governance ambitions. To many of them, investment is a gamble—a means to make money.

Institutional investors tend to dominate advanced stock markets. In the Chinese market they are not yet highly significant. There are some, such as Changjiang Pension Insurance, China Universal Asset Management, the Huaxia Fund, the National Social Security Fund, and other institutions in Shanghai and Shenzhen. But they do not wield the power of Western institutional investors on issues such as major strategic decisions, or directors' remuneration.

Private equity in the West has transformed corporate governance power. There are no significant hedge funds or private equity investors to put pressure on

2. Schwab, 2016.

boards in China. Consequently, there is little shareholder activism; but awareness is growing. Retail investors are no longer shy and have taken listed companies to court.³ In the first-class action lawsuit, in 2015, 2,700 investors had won a judgment of RMB 180 million against the Foshan Electrical & Light Company for alleged misrepresentation.

However, the Chinese stock markets are becoming more mature, with retail customers more sophisticated, making decisions on a sober assessment of risk rather than gambling. The influence of institutional investors, based in mainland China, Hong Kong, and possibly overseas, is also likely to continue to increase. The growing closeness between the two Chinese stock exchanges and the HKSE will undoubtedly play an important role in this professionalization and market maturity.

Before 1997, much of the wealth came from abroad. By 2017, enormous wealth was coming from within China. Increasingly sophisticated Chinese investors with global ambitions are using Hong Kong to purchase companies and assets abroad. Similarly, Chinese domestic companies are increasingly using the HKSE to raise capital. Over 60% of the listed vehicles on the HKSE are now Chinese domestic firms. Before the handover in 1997, there were effectively none. Foreign capital coming into China has not dwindled either. In summary, the ecosystem has become much bigger, more sophisticated, and has more and diversified players.

New sources of finance are also likely to emerge, probably Internet-based and possibly from sources other than the stock markets and banks. The New Economy with its Fourth Industrial Revolution will need more capital and different forms of weighted voting rights, such as dual-class shares.

However, the state will continue to scrutinize and regulate cross-border monetary flows. The role of state-owned banks in providing finance for business is also likely to come under scrutiny from state regulators. At the other end of the spectrum, the China Investment Corporation (CIC), China's sovereign wealth fund, is slowly making an impact through its oversea purchases through its three subsidiaries: CIC International, CIC Capital, and Central Huijin. Large firms, those with hidden state ambition, will continue to push the boundaries. ChemChina bought Syntex; HNA (Hainan Air) is buying the whole world;⁴ CNOOC bought Nexen, a Canadian oil firm, and was still writing off the purchase. Dalian Wanda, Fosun, and Anbang have bought hotels, a Portuguese bank, and a Russian gold mine. Overpaying for trophy assets, without any synergistic purpose, however, appeared to have been common.⁵

The next decade or so is likely to see consolidation and reorganization of existing companies, promoted by merger and acquisition activity but regulated and sometimes sponsored by the state.

3. Zhu, Fei, & Cheng, 2017.

4. Weinland, Massoudi, & Fontanella-Khan (2017, July 30).

5. Chinese companies' weak record on foreign deals (2017, June 8).

The impact of corporate restructuring

In recent years some Chinese companies have formed strategic alliances with overseas companies to use their manufacturing technologies. Others have entered JVs to market products or services. Chinese firms are buying American AI companies, for example. Predictably, not all of these ventures have been successful. Some have been closed; others have been restructured or acquired by other firms.

But merger and acquisition activity within China to date has been spasmodic. In some cases the take-over process has come under scrutiny. For example, Evergrande and Baoneng companies were both criticized for aggressive take-overs using investments in their insurance companies.

Acquisition activity outside China, however, has been striking. Some SOEs have made significant acquisitions abroad, presumably with party approval. As cited, some Chinese entrepreneurs have invested in a range of companies such as hotel chains, a gold mine, and football clubs, without apparent strategic logic other than the possibility of quick returns.

In Western corporate governance, there is a “market for control,” which means that boards of listed companies know that predators constantly look for take-over opportunities. Consequently, these boards try to run successful companies and position themselves so that they are not prone to hostile bids. Regulators, meanwhile, try to prevent companies from taking measures that would protect them from such bids. No such market for control yet exists in China. The case of Vanke, described at the end of Chapter 5, is a vivid example of how the state is learning to mediate aggressive takeover activities.

The impact of changes in the labor market

China’s enormous economic success in recent years has relied on a vast and inexpensive labor force. The move from countryside to city provided the workers for the manufacturing industries. Now that is changing.

The development of robotics and automation replaces routine jobs and needs better-educated, more knowledgeable workers. Similarly, new service industries need better-educated employees. But the population is aging. The cohort of young people is smaller than in the past because of the one-child policy. A new middle class has also emerged with more affluence, education, and information than their parents had. Travel to Hong Kong and abroad has widened their horizons. They are aware of alternatives; expectations are inevitably changing.

This could lead to growing dissatisfaction with existing corporate governance processes. A sense of impotence could lead to calls for genuine employee participation, a new focus on labor relations, workers’ and women’s rights, and calls for greater transparency in business. In other words, the traditional acceptance of authority might be questioned, which the party would undoubtedly counter.

The impact of technological change

Information technology provides new opportunities for corporate governance practices everywhere in the world but particularly in China, where electronic interaction, not the least in smart cities, is widespread. Given China's full-scale push towards artificial intelligence, having a full AI machine advising a board of directors may not be that far off. The first such machine may just set its foot on a Chinese board. Klaus Schwab, the founder and executive chairman of the World Economic Forum, predicted this will happen by 2025.⁶

Opportunities for employing IT and AI are immense; for example, the delivery of information to top management and the other participants.

Clearly the corporate regulators and others in the party hierarchy could be included in the loop. Oversight and regulation of the business sector is, obviously, vital for centralized state oversight and control. Internet technology provides the means for monitoring activities and accessing information.

As boards become more conscious and aware, through AI, IOT (Internet of things), cognitive engines, and dynamic filtering, virtually everything that is done by management will be visible.

There are strict controls on the movement of data over China's national borders. Overseas companies are required to run their China-based activities on information systems based in China and to hold information on Chinese subjects only within China. This has significant implications for international companies wanting to connect their Chinese operations with their global systems. Clearly, this also affects corporate governance systems for handling reporting to senior management and directors.

Information technology also raises the possibility of rethinking business boundaries. In corporate governance, companies are defined by their financial and ownership structures. New thinking might also define businesses by the structure and boundaries of their information networks. The democratization of information and expectations on transparency that come with digital assets will give more power to shareholders and, in China's case, power to its citizens, government agencies, or the party to hold companies to account.

The impact of changes in societal expectations

People growing up in China during the past 20 years will have seen amazing changes in their world. In the process, they will have acquired new expectations about the future. Traditionally, Chinese society respected authority, wisdom, and old age. New thinking is now needed, as Chinese society becomes more conscious of its roles and impact in this changing world.

6. Schwab, 2016, p. 26.

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