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A case study of corporate governance practice of SMEs listed on ChiNext, China's Growth Enterprise Market

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Thesis submitted for the degree of PhD in Law

2014

Department of Law

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Declaration for SOAS PhD thesis

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A handwritten signature in purple ink, consisting of a large loop followed by a series of smaller, connected strokes.

Abstract

Launched in October 2009, ChiNext provides finance for hi-tech and innovative SMEs from China's Strategic Emerging Industries. SMEs with families, individuals and groups of individuals as controlling shareholders dominate listings.

Employing both qualitative and quantitative research methods with a socio-legal approach, this thesis examines the legal and regulatory framework and practice at company level emerging in a market dominated by private 'owner-managers'. The research makes three main contributions as follows.

Firstly, the thesis finds that social norms such as Chinese networks (*guanxi*) and Confucian filial piety (*xiaoshun*) play an important role in internal governance privately listed SMEs in ChiNext. Interestingly, large individual pre-IPO subscriber who hold non-executive directorships have the potential to and do constrain controlling shareholders through the use of *guanxi* arising from being key start-up or early investors in the company. Their effectiveness as a corporate governance mechanism may depend on how aligned their interests are with minority shareholders. Equally, filial piety plays a key internal governance role in (conflicting and complementary) parallel to the legal and regulatory corporate governance framework, not only in family-run listed companies but also in other private and State listed companies.

Secondly, the thesis finds that bottom-up corporate governance innovations occur in privately listed companies on ChiNext by adapting existing institutions or adopting non-mandatory requirements to their corporate framework. Results of the research demonstrates the emergence of a new category of supervisors sitting on the supervisory board at company level not expressly provided for under Chinese Company Law or corporate governance regulations.

Finally, the research observes two key mechanisms in support regulatory enforcement in the private listed sector, namely the media as a corporate governance watchdog on ChiNext based on its state role as public opinion supervisor (*yulun jiandu*), and China's public whistle-blowing system (*jubao*) as a voice for investors and stakeholders alike.

Dedication

For my parents Ebony Gwendolyn Olivia and Adeyemi Goodman (late)

and for my sister Adenrele Anna.

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Any errors contained herein are entirely my own, and for which I take full responsibility.

Contents

| | |
|---|-----------|
| <i>Abstract</i> | 2 |
| <i>Dedication</i> | 4 |
| <i>Acknowledgements</i> | 5 |
| <i>Contents</i> | 6 |
| List of Case Studies | 12 |
| List of Figures | 12 |
| List of Tables | 13 |
| <i>Chapter One - Theoretical Framework and Methodology</i> | 15 |
| I. Introduction | 15 |
| A. What is ChiNext? | 16 |
| B. Objectives of Research | 18 |
| C. Justification of Research..... | 19 |
| D. Delimitation of Research..... | 20 |
| II Corporate Governance Theory | 21 |
| A. Defining Corporate Governance | 21 |
| B. Legal Stewardship Theory | 23 |
| C. Economic Theories | 25 |
| D. Alternative Perspectives | 30 |
| III. Theoretical Framework | 34 |
| A. Defining Corporate Governance in China | 35 |
| B. Public and Private Corporate Governance Institutions and Mechanisms in China | 37 |

| | |
|---|------------|
| C. Corporate Governance in Listed SMEs | 41 |
| D. Securities Markets and Regulation | 43 |
| E. Institution-based and Process-based Analysis of Corporate Governance | 45 |
| IV. Methodological Framework | 46 |
| A. Quantitative Method: Identifying Trends | 47 |
| B. Qualitative Method: Case Studies | 49 |
| V. Summary of Chapters | 52 |
| <i>Chapter Two - Regulating ChiNext.....</i> | 55 |
| I. Development of ChiNext..... | 55 |
| II. Legal Governance Mechanisms and Framework of ChiNext..... | 59 |
| A. Capital Structure of ChiNext Companies: A Shares Only..... | 61 |
| B. People's Court as a Corporate Governance Mechanism..... | 64 |
| C. External Enforcement Mechanism: CSRC | 65 |
| III. Regulatory Mechanisms under the ChiNext Framework | 67 |
| A. Interim Measures for IPO and Listing 2009 | 70 |
| B. ChiNext Listing Rules | 74 |
| C. Internal Governance under Company Law and Securities Law | 78 |
| D. Duties of Directors, Supervisors, Controlling Shareholders and de Facto Shareholders | 86 |
| IV. Key Developments in Corporate Governance as Reflected in ChiNext Framework | 88 |
| A. Empowered Role of the Board Secretary | 88 |
| B. Sponsors | 91 |
| C. Heightened Information Disclosure Obligations for Particular Constituents | 93 |
| D. Mandatory Disclosures and Independent Opinions | 96 |
| V. Evaluative Summary | 100 |
| Closing remarks..... | 106 |

Chapter Three - Private Ownership and Corporate Governance Practice on ChiNext.... 108

I. Who Controls ChiNext Companies? Trends in Share Ownership on ChiNext..... 109

A. Family Ownership 111

Case study: Husband and Wife Partnerships..... 112

B. Individual Controlling Shareholder 118

Case study: Entrepreneur-founder..... 118

C. Affiliated Individuals as Controlling Shareholders 122

Case study: Covenants to Act in Concert..... 123

D. State as Controlling Shareholder 126

Case Study: State-Private Joint Ventures 127

II. Non-controlling Shareholders on ChiNext? 131

A. Venture Capital Investors - Cornerstone of ChiNext Investment? 133

B. Private Equity Investors 139

C. Institutional Shareholders 140

D. Individual Investors..... 148

E. Foreign Investors 153

III.How Engaged are Shareholders of ChiNext Companies?..... 154

A. Shareholders' Meetings as a Forum for Engagement..... 154

B. Increased Meetings Equal Increased Shareholder Engagement?..... 158

C. Voting: One-share-one vote 161

D. Shareholder Proposals at General Meetings 169

IV. Evaluative Summary..... 172

Closing Remarks..... 181

Chapter Four - Internal Governance Mechanisms on ChiNext 184

I. Emerging Management Structure Trends on ChiNext 185

II. How Engaged is the Board in Decision-making and Monitoring? 186

| | |
|--|------------|
| A. Size and Composition of the Executive Board | 187 |
| B. How Professional is the ChiNext Executive Board? | 201 |
| C. Board Committees | 202 |
| D. Corporate Conduct | 205 |
| Case study – To Resign or Not to Resign | 208 |
| III. How Independent is the ChiNext Board of Directors? Independent Directors | 211 |
| A. Who are the INEDs in ChiNext Companies? | 212 |
| B. Skill and Experience | 214 |
| C. Bringing Independence to ChiNext Board | 215 |
| D. Monitoring and Provision of Independent Opinions | 217 |
| E. Attendance as an Indicator of Effectiveness? | 219 |
| Case Study: Wang Kaitian | 220 |
| IV. Supervisory Board | 223 |
| A. Composition and Appointment | 224 |
| B. Size of the Supervisory Board | 226 |
| C. Skill and Experience | 227 |
| V. Board Secretary | 229 |
| A. Selection and Appointment | 230 |
| B. Skill and Expertise | 231 |
| C. Quasi-independent Role | 233 |
| D. Disclosure Obligations | 234 |
| Case Study: A Senior Management Role? | 235 |
| VI. How Engaged is the Management Structure of ChiNext Companies? | 238 |
| A. Increased Engagement in Decision-making | 239 |
| B. Confucian Ideals and Board Governance | 241 |
| C. Undesirable Corporate Conduct | 244 |
| D. Independence of the Board | 245 |

| | |
|---|-------------------|
| Closing Remarks..... | 250 |
| <i>Chapter Five - Enforcement Mechanisms on ChiNext</i> | <i>252</i> |
| I. Trends in Corporate Governance Compliance | 252 |
| A. Disclosure Compliance | 253 |
| B. Related Party Transactions | 258 |
| C. Guarantees | 261 |
| D. Insider Trading | 264 |
| II. Reality Enforcement of Corporate Governance on ChiNext..... | 266 |
| A. CSRC and Enforcement Tools on ChiNext..... | 267 |
| B. Role of Shenzhen Stock Exchange | 283 |
| C. New Delisting Regime to Suit Profile of ChiNext Companies..... | 295 |
| D. Missing Link: Role of Intermediaries in Enforcement - Sponsors | 301 |
| III. Role of the Press | 304 |
| A. Media and Corporate Governance..... | 306 |
| B. Public Opinion Supervision and Corporate Governance on ChiNext..... | 307 |
| C. The Press, Public Whistleblowing, CSRC and Exchange | 308 |
| D. Limitations of the Media in Corporate Governance | 309 |
| IV. China's Public Whistleblowing System (<i>jubao</i>) | 311 |
| A. Origins of <i>Jubao</i> | 311 |
| B. Role of <i>Jubao</i> in Corporate Governance: Potential Voice of (Retail) Shareholders | 312 |
| C. Limitations of <i>Jubao</i> | 313 |
| V. Wither the Market for Control and Private Ordering..... | 314 |
| A. Market for Control | 314 |
| B. Private Ordering: Litigation and the Courts | 315 |
| Closing Remarks..... | 317 |
| <i>Chapter Six - Corporate Governance Practice on ChiNext</i> | <i>319</i> |

| | |
|--|------------|
| I. What is the Most Effective Type of Shareholder for ChiNext Listed SMEs? | 320 |
| A. Limitations of Institutional Shareholders in Privately Controlled Listed SMEs | 321 |
| B. Proposing Pre-IPO Individual Subscribers as Effective Corporate Governance Mechanisms | 322 |
| C. Confucian Filial Piety (<i>Xiaoshun</i>) and Corporate Governance | 323 |
| D. Relationships (<i>Guanxi</i>) and Corporate Governance | 330 |
| II. What Accounts for the Influence of pre-IPO Individual Subscribers cum NEDs?..... | 334 |
| A. Effectiveness of pre-IPO Individual Subscribers cum NEDs | 334 |
| B. Pre-IPO Individual SNEDs vs INEDs | 340 |
| III. How Individual SNEDs Contribute to Executive Board Effectiveness?..... | 342 |
| A. An Empowered and More Effective Supervisory Board | 343 |
| B. Empowering Independent Directors | 345 |
| IV. Self-regulation by Controlling Shareholders | 346 |
| A. Legal, Regulatory and Contractual Undertakings | 346 |
| Closing Remarks..... | 352 |
| <i>Chapter Seven - Conclusion</i> | 353 |
| I. Contributions to Literature | 353 |
| A. Privately Controlled Listed Companies..... | 354 |
| B. Family-controlled Listed Companies | 354 |
| C. Individual pre-IPO Investor as a Key Corporate Governance Mechanism..... | 356 |
| D. Enforcement Mechanisms with Chinese Characteristics..... | 357 |
| II. Recommendations for Policy and Practice | 358 |
| A. Specific to China | 358 |
| B. Specific to Growth Enterprise Markets | 359 |
| C. Implications for Methodology | 360 |
| D. Limitations of Research | 360 |
| III. Implications for Further Research..... | 361 |

| | |
|--|-------------------|
| Conclusion | 361 |
| <i>Appendices</i> | <i>363</i> |
| Appendix 1 - List of Surveyed Companies with Industry and Type of Controlling Shareholder¹ | 363 |
| Appendix 2 - List of Main Interview Questions Categorised by Type of Interviewee | 366 |
| <i>Bibliography</i> | <i>370</i> |
| English language..... | 370 |
| Chinese language | 382 |

List of Case Studies

| | |
|---|------------|
| <i>Case study 1: The Husband and wife ‘army’ (fuqibing) – Beijing Toread Outdoor Products Co. Ltd.</i> | <i>112</i> |
| <i>Case study 2: Case study – Dinghan Tech Limited</i> | <i>118</i> |
| <i>Case study 3: Wuhan Zhongyuan Huadian Science & Technology Co. Ltd.</i> | <i>123</i> |
| <i>Case study 4: Case study of board of directors on a state-private joint venture</i> | <i>127</i> |
| <i>Case study 5: Wangsu Science & Technology Co. Ltd.</i> | <i>208</i> |
| <i>Case study 6: Wang Kaitian</i> | <i>217</i> |
| <i>Case study 7: Varying notions of independence in an SOE</i> | <i>220</i> |
| <i>Case study 8: Empowering the role of the board secretary.....</i> | <i>235</i> |
| <i>Case study 9: Suzhou Goldengreen Technologies Ltd.</i> | <i>284</i> |

List of Figures

| | |
|--|------------|
| <i>Figure 1: Legal internal governance structure of all companies listed in China</i> | <i>59</i> |
| <i>Figure 2: Regulatory framework of ChiNext</i> | <i>69</i> |
| <i>Figure 3: Listing process and timing on ChiNext.....</i> | <i>73</i> |
| <i>Figure 4: Internal governance structure of companies listed under the ChiNext framework</i> | <i>102</i> |

| | |
|---|------------|
| <i>Figure 5: Husband and wife family controlling shareholders of Beijing Tread Out ownership structure</i> | <i>113</i> |
| <i>Figure 6: Beijing Dinghan Electric Technology Co. Ltd. ownership structure</i> | <i>119</i> |
| <i>Figure 7: Multiple persons acting in concert - Wuhan Zhongyuan Huadian Science & Technology Co. Ltd.</i> | <i>124</i> |
| <i>Figure 8: Lepu Medical Technology (Beijing) Co. Ltd. state and private joint venture ownership structure</i> | <i>128</i> |
| <i>Figure 9: Ratio of institutional shareholders to individual shareholders holdings in free-floating shares on ChiNext as of 31 December 2009, 2010 and 2011</i> | <i>131</i> |
| <i>Figure 10: Average composition of the board of directors</i> | <i>189</i> |
| <i>Figure 11: State-owned ownership and asset management structure of CISRI Gaona Co. Ltd.</i> | <i>221</i> |
| <i>Figure 12: Ultrapower Software Co. Ltd. ownership structure</i> | <i>236</i> |
| <i>Figure 13: Communist Party of China members on board of directors</i> | <i>248</i> |
| <i>Figure 14: Illegal RPTs by Shanxi Zhendong Pharmaceutical Co. Ltd.</i> | <i>291</i> |

List of Tables

| | |
|---|------------|
| <i>Table 1: Survey of emerging trends in controlling share ownership trends of first 40 companies listed on ChiNext (the ‘surveyed companies’) as of 31 December 2009.</i> | <i>110</i> |
| <i>Table 2: Percentage of free-floating shares held by institutional investors on ChiNext</i> | <i>141</i> |
| <i>Table 3: Annual and interim shareholders’ meetings held by ChiNext companies</i> | <i>155</i> |
| <i>Table 4: Percentage of companies with shareholders physically present at AGMs</i> | <i>159</i> |
| <i>Table 5: Percentage of surveyed companies using online voting at annual general meetings</i> | <i>166</i> |
| <i>Table 6: Percentage of shareholders in attendance at meetings with attendance</i> | <i>170</i> |
| <i>Table 7: Ownership and control of the executive board of surveyed companies</i> | <i>190</i> |
| <i>Table 8: Number of meetings of the board of directors during the year of surveyed companies</i> | <i>196</i> |
| <i>Table 9: Average percentage attendance of board meetings of ChiNext listed companies by INEDs</i> | <i>215</i> |
| <i>Table 10: Percentage attendance of executive board meetings by independent directors (INEDs) in surveyed companies</i> | <i>220</i> |
| <i>Table 11: Average number of meetings of supervisory board of surveyed companies</i> | <i>223</i> |
| <i>Table 12: The average number of meetings of the boards of directors and supervisors and audit committee per year of surveyed companies</i> | <i>240</i> |

| | |
|--|------------|
| <i>Table 13: Percentage of companies disclosing an engaging in RPTs and issuing guarantees surveyed</i> | <i>263</i> |
| <i>Table 14: (Self) investigations imposed by CSRC on ChiNext companies as disclosed in annual reports of surveyed companies</i> | <i>273</i> |
| <i>Table 15: Percentage of companies with enforcement actions disclosed in annual reports of surveyed companies.....</i> | <i>316</i> |

Chapter One – Theoretical Framework and Methodology

I. Introduction

China aims to maintain a relatively high economic growth rate in order to rapidly transition into an industrialised market economy. One pathway to achieving this has been to focus on developing hi-tech and innovative strategic emerging industries. The establishment of ChiNext, a growth enterprise market, presents a key strategy that targets hi-tech and innovative small and medium-sized enterprises ('SMEs') that fall into these industries by providing them with much needed financing. Another pathway has been the promotion of corporate governance in companies listed on stock exchanges in China. One of the reasons for raising the importance of corporate governance is to promote a 'harmonious society' in China. Good corporate governance also enhances firm performance, which ultimately results in economic growth at the macro level. In addition, it will attract foreign investors, with the objective of internationalising China's equity markets.

Thus, the domestic focus on corporate governance implementation and enforcement in China has never been more apparent than in the SMEs applying and obtaining a listing on ChiNext. Indeed, ChiNext can rightly be perceived as a showcase of corporate governance in China in the twenty-first century. This thesis examines the nature of corporate governance practice on ChiNext from a legal perspective through case studies.

Chapter One is divided into five sections, with the first section providing an overview of ChiNext and its development. Section II delves into the key theories of corporate governance. Section III presents the theoretical underpinning of the thesis, while Section IV presents the methodological framework. Finally, Section V provides a summary of each chapter.

A. What is ChiNext?

ChiNext was officially launched and open for trading on 30 October, 2009, to provide capital market funding for China's innovative and hi-tech small and medium-sized enterprises. SMEs are generally perceived as economic drivers and, therefore, important to emerging economies.¹ China has focused on promoting its domestic SMEs for this reason, but also because, compared to large enterprises, SMEs are highly innovative and have growth potential. The SMEs chosen for listing on ChiNext fall within the Chinese government's Strategic Emerging Industries (SEIs). They include new energy, new materials, information technology, biomedicine, green technology, advanced manufacturing, hi-tech, ocean-related technology and innovative businesses in other sectors. Thus, the SMEs listed on ChiNext are deemed to be hi-tech and innovative with core competences and growth potential.

The seeds for developing ChiNext were, arguably, only planted in a competitive impulse when, in 1998, the Hong Kong Stock Exchange submitted a consultative paper for the establishment of its own growth enterprise market based on the US NASDAQ model, which opened for business later that year. After a decade of deliberation, urgency for a growth enterprise market re-emerged with the financial crises, and this time transformation of China's economic model took precedence, with SMEs tasked with a key role.

A well-publicised economic policy in China is to steer the economy from export-led growth and re-focus on consumer-led growth. China's SMEs make key contributions to China's domestic economy, not only in providing goods and services but also in terms of employment. The creation of these stock markets sits well with China's ambitions to become a global hub of finance. The trend toward globalisation means that investors are seeking investment opportunities all over the globe in the form of direct investments and investing in

¹ See, Charles Harvie and Boon-Chye Lee, eds., *The Role of SMEs in National Economies in East Asia*, Studies of Small and Medium Sized Enterprises Series (Cheltenham: Edward Elgar, 2002). See also the series of studies by Charles Harvie and Boon-Chye Lee between 2002 and 2007 of mostly unlisted SMEs in East Asia, from an economic perspective.

securities markets.² China is making its SMEs accessible through listing, but investor confidence and regulatory compliance by enterprises are integral. As such, corporate governance is now firmly on the political agenda.

In general, SMEs are important in emerging economies such as China because they assist in industry restructuring, employment growth, as a source of competition for large enterprises, be they state-owned or private, for improving skills, increasing flexibility and innovation.³ This is of great importance as China refocuses on building demand in the domestic economy. In addition to these strategic advantages of SMEs, they also have the potential to contribute to the promotion of regional trade and investment within the local economy, especially in China with its urban-rural growth disparity. According to the Shenzhen Stock Exchange, China's domestic SMEs are responsible for 60% of China's gross domestic product (GDP), 70% of exports and 80% of urban employment, and they hold 70% of patents for technology inventions.⁴ The trend toward globalisation also means that investors are seeking investment opportunities all over the globe in the form of direct investments and investments in securities markets⁵

So far, ChiNext has proved itself: in the first year of business, 134 SMEs listed on ChiNext raised US\$14.8 billion.⁶ Foreign financial institutions such as Goldman Sachs and investment vehicles of foreign organisations such as Columbia University increasingly invest on ChiNext, making handsome returns on their investments.⁷ However, the ability to be a successful equity market delivering on its objectives for China in the long term will depend

² Yuwa Wei, *Securities Markets and Corporate Governance: A Chinese Experience* (Farnham: Ashgate, 2009).

³ Henry Wan Jr., "SMEs in the Globalised Developing Economies: Some Asia-Pacific Examples," in *Globalisation and SMEs in East Asia*, edited by Charles Harvie and Boon-Chye Lee, Studies of small and medium size enterprises in East Asia v.1 (Cheltenham, UK: E. Elgar, 2002).

⁴ Shenzhen Stock Exchange, Small is beautiful, Focus No213 (publisher WFE, November 2010): 3 to 7 at page 3.

⁵ Yuwa Wei, *Securities Markets and Corporate Governance: A Chinese Experience* (Farnham: Ashgate, 2009).

⁶ Shenzhen Stock Exchange, Small is beautiful, *Focus*, No.213 (publisher WFE, November 2010): 3.

⁷ RefKe Zhihua, "QFII de'er da fu jianchi dichan gu [QFII Huge Sell-off of Property Shares: Columbia University Loves ChiNext Most]," News, *Dongfang Zaobao [Eastern Morning Paper]*, (August 9, 2011), url: http://epaper.dfdaily.com/dfzb/html/2011-09/08/content_527198.htm.

on the investment protection afforded investors, whether foreign or domestic, and whether institutional or individual.

B. Objectives of Research

The main objective of this research is the examination of company-level practice and the legal and regulatory enforcement of corporate governance in SMEs listed on ChiNext.

The research aims to make three main contributions.

Firstly, the thesis proposes that institutional shareholders may not necessarily be the most effective mechanisms for shareholder activism in listed SMEs in China. This thesis proposes that individual (large) shareholders who subscribe before the initial public offer of the company, and crucially hold non-executive directorship on the board of directors, present a more effective mechanism, especially when their interests align with those of the other shareholders of the company. In this examination, the thesis proposes that Chinese ‘relationships’ (*guanxi*), as a key source of empowerment for this type of shareholder, enable an effective check and balance on private controlling shareholders.

Secondly, it proposes that bottom-up corporate governance innovations occur in China’s corporate governance environment. The results of the research demonstrate the emergence of a new category of supervisors sitting on the supervisory board at the company level clearly not provided for under Chinese Company Law or any corporate governance regulations.

Finally, it also proposes that the dynamics of regulation change depending on whether the listed regulated entity is state-owned or private controlled, with the regulations becoming more effective, and the listed companies more compliant.

In general, this research amounts to the first comprehensive case study of the corporate governance of privately controlled SMEs listed in China, which identifies the less-

discussed mechanisms of corporate governance. Thus, in addition to an examination of the role of the media as public opinion supervisor on an equity market, the study contributes an analysis of the supportive role that China's public whistleblowing system (*jubao*) plays in corporate governance, especially in terms of the voice of the stakeholder.

C. Justification of Research

There are three justifications for this research. Firstly, understanding corporate governance issues and dynamics on ChiNext is invaluable since its objective is to foster SMEs in hi-tech and innovative industries that will assist in the transformation of China's economic model from an export-led to a domestic consumption-led model. SMEs, be they listed or unlisted, are an important component of China's economic growth. Therefore, the SME board on both the Shenzhen and Shanghai Stock Exchanges, along with ChiNext, are pivotal in providing much needed funding to these businesses. Indeed, listed SMEs today may be China's listed multinationals tomorrow.

Secondly, privately controlled listed companies have overtaken and now dominate listings equity markets in China's. However, as will be demonstrated later in this chapter, the literature mostly focuses on corporate governance issues relating to state-owned enterprises. This thesis redresses this balance by focusing on ChiNext, which happens to be dominated by private sector listings.

It plays a key role in providing finance for China's expansive private sector. Gurmeet, Bhabra and Powell attribute this lack of private financing to a bias in favour of state-owned enterprises ('SOEs') in China's banking system and the absence of venture capital funding.⁸

⁸ Gurmeet Bhabra and Jian Shi, "Financing Issues: SME IPOs in China and Australia," in *Globalisation and SMEs in East Asia*, edited by Charles Harvie and Boon-Chye Lee, Studies of Small and Medium Size Enterprises in East Asia (Cheltenham, UK: E. Elgar, 2002): 96.

These two facts naturally raise questions about corporate governance practice as it is well documented that the size and source of the funding of companies affect the corporate governance issues that emerge.

Fourth, understanding corporate governance practice on ChiNext becomes important for present and future international and domestic investors. Finally, the previous justification can also be linked to the increasing investments by China's listed companies, which makes it imperative to understand their corporate governance practices since they will be effectively exporting their models to the countries in which they operate, located in South Asia, Africa and South America. ChiNext has proved an important source of funding for SMEs in China that are geared to be the international and multinational companies of the future.

D. Delimitation of Research

Due to the broad nature of corporate governance theory and practice, clear boundaries have been set for this study. The thesis focuses on privately controlled SMEs listed on ChiNext, almost to the exclusion of state controlled SMEs. The reason for this is that, for the first time, the private sector, in the form of individuals, families and legal entities, has dominated an equity market in China from the outset.

In terms of corporate governance mechanisms, analysis of fiduciary duties, which are a key to the promotion of desirable corporate conduct, are only referred to insofar as it gives context to the issues of corporate conduct raised in the case studies. Equally, the examination of remuneration has been excluded because the market for professional management remains underdeveloped. Moreover, most of the companies listed on ChiNext are privately controlled and tend to be managed by those who control most of the total voting rights. Equally, the thesis does not employ cash-flow rights as a means of assessing control and private benefits as used in the law and finance and law and economic analyses. Instead, reflecting a legal

perspective, total voting rights and roles held in management and significant influence in the company are employed to measure control in corporate governance terms.

Lastly, the use of case study research methods results in a socio-legal approach and precludes in-depth doctrinal analysis of the suitability of laws, which, in any event, gives a limited analysis to corporate governance studies. Consequently, the literature review and main body of the thesis do not directly encompass the aforementioned areas.

II Corporate Governance Theory

As stated in the preceding section, the examination of corporate governance practice on ChiNext using a case study approach forms the basis of this study. Thus, the fundamentals of corporate governance theory stand as the most appropriate point of departure in preparation for understanding and giving theoretical context to the results of the case studies undertaken in the chapters that follow. To accommodate a comprehensive discussion of the key theories and model of corporate governance, this section is divided into five sections, which examine theories of corporate governance that span the legal, economic, societal, organisational and political.

A. Defining Corporate Governance

Corporate governance is a dynamic area in both theory and practice, with a foray into English language literature providing various definitions of corporate governance depending on the objective or perspective of analysis as reflected in the taxonomies of corporate governance mentioned below.

In the late eighteenth century, Adam Smith, in his eminent treatise, *Wealth of Nations*, wrote:

The directors of companies, being managers of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance which the partners in a private copartnery frequently watch over their own.⁹

Although the term *corporate governance* was not used, Smith's writing nonetheless presents a separation of the ownership of shareholders¹⁰ and the control of managers as a key issue at the time, which continues in contemporary corporate governance theory and practice today.

The most prominent definition of corporate governance is by the UK Cadbury Report, which states that,

Corporate governance is the system by which companies are directed and controlled.¹¹

An equally prominent definition, and one particularly favoured by Chinese policy makers and legislature,¹² is that of the Organisation for Economic Cooperation and Development (OECD), which defines corporate governance as 'Procedures and processes according to which an organisation is directed and controlled.'¹³

⁹ Adam Smith, *The Wealth of Nations*, Everyman's Library (London: New York: Dent; Dutton, 1910), vol. 1: para. 107.

¹⁰ In law, shareholders do not actually have 'ownership' but rather hold interests in shares of the company.

¹¹ *Financial Aspects of Corporate Governance* (Report of the Cadbury Committee, 1992): para. 2.5. See, Chao Xi, *Corporate Governance and Legal Reform in China* (London: Wildy, Simmonds & Hill Pub, 2009).

¹² For example, the China Securities and Regulatory Commission (the 'CSRC'), which oversees and regulates China's capital markets.

¹³ See, Organisation for Economic Co-operation and Development, "OECD Principles of Corporate Governance" (OECD Publications Service, 2004). See also James Feinerman, "New Hope for Corporate Governance in China?," *The China Quarterly*, v. 191 (September 2007): 590-612. In contrast, OECD guidelines have been criticised because, when applied to emerging, developing or transition economies, they cover too broad a range of rules and principles without specifying clear priorities. See, Erik Berglöf and Ernst-Ludwig Von Thadden, "The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries," *William Davidson Institute Working Papers Series*, no. 263 (June 1999): 31. url: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183708. This is very interesting, especially since the Party and State now prefer that international standards are applied to China rather than regional or country standards, as represented in the slogan *guoji jiegui*. Hongying Wang, "'Linking Up with the International Track': What's in a Slogan?," *The China Quarterly*, v.189 (2007): 1-23, doi:10.1017/S0305741006000774..

This thesis takes a legal approach in examining corporate governance practice on ChiNext. Thus, this section outlines the legal aspects of corporate governance and reflects the issues raised and discussed later in the thesis. Legal scholarship on corporate governance has developed over 20 years, with a focus on examining the law governing the conduct of directors and shareholders of companies.¹⁴ Apart from scholarship, there are also legal models of corporate governance as discussed in the next section. Research in corporate governance is not limited to legal scholarship but also includes management and political science, with economics being the most prominent area studied. Multi-disciplinary approaches have also gathered pace.¹⁵ Legal scholars have also increasingly embraced empirical approaches to corporate governance.¹⁶ The next section examines the only corporate governance theory developed out of legal theory and practice, which essentially reflects and attempts to meet the concerns expressed by Smith: legal stewardship theory.

B. Legal Stewardship Theory

Legal stewardship in the UK and the separation of ownership and control expressed by Smith were dealt with in the English Common Law stewardship theory and model, which comprised, among other laws, fiduciary duties developed by the law courts in England. The stewardship model originated in mid-nineteenth-century industrial England and was enacted in law.¹⁷ In the context of a free market and a relatively non-state interventionist economy, the law attempted to regulate conflicts while facilitating the economic activities of

¹⁴ For example, B.R. Cheffins, "Does Law Matter - The Separation of Ownership and Control in the United Kingdom," *J. Legal Stud.*, v.30 (2001). Douglas M. Branson, *Corporate Governance* (Charlottesville, US: Michie Co., 1993).

¹⁵ For example, the most famous is the 'law matters' debate contributed to by both law, finance and economics scholars.

¹⁶ For example, Benjamin L. Liebman and Curtis J. Milhaupt, and economics scholars. in ChinaL. Liebman and Curtis J. *Columbia Law Review* 108, no. 4 (May 1, 2008): 929-83, doi:10.2307/40041782.

¹⁷ For ministerial discussions and comments on enlightened shareholder value see DTI, "Companies Act 2006 Duties of Company Directors - Ministerial Statements," (June 2007), url: <http://www.bis.gov.uk/files/file40139.pdf>.

incorporated enterprises. At the core was the enterprise, incorporated as a separate entity, with shareholders who appointed directors to act as steward over their interests. As such, the law provided that the directors' sole concern was to act in the interests of their present and future shareholders.¹⁸ Common-law-developed fiduciary duties were also owed by directors to shareholders in recognition of the fact that directors do not always act in the best interests of the shareholders. This system was in place in relation to all companies incorporated in England and Wales up until 2006. Recently, English legislation introduced a statute-based model, namely the enlightened shareholder value model.¹⁹ Both are recognised as the legal stewardship models of corporate governance.²⁰ These models must be distinguished from management-theory-based stewardship theory.²¹ The legal stewardship models must also be distinguished from stakeholder theory, which also warrants some explanation because of its potential relevance to China's experience of corporate governance.

In China, in efforts to find theoretical and policy solutions to the inadequate performance of independent directors, scholars have begun to take a more critical interest in the UK legal stewardship model of corporate governance. However, there is, as yet, no literature regarding this.

¹⁸ The problem is that, apart from profit maximisation to ensure shareholder return on investment, there is no other way of judging non-financial interests.

¹⁹ The enlightened shareholder value model is the current model in English company law. The Companies Act 2006 promotes enlightened shareholder value, which has an inclusive societal flavour in ensuring that directors also consider the interests of other stakeholders. DTI, 'Companies Act 2006 Duties of Company Directors - Ministerial Statements.' The new fiduciary duty to act for the success of the company is an example. Existing fiduciary duties were also codified in the Act. There is still some debate as to the practicability of this new theory of enlightened shareholder value. Because of its societal aspects, it is arguably harder to empirically judge.

²⁰ To be distinguished from management theory of stewardship, which is less relevant to understanding the PRC. The theory emphasises the importance of structures used to empower the steward and offers maximum autonomy so the interests of the shareholder can be maximised. The theory has since been developed in the field of management, where it was defined by Davis, Schoorman and Donaldson as a theory in which "a steward protects and maximises shareholders [sic] wealth through firm performance, because by doing so, the steward's utility function are [sic] maximised." James H. Davis, F. David Schoorman and Lex Donaldson, "Toward a Stewardship Theory of Management," *The Academy of Management Review* 22, no. 1 (January 1997): 20.

²¹ Robert Ian Tricker, *Corporate Governance Principles, Policies and Practices* (Oxford: Oxford University Press, 2009). Bob Tricker identifies two legal models of corporate governance as the stewardship model and the enlightened shareholder value model.

C. Economic Theories

In contrast to the legal perspectives and models developed in the UK, the economic perspectives developed in the US attempt to explain and correct the presumed misalignment of interests between principals (shareholders) and their agents (directors), which is said to arise when there is a separation of management and control in an enterprise; otherwise known as the concept of separation of ownership and control. The predominant theories of corporate governance are agency theory, transaction costs theory and managerial stewardship theory thus centre on the relationship between owner and manager, and between owners.

The most prominent economic perspective expounded two centuries after John Smith was in 1932, by Berle and Means, who built on Smith's sentiments in their seminal work, *The Modern Corporation and Private Property*.²² Based on the results of a survey of large listed companies in the US, Berle and Means demonstrated that, in the modern large listed company where share ownership is widely held, managerial actions naturally depart from those required to achieve shareholder returns, which gives rise to a conflict of interests between shareholders and those who manage the company.²³ In addition to their contribution to scholarship, the work of Berle and Means is particularly significant as it laid the groundwork for the concentration on research on large listed companies to the exclusion of small and medium-sized listed companies.

1. Agency Theory

Focusing on 'agent-principal' relations, in 1937, Robert Coase, in the *Nature of the Firm*, proposed that firms grow to a point where the external market (for labour) becomes

²² Adolf A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New Brunswick, N.J., USA: Transaction Publishers, 1991).

²³ Ibid.

cheaper, and this eventually gives rise to agency relationships as owners are no longer managers.²⁴

These perspectives and observations were developed and formalised into ‘agency theory’ by Jensen and Meckling, who provide a rationale for ensuring the survival of a (listed) company, despite self-interested managers, by defining the owners or shareholders as principals and the managers or directors becoming their agents.²⁵ They posit that, in the modern listed company where share ownership is widely held, there is a conflict of desire or interest between shareholders and directors. The extent to which the residual return to owners falls below that which it would have been if they had exercised direct control over the company is known as the agency *loss* or *cost*. Therefore, agency costs occur when the residual returns to shareholders fall short of the amount expected had the shareholders exercised direct control over the corporation.^{26,27}

This arises from the separation of ownership and control. The agency theory, therefore, proposes mechanisms to deal with this loss. The agency theory has gathered pre-eminence because it is used foremost as a tool for empirical study and it proposes mechanisms to counter agency problems. It proposes mechanisms to deal with this loss, which include internal and external audits, information disclosure, independent outside/external directors, separation of board chairmanship from CEO, risk analysis, and the establishment of audit, nomination and remuneration committees.²⁸ The theory was developed further in 1983 by using financial economics to examine the causal links between

²⁴ R. H. Coase, “The Nature of the Firm,” *Economica* 4, no.16 (1937): 386-405.

²⁵ Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” *Journal of Financial Economics* 3, no.4 (October 1976): 305-60, doi:10.1016/0304-405X(76)90026-X.

²⁶ Ibid.

²⁷ Adolf A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New Brunswick, N.J., USA: Transaction Publishers, 1991).

²⁸ Kathleen M. Eisenhardt, “Agency Theory: An Assessment and Review,” *The Academy of Management Review* 14, no. 1 (January 1, 1989): 57-74.

governance systems put in place to control the agent and the effect on the interests of the principal.²⁹

Agency theory proves popular for three likely reasons. Firstly, it is a simple theory in which a company of any size can be reduced to two participants, namely managers and shareholders, with each of their interests assumed to be clear and consistent.³⁰ Secondly, agency theory supposes that people are self-interested and unwilling to sacrifice personal interests for the interests of others that play into age-old and widespread beliefs.³¹ Thirdly, the theory has gathered pre-eminence because it is used foremost as a tool of empirical study and it proposes mechanisms to counter agency problems.³² The theory can, arguably, be seen in the corporate governance controls devised to protect the shareholders' interests.

It is perhaps for the aforementioned reasons that there exists an abundance of quantitative research on corporate governance in China which expressly relies on agency theory as the point of departure for analysing shareholder-management relations.³³ Later, qualitative research also expressly or implicitly examines the agency dilemma especially in the context of the State being controlling shareholder, regulator and manager of listed SOEs. Most qualitative research is led by law scholarship.³⁴ The full extent of the influence of agency theory, and indeed transaction costs theory discussed below, in China is probably reflected by the adoption of the fundamentals of capital market regulatory framework found

²⁹ Eugene F. Fama and Michael C. Jensen, "An Assessment and Review," *Journal of Law and Economics* 26, no. 2 (June 1, 1983): 301-25.

³⁰ Catherine M. Daily, Dan R. Dalton, and Albert A. Cannella Jr., "Corporate Governance: Decades of Dialogue and Data," *The Academy of Management Review* 28, no.3 (July 1, 2003): 372, doi:10.2307/30040727.

³¹ Ibid.

³² Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review," *The Academy of Management Review* 14, no.1 (January 1, 1989): 57-74, doi:10.2307/258191. Agency theory can also be applied in disciplines beyond the law and economic theories of the firm to political science and sociology. See Edgar Kiser, "Comparing Varieties of Agency Theory in Economics, Political Science, and Sociology: An Illustration from State Policy Implementation," *Sociological Theory* 17, no. 2 (July 1, 1999): 146-70, doi:10.2307/202095.

³³ There is an abundance of quantitative research arguably first led by Xiaonian Xu and Yan Wang's research on ownership structures and corporate governance in China. See Xiaonian Xu and Yan Wang, "Ownership Structure and Corporate Governance in Chinese Stock Companies," *China Economic Review* 10, no. 1 (1999): 75-98.

³⁴ See Gan Peizhong, *Qiyu gongsi faxue [Jurisprudence on Enterprises and Companies]* (Beijing: Beijing daxue chubanshe, 2012). See also Chao Xi, *Corporate Governance and Legal Reform in China* (London: Wildy, Simmonds & Hill Pub, 2009).

on US stock markets (ie which are aimed at their simplest aimed at monitoring and reducing agency costs) with slight policy modifications for State ownership and policies (i.e. Chinese-style).

2. Transactions Cost Theory

Transactions cost theory, similarly to agency theory, presumes an agency relationship based on contract, with goal conflict between shareholder and director. Williamson developed the theory further and argued that large corporations could overcome this goal conflict by their choice of governance systems.³⁵

More recently, Strange, Filatotchev, Wright and Buck have attempted to develop the theoretical aspect further by proposing that parties to a transaction (in this case enterprise) will minimise the expected combined production and transaction costs.³⁶

3. Institutions and Mechanisms of Corporate Governance

The Anglo-US approach to corporate governance described above is effectuated by its key institutions. These can be divided into private market-based institutions and public (state) promulgated institutions.³⁷

Private market-based institutions purport to align the interests of managers with those of shareholders. Market mechanisms of corporate governance traditionally include the market for management and the market for control, and executive compensation. Broadly speaking, they can also include informal mechanisms and institutions such as whistleblowing, as well

³⁵ Oliver Williamson, "Why Law, Economics, and Organization," *Annual Review of Law and Social Science* 1, no.1 (2005): 369-96.

³⁶ Roger Strange et al., "Corporate Governance and International Business," *Management International Review* 49, no.4 (October 2009): 395-407, doi:10.1007/s11575-009-0001-z.

³⁷ This taxonomy is broader than the usual of taxonomy of only distinguishing between the market, legal and regulatory. For example, see Xi, *Corporate Governance and Legal Reform in China*, (2009), chap. 1.

as nongovernmental institutions that influence corporate governance such as credit-rating agencies, and commercial and investment banks.³⁸

Public institutions of corporate governance include those provided for under company law and securities laws, and regulations. They aim to regulate the conduct and activities of those who manage and control companies for the benefit of shareholders (and stakeholders). In terms of internal governance, the institutions of corporate governance are the shareholders' general meeting and the board of directors. At shareholders' general meetings, shareholders cast their votes relating to important matters affecting the company and especially to elect the board of directors. In turn, generally, the role of the board of directors in corporate governance is two-fold: they provide strategic management advice to managers and also monitor the actions of management. Therefore, they have key obligations imposed by law and regulation reflecting their responsibilities to the shareholders as a whole. The disclosure of information to shareholders and stakeholders is, therefore, another institution formulated under law and regulations. Here, those who manage the company (both directors and managers) must provide full, true and verified information to the shareholders and other eligible constituents. Public institutions include the regulators such as the US Securities and Exchange Commission and the UK's Financial Conduct Authority. Of course, the judiciary systems in each of these countries also play a key role, especially in corporate governance norm creation.³⁹

These aforementioned public and to some extent private institutions and mechanisms of corporate governance found in Western economies, today also apply in China, however

³⁸ Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press, 2008), 44.

³⁹ See, Troy A. Paredes, "Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer," *William and Mary Law Review* 45 (2003), url: <http://heinonline.org/HOL/Page?handle=hein.journals/wmlr45&id=1069&div=&collection=usjournals>. (Describes the role of the judiciary as 'norm entrepreneurs', especially in regard to corporate governance practice.)

they remain relatively undeveloped.⁴⁰ Moreover, the extent to which they are effective mechanisms in practice has been of some debate. China's disclosure of information mechanism is relatively the most functional market mechanism in corporate governance, as will be demonstrated later in the study. One reason for this is the use of state policy to ensure the fair distribution of information among participants in the market. As will be seen, there is a limited market for the supply and demand of professional managers, which means that an inefficiently managed company may not result in a change in management. Another reason is the limited market for control, which arises not only from state policy but nonetheless means that there is no external impetus or threat to improve management or compliance.

D. Alternative Perspectives

1. Societal Theory - Stakeholder Theory

As the only prominent theory with a societal perspective of corporate governance, stakeholder theory deserves individual mention. In contrast to the stewardship models discussed in Section A above, stakeholder theory assumes a more inclusive perspective.⁴¹ It is 'premised on the theory that groups in addition to shareholders have *claims* on a company's assets and earnings because those groups contribute to a company's capital'.⁴²

There are two approaches to stakeholder theory. The first, the fiduciary model, complements the stewardship theory above in that the board is perceived as neutral with neither bounded rationality nor otherwise positive traits, rather they have have fiduciary

⁴⁰See, Stoyan Tenev, Chunlin Zhang, and Loup Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, (2002), chap. 5. For more recent scholarship, see also Wei, *Securities Markets and Corporate Governance*, (2009).

⁴¹Antonio Argandoña, "The Stakeholder Theory and the Common Good," *Journal of Business Ethics* 17, nos.9/10 (July 1, 1998): 1093-1102.

⁴²Roberta S Karmel, "Implications of the Stakeholder Model," *George Washington Law Review* 61 (1992): 1171, url: <http://heinonline.org/HOL/Page?handle=hein.journals/gwlr61&id=1164&div=&collection=journals>.

duties. Under this theoretical model, stakeholders are not given direct rights of representation on the board, they are protected through (as yet undefined) mechanisms that relax the board's duty or incentive to solely represent the interests of shareholders. The second is the representative model. Here, two or more stakeholders would have representatives on the board of directors. The drawback is that the board then becomes what has been aptly termed as a 'coalition of stakeholder groups'.⁴³ Like most coalitions, there are implications for the expediency of decision-making.

A particular criticism from the comparative corporate law school is that stakeholder theory is merely a combination of elements found in older manager-orientated and labour-orientated models that are inefficient and, consequently, outdated models of corporate governance.⁴⁴ The theory is held to have little application in practice because of empirical difficulty in defining and researching societal perspectives. For instance, there remain different perspectives and approaches to defining the stakeholders of a firm.⁴⁵

Stakeholder theory may prove relevant for China where, with an autocratic top-down decision-making system, choices are made arbitrarily as to who amounts to a stakeholder of a company and how they can be represented. For instance, China's two-tier board system, one being executive and the other supervisory in nature, potentially reflect the stakeholder representative system, at least on paper. Stakeholders such as employees and creditors can be co-opted onto both boards, with compulsory representation on the supervisory board. The board itself has been criticised as being weak and ineffective in monitoring management and sometimes a hindrance when dominated by, say a controlling shareholder.

⁴³ Henry Hansmann and Reinier Kraakman, "The End of History of Corporate Law," in *Convergence and Persistence in Corporate Governance*, edited by Jeffrey N. Gordon and Mark J. Roe (Cambridge, UK: Cambridge University Press, 2004).

⁴⁴ *Ibid.*, 36.

⁴⁵ Anna Grandori, "Reframing Corporate Governance: Behavioural Assumptions, Governance Mechanisms, and Institutional Dynamics," in *Corporate Governance and Firm Organization Microfoundations and Structural Forms* (Oxford: Oxford University Press, 2004).

2. Organisation Theory

The main organisation models of corporate governance include organisation theory and resource dependency theory. Organisation theory in corporate governance is a relatively new approach. Organisation theory challenges agency theory's 'closed system' approach, which presumes that the principal-agent relationship is the core issue in corporate governance.⁴⁶ Instead, the theory advocates an 'open-systems' perspective also referred to broadly as 'complementarity'. It proposes that different corporate governance practices may be more or less effective depending on differing contexts in different organisational environments.⁴⁷ However, like similar organisation theories such as resource dependency theory, this theory is hampered by the difficulty in collecting empirical evidence.⁴⁸ Another particular limitation is that it takes a managerial perspective and assumes the organisation structure peaks at the chief executive level. Organisation theory also retains some relevance in that substantial contributions to comparative corporate governance have come from organisational scholars, particularly in their attempt to 'open' perspectives on corporate governance. Other aspects of organisational theory include resource dependency theory, which denotes the importance of power relations in and around enterprises.⁴⁹ The problem with resource theory, as with the other organisational theories, is the lack of empirical examination and clarification of the theory's basic premise.⁵⁰ Similarly, systems theory purports to identify an appropriate

⁴⁶ Ruth V. Aguilera et al., "An Organizational Approach to Comparative Corporate Governance: Costs, Contingencies, and Complementarities," *Organization Science* 19, no. 3 (May 2008): 475-492.

⁴⁷ *Ibid.*, 476.

⁴⁸ Gerald F. Davis and Adam Cobb, "Resource Dependence Theory: Past and Future," *Sociology of Organizations* (April 2009).

⁴⁹ Jeffrey Pfeffer and Gerald R. Salancik, *The External Control of Organizations: A Resource Dependence Perspective* (Stanford University Press, 2003); Howard E. Aldrich and Jeffrey Pfeffer, "Environments of Organizations," *Annual Review of Sociology*, no.2 (1976): 79-105.

⁵⁰ Gerald F. Davis and Adam Cobb, "Resource Dependence Theory: Past and Future," *Sociology of Organizations*, (April 2009).

corporate governance system by defining the system itself and the environment in which it exists, the proposed level of abstract of its examination and the function of the system.⁵¹

Despite the criticism regarding their limitations for the purpose of empirical research, the abovementioned theories are each nonetheless useful qualitatively as they aid understanding of the impact of diverse and seemingly unrelated mechanisms.

3. Political Theory

This theory acknowledges the existence of government in the regulation of enterprises, which has resulted in strong political influence. The theory was developed by Mark Roe in response to a conundrum of dispersed share ownership seemingly prevailing in the US and the UK, while it was empirically proved that concentrated ownership dominated around the globe.⁵² Roe proposes that dispersed ownership arises in the Anglo-US experience as a result of an immense distrust of concentrated financial power. Thus, he challenges the premise that only law matters and proposes that politics also plays a more significant role, especially in corporate governance.⁵³

In terms of China, political theory remains relevant as a tool to understand the powerful and influential role of the Communist Party of China, especially in determining

⁵¹ See Paredes, "Systems Approach to Corporate Governance Reform." When applied to the PRC, the 'system' would be corporate governance as located within a top-down autocratic political system based on socialist ideology, which operates a semi-regulated market economy. The level of abstraction is potentially high, but wide, including shareholders, boards of directors, competitors, regulators, the State and the Party. The function of the corporate governance system would be to promote economic growth by encouraging shareholder, State and Party confidences. This includes striking the right balance between the distributions of power. For a discussion on balancing the power and interests of actors within a corporate governance system, see Mark J. Roe, "The Institutions of Corporate Governance," (1 August, 2004), url: http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers.shtml.

⁵² Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, 1994), url: <http://books.google.co.uk/books?hl=en&lr=&id=GGubplxpy8YC&oi=fnd&pg=PP2&dq=roe+strong+managers+weak+owners&ots=7FSUqap6tm&sig=NPx5IBrrFvLXaxYZIGL2D3n0qWo>. For a brief critique of Roe's book, see John C. Coffee, *Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between "Lumpers" and "Splitters"*, SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, February 2, 2010), url: <http://papers.ssrn.com/abstract=1532922>.

⁵³ Mark J Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact*, Clarendon Lectures in Management Studies (Oxford: Oxford University Press, 2003).

economic structures such as share ownership.⁵⁴ As such, this theory instinctively has particular credence when considering China's polity.

III. Theoretical Framework

This section constructs the theoretical framework that underpins this thesis on the corporate governance practices of companies listed on ChiNext. As a general background framing the theoretical framework, it first presents the key corporate governance theories, indicating their reception in China, where relevant. Equally, certain key concepts of comparative law aid analyses of corporate governance in China. This section sets out the analytical framework that facilitates the description and the understanding of corporate governance practice and enforcement patterns emerging on ChiNext.

With the recent surge in privately controlled listed companies, the traditional approach of examining corporate governance practice solely through the lenses of the State and Party relations is no longer relevant. Within this, there appears to be an obvious taxonomy in the literature on corporate governance in China, which includes analysis of SOEs, the securities market in terms of listed SOEs, corporate governance modelling for SOEs and identifying and proposing reforms for agency problems. This veers away from the macro theorising approach that takes a high-level view – the so-called *lumpers* approach. Instead, it takes a micro-level approach, focusing on a specific equity market and the companies listed on it with the objective of providing insight into the prevailing corporate governance practice.

Less research has been undertaken in relation to non-state-owned listed companies. There has been even less research on small and medium-sized state and non-SOEs. It is anticipated that this thesis will go some way to filling this gap.

⁵⁴ For a critique of Mark Roe's politics thesis, see Coffee, *Dispersed Ownership*.

A. Defining Corporate Governance in China

One of the main issues facing this study is how best to define the corporate governance that ChiNext-listed SMEs (CSMEs) are purported to have. There are various definitions, depending on the objective or perspective of analysis as reflected in the taxonomies of corporate governance. Nonetheless, there are three noticeable trends in the literature on corporate governance in China. One trend is to narrowly define corporate governance as it relates to the subject of discussion. Some scholars prefer to use a narrow shareholder-orientated definition that relates to SOEs listed on the stock exchange.⁵⁵ Others use broader definitions in which stakeholders are reflected, such as Tam's proposed model that includes an institutional role for the Communist Party of the People's Republic of China (the 'Party').⁵⁶ The final trend disregards definition, perhaps because all definitions are perceived to be too confining. Instead it dives straight into the issues that arise; these tend to lean toward a shareholder-orientated view.⁵⁷ Definitions of international corporate governance, namely the OECD definition and general principles, are rarely used as a starting point.⁵⁸ As there is no right or wrong definition, it is anticipated that systems theory,

⁵⁵ Donald C. Clarke, "The Ecology of Corporate Governance in China," *SSRN eLibrary*, (29 August, 2008), url: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245803; Roe, "The Institutions of Corporate Governance," August 1, 2004; Jing Leng, *Corporate Governance and Financial Reform in China's Transition Economy* (Hong Kong: Hong Kong University Press, 2009); Guanghua Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (London: Routledge, 2007).

⁵⁶ He states that corporate governance is "the processes and mechanisms for ensuring that a company performs in a responsible, responsive and pro-active way in the interests of its stakeholders." On Kit Tam, *The Development of Corporate Governance in China* (Cheltenham: Edward Elgar, 1999), 18. cf: Merritt B. Fox and Michael Heller, eds., *Corporate Governance Lessons from Transition Economy Reforms* (Princeton, N.J: Princeton University Press, 2008). In terms of dealing with transition economies, Fox and Heller argue that good corporate governance is best defined by looking at the economic functions of the firm rather than any particular set of corporate laws.

⁵⁷ Jane Fu, *Corporate Disclosure and Corporate Governance in China* (Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2010); Chao Xi, *Corporate Governance and Legal Reform in China* (London: Wildy, Simmonds & Hill Pub, 2009).

⁵⁸ James Feinerman, "New Hope for Corporate Governance in China?" *The China Quarterly* 191 (September 2007): 590-612. In contrast, Berglof and Thadden criticise the OECD guidelines as not particularly helpful when applied to emerging, developing or transition economies because they cover a broad range of rules and principles but without specifying clear priorities. Erik Berglöf and Stijn Claessens, "Enforcement and Good

discussed later, presents the best way to develop a suitable working definition for this study.⁵⁹

The aspect that most of the literature on China has in common is the focus on identifying the agency costs arising and the effect on the protection of shareholders, especially minority shareholders.

1. Transition vs Emerging Economy

In terms of definitions, China has almost solely been categorised as a transition economy⁶⁰ due to the predominance of comparative studies into the development of a market economy and modern legal system in the former Soviet Bloc and Eastern Europe.⁶¹ It could be argued that the treatment of China as an emerging economy⁶² is more accurate than as a transition economy. After all, China is an emerging (as opposed to developed) economic

Corporate Governance in Developing Countries and Transition Economies,” *The World Bank Research Observer* 21, no.1 (2006): 31, doi:10.1093/wbro/lkj005. This is very interesting, especially since the Party and State now prefer that international standards are applied to the PRC rather than regional or country standards as represented in the slogan *guoji jiegui*. For a general discussion, see Hongying Wang, “Linking Up with the International Track’: What’s in a Slogan?” *The China Quarterly* 189 (2007): 1-23, doi:10.1017/S0305741006000774.

⁵⁹ Paredes, “Systems Approach to Corporate Governance Reform.”

⁶⁰ For corporate governance purposes, a transition economy in general is one that is in transition from a planned or other economic model to a market economy. See Masahiko Aoki and Hyung-Ki Kim, eds., *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks*, EDI Development Studies (Washington, D.C.: World Bank, 1995). See also Fox and Heller, *Corporate Governance Lessons from Transition Economy Reforms*.

⁶¹ It has become of significant importance in corporate governance due to a plethora of comparative studies of the development of the market economy and legal system. Leng, *Corporate Governance and Financial Reform in China’s Transition Economy*; Fox and Heller, *Corporate Governance Lessons from Transition Economy Reforms*; Donald C. Clarke, “Legislating for a Market Economy in China,” *The China Quarterly* 191, no.1 (2007): 567-85, doi:10.1017/S0305741007001579; R. Randle Edwards, “An Overview of Chinese Law and Legal Education,” *Annals of the American Academy of Political and Social Science* 476 (November 1984): 48-61; Esin Örüçü, *Critical Comparative Law: Considering Paradoxes for Legal Systems in Transition*, Preadvies Uitgebracht Voor de Nederlandse Vereniging Voor Rechtsvergelijking (Deventer: Kluwer, 1999); Aoki and Kim, *Corporate Governance in Transitional Economies*.

⁶² An emerging economy is one in which the economy (whichever the model) is generally developing or underdeveloped as opposed to a developed economy. For this corporate governance focussed definition, see Mark J Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact*, Clarendon Lectures in Management Studies (Oxford: Oxford University Press, 2003), chap. 14. For more economic definitions, see Gill Hammond, S. M. Ravi Kanbur, and Eswar Prasad, eds., *Monetary Policy Frameworks for Emerging Markets* (Cheltenham, UK: Edward Elgar, 2009); Barry J. Eichengreen, Poonam Gupta, and Rajiv Kumar, eds., *Emerging Giants: China and India in the World Economy* (New York: Oxford University Press, 2009); Yue-man Yeung and Jianfa Shen, eds., *The Pan-Pearl River Delta: An Emerging Regional Economy in a Globalizing China* (Hong Kong: Chinese University Press, 2008); Peter Enderwick, *Understanding Emerging Markets: China and India* (New York: Routledge, 2007). For a more political use see Cornelis de Groot, *Corporate Governance as a Limited Legal Concept* (Kluwer Law International, 2009); Yongjin Zhang, *China’s Emerging Global Businesses: Political Economy and Institutional Investigations* (Basingstoke: Palgrave Macmillan, 2003).

power as testified by, among other things, China's purchasing power parity world ranking at second only to the US.⁶³ Notwithstanding this, one cannot remove China from its strong ideological context, which still overlooks every aspect of economic activity, especially those related to listed enterprises. Thus, this trend has extended into corporate governance literature, which unequivocally states or assumes the ontology of China as a transition economy as the point of departure.⁶⁴ As both terms fundamentally assume a predisposition to convergence toward an advanced market economy, which is the assumed bedrock of good corporate governance, this thesis ignores such categorisations of China. It adopts Mark Roe's argument that the emerging economy, developing economy and transition economy can be viewed together because, for him, they have similar features.⁶⁵

B. Public and Private Corporate Governance Institutions and Mechanisms in China

The literature forewarns of the pitfalls of ignoring culture when trying understanding the dynamics of internal governance in privately controlled companies, whether listed or non-listed.⁶⁶ A taxonomy of public and private can again be employed to understand the types of corporate governance mechanism and institution in China. Indeed, the emergence of the private sector in the ownership and control of companies listed in China arguably brings hitherto private institutions and mechanisms of governance to the public arena of the equity market. Thus, the ways in which these private governance mechanisms and institutions

⁶³ This measures what a US dollar can buy more of in some countries and less of in others; the PRC has a lot of spending power. Economy Watch, "The World's Largest Economies | Economy Watch," *Economy Watch*, (2011), url: <http://www.economywatch.com/economies-in-top/>.

⁶⁴ Fu, *Corporate Disclosure and Corporate Governance in China*, (2010); Leng, *Corporate Governance and Financial Reform in China's Transition Economy*; Aoki and Kim, *Corporate Governance in Transitional Economies*; *ibid.*; R. Randle Edwards, "An Overview of Chinese Law and Legal Education."

⁶⁵ Roe, *Political Determinants of Corporate Governance*, (2003), 106.

⁶⁶ Li Wenyi and Liu Chundan, "Kong meng ruxue yu dangdai minying qiye guanli [Confucianism, Mencianism and Contemporary Private Business Management]," (*Dong Yue Tribune*) 27, no.1 (2006): 196-98. From a historical perspective, see George Jamieson, *Chinese Family and Commercial Law* (Hong Kong: Vetch and Lee, 1970).

impact and react to those of corporate governance are brought to the fore. Douglas North's definition of institutions gives some clarity:

...humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights).⁶⁷

This thesis proposes that, in particular, Confucian filial piety (*xiaoshun*) and Chinese relationships (*guanxi*) have important implications for the protection of shareholders.

1. Public: State Institutions and Mechanisms

In terms of public mechanisms and institutions, China has adopted the basic corporate governance approaches found in the Anglo-American model described in Section II above. China has a tripartite system comprising the shareholders' general meeting, and a two-tier board system comprising the board of directors and the board of supervisors. Thus, the key difference in form is the addition of the board of supervisors intended to monitor the board of directors. Employees also have a key role in corporate governance due to mandatory representation on the supervisory board, as well as the possibility of presentation on the board of directors. In terms of institutions, China has the China Securities Regulatory Commission, and stock exchanges issue regulations and enforce corporate governance.⁶⁸ The courts play a relatively minor role with much emphasis on so-called administrative governance by regulators.⁶⁹

⁶⁷ Douglass C. North, "Institutions," *Journal of Economic Perspectives* 5, no.1 (February 1991): 97.

⁶⁸ Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008). (Donald Clarke refers to them as 'state institutions' of corporate governance, thereby devising a taxonomy between 'state' and 'private'.)

⁶⁹ Katharina Pistor and Chenggang Xu, "Governing Emerging Stock Markets: Legal vs Administrative Governance," *Corporate Governance: An International Review* 13, no.1 (January 1, 2005): 5-10, doi:10.1111/j.1467-8683.2005.00398.x.

However, the literature largely ignores two institutions in China that play a key role in corporate governance, namely the press and China's public whistleblowing system (*jubao*). Scholars have made passing references to the role of the press but have not provided a full treatment in relation to corporate governance.⁷⁰ To date, there has been little written on China's public whistleblowing system itself, and none in relation to its role in corporate governance. This thesis intends to fill both of these gaps in knowledge in the context of this case study of ChiNext.

2. *Private I: Confucian Filial Piety (Xiao)*

The emergence of families as controlling shareholders in both private and listed companies is in line with the Confucian tradition, and, more specifically for the purpose of this thesis, filial piety. The Tsinghua dictionary neutrally defines filial piety as 'devotion to caring for parents and obeying their will'.⁷¹ Thus, filial piety denotes obedience to and reverence for one's parents. Importantly, filial piety is perceived as the root of all virtues in Confucianism and is considered relevant to contemporary society in China.⁷²

Filial piety plays an important role in developing private enterprise in China, in that strict enforcement of filial piety in Chinese society translates into obligations such as honesty in statements and actions, loyalty to superiors (bosses), respectfully (*jing*) carry out public office and being trustworthy with friends.⁷³ These four obligations arguably make up the

⁷⁰ For example, see Benjamin L. Liebman and Curtis J. Milhaupt, "Reputational Sanctions in China's Securities Market," *Columbia Law Review* 108, no.4 (May 1, 2008): 929-83, doi:10.2307/40041782. See also, Donald C. Clarke, "The Ecology of Corporate Governance in China," *SSRN eLibrary*, (The George Washington University Law School, August 29, 2008): 59.

⁷¹ *Xinhua cidian [Tsinghua Dictionary]* (Beijing: Shangwu yinshuguan, 2004). Another definition is 'to use assets to bribe or repay officials or elders'. *Cf. Zhongguo she hui ke xue yuan, Xiandai Hanyu Cidian [Modern Chinese Dictionary]*, Di 5 ban, [Rev. ed.] (Beijing: Shangwu yinshuguan, 2005). Although the same publisher, the *Modern Chinese Dictionary*, takes a politically nuanced approach, stating that filial piety refers to olden day burial rituals and 'a type of moral code of feudalistic society'.

⁷² Martin Lu, *Confucianism: Its Relevance to Modern Society* (Federal Publications, 1983): 65-67.

⁷³ Li Wenyi and Liu Chundan, "Kong meng ruxue yu dangdai minying qiye guanli [Confucianism, Mencianism and Contemporary Private Business Management]": 196-198. *Qianzhan rujia sixiang dui xiandai*

internal governance and control dynamics in private enterprises controlled by families. Importantly, when a family-controlled company becomes listed, these obligations do not disappear but continue to exist alongside the legal and regulatory framework of the relevant equity market.⁷⁴ Inevitably, this has implications for corporate governance in terms of which internal control and governance system takes precedence, and the implications for protection of shareholders who are not family.

3. Private II: Relationships (Guanxi)

Guanxi can simply be defined as interpersonal relationships – a form of personal network – and is one of the longest-standing, most pervasive of traditions in contemporary China.⁷⁵ Most of the literature on *guanxi* concentrates on its role in business relations in China⁷⁶, which has been a key challenge for foreign businesses.⁷⁷ Business and management scholars have alluded through definitions of *guanxi* to distinctions between social⁷⁸ and economic,⁷⁹ and between formal and informal.⁸⁰ For the purpose of this thesis, it suffices that

⁷⁴ Xiaowei Rose Luo and Chi-Nien Chung, “Filling or Abusing the Institutional Void? Ownership and Management Control of Public Family Businesses in an Emerging Market,” *Organization Science* 24, no.2 (2013): 591-613. (Using an agency theory perspective, it is found that family governance fills institutional gaps where there are weak institutions. However, whether or not the gap-filling has a positive or negative impact depends on the nature of the family control exercised.)

⁷⁵ See generally, Thomas B. Gold, Doug Guthrie, and David L. Wank, eds., *Social Connections in China: Institutions, Culture, and the Changing Nature of Guanxi*, Structural Analysis in the Social Sciences 21 (Cambridge, UK; New York: Cambridge University Press, 2002).

⁷⁶ There exists a plethora of studies; for example, Zhilin Yang and Cheng Lu Wang, “Guanxi as a Governance Mechanism in Business Markets: Its Characteristics, Relevant Theories, and Future Research Directions,” *Industrial Marketing Management* 40, no.4 (2011): 492-95; Steve Lovett, Lee C. Simmons, and Raja Kali, “Guanxi versus the Market: Ethics and Efficiency,” *Journal of International Business Studies* 30, no.2 (1 June, 1999): 231-47.

⁷⁷ For example, see Flora F. Gu, Kineta Hung, and David K. Tse, “When Does Guanxi Matter? Issues of Capitalization and Its Dark Sides,” *Journal of Marketing* 72, no.4 (July 2008): 12-28, doi:10.1509/jmkg.72.4.12.

⁷⁸ The social perspectives on and definitions of *guanxi* tend to be based on ethnographic studies that focus on its role in society and how it may be brought to play in different types of relationship. For a socio-legal perspective and ethnographic approach, see Bee Chen Goh, *Law without Lawyers, Justice without Courts: On Traditional Chinese Mediation* (Aldershot: Ashgate, 2002). See generally, Andrew B. Kipnis, *Producing Guanxi: Sentiment, Self, and Subculture in a North China Village* (Durham, NC: Duke University Press, 1997).

⁷⁹ From an economic perspective, Y. H. Wong defines *guanxi* as an ‘...economic rent-seeking behaviour’ characterised by ‘the development of trust between potential business player with the objective of reducing transactions costs and improving the efficiency of the market economy by sharing resources such as capital.’

guanxi falls outside of state law and regulation. It assumes for the purposes of this analysis that all of these traits are subsumed into a generic “*guanxi*”, which this thesis proposes acts as a key source of empowerment for non-controlling shareholders in restraining undesirable corporate conduct by controlling shareholders by methods such as expropriation.

C. Corporate Governance in Listed SMEs

As comparative corporate governance scholarship has attested, corporate governance differs from country to country depending on the received knowledge regarding corporate governance, which is most crucial for large listed companies. Consequently, the literature has, to the neglect of listed SMEs, largely focused on corporate governance in large listed companies. In China, this has manifested in a predominant focus on large listed companies, too. This has added complexity and curiosity about governance in listed companies in which the state is controlling shareholder-fuelled research. However, Tenev and Zhang’s economic analysis of corporate governance in state-owned SMEs ⁸¹ is well received. Thus, the study of SMEs listed on the Shenzhen stock markets will contribute to the literature on both listed private and state-owned SMEs from a legal perspective. As mentioned earlier, similarly to the West, there has been a predominance of research in the large listed enterprises in China,

See Y. H. Wong, *Guanxi: Relationship Marketing in a Chinese Context* (New York: International Business Press, 2001).

⁸⁰ For instance, Chen, Chen and Xin distinguish between ‘...*guanxi* as informal personal relationships...’ and ‘...as formal, official relationships in organisations...’ They, however, acknowledge that both formal and informal *guanxi* may overlap in some organisations. Chao C. Chen, Ya-Ru Chen, and Katherine Xin, “*Guanxi Practices and Trust in Management: A Procedural Justice Perspective*,” *Organization Science* 15, no.2 (2004): 200-201. From an institutional perspective, *guanxi* can be categorised as informal because it is a ‘non-market institution’ or a ‘non-price institution’. See, Biliang Hu, *Informal Institutions and Rural Development in China*, Routledge Studies on the Chinese Economy (New York, NY: Routledge, 2007), 28. Hu’s classification of *guanxi* as an informal institution is based on Douglas North’s definition of institutions and their role in economy. See generally, Douglass C. North, “Institutions,” *Journal of Economic Perspectives* 5, no.1 (February 1991): 97-112.

⁸¹ Stoyan Tenev and Chunlin Zhang, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (Washington, D.C.: World Bank, 2002).

which have been dominated by scholars in management⁸² and a few in law⁸³. They have focused mainly on understanding corporate governance practice in SOEs since they form the majority of listed enterprises, and have been a relative rarity in the West prior to the financial crises government bailouts. However, Tenev and Zhang's economic analysis of corporate governance in state-owned SMEs⁸⁴ is well received. Moreover, literature on SMEs in China has focused on their management systems and their role as drivers of the economy.

The literature on SMEs is dominated by economic arguments that SMEs are key drivers in economic development. Thus, the literature on SMEs in China has focused on their management systems and role as drivers of the economy.⁸⁵ There has been little corporate governance research on SMEs except for an in-depth case study of transformed (i.e. privatised or corporatized) state-owned SMEs by Tenev and Zhang, from an economic theory perspective.⁸⁶ This is because most SMEs are private and, therefore, there is both a lack of information about and access to the enterprises. For this practical reason, this thesis focuses on those SMEs that are listed. Another reason for focusing on listed SMEs is the important role that the stock market is said to play in promoting economic growth and developing an economy. One way of spurring economic growth in emerging countries (such as China) is to promote securities markets.⁸⁷ Empirical studies have focused on listed enterprises because of the apparent link between the development of capital markets and economic growth. Roe also

⁸² Grace Jinying Hu and Marc Goergen, "A Study of Ownership Concentration, Control and Evolution of Chinese IPO Companies," *SSRN eLibrary*, (2005), url: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=286612; Fu, *Corporate Disclosure and Corporate Governance in China*, (2010); Tong Lu, Jiiyin Zhong, and Jie Kong, "Corporate Governance Assessment on the Top 100 Chinese Listed Companies," (2007); Donald C. Clarke, "Independent Director in Chinese Corporate Governance, The," *Delaware Journal of Corporate Law* 31 (2006): 125-228; Iain MacNeil, "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies," *Journal of Corporate Law Studies* 2 (2002).

⁸³ Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008); Fu, *Corporate Disclosure and Corporate Governance in China*, (2010); MacNeil, "Adaptation and Convergence in Corporate Governance."

⁸⁴ Tenev and Zhang, *Corporate Governance and Enterprise Reform in China*.

⁸⁵ Anne S. Tsui, Yanjie Bian, and Leonard K. Cheng, eds., *China's Domestic Private Firms: Multidisciplinary Perspectives on Management and Performance* (Armonk, N.Y.: M. E. Sharpe, 2006).

⁸⁶ Tenev and Zhang, *Corporate Governance and Enterprise Reform in China*, chap. 3.

⁸⁷ Paredes, "Systems Approach to Corporate Governance Reform"; Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008).

argues that the capital market, among others, is the most important institution of corporate governance.⁸⁸ It is perhaps for these reasons, but weighing heavily toward the latter reason, that PRC corporate governance scholars have focused entirely on listed enterprises.⁸⁹

Therefore, this study of PRC SMEs within their listed environment should accomplish a compelling demonstration of the practice of corporate governance and its contribution to the economic development of China.

Research on privately controlled listed companies in China remains sparse, but is gradually increasing, as least in the Chinese language literature, especially with the rising interest of China's stock exchange regulatory authorities.⁹⁰ Thus, this case study of SMEs listed on ChiNext seeks to fill this gap, and from a legal perspective.

D. Securities Markets and Regulation

The effectiveness of law enforcement also remains a key area of concern in corporate governance, especially in the advanced market economies. This is because scholarship proposes that strong equity markets promote economic growth. The key aspects are the availability of good information about the company's business and the protection of shareholders from self-dealing by managers and/or controlling shareholders is crucial.⁹¹ Emphasis on the importance of legal and regulatory mechanisms in enforcement, particularly by the courts and regulators, has dominated the literature. Some research has also been

⁸⁸ Roe, "The Institutions of Corporate Governance," (1 August, 2004): 6.

⁸⁹ Hu and Goergen, "A Study of Ownership Concentration, Control and Evolution of Chinese IPO Companies"; Fu, *Corporate Disclosure and Corporate Governance in China*, (2010); Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008); Chengwei Liu, *Chinese Company and Securities Law: Investment Vehicles, Mergers and Acquisitions and Corporate Finance in China* (Alphen aan den Rijn: Kluwer Law International, 2008); Sanzhu Zhu, *Securities Dispute Resolution in China* (Aldershot, England: Ashgate, 2007); Lu, Zhong, and Kong, "Corporate Governance Assessment on the Top 100 Chinese Listed Companies"; Clarke, "The Independent Director in Chinese Corporate Governance"; MacNeil, "Adaptation and Convergence in Corporate Governance"; Sanzhu Zhu, *Securities Regulation in China* (Ardsley, N.Y.: Transnational Publishers, 2000).

⁹⁰ For example, Chen Zheng, *Yanjiu baogao: minying shangshiResearch Report: Research on Problems of Share Incentives in Privately Controlled Listed Companies* (Shenzhen Stock Exchange, 2011), url: <http://www.szse.cn/main/files/2011/05/12/844935317842.pdf>.

⁹¹ B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA L. Rev.* 48 (2000): 783.

undertaken regarding transition and emerging economies. Pistor and Xu's series of studies of governance on equity markets identify the dilemma of requiring financial markets for economic development but not having the necessary institutions for monitoring and enforcement.⁹² They enumerate the positives of administrative governance using China's quota system as a case study, noting that the courts have played a minute role in enforcement since the establishment of China's equity markets in the early 1990 s.⁹³

Regarding China, the literature can be taken from general overviews of securities market regulation⁹⁴ to specific treatments such as Jane Fu's examination of disclosure obligations and regulatory framework in context of the theories of convergence, divergence and differentiation, where she finds the CSRC less than adequate in fulfilling its enforcement function.⁹⁵ Zhu Sanzhu's study on securities dispute resolution neutrally lays the groundwork for further examination of developing civil-law-focused enforcement practices.⁹⁶ From a corporate governance enforcement angle, Donald Clarke assesses the relevance of China's stock markets as institutions of corporate governance, and the effectiveness of the CSRC and stock exchanges in enforcing law.⁹⁷ He finds that China too has gaps in the law that the regulatory framework and enforcement cannot fill, and which can only be filled by market institutions. Liu Chengwei examines the role of China's Securities Law from a transactional perspective, focusing on investment vehicles, mergers and acquisitions.⁹⁸ Crucially, the aforementioned studies have taken place in the context of the dominance of SOEs in China's equity markets. This thesis will assess enforcement and the role of the regulators in the context of an equity market dominated by the private sector rather than the public sector. It is

⁹² Pistor and Xu, "Governing Emerging Stock Markets."

⁹³ The quota system has since been abolished.

⁹⁴ Wei, *Securities Markets and Corporate Governance*, (2009); Zhu, *Securities Regulation in China*.

⁹⁵ Fu, *Corporate Disclosure and Corporate Governance in China*, (2010).

⁹⁶ Zhu, *Securities Dispute Resolution in China*.

⁹⁷ Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008).

⁹⁸ Liu, *Chinese Company and Securities Law*.

envisaged that, although the substantive law may remain mostly the same, there will be some differences in the approaches of the regulators and the regulated on ChiNext because of the dominance of the private sector in the market.

E. Institution-based and Process-based Analysis of Corporate Governance

Corporate governance scholars have developed institution-based and process-based approaches to understanding corporate governance practice. An institution-based approach⁹⁹ examines the institutional framework;¹⁰⁰ that is, it focuses on the mechanisms of corporate governance.¹⁰¹ In regards to China, research initially took an institutional approach by identifying and analysing the political and legal infrastructure within which corporate governance is developing.¹⁰² PRC scholars have also undertaken theoretical modelling but mostly focus on SOEs.¹⁰³ Most research has also taken an institutional perspective of corporate governance in relation to China's political and legal infrastructure.¹⁰⁴ Most notable is On Kit Tam's complex model for China, which includes both the Party and State as mechanisms of corporate governance.¹⁰⁵ The process-based approach focuses on how and why (prescribed) institutions carry out their corporate governance functions and assesses their functional effectiveness within their environment.¹⁰⁶ Questions of how to treat China's

⁹⁹ This is now the predominant approach; Mark J. Roe, "The Institutions of Corporate Governance," (1 August, 2004), url: http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers.shtml. In the 1990s, this approach was not as popular as On Kit Tam, *The Development of Corporate Governance in China* (Cheltenham: Edward Elgar, 1999).

¹⁰⁰ North, "Institutions."

¹⁰¹ For example, John C. Coffee, "A Theory of Corporate Scandals: Why the USA and Europe Differ," *Oxford Review of Economic Policy* 21, no.2 (2005): 198-211.

¹⁰² Wei, *Securities Markets and Corporate Governance*, 2009; Guanghua Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (London: Routledge, 2007).

¹⁰³ Aoki and Kim, *Corporate Governance in Transitional Economies*; Yu, *Comparative Corporate Governance in China*, (2007).

¹⁰⁴ Wei, *Securities Markets and Corporate Governance*, (2009); Yu, *Comparative Corporate Governance in China*, (2007).

¹⁰⁵ Tam, *The Development of Corporate Governance in China*, (1999).

¹⁰⁶ For example, Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008). See also, Jane Fu, *Corporate Disclosure and Corporate Governance in China* (Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2010); Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008).

categorisations and analytical approaches to corporate governance are important in understanding the implicit perspectives of many of the scholars in their analysis of China. Both approaches conclude with proposals for reform.

Thus, this thesis strides both the institution-based and process-bases approaches. The structure of the thesis reflects an institutional approach, with the study spread over four chapters, starting with an analytical description of the institutional framework on ChiNext. Equally, the case studies enlist a process-based approach to examine the roles of identified mechanisms and institutions and their effectiveness in carrying out their functions. Importantly, this approach also aids assessment of the extent to which private mechanisms such as Confucian filial piety and *guanxi* play a role in corporate governance.

The next section builds on this theoretical framework by detailing the methodology employed in examining the above facets of corporate governance practice and enforcement on ChiNext.

IV. Methodological Framework

The previous section explained the basis of the analytical framework in understanding corporate governance practice and enforcement on ChiNext. However, the question remains as to how to ascertain and assess this. To this end, this thesis employs a combination of qualitative and quantitative methods that complement the combination of institution-based and process-based approaches for the analysis in this thesis. It also reflects the overall socio-legal approach of the thesis, which, in turn, complements comparative corporate governance perspectives of complementarity.

A. Quantitative Method: Identifying Trends

1. Chosen Subjects

The chosen subjects are the first 40 companies listed on ChiNext.¹⁰⁷ These companies were selected for a number of reasons. Firstly, they demonstrate the initial requirements of corporate governance. Secondly, the analysis enabled their progress on ChiNext to be monitored over a three-year period, thereby providing a more accurate understanding of emerging and dominant trends in corporate governance practice on ChiNext. Thirdly, as the first 40 companies chosen for listing, they represent the types of share ownership and internal governance structure that the government and regulators deemed worthy of listing. Finally, methodologically, having a defined set of entities also controls extraneous variation and assists in defining the limits for any generalisation in the findings.¹⁰⁸ These companies also have published annual reports for 2009.¹⁰⁹ The difficulty envisaged here is the potential lack of transparency in ChiNext information and an unwillingness to divulge information.

An archival survey of the first 40 companies ('surveyed companies') proved effective in identifying the prevalent and emerging trends in share ownership and internal governance as well as compliance and enforcement on ChiNext. This involved the examination of the annual reports of each CSME over a three-year period, namely 2009, 2010 and 2011; a total of 120 annual reports. Further analysis was undertaken on the information about shareholdings and each company announcement. Utilising a case study allows the use of a multiple set of methods; namely, interviewing, examination of primary and secondary

¹⁰⁷ See, Appendix 1 for the list of the 40 surveyed companies listed on each exchange as of 20 April 2011: page 348.

¹⁰⁸ Kathleen M. Eisenhardt, "Building Theories from Case Study Research," *The Academy of Management Review* 14, no.4 (October 1989): 537.

¹⁰⁹ Initially, the research focused on the first 60 listed companies; however, this was reduced in the interest of presenting simple and uniform results in the survey for a number of reasons. Firstly, the survey was based on 60 companies; however, one of them unceremoniously had its listing license revoked in mid-2010. A case study of this company is presented in the chapter on disclosure and enforcement practice as an example of the regulators' purported strictness. Secondly, and more importantly, annual reports for 2009 remain unpublished for companies 40-60 because their IPO timelines were such that their financial reporting obligations only arose for the next financial year, i.e. for 2010.

documentary evidence and observations. Empirical evidence also forms an important aspect of this research and was sourced from both primary and secondary sources.

As stated earlier, as a key objective, this thesis demonstrates the changing trend from state-ownership to private ownership for the purpose of understanding the implications for corporate governance policy and practice.

2. Documentary Text: Sources of Company Data and Information

The key sources of data for the company annual reports, initial public offer prospectuses, regulatory disclosures and websites of enterprises assisted in selecting CSMEs for case study. It was hoped that, during field study, the veracity of these texts could be ascertained.

Data from a total of 138 annual reports for the years 2009, 2010 and 2011 provided data for assessing patterns in share ownership, internal governance, and legal and regulatory compliance. Details of shareholder attendance and voting gleaned 40 annual shareholders' meetings resolutions and several hundreds of stock exchange announcements provided data for assessing shareholder engagement.¹¹⁰ In addition, prospectuses and other public announcements and websites of the companies provided supplementary historical background on ownership and management where annual reports could not. The results of the survey provided the basis of examination of ownership and control structures in chapters Three and Four, and enforcement trends in Chapter Five.

Library-based archival research poses two problems. First, there is no ready-made formula to assess the accuracy of written material and so caution must be used. Therefore, although newspapers are used, they rarely provide sophisticated theoretical analyses and, as a

¹¹⁰ The original population of 60 companies comprised just over 25% of the total number of companies listed on ChiNext at the time. This number was brought down to the first 40 companies listed to ensure the availability of annual reports dating from 2009. The 2009 annual reports remain key, as they present details of the company during the crucial year of just before and after initial public offer.

result, are considered to be a primary rather than a secondary source.¹¹¹ Secondly, regardless of the amount of objectivity professed, published material still introduces a certain amount of bias into research results. This results in incompleteness of a study if it is solely library-based. These two limitations were mitigated through field study, whereby interviews were undertaken.

B. Qualitative Method: Case Studies

Case study evidence remains one of the best methodologies for understanding mechanisms at work in social systems. There remains no standard format for case study analysis.¹¹² Legal quantitative measurements, however conclusive in revealing trends, cannot be used as substitutes for legal analysis and qualitative approaches. A total of ten companies provided case studies on ownership and control. Purposely chosen from the pool of the first 40 companies, they give a detailed and nuanced examination of corporate governance practice. Chapter Three provides case studies on the dynamics and role of the share ownership structure. Chapter Four provides case studies on the management structures and independent directors.

The data collection methods used included questionnaires, interviews and observations. The case study approach was chosen because the objective is to understand corporate governance practice from a legal perspective. This entailed understanding the share ownership structure to ascertain who needs protection and why, and the methods below were employed.

¹¹¹ Donald C. Clarke, "Methodologies for Research in Chinese Law," *University of British Columbia Law Review* 30 (1996): 204, url:

<http://heinonline.org/HOL/Page?handle=hein.journals/ubclr30&id=207&div=&collection=journals>.

¹¹² Eisendhardt, "Building Theories," 542.

1. Field Research and Interviews

To enhance the veracity of the case study approach, field research was undertaken in China with five target groups for interview in Shenzhen, Beijing and Hong Kong.¹¹³

The first group of interviews comprised both foreign and domestic shareholders, and included individuals and institutions (e.g. fund managers and venture capitalists). Interviews with shareholders were mostly with retail shareholders who were probed on the appeal for investing in ChiNext and their understanding of corporate governance. The second group comprised entrepreneurs, directors and managers. For directors, the questions focused on internal governance systems and particularly the board of directors process. The third group included professional intermediaries such as China-based lawyers, public auditors, public accountants and Hong Kong chartered secretaries, who provide fruitful insights regarding the key dynamics that influence and challenge privately controlled companies in China.

The fourth group of interviews related to regulatory authorities. Interviews were undertaken at the Shenzhen Stock Exchange, in particular with regulators of ChiNext. The questions concentrated on regulation and the law enforcement process and the reactions of companies. Interviews were also undertaken at the Hong Kong Stock Exchange, which proved fruitful in giving more context to the challenges of corporate governance in the region, especially from the point of view of a mature and international regulator. No interviews were undertaken at the CSRC because it operates a blanket ban on interviews unless undertaken in an official (i.e. state) capacity.

The fifth group included government policy makers and senior academics, who were interviewed on the adequacy of current law and future reforms for the protection of investors and stakeholders. Interviews were also undertaken with senior law and economics academics based at the Shenzhen Stock Exchange Research Centre, the Beijing People's University and

¹¹³ Appendix 2 has a list of the key questions asked of interviewees. See page 348

the China Academy of Social Sciences School of Law. These institutions are influential because of the significant role played in the theoretical aspects of public policy that is subsequently translated into law.

The final group comprised financial markets journalists based in China, who were also interviewed to gain a sense of the perceived and actual role of the media in corporate governance in general, and specifically on ChiNext.

2. Documentary Text Research I: Sources of Chinese Law

The School of Oriental and African Studies (SOAS) library and the British Library were the main UK resources used in this research, as well as the Internet. SOAS library provides rich electronic online databases of primary data in English and Chinese language law, regulations and judicial decisions. Most primary and secondary sources of data are obtainable through Internet research. However, treatises and textbooks by Chinese language scholars remain in hard copy form, as explained below.

a. Primary Sources

SOAS library provides rich electronic online databases of primary data in Chinese language law, regulations and judicial decisions. Due to the relative newness of ChiNext, most primary sources of data were obtained through the Internet. Primary legislation, along with official and unofficial documents, were sourced from the official websites of China's legislature, central and local governments, and government departments. These included the National People's Congress Standing Committee and the Legislative Affairs Bureau of the State Council. Secondary (such as listing rules) and tertiary legislation (such as guidance) and enforcement data relating to listed companies, and ChiNext in particular, were mainly sourced from websites of the China Securities Regulation Commission, the Shenzhen Stock

Exchange, ChiNext and Shanghai Stock Exchange websites. Judicial interpretations were sourced from the website of the People's Supreme Court.

b. Secondary Sources

Secondary sources of Chinese law included the China Law Yearbook series, Chinese language textbooks, and articles in journals and magazines, which assisted in identifying and clarifying the predominant paradigm relating to corporate governance in contemporary China. These texts are mostly published by the government and written by academics that have strong ties with the government. In addition, newspapers, especially the *People's Daily*, magazines and other reports proved useful in gathering information about enforcement practices in China. Yearbooks also provided information on industries and enterprises considered to be drivers of China's economy.

Notably televised and documentary interviews by leading investigative magazines such as China Network Television's (CNTV) *Jingji banxiaoshi* (Half Hour Economy) and *Dongshi hui* (Directors and Boards) were used as secondary sources. As state-owned organisations, they have a high and wide reach in terms of interviews, and are able to act as an implicit barometer of matters of particular interest or importance to the State or general public.

V. Summary of Chapters

Chapter One, as the introductory chapter, has three functions. Firstly, it locates this study within the larger discourse on state policy for China's economic development and the role of ChiNext. Secondly, the chapter provides both the theoretical and methodological framework of the thesis, which is, in essence, socio-legal.

Chapter Two provides both the historical development of ChiNext and its legal and regulatory framework. It presents, in context, the development of corporate governance regulation to counter problems apparent on the other equity markets in China. The chapter sets out the main features of the corporate governance framework of ChiNext, including the ways in which it relates to Company Law and Securities Law.

Chapter Three presents the trends in share ownership; in essence, the different goals and expectations of shareholders on ChiNext, with reference to case studies of purposively chosen case studies. Within this analytical framework, the chapter seeks to identify the minority and the majority shareholders, probing any difference between the two in dealing with their interests and expectations in the company. Not only do shareholders have their own goals and expectations but also their own behavioural patterns.

Chapter Four, following the format of the preceding chapter, provides trends in internal governance structures, with case studies. The chapter presents the management structure of companies listed on ChiNext. Indicators are used to determine the effectiveness of the internal governance of CSMEs. They include the number and type of committees, their constituents and attendance.

Chapter Five assesses the effectiveness of external mechanisms for enforcement. It integrates into the enforcement debate, and the watchdog role played by both the Chinese media and China's public whistleblowing system in facilitating effective regulation by the regulators.

Chapter Six analyses which type of shareholder may be the most effective for corporate governance based on the results of the survey and case studies. In particular, it focuses on the role of pre-initial public offer (IPO) individual subscribers as being the most effective contributors to corporate governance at listed SME level.

Chapter Seven concludes the thesis with a summary and evaluation of the contributions of the study, highlighting the implications for comparative and traditional corporate governance theory, policy and practice, as well as making recommendations based on the study. It also indicates other disciplines to which the thesis makes contributions, as well as the limits of the research.

Chapter Two – Regulating ChiNext

I. Development of ChiNext

The idea for a growth enterprise market for China was first hatched in 1998. That year, under the leadership of Premier Li Peng of the State Council's National Science and Technology Leaders Working Group (*guojia keji lingdaoxiaozu*), official research started into the development of an equity market solely dedicated to funding the science and technology industry and the establishment of a venture capital system.¹¹⁴ Even then, the Shenzhen Stock Exchange was the choice for the new equity board. Following recommendations of the then chairman of the CSRC, Zhou Zhengqing, and research commenced on how the Shenzhen Stock Exchange could support technology transfer and promote the development of a hi-tech board.¹¹⁵ Although no official reason was proposed for the selection of Shenzhen as the choice for the new market, clearly its location in the southern economic zone, its proximity to Hong Kong and, most importantly, the region's historical significance as being where Deng Xiaoping gave a mandate for market-based economic development are significant factors.

As noted above, it took a decade before the actual establishment of ChiNext. Three practical reasons contributed to the long wait in establishing China's growth enterprise market. Firstly, venture capital investor financing, which was meant to be the core source of start-up funding, was limited.¹¹⁶ For instance, as well as the lack of knowledge, there was no definite government policy, especially in terms of exit strategy by IPO or private transfer.¹¹⁷

¹¹⁴ Zou Jian, ed., *Zhongxiaoye chuangyeban shangshi shiwu [Small and Medium-sized Enterprises on ChiNext: Listing Practice]*, 1st ed. (Beijing: Falu chubanshe [Law Press China], 2009).

¹¹⁵ Ibid., 8-16.

¹¹⁶ Hong Kong was perceived as the only real option for obtaining venture capital funding with an IPO exit strategy. See "Neidi Qiye Ruhe Dao Xianggang Chuangyeban Shangshi? [How Can Mainland Enterprises List on Hong Kong's Growth Enterprise Market?]," n.d., Fazhi yu shenghuo edition.

¹¹⁷ Wu Jingqiu, "Woguo chuanye huanjing bu you de xianzhuang fenxi [An Analysis of the Current Wanting Circumstances of China's Entrepreneurial Environment]," *Dangzhengganbu luntan (Cadre's Tribune)*, no.8 (2005): 20-21. (A comprehensive discussion of the deficiencies in venture capital and fostering entrepreneurialism in China.)

Secondly, there were not enough hi-tech SMEs for listing. Although China's answer to Silicon Valley, Zhongguancun Science Park, was established as early as 1988, it was a regional initiative by the Beijing government.¹¹⁸ China's national economy mainly focused on the manufacture of cheap exports to the West, mostly by medium and large SOEs, which dominated the funding. Official promotion of hi-tech science and technology industry had only just started in early 1996 with the establishment of the State Council's national science and technology leaders working group. Even if the hi-tech industry had true potential at the time, it was marred by the problem of funding on two levels. One was the deep-rooted and ideological problems in the national banking system, because SOEs were funded regardless of their financial viability, and consequently had had a high number of non-performing loans.¹¹⁹ The healthy few were geared at financing large SOEs. The other problem was the state policy of getting rid of SMEs, twinned with the fact that most of the burgeoning technology-focused enterprises were not state-owned but rather private. In all, few official avenues lay available for the funding of SMEs, especially for those in the private sector.¹²⁰ By the mid-1990s, getting rid of state-owned SMEs through absorption, bankruptcy or privatisation became the focus.¹²¹ Consequently, there was no encouragement of SMEs at either government, or private level where they now mostly existed.

Despite the above and the lack of funding for the private sector, constitutionally, ideological changes took place with the private sector being expressly encouraged to partake in the economy. In 1999, at the second session of the Ninth National People's Congress, the importance of the role of the self-employed, private enterprise and non-public sectors in

¹¹⁸ See, Susan M. Walcott, *Chinese Science and Technology Industrial Parks* (Aldershot: Ashgate, 2003).

¹¹⁹ Tenev and Zhang, *Corporate Governance and Enterprise Reform in China*, 21.

¹²⁰ Privatisation of state SMEs largely involved private funding from employees who were encouraged, where possible, to assume ownership through a management buyout. See Tenev and Zhang.

¹²¹ Tenev and Zhang, *Corporate Governance and Enterprise Reform in China*.

China's growth was emphasised, and reflected in the revised constitution.¹²² In 2004, this reached a crescendo with another amendment to the Constitution recognising that 'the non-public ownership economy is an important component of the socialist market economy.'¹²³

Equally, article 17 states that:

Collective economic organisations have decision-making power in conducting independent economic activities, on condition that they abide by the relevant laws.

This was effectively freedom to undertake economic activity in whatever form. This saw not only the increase of privately controlled enterprises but also the emergence of privately controlled listed enterprises, either as a result of private sector entrepreneurship or management buy-outs of former state-owned SMEs, and, importantly, their subsequent public listing in China. But, as mentioned earlier, a lack of funding from the state and limited private funds incapacitated the very hi-tech enterprises the state wished to encourage.

A policy turning point came in March 2002, with a three-step process ('*sanbuzou*'). Step one was the establishment of SME Boards on both the Shanghai and Shenzhen stock exchanges for subsequent development into a venture capital market. Step two was the promotion of venture capitalism as the initial funding mechanism for SMEs to enable transition into a venture capital market. The final step was the establishment of the venture capital market.¹²⁴ By the end of 2003, the Party finally indicated that China should focus on

¹²² See National People's Congress, "*Zhonghua Renmin Gonghe Guo Xianfa Xiuzhengan* (1999) (Amendment to the Constitution of the People's Republic of China (1999))," *Zhongguorenda Wang: Wwww.npc.gov.cn*, (28 September, 2010), url: <http://www.lawinfochina.com.ezproxy.soas.ac.uk/law/display.asp?db=1&id=6184&keyword=%CF%DC%B7%A8>.

¹²³ National People's Congress, "*Zhonghua Renmin Gonghe Guo Xianfa* 中华人民共和国宪法 (2004 年) (Constitution of the People's Republic of China 2004)," *Zhongguorenda Wang: Wwww.npc.gov.cn*, (28 September, 2010), url: http://www.npc.gov.cn/wxzl/wxzl/2004-04/19/content_334617.htm.

¹²⁴ Zou Jian, *Zhongxiaoye chuangyeban shangshi shiwu* [Small and Medium-sized Enterprises on ChiNext: Listing Practice], 8.

the establishment of multi-level stock exchanges.¹²⁵ In early 2004, the State Council produced a notice on the establishment of multi-level capital markets to address the funding needs of various SMEs.¹²⁶ Importantly, the proposals were no longer for a board dedicated only to hi-tech, science and technology enterprises. Instead, focus turned to establishing boards for SMEs in China's traditional industries of manufacturing, construction and engineering enterprises. In May 2004, SME Boards were launched on each stock exchange as pilot markets designed for the eventual conversion into a venture capital market. But, as noted above, most of the companies came from traditional industries. Furthermore, the venture capitalist industry in China remained too small and, therefore, not enough ventures were eligible for the establishment of a venture capital market.¹²⁷ From 2005 to 2008, research and reports were presented at the Party, State Council and central government levels discussing and recommending the form and regulatory framework ChiNext should take. For example, during this time, China's venture capital industry received a lot of patronage from the state. In November 2009, the ChiNext board was finally established as a standalone board rather than a conversion of existing SME Boards. This, in section, related to the relative success of the boards in raising funds. For example, between 2004 and 2010, the SME Board of the Shenzhen Stock Exchange raised USD53bn.¹²⁸

The 11-year history of ChiNext before its final establishment illustrates the acknowledgement of two deficiencies in China, namely the inadequacy of corporate governance practice and the lack of venture capital, private equity and institutional investors

¹²⁵ Paragraph 15 of CPC Central Committee, “*Zhonggongzhongyang guanyu wanshan shehuizhuyi shichang jingji tizhi ruogan wenti de jueding (2003nian 10yue 14ri zhongguogongchandang di shiliu jie zhongyang weiyuanhui di sanci quanti huiyi tongguo)*” (CPC, 2003), url: <http://cpc.people.com.cn/GB/64162/64168/64569/65411/4429167.html>.

¹²⁶ Zou Jian, *Zhongxiaoye chuangyeban shangshi shiwu [Small and Medium-sized Enterprises on ChiNext: Listing Practice]*.

¹²⁷ Li Tao and Zhang Sutang, “*Guojia keji jishu lingdao xiaozu huiyi; Li Peng zongli zhuchi shenqi bing yuanze tongguo guojia kewe guanyu jiashu keji jinbu huibao tigang deng*,” (1 September, 1998), 12th edn., sec. front page.

¹²⁸ Shenzhen Stock Exchange, *Small is Beautiful*, Focus No.213, (Nov 2010): 3.

required for venture capital. Undoubtedly, corporate governance practice needed to be improved before a market on similar terms to NASDAQ could be introduced in China. Moreover, such a market could only succeed with a mix of both venture capital investors and institutional investors that would not only provide much needed funding but also monitoring and governance. China enlisted a gradual approach to the development of ChiNext.¹²⁹

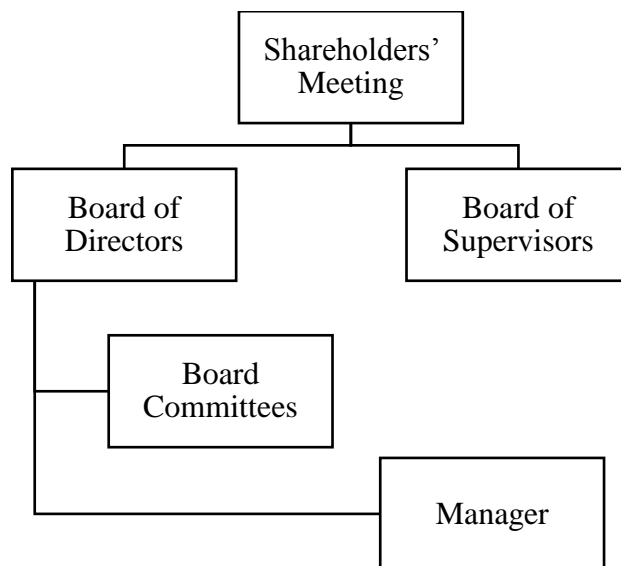
II. Legal Governance Mechanisms and Framework of ChiNext

All companies listed in China are also domiciled in the country and registered as joint stock companies in accordance with Chinese Company Law. China has developed its own model of internal governance structure for companies distinct from those of the advanced economies in North America, Europe and Asia Pacific. Under Chinese Company Law, the key constituents of an incorporated joint stock company in China are shareholders who are considered to be owners, represented by the shareholders' meeting, and a dual board system consisting of the board of directors and the board of supervisors and managers. The diagram below illustrates the basic structure required of all listed companies, i.e., companies incorporated as joint stock companies.¹³⁰

Figure 1: Legal internal governance structure of all companies listed in China

¹²⁹ Leng, *Corporate Governance and Financial Reform in China's Transition Economy*.

¹³⁰ See, Section III of this chapter from page 70. In China, companies can only be listed in the form of joint stock companies.



Further guidance supplements the cavities of the 2005 revision of both Company Law and Securities Law.¹³¹ The Listed Companies' Articles of Association Guidance 2006, the Listed Companies' Shareholders' Meetings Rules 2006, and similarly, the Takeover of Listed Companies Regulations 2007 each correspondingly set the disclosure obligations that related to direct and indirect purchases among other provisions and related legal liability. The Listed Companies' Information Disclosure Regulations 2007 introduced further information disclosure requirements for an IPO. It details information obligations in the publication of an IPO prospectus, periodic reports, ad hoc reports, information disclosure management, supervision and legal liability.

Company Law has two main functions: to promote business and to protect the interests of small and medium-sized shareholders.¹³² The emphasis of the revised law on the spirit of self-regulation by companies affords a more flexible approach to decision-making

¹³¹ For a detailed treatise on the defects of revisions of Chinese Company Law, see Liu Junhai, *Xin gongsifa de zhidu chuangxin: lifa zhengdian yu jieshi nandian (Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies)*, Di 1 ban (Beijing Shi: Falü chubanshe, 2006). Cf. Gan Peizhong, *Qiyue yu gongsi faxue [Jurisprudence on Enterprises and Companies]*.

¹³² Hu Tianye, *Gongsi Falü Caipan*, Di 1 ban (Beijing shi: Falü chubanshe, 2012): 4.

and reflects a key objective to promote business.¹³³ This not only reflects the freedom of enterprise afforded under the 2004 Amended Constitution but also, equally, provisions empowering shareholders such as derivative-type actions.

A. Capital Structure of ChiNext Companies: A Shares Only

The listing requirements on ChiNext are less vigorous and cheaper than the main markets in China. The minimum registered capital for listing on ChiNext is 30 million yuan¹³⁴ with at least 25% of the total amount of the company's shares stipulated for IPO.¹³⁵ Although these are the main share capital requirements, others can be imposed at the discretion of ChiNext (which is the market and regulatory body, too). However, the surveyed companies showed that all of the first 40 companies listed on ChiNext had less than 25% but more than 20% in the hands of the public. Thus, 80% or more of the share capital is retained by subscribers to the company who tend to be highly concentrated in a small group of 100 shareholders or less. The average percentage holding of share capital retained by subscribers on IPO of the surveyed companies is highly concentrated at 68.58%. There remains reason to believe that this average is unlikely to change much due to the origins of the companies, as explained later.

¹³³ An interesting survey of words and phrases connoting such flexibility such as 'can', 'as provided by the articles of association', 'except for approval by the shareholders as a whole' and similar that indicate they appear 117 times in the 2005 Company Law compared to only 75 times in the 1993 Company Law. Conversely, the use of 'court' appears 23 times compared to nine times, respectively. For details, see Luo Peixin, "Tianpu gongsi hetong 'fengxi' - gongsi jieru gongsi yunzuo de yige fenxi kuangjia [Filling the 'Chinks' in Company Contracts - A Framework for Analysing the Administrative Law Entering into Company Operations]," *Beijing Daxue xuebao (zhexue shehuikexue bao) [Beijing University Review]*, no.1 (2007).

¹³⁴ See Rule 5.1.1 of the Rules Governing the Listing of Shares on the ChiNext of Shenzhen Stock Exchange 2009 (the 'ChiNext Rules'). This is in the ballpark of US\$4.7million at today's exchange rate. However, where the share capital exceeds 400 million yuan, the minimum percentage is reduced to 10%. Few SMEs have been eligible for this exception.

¹³⁵ See Interim Measures on the Administration of Initial Public Offerings and Listings of Shares on ChiNext 2009 ('ChiNext Measures'). These rules are formulated in accordance with Article 145 of *Company Law of the People's Republic of China 2005* ('Company Law') and *Securities Law of the People's Republic of China 2005* ('Securities Law').

1. Capital Structure of ChiNext Companies

Under company law, all companies listed on stock exchanges in China must be incorporated as or converted to joint stock limited companies. They have common shares that rank equally, with each common share carrying one vote.

Two important observations can be made specifically about the companies listed on ChiNext. One is that shares issued in CSMEs are all tradable and only subject to subscriber-related lock-up trading provisions, as discussed below. Moreover, as most of the companies have been incorporated or converted to joint stock companies after China's share reform,¹³⁶ they are relatively free of legacy on non-tradable shares. Another is that the ChiNext framework does not permit multiple classes of shares in CSMEs. That is, no dual class of A and B shares exist. This means that domestic and foreign investors can invest equally and, thus, be exposed to the same investment risks and returns.¹³⁷ This did not help the already problematic oversight and monitoring problems of the state, as evidenced by tens of billions of US dollars expropriated from listed SOEs between 1998 and 2006.¹³⁸

¹³⁶ Historically, non-circulating shares were not tradable on any exchange even though the company, and the rest of its shares was listed. In January 2004, the State Council issued its Promoting the Reform, Opening and Steady Growth of Capital Markets Opinions, which removed 'non-circulating' shares and was implemented from April 2005. There are different takes on the purpose of non-tradable shares. It was recently admitted by the Securities Regulatory Commission that non-circulating shares amounted to a residual problem from a period before the SOEs became listed. Miao Yanjuan, "Yingmei shangshi gongsi nekong xinxi pilu zhidu dui wo guo de qushi (The Enlightenment of the Institutions for Public Companies Internal Control Disclosure from UK and US)," *Huiji yanjiu (Accounting Research)*, no. 9 (2007): 67–73. For a more critical assessment, see Donald C. Clarke, "The Ecology of Corporate Governance in China," SSRN eLibrary, (29 August, 2008), url: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245803.

¹³⁷ For instance, one conundrum facing scholars is why B shares, from inception, have traded at a considerable discount to A shares. See Gongmeng Chen, Michael Firth, and Jeong-Bon Kim, "The Use of Accounting Information for the Valuation of Dual-Class Shares Listed on China's Stock Markets," *Accounting and Business Research* 32, no.3 (2002): 123-31, doi:10.1080/00014788.2002.9728963.

¹³⁸ Andrea Beltratti and Bernardo Bortolotti, "The Nontradable Share Reform in the Chinese Stock Market," *Fondazione Eni Enrico Mattei Note Di Lavoro Series Index* 15 (2006): 2-3, url: http://it.cm.hit-u.ac.jp/sangyokai/jae/papers/beltratti_bortolotti.pdf.

2. Restricted Shares and Free-floating Shares on ChiNext

With IPOs, restrictions on the trading or transfer of shares issued may be imposed for a predetermined period of time by law, the regulators, the company or by mutual agreement. In most jurisdictions, these ‘lock-up’ provisions attached to shares apply to those who fund the company prior to its listing. They may include founders, members of management, employees, venture capitalists and other investors who invested in the company pre-IPO, referred to as insiders.

The same applies for companies listed in China, and they are referred to as restricted shares (*youxianshou tiaojian gupiao*). Those without trading restrictions are free-floating shares (*wuxianshou tiaojian gupiao*).¹³⁹ On ChiNext, at least 20% of the issued shares must be subject to IPO, i.e., free-floating shares. Most restricted shares are locked in for either 12 months or 36 months. The latter time period is voluntary because Company Law and Securities Law, as well as the ChiNext framework, only provide for an initial 12 month restriction on the trading of the shares to a maximum of 25% of the total holding in any financial year. In all of the surveyed companies, the controlling shareholders were covenanted to not transfer or deal in the shares of the company within the first 36 months following IPO. The average percentage of free-floating shares in the surveyed companies on IPO is 42.42%. Companies with more floating shares tend to be those that do not necessarily have maintaining a substantial part of the share capital as priority because they have non-monetary reasons for investment. This may be due to the need for funding outweighing retention of most of the shares in the company. That is, they are willing to sacrifice a substantial dilution of their shareholding in return for funding from the public. On the other hand, it may be a combination of both reasons.

¹³⁹ It must be noted that restricted shares are different from so-called non-tradable shares, which are being phased out. Non-tradable shares were held by the state and not subject to trade on any exchange, even though they formed part of the share capital of the company.

B. People's Court as a Corporate Governance Mechanism

The limitations of the People's Courts as general enforcers of law and, in particular, corporate governance are well documented.¹⁴⁰ In addition, there are legal and regulatory constraints. Investors are particularly limited; for instance, there is no recourse for action under Company Law for actions arising from related party transactions.¹⁴¹ There are also two hurdles before a claim gets to court. The first hurdle is that such actions can only be instigated where the Exchange to CSRC has first escalated the matter, or any other administrative agencies, the CSRC, or any other administrative agencies have found criminal acts or imposed administrative sanctions on the company or directors in question. Without either of these two decisions, the matter cannot be litigated. As a result, private litigation is very rare.¹⁴² For instance, between 2002 and 2003, only ten listed companies subjected to litigation reached the Supreme Court out of 900 cases heard at various levels in regional courts.¹⁴³ The second hurdle is that such an action would need the approval of the legal representative of the company. The legal representative is also likely to be the controller (or an associate), who is unlikely to authorise an action that could be to his or her detriment. Thus, minority shareholders seeking legal redress are limited in private law. Conversely, the chairman's signature is both necessary and sufficient for the company to act as a plaintiff in litigation. If litigation is unfavourable to his or her position, most certainly if a defendant,

¹⁴⁰ Studies have indicated the problems of corruption, fraud, lack of independence or political power in China. For corporate law and governance perspectives, see Peizhong Gan and Liu Lanfang, eds., *Xinlei Xing Gongsì Susong Yinan Wenti Yanjiu (Studies on the Litigation Difficult Issues of New Style Corporate)*, Di 1 ban, Jingji Faluncong (Series of Economic Law) (Beijing: Beijing daxue chubanshe, 2009); Clarke, "The Ecology of Corporate Governance in China." For a general perspective of the (limited) role of the courts in the legal system, see Tang Xin, "Siren Susong Yu Gongsìzhili (Personal Litigation, Corporate Governance and Law Enforcement in Securities)," in *Gongsìzhili Zhuanlun (Studies on Corporate Governance)*, ed. Gan Peizhong and Lou Jianbo, Di 1 ban (Beijing: Beijing da xue chu ban she, 2009), 381-419; R. P. Peerenboom and Cambridge Books Online, *China's Long March Toward Rule of Law* (Cambridge, UK: Cambridge University Press, 2002).

¹⁴¹ Hu Tianye, *Gongsì Falü Caipan*, Di 1 ban (Beijing shi: Falü chubanshe, 2012): 4. See also, Liu Junhai, *Xin gongsìfa de zhidu chuangxin: lifa zhengdian yu jieshi nandian (Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies)*.

¹⁴² For a detailed case-study examination, see Clarke, "The Ecology of Corporate Governance in China."

¹⁴³ See Song Xiao, *Zhongxiaotouzizhe baohu falü zhidu yanjiu [Research on the Legal Protection Framework for Small and Medium sized Investors]* (Beijing: Beijing shifan daxue chubanshe, 2012): 142.

then it is unlikely to proceed without agreement, except in certain circumstances.¹⁴⁴ The matter is worsened where the legal representative also holds the role of chairman and controlling shareholder. In any event, it is currently unlikely that the government will permit private litigation so soon on ChiNext. The implications of permitting such loosening of the CSRC's tie are that the floodgates might be opened. Discussions about shareholder actions fall outside the remit of this thesis, largely because of empirical results demonstrating that there has been no corporate governance litigation relating to ChiNext listed companies either disclosed or revealed through news media. In general, scholars have found that company-law-based litigation has been mostly related to non-listed companies, specifically limited liability companies.¹⁴⁵

C. External Enforcement Mechanism: CSRC

The China Securities and Regulatory Commission (the 'CSRC'), formally established in October 1992, had its regulatory role confirmed under Securities Law in 1998, and expanded upon in the revised Securities Law in 2005. The CSRC reporting directly to the State Council has generated some debate about the extent of the powers of the CSRC, whether it is merely an institutional unit (*shiye danwei*) or an administrative department with powers to enforce rules.¹⁴⁶

In terms of its administrative function, the CSRC presides over the Shenzhen Stock Exchange as a whole. Indeed, the CSRC approves the articles of association of each stock

¹⁴⁴ See Fang Liufang, "Guoqi fading daibiaoren de falu diwei, quanli he liyi chongtu [The Position, Powers and Conflicts of Interest of the Legal Representative in State-owned Enterprises]," *Bijiaofa yanjiu [Research in Comparative Law]*, no.3 (1999), url: <http://www.civillaw.com.cn/article/default.asp?id=9199>.

¹⁴⁵ See Peizhong Gan and Liu Lanfang, eds., *Xinlei Xing Gongsì Susong Yinan Wenti Yanjiu (Studies on the Litigation Difficult Issues of New Style Corporate)*, Di 1 ban, Jingji Faluncong (Series of Economic Law) (Beijing: Beijing daxue chubanshe, 2009). (Collection of essays relating to company law and corporate governance litigation with Beijing courts as a case study, wherein most of the judicial decisions are related to non-listed companies.)

¹⁴⁶ See Fu, *Corporate Disclosure and Corporate Governance in China*, (2010). See also Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008).

exchange and appoints their general managers, including ChiNext. Although the Exchange issues and enforces the ChiNext Measures and the Rules, overall power remains with the CSRC as new regulations fall within its purview and are, therefore, subject to its prior approval.

The challenge for the CSRC and the Exchange is to balance corporate governance regulation and the need to encourage entrepreneurial spirit and innovation. As Clarke notes, these debates are academic in China, as the wielding of power is political and the CSRC can only be judged by its success or limitations in exercising its authority under Securities Law.¹⁴⁷ The recent focus on corporate governance indicates a move away from a sole focus on economic growth. The corporate conduct of both companies, their directors and officers was overlooked by imposing barriers to private law enforcement and law administrative enforcement. As will be seen below, this change toward a more proactive corporate governance environment is also demonstrated by the new delisting rules, which emphasise corporate governance failure as just as important a reason for delisting a company.

As the institutional corporate governance framework for enforcement under the CSRC was perceived inadequate, during the revision of Securities Law in 2005 its role and remit was reinforced with detailed specific securities offences for which it imposed fines on market participants. Notwithstanding this authority, from 2002 to 2007, none of the punishment decisions by the CSRC or stock exchanges related to any substantive rule of corporate governance.¹⁴⁸ A study by Pistor and Xu indicates that, in 2003, only one in 25 companies listed on both stock exchanges were subject to any type of enforcement activity.¹⁴⁹ Part of the reason for the weak enforcement was the lack of clear apportionment in law and rules of

¹⁴⁷ For further details on the debates, see Clarke, “The Ecology of Corporate Governance in China,” (29 August, 2008), 32ff.

¹⁴⁸ Ibid., 42.

¹⁴⁹ Katharina Pistor and Chenggang Xu, “Governing Stock Markets in Transition Economies: Lessons from China,” *American Law and Economics Review* 7, no.1 (Spring 2005): 195, doi:10.1093/aler/ahi008.

responsibility for ensuring a robust internal governance system in listed companies. Only general principles were provided under Company Law and Securities Law, and no procedural guidance or designated mechanisms were used for ensuring internal controls that companies and their constituents implemented and complied with until a spate of secondary and tertiary legislation after the amendment of both laws in 2005.

The CSRC has been described as policy-driven in application of its rules and enforcement activities.¹⁵⁰ Nonetheless, it appears that individual shareholders (and stakeholders) have confidence in the CSRC to resolve issues.¹⁵¹ The CSRC has proved a more effective and even shareholder-friendly mechanism for the protection of shareholder rights, compared to the courts.

III. Regulatory Mechanisms under the ChiNext Framework

The legal, regulatory and operational rules of both the Shanghai Stock Exchange and the Shenzhen Stock Exchange, including ChiNext, remain very much the same.¹⁵² Thus, this thesis focuses on the ChiNext framework, examining those areas that are unique. Where required, this thesis will provide the context of ChiNext in relation to the Shenzhen Stock Exchange Main Board rules. Legal commentators have advised that the scope, quality and characteristics of different listed companies clearly demonstrate that there should be different market trading rules.¹⁵³

¹⁵⁰ For an analysis of the CSRC's role and effectiveness see Jane Fu, *Corporate Disclosure and Corporate Governance in China* (Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2010).; Xi, *Corporate Governance and Legal Reform in China*, (2009); Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008).

¹⁵¹ A study of enforcement by CSRC and court between 1992 and 2009 by Xiao Song shows that small investors on China's stock exchanges were more likely to report an infraction to the CSRC than the courts, seemingly due to ease of access and cost-effectiveness of the regulator. See Song Xiao, *Zhongxiaotouzizhe baohu falü zhidu yanjiu [Research on the Legal Protection Framework for Small and Medium sized Investors]* (Beijing: Beijing shifan daxue chubanshe, 2012).

¹⁵² See Gan, *Qiyu gongsi faxue [Jurisprudence on Enterprises and Companies]*, (2012): 215.

¹⁵³ Ibid.

The details of the regulatory framework of ChiNext are set out in three main documents. Firstly, the Temporary Administrative Measures for Initial Public Offerings and Listing on ChiNext 2009 (the ‘ChiNext Measures’) provides the basis standards and requirements for listing and applies prior to and after IPO. Secondly, the Rules Governing the Listing of Shares on the ChiNext board of the Shenzhen Stock Exchange 2009 (the ‘ChiNext Rules’;) sets out the continuing obligations of listed companies. Finally, the Guide to Operational Standards on ChiNext 2009 (the ‘ChiNext Standards’) provides further guidance that complements and supplements the former two regulations. Since the establishment of ChiNext in November 2009, the CSRC and Shenzhen Stock Exchange have formulated further regulations. Most importantly, they include the revision of the Listing Rules in 2012 to crucially include tailor-made and detailed delisting rules for ChiNext, and earlier in 2011 the issue of the ChiNext Public Condemnation Rules (the ‘Public Condemnation Rules’) provide clarity on violations and corresponding disciplinary actions, both of which aimed at managing the expectations of listed companies, their investors and their advisers. An examination of both of these regulations and developments and others takes place in Chapter Five as a demonstration of the continuous development of corporate governance law-making and enforcement by the regulators in response to undesirable corporate conduct.

The 2009 ChiNext Rules apply after listing as continuing obligations that provide the detail that the general principles of Company Law and Securities Law omit. Thus, to meet the corporate governance legislative requirements, a company publicly listed on ChiNext must comply with the provisions of Company Law, Securities Law, the Corporate Governance Standards of Listed Companies 2002 jointly issued by the CSRC and the defunct State Economic and Trade Commission (SETC),¹⁵⁴ the Rules on Listed Companies Shareholders

¹⁵⁴ See China Securities Regulatory Commission, and State Economic and Trade Commission, “*Guanyu fabu shangshi gongsi zhili zhunze de tongzhi* [Corporate Governance Standards of Listed Companies 2002].” Government. China Securities and Regulatory Commission, July 1, 2002. url:

Meetings,¹⁵⁵ the Guide to Articles of Association for Listed Companies¹⁵⁶ and the Guiding Opinion on the Establishment of a System of Independent Directors.¹⁵⁷ Both the Measures and the 2009 Rules must also be taken in the context of other provisions such as those relating to independent directors, shareholder meetings and articles of association.¹⁵⁸ The figure below provides an overview of the regulatory corporate governance structures of ChiNext. The main difference from the basic structure under Company Law is that there must be a board of supervisors rather than an appointed person and there are prescribed board committees.

Figure 2: Regulatory framework of ChiNext

http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167722.htm. In March 2003, the responsibilities of SETC were taken over by the National Development and Reform Commission (NDRC), and SETC no longer exists as a commission.

¹⁵⁵ Issued and announced on 16 March, 2006. See China Securities Regulatory Commission, “*Shangshi gongshi gudong dahui guize* [Rules on Listed Company Shareholders General Meeting 2006].” Government. *China Securities and Regulatory Commission*, (16 March, 2006). url: http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167766.htm.

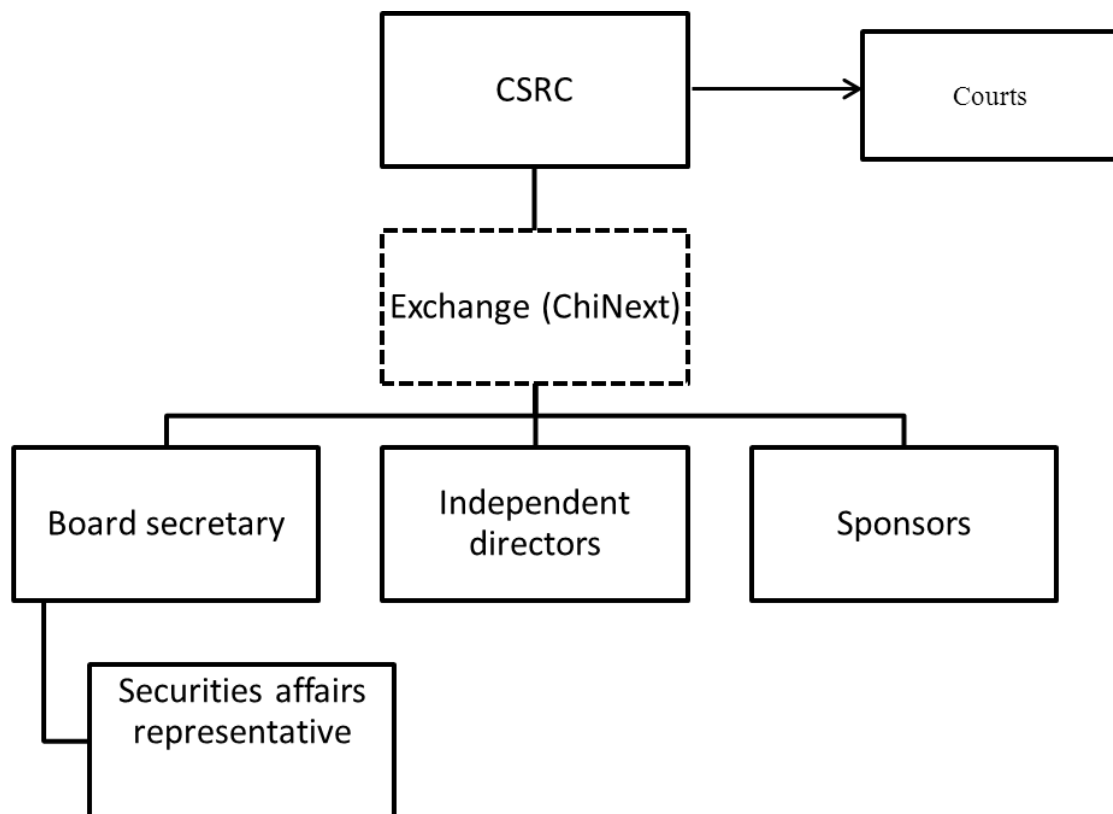
¹⁵⁶ See China Securities Regulatory Commission, “*Guanyu fabu shangshi gongsi zhangcheng zhiyin (2006nian xiuding)* [Guide to Articles of Association for Listed Companies (As Amended in 2006)].” Government. *China Securities and Regulatory Commission*, (16 March, 2006). url:

http://www.csrc.gov.cn/pub/shenzhen/xxfw/tzzsyd/ssgs/sszl/ssgsxx/200902/t20090226_95494.htm. The 2006 Guide amends the Guide to Articles of Association for Listed Companies issued by the CSRC in 1997. [Do I need to discuss the differences briefly to highlight how far China has come in corporate governance?]

¹⁵⁷ See China Securities Regulatory Commission, “*Guanyu fabu guanyu zai shangshi gongsi jianli duli dongshi zhidu de zhidao yijian* [Guiding Opinion on the Establishment of a System of Independent Directors].” Government. *China Securities and Regulatory Commission*, (16 August, 2001). url:

http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080305_77981.htm.

¹⁵⁸ Rule 3.1.11 of ChiNext Rules.



Source: Author's impression

Public enforcement mechanism – CSRC

A. Interim Measures for IPO and Listing 2009

The Measures provide the overall objectives of the regulatory framework of ChiNext where it expressly promotes good corporate governance practice. The Measures state four principles, namely, to promote independent innovative enterprise, the development of long-term growth enterprises, the protection of shareholders and the protection of the public interest as a whole.¹⁵⁹ Of especial note is that the objective to promote independent enterprise appears to

¹⁵⁹ Article 1 of China Securities Regulatory Commission, “*Shouci Gongkai Faxing Gupiao Bing Zai Chuangyeban Shangshi Guanli Zanxing Banfa* [Temporary Administrative Measures for Initial Public Offerings and Listing on ChiNext].” Government. The Central Government of People’s Republic of China, (31 March, 2009). url: http://www.gov.cn/gongbao/content/2009/content_1399851.htm.

have developed into a concept that underpins law-making, application approvals and rejections and general enforcement activity on ChiNext.

1 Mandatory Internal Governance Structure

The Measures give detail on the broad principles enunciated under both Company Law and Securities Law. Any company wishing to publicly list on ChiNext must undertake corporate governance as a responsibility of the company under law.¹⁶⁰ The Measures detail the corporate governance principles and rights and obligations arising. In addition to the legal requirement of a shareholders meeting, board of directors, board of supervisors, independent directors and board (or company) secretary, the Measures also make mandatory the audit committee system. They also provide the overall objectives of the regulatory framework of ChiNext, expressly promoting good corporate governance practice. Other objectives are implicit in the texts of both the Measures and the 2009 Rules.

In addition, to the legal requirements of the executive board, supervisory board and independent directors, the Measures impose a mandatory internal governance structure that must be in place at the time of application for listing. Emphasis has been on prescribing in detail the internal governance system of companies wishing to list on ChiNext. For instance, the Measures require that every company must have an audit committee.

Chinese scholars believe that, without more detailed internal governance as prescribed under ChiNext, listed companies would collapse out of managerial chaos, thereby defeating the objective of promoting and sustaining long-term companies in the market.¹⁶¹ Thus, the Measures and 2009 Rules complement China's modern enterprise system by imposing managerial governance benchmarks and regulating compliance.

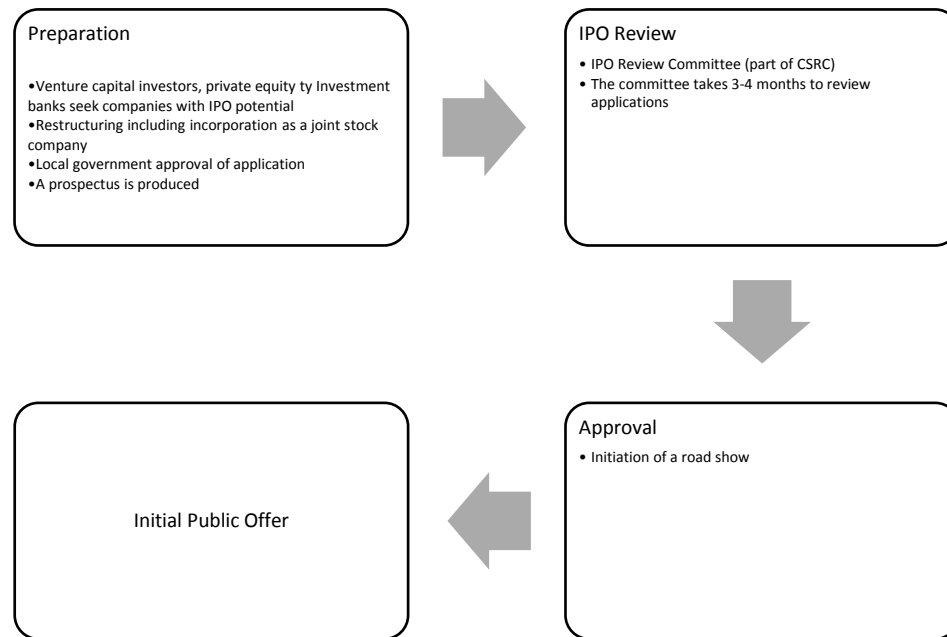
¹⁶⁰ Article 19 of the ChiNext Measures.

¹⁶¹ Zou Jian, *Zhongxiaoye chuangyeban shangshi shiwu [Small and Medium-sized Enterprises on ChiNext: Listing Practice]*, 136.

2 Listing Process and Criteria

An independent IPO Review Panel presides over the selection of companies for IPO, while the Expert Advisory Committee proffers expert advice according to the type of industry of the company applying for listing. The figure below illustrates a snapshot of the application process.

Figure 3: Listing process and timing on ChiNext



Despite going through such a long and expensive process, companies are not automatically listed just because they have applied. Chapter Six will demonstrate that the reasons for rejection are overwhelmingly because of corporate governance irregularities and financial reporting disclosures.

Since late 2012, in a drive to increase transparency and also to set precedents and examples, the CSRC and the Exchange started publishing the IPO application waiting lists and rejection notifications.

B. ChiNext Listing Rules

The 2009 Rules detail the procedures and documents mainly aimed at setting out disclosure obligations and identifying those responsible for fulfilling such obligations, as well as disciplinary actions and sanctions for their breach. Of its 19 chapters, six deal with substantive corporate governance issues. Chapter II sets out the general principles and provisions on information disclosure, with further obligations particularly imposed on de facto controllers. Chapter III defines the roles and duties of directors, supervisors, senior management, controlling shareholders and de facto controllers. Chapter IV relates to sponsors, Chapter VIII to resolutions of boards of directors and supervisors and shareholders' general meetings, Chapter IX to disclosable transactions, Chapter X to related party transactions and Chapter XVIII to regulatory measures and disciplinary actions against breaches

1. Prohibited Trading Periods

Directors and senior managers cannot transfer the shares they hold in the company within one year of the date of listing of the company's shares and within half a year of the date of leaving office.¹⁶² In addition, along with shareholders who own 5% or more of the total shares in the company, they must not purchase to then sell, or sell to then purchase the shares of the company within a six month period. Profits accrued from such trading belong to the company, and it is the duty of the executive board to disgorge the offending person of the profits.¹⁶³

¹⁶² Rule 3.1.11 of ChiNext Rules.

¹⁶³ Rule 3.1.11 of ChiNext Rules. Chapter Five demonstrate how enforcement of this rule has been strict.

2. Delisting of Shares

As mentioned earlier, the ChiNext Rules were revised in 2012 specifically to include detailed rules relating to a delisting criteria developed uniquely for ChiNext listed companies. Prior to the revision of the ChiNext Rules relating to delisting, there was no clear delisting mechanism for companies listed, and the focus was on a graded risk warning process ultimately leading to delisting. The ChiNext Rules set out ten predominantly financial-performance-based circumstances based on which the Exchange will issue a delisting risk warning.¹⁶⁴ An important problem is that the ten scenarios where for which the Exchange will issue such a warning does not include corporate- governance- related matters, with the exception of false financial reporting. It is essentially an earning-based delisting regime.

The delisting risk warning requires the company to revise its short stock name by adding a prefix of ‘ST’ to denote its Special Treatment status.¹⁶⁵ The Exchange further imposes a daily share price movement limit of 5% on ST companies. The ChiNext Rules also set out details on how companies can apply for removal of the risk warning, which in general tends to point to improved financial performance. However, there is no indication of what violations will result in an automatic delisting, nor is there a clear graded progression toward delisting as a penalty.

This graded risk warning process meant that there was no real and immediate practical sanction for companies exhibiting extremely undesirable corporate activity or underperformance as on all other equity markets in China.¹⁶⁶ But the problem with this

¹⁶⁴ Rule 13.1.3 of ChiNext Rules.

¹⁶⁵ Companies to be delisted were labelled to “*ST*” as a warning to investors. Rule 13 of ChiNext Rules mirrors a generic set of provisions found in rules of the other equity boards on both the Shanghai and Shenzhen Stock Exchanges.

¹⁶⁶ Importantly, ST companies are put on a separate list and, therefore, effectively under a different listing regime. One problem with this system is that many companies have comfortably remained under the ST regime for years, which indicates that they have not improved, yet have are not being delisted. Ironically, the ST regime has resulted in a parallel ST market for investors to make huge returns by investing in underperforming companies which eventually recover performance to return to the standard market.

process was that many companies continued their poor performance for years without ever being delisted.¹⁶⁷

In terms of corporate governance, issues relate to the content and publication of the financial position of the company or changes to its equity structure. They include correcting material errors or false representation in a previously released financial report, or failure to make amendments on time,¹⁶⁸ and a failure to disclose changes to its equity structure on time.¹⁶⁹ Clearly, these rules do not have direct corporate governance reasons for issuing a delisting warning.

As will be seen in Chapter Six, a combination of pressures from the market and the media and a regulatory scandal to the detriment of investors led to the regulators setting out a clear-cut and (in theory a) quick process for delisting an errant company. Crucially, the Exchange now holds the power to delist under the ChiNext framework rather than the CSRC.

3. ChiNext Operational Standards - Enforcement Proceeding

As stated earlier, the Shenzhen Stock Exchange, in addition to managing ChiNext and the other markets on its exchange, also investigates and enforces disciplinary actions and sanctions against those in violation of the ChiNext framework, which falls within its remit.¹⁷⁰ The Exchange has the following regulatory measures at its disposal, depending on the nature and gravity of the breach. It can require explanations and clarifications, require intermediaries to conduct checks and issue opinions or request the appointment of intermediaries for that purpose, issue written warnings (various notices and letters), issue summonses to individuals for regulatory talks, cancel the qualification certificates of individuals, refuse to accept the

¹⁶⁷ Ma Jun, “Lun Woguo Chuangyeiban Tuishe Chengxu de Wanshan: Jiyu Touzizhe Quanyi Baohu Shijue (The Improvement of Delisting Procedures of China’s Growth Enterprise Market: From the Perspective of Investor Rights Protection),” *Shanghai Jinrong (Shanghai Finance)*, 2011.

¹⁶⁸ Rules 13.2.1 (2) and (4) of ChiNext Rules.

¹⁶⁹ Rules 12.13 and 13.2.1 (8) of ChiNext Rules.

¹⁷⁰ Rule 17.1 of ChiNext Rules.

documents issued by relevant parties, restrict trading, report (escalate) matters to the CSRC and other measures that are appropriate. Unlike the CSRC, the Exchange does not have any powers under Securities Law. Therefore, its ability to enforce is not limited to the specific offences and rules laid out in Chapter 11 of Securities Law. Indeed, a disciplinary action committee first reviews the actions of the persons and must then issue its independent and professional judgement to the Exchange, which the Exchange can decide whether or not to follow.¹⁷¹

The Exchange is also empowered to discipline directors, supervisors, senior management, board secretaries and sponsors in breach of their disclosure obligations. Depending on the seriousness, this can be by circulating a notice of criticism or imposing a public announcement that the person is unsuitable for the position to be held.¹⁷²

4. A Principle of Independence for the Company and its Key Constituents

The regulatory framework of ChiNext promotes independent innovative enterprise by requiring clear and strengthened information disclosure by companies. The key to ensuring transparency and the viability of the company is the principle of independence. The principle of independence does not only relate to the independence of the company as a going concern in its own right but also refers to independence in the context of assets, management and ownership structure.

This remains one of the main challenges of growth enterprise markets in striking a balance between investors' need for information about their investments in a high-risk enterprise and the company's need for innovation requiring a degree of secrecy. Information asymmetry is especially high where products have not come to market and, thus, there is no

¹⁷¹ Rules 17.7 of ChiNext Rules.

¹⁷² Rules 17.2 to 17.5, inclusive, of ChiNext Rules.

precedence for the investor to rely on when exercising the right to buy or sell shares in a company. Hi-tech companies tend to have price-sensitive information that they also wish to keep secret; however, the disclosure of information about company projects, innovation and progress is fundamental. To ensure listing companies are independently innovative within a month of listing, they are required to hold an annual report meeting to provide investors and potential investors with information about their product strategy, operational performance, new product or technology development, financial results, investment projects, sales and purchase of core technology, changes in core technology teams or key technical personnel.¹⁷³ Thus, the operational ideal of ChiNext is an emphasis on strict information disclosure.

C. Internal Governance under Company Law and Securities Law

This section outlines the internal governance mechanisms laid down by Company Law and Securities Law.

1. Shareholders' Meeting

China has a shareholder-centred model of corporate governance wherein all decision-making powers are vested in the shareholders' meeting. The shareholders' meeting is also known as the 'organ of intention' (*yisi jiguan*), which reflects the fact that opinions expressed at the shareholders meeting should have (at least in theory) a restraining effect on the external activities of the company.¹⁷⁴ Under Company Law, the shareholders' meeting is the organ of power.¹⁷⁵ As a joint stock company, an annual general meeting ('AGM') must be held each

¹⁷³ Shenzhen Stock Exchange, *Small is Beautiful*, Focus No213 (publisher is WFE) November, 2010: 7.

¹⁷⁴ Gan, *Qiyu gongsi faxue [Jurisprudence on Enterprises and Companies]*, 2012: 219.

¹⁷⁵ Article 37 of Company Law.

year¹⁷⁶ where shareholders decide the following matters: the business policy and investment plans, election and recall of members of the board of directors and board of supervisors and their remuneration and examination and approval of the reports of the board of directors and board of supervisors. The meeting also examines and approves the annual financial budget plan and final accounts, plans for profit distribution of the company and plans for making up losses, adoption of resolutions on the increase or reduction of the registered capital of the company, the issuance of company bonds and assignment of capital contribution by a shareholder to a person other than the shareholders. The meeting also presides over matters such as the merger, division, transformation, dissolution and liquidation of the company and amendments to the articles of association of the company.¹⁷⁷

In addition to the requirement of at least an AGM, joint companies must convene an ‘interim’ general meeting when the number of directors is less than two-thirds of the number of directors, unrecovered losses amount to one-third of the total paid-up capital, or at the request of shareholders separately or in aggregate holding 10% or more of the total share capital of the company, or by either the executive board or supervisory board.¹⁷⁸

The board of directors (‘executive board’) is not independent of the shareholders’ meeting and, thus, can only act in accordance with powers delegated under the company’s articles of association or by a shareholders’ meeting.¹⁷⁹ The concentration of so much power in shareholders has been a source of criticism.¹⁸⁰ It has been perceived as a product of the effects of state-ownership and the pervasive influence of the Party in corporate law.

¹⁷⁶ Article 101 of Company Law. In contrast, limited liability companies are not required to have one regular meeting a year; instead Article 40 leaves it for the company’s articles of association to stipulate when it will hold regular meetings.

¹⁷⁷ Article 38 of Company Law.

¹⁷⁸ Article 101 of Company Law. Unlike joint stock companies, under article 40 limited liability companies need only hold an interim shareholders’ meeting when requisitioned by shareholders of 10% of the total voting rights, or by the executive or supervisory boards (or supervisor).

¹⁷⁹ Zhao Xudong, *Gongsi faxue [Jurisprudence on Companies]* (北京市: 高等教育出版社, 2006): 381.

¹⁸⁰ Liu Junhai, *Legislative and Judicial Controversies*, (2006).

2. Board of Directors

The development of a stronger board of directors compared to the shareholders' meeting in the last several years may appear a contradiction seeing that overriding power is located in the board. Commentators explain that this emphasis on directors' duties in China's Company Law has being spurred by developments in the West.¹⁸¹

The ChiNext framework does not provide a benchmark for judging the eligibility of a person nominated to be a director of a CSME. Instead, guidance must be sought in article 147 of Company Law, which prescribes the six circumstances in which a person becomes ineligible to be a director. Firstly, a person of limited or no capacity for civil conduct cannot be a director. Secondly, anyone who, within five years or less, was sentenced criminally for bribery, embezzlement, seizure or misappropriation of property or sabotage of the socialist market economic order, where less than five years have elapsed after the expiration of the period of execution. Thirdly, a person deprived of his political rights because of the commission of a crime and less than five years have elapsed since the expiration of the period of execution. Fourthly, a person who was a director, the head or manager of a company or enterprise that went into bankruptcy and liquidation and was personally liable for the bankruptcy of the said company or enterprise and less than three years have elapsed from the date of liquidation of the company or enterprise is completed. Fifthly, a person who, being the legal representative of a company or an enterprise, the business license of which was revoked for violation of law and which was ordered to close down, was personally liable for the above, where less than three years have elapsed from the date the business license of the company or enterprise is revoked. Finally, a person who fails to liquidate a relatively large amount of personal debts when they are due cannot be director of a company. The provision

¹⁸¹ Ibid.

makes invalid any such appointment and also demands the removal of existing directors who fall within the list. But these provisions do not focus on promoting behavioural expectations.

ChiNext rules primarily legislate to ensure the quality of the constituents of the executive board, which remains especially important given the potential for managers to control an enterprise for their own benefit. The Measures require directors to have the professional qualifications required by law, administrative regulations and rules, though no details are given. To be eligible, a person must not be under an existing CSRC ban from the securities market,¹⁸² neither must she be subject to any administrative sanction by the CSRC in the last three years¹⁸³ nor recent public censure by a ChiNext regulator, nor under investigation by a judicial authority for suspected crimes or under investigation by the CSRC for suspected irregularities, when there has been no conclusive enforcement decision as yet.¹⁸⁴

However, most directors tend to be guilty of neglect rather than a breach of any of the above provisions. This neglect may be attributed to lack of time, knowledge or expertise or even interest in the enterprise. Therefore, even more de facto power devolves to managers since members of the board fail to engage with the company.

3. Independent Directors

Independent directors in China are an important mechanism for the protection of minority shareholders, the monitoring of the board of directors and the provision of independent opinions to the regulators and the public. Company Law requires that a joint stock company ‘shall have independent directors and the specific measures shall be stipulated

¹⁸² Article 25(1) of ChiNext Measures.

¹⁸³ Article 25(2) of ChiNext Measures.

¹⁸⁴ Article 25(3) of ChiNext Measures.

by the State Council'.¹⁸⁵ The Guiding Opinions on the Establishment of the System of Independent Directors in Listed Companies 2001 mandates that independent directors

...pay attention that the lawful rights and interests of small and medium shareholders are not prejudiced.¹⁸⁶

At least one third of the board of directors must be independent. There is a lot of literature, both academic and in practice, about the importance of independent directors in providing the 'independent' element that a board of directors needs in order to be effective in its decision-making and monitoring of management. In terms of appointment, it remains difficult to ascertain the process by which non-executives without representative shareholding are selected. The 2009 Rules in line with Company Law and the Code require cumulative voting at a shareholder's meeting where independent directors will be elected. The company must circulate to all shareholders a notice of meeting, which provides the name of the nominator, the candidate's statement and curriculum vitae.¹⁸⁷ Before election, information about the candidate must be submitted to the CSRC, which then appraises the suitability of the candidate as an independent director. The CSRC can object to an appointment, which can result in the removal of the candidate from the election process.¹⁸⁸ Again, in a drive toward transparency, and in addition to the disclosure announcement by the company, the Exchange also publishes the name and brief details of the independent directors on its website as part of the so-called credibility record system detailed under the 2009 Rules.¹⁸⁹ Indeed, of late there has been a rise in the number of directors rejected not only as independent directors but also

¹⁸⁵ Article 123 of Company Law.

¹⁸⁶ Article 1(2) of Guiding Opinions on Independent Directors.

¹⁸⁷ Rule 3.1.13 of ChiNext Rules.

¹⁸⁸ Rules 3.1.14 and 3.1.13 of ChiNext Rules.

¹⁸⁹ Rule 3.1.16 of ChiNext Rules.

as either directors or as persons participating in China's capital markets. Some suspensions have lasted for up to ten years.¹⁹⁰

4. Board of Supervisors

Under Company Law, all listed companies must have a supervisory board.¹⁹¹ The supervisory board acts as a whole and not as individual members. The only time supervisors are given individual powers to act is where there is only one appointee to the position in a limited liability company. Consequently, decisions must be unanimous or represent a majority. Under Company Law supervisors have express duties, fiduciary and otherwise, which are much the same as those of the directors of the board. The terms of reference of supervisors include monitoring directors and officers, examining the financial affairs of the company, supervising acts of management that violate laws, regulations and articles of association, demand that the management rectify wrong-doings and propose the convening of an extraordinary meeting.¹⁹² They are also empowered to conduct an investigation and engage an accountancy firm if they believe the company's situation is abnormal.¹⁹³ The votes of half of the board are required to adopt a resolution.¹⁹⁴ As one third of the board must consist of employees of the company, this means that most non-employee members must agree before a resolution is passed. Meetings are infrequent since the minimum requirement is every six months, to which most companies adhere, although interim meetings are permitted.¹⁹⁵ Voting and other procedures must be in accordance with the articles of association.¹⁹⁶ The remit of the supervisory board is to supervise directors, officers and the

¹⁹⁰ The CSRC publishes approvals, rejections and bans on its website: www.csrc.org.cn.

¹⁹¹ Article 118 of Company Law.

¹⁹² Article 54 of Company Law.

¹⁹³ Article 118 of Company Law.

¹⁹⁴ Article 120 of Company Law.

¹⁹⁵ Article 120 of Company Law.

¹⁹⁶ Article 120 of Company Law.

senior management of the company. Supervisors are permitted to attend board meetings in a non-voting capacity,¹⁹⁷ which is supposed to enable them to carry out their obligation to prevent the abuse of power by the company directors, controlling shareholders, de facto controllers and related third parties. However, it is well documented that, although this is a mandatory organ of the company that reports directly to the shareholders' general meeting, it rarely does so and remains powerful only in print but weak in practice.¹⁹⁸ Unsurprisingly, the 2009 Rules do not make any specific provisions for the supervisory board; rather, both the Measures and 2009 Rules focus on reinforcing the role of the independent director and empowering the secretary and sponsors to monitor the company, with obligations to report irregularities. This regulatory framework in which the secretary has a dominant role in information disclosure, internal governance and investor relations is exclusive to ChiNext.

5. Manager

Under article 119 of Company Law, the manager (also referred to as 'general manager' or 'chief executive') reports directly to the board of directors as well as being appointed and dismissed by them. However, the manager has extensive powers, albeit that he or she is directly responsible to the board of directors for the production, operation and management of the company and the implementation of resolutions of the board. The manager has authority under law to implement annual business and investment plans, establish internal management organs, establish a basic management system and formulate specific rules and regulations. Managers also recommend the appointment or dismissal of deputy manager(s) or persons in charge of the financial affairs of the company, and in their own right can appoint and dismiss management personnel not appointed or dismissed by the board of directors. Managers also

¹⁹⁷ Article 119 of Company Law.

¹⁹⁸ Article 118 of Company Law; Liu Junhai, *Legislative and Judicial Controversies*, (2006). See also Zhao Xudong, *Gongsi faxue [Jurisprudence on Companies]* (Beijing: Gaodeng jiayu chubanshe, 2006).

exercise any powers delegated under the company's articles of association. Although the remit of managers may not appear wide, their remit is one that is provided for under primary legislation, and, therefore, to that extent, is not a matter for internal negotiation by the board of directors, or even the shareholders for that matter. In effect, the board can delegate other functions and powers to managers but they cannot delimit those already set out in Company Law 2005. This, combined with the concentration of day-to-day operational power and the manager's knowledge of the company, effectively means that the power to appoint and dismiss worthless, otherwise the company may be put into dire straits. This remains a profound legacy of the state-ownership mind-set of China in transition during the 1980s.

Apart from their privileged authority under Company Law, in reality managers also wield an immense amount of power that dates back to the policy of the separation of the state from enterprises aimed at developing efficient and competitive enterprises.¹⁹⁹ For instance, in 1984, the Party Central Committee and the State Council together issued the Terms of Reference for Managers of State-owned Industrial Enterprises, which unprecedentedly stipulated that the manager was the company's representative of legal personality. In those days, the potential for extensive managerial powers was naturally constrained by a supervisory and guaranteed role for the enterprise's own Party sub-committee and democratic management of employees. More power devolved to managers in 1988 under the Law on Industrial Enterprises Owned by the Whole People, which prohibited any state organ or unit from interfering with the managerial powers of SOEs. This safeguarded the day-to-day managerial powers of management as well as (crucially) explicitly vesting management with powers to which they hitherto were not entitled. Interestingly, the law became effectual because of its punitive nature against those that interfered. Furthermore, legal remedies were

¹⁹⁹ Su Chen, "The Establishment and Development of the Chinese Economic Legal System in the Past Sixty Years," *Colum. J. Asian L.* 23 (2009): 109-37.

given to the management of SOEs in the event that any organ or individual interfered with their ‘operational rights’. This, Chao Xi notes, has resulted in managers honing an all-powerful position in the last 20 years.²⁰⁰

The Measures and Rules are formulated specifically to counter and prevent the mistakes and weaknesses of the stock exchanges of the 1980s from being transmitted in the companies that list on ChiNext. These ChiNext Measures and Rules deal with the legacy of the notoriously extensive power vested in managers of listed companies arising in part under Company Law (both the revised 2005 and original 1993) and the legacy of ‘insider’ power that dates back to legislation promoting the separation of enterprises from the state. The Measures and 2009 Rules do so by imposing more monitoring and reporting obligations on independent directors, board secretaries and sponsors, as illustrated later in this section. Whether they are effective mechanisms to counter insider control will be discussed based on case study evidence later in the thesis.

D. Duties of Directors, Supervisors, Controlling Shareholders and de Facto Shareholders

Although this thesis does not focus on the duties of directors, the main duties are reiterated as they become useful in understanding the basis upon which the regulators regulate corporate conduct in companies listed on ChiNext.

1. Duties of Loyalty and Due Diligence

The Measures importantly reiterate and expand on the fiduciary duties of directors, stating that directors, supervisors and the senior management of the company must be loyal and diligent as set out in article 148 of Company Law.²⁰¹ The ChiNext Rules further sets out

²⁰⁰ For more details, see Xi, *Corporate Governance and Legal Reform in China*, (2009), chap. 2.

²⁰¹ Article 25 of ChiNext Measures.

the same duties, which are then used as the point of reference for enforcement proceedings. They must also make express undertaking to fulfil their fiduciary duties and due diligence duties, and those duties imposed by the articles of association and the Exchange, the duties extended to ensuring that the company complies.²⁰² The fiduciary duties and due diligence duties of directors are detailed as follows under rule 3.1.9.

The Measures further lay out in detail other duties of directors to ensure that, prior to listing, directors are aware of their duties and the level of corporate conduct that is required of them if they want their company to be listed.

Directors, supervisors and the senior management of the company are familiar with their corporate governance obligations. They must understand relevant laws and regulations regarding the offering and listing of shares. They must also be familiar with their statutory obligations as directors, supervisors and senior management.²⁰³ Thus, the excuse of ignorance cannot be used.

Directors also have directions on how to behave at board meetings. For instance, when in attendance at board meetings they must act with due diligence and reasonable prudence, expressing their opinions explicitly on the matters under consideration.²⁰⁴ This sub-rule becomes even more rigorous for independent directors because it requires them to disclose to the market and regulators their independent opinions on certain matters. To this end, they must carefully read all the business and financial reports of the listed company as well as any media coverage on the company, keeping informed of and paying continuous attention to the company's operations and management as well as the material events that have occurred or are likely to occur and the effect of such material events. Independent directors are also obliged to report problems existing in the company's operations in a timely

²⁰² Rules 3.1.5(1) and 3.1.5(1-4) of ChiNext Rules.

²⁰³ Article 24 of ChiNext Measures.

²⁰⁴ Article 25 of ChiNext Measures.

manner to the board of directors, and cannot shirk the responsibility under the excuse of not being engaged directly in the operation and management of the company or having insufficient knowledge thereof.²⁰⁵

2. Duty of Care and Duty of Honesty and Good Faith

A further duty of honesty and good faith underlies the regulatory framework on ChiNext, more so than the duties of loyalty or duty care. In the performance of their duties, directors must also act honestly and in good faith, exercising their rights within their authority in the best interests of the company as a whole and all shareholders, and avoiding actual and potential conflicts of interest and duty. Finally, they must perform all other duties and due diligence duties as set forth in the Company Law and the Securities Law as well as those acknowledged by the public. Judging whether the public has acknowledged a fiduciary duty is difficult. There are issues regarding what is meant by the ‘public’ in this context, and whether it represents retail shareholders on the stock market or the citizens of China in general.

IV. Key Developments in Corporate Governance as Reflected in ChiNext

Framework

A. Empowered Role of the Board Secretary

Under the ChiNext Rules, the role of the board secretary²⁰⁶ is enhanced, firstly, because she is responsible to the company itself and not only the board of directors.²⁰⁷ Under

²⁰⁵ Article 25 of ChiNext Measures.

²⁰⁶ It is worth noting the differences between “board secretary”, “corporate secretary” and “company secretary” to understand better differences in their functions. However, the role of the company secretary is broader than that of board secretary both semantically and in practice. Board secretaries focus specifically on board matters and in supporting the chairman of the board. The role differs from so-called “corporate secretaries” which mainly on administrative and transactional matters relating to company law, and are not at listed company board

Company Law, it is compulsory for all publicly listed companies in China to have a board secretary.²⁰⁸ However, under ChiNext's regulatory framework, the board secretary holds a pivotal and indispensable internal governance role, and is also responsible to external regulators of ChiNext. This is in contrast to Company Law, wherein the secretary's remit is decidedly limited to preparing for board and shareholders meetings, keeping company records, managing materials relating to shareholders and handling information disclosure matters. The perceived importance of secretaries in ChiNext companies cannot be overstated, as demonstrated by the devotion of 15 sub-rules detailing their obligations and responsibilities.

In terms of expertise and eligibility for appointment, under the ChiNext Rules, a secretary must have the 'necessary financial, management and legal expertise for performing his duties, have good professional ethics, and have obtained the certificate for secretaries issued by the Exchange'.²⁰⁹ This contrasts with Company Law, which does not provide for any particular qualification but merely enumerates the appointment procedures of the role and its key obligations. This narrow remit and lack of clear requirement for a type of skill and expertise mean that board secretaries require little knowledge of corporate governance,

level. The role of company secretary as found in the UK, Hong Kong and in most other existing or former Commonwealth jurisdictions such as Nigeria has a wider remit of responsibility that encompass the role of both the board secretary and corporate secretary as part of its remit. The company secretary supports the Chairman in his role in agenda setting and meeting planning. In addition responsible for ensuring compliance with the articles of association, company law, listing regulations, relevant code of corporate governance and best practice. They facilitate the circulation of information to all directors of the board. In UK companies, the company secretary also has an advisory role to the Board, and is will arrange for independent advice to be made available to the independent non-executive directors or committees should they require it. In addition, the company secretary acts as a quasi-independent adviser to the board (only quasi because they are employees with reporting lines), and responsible for ensuring non-executives receive independent advise where required or requested. For further details on the role of the company secretary are available on the ICSA International's website:

<https://www.icsa.org.uk/products-and-services/knowledge-and-guidance/resources/role-of-the-company-secretary>

²⁰⁷ Rule 3.2.2 of ChiNext Rules.

²⁰⁸ Article 124 of Company Law. This provision is similar to the UK where all listed companies must have a company secretary.

²⁰⁹ Rule 3.2.4 of ChiNext Rules. In the UK and Hong Kong and most commonwealth countries, the Institute of Chartered Secretaries and Administrators under royal charter is a non-governmental professional awarding body that requires the passing of professional examinations at the equivalent level of Association of Chartered Certified Accountants and Chartered Institute of Management Accountants.

Company Law or financial management. There are no chartered secretaries in Mainland China, despite Hong Kong having an Institute of Chartered Secretaries. Some companies have company secretaries with financial backgrounds, but their level of skill and expertise is still unknown, mostly because there has been little focus on the role of the board secretary in corporate governance in the Anglo-US literature, and the same is almost non-existent in the literature on China.

To ensure a certain level of compliance, each person appointed as a board secretary must already have the Exchange's certificate for secretaries filed with the Exchange, along with other personal information.²¹⁰ The secretary can appoint a securities affairs representative who is responsible for direct liaison with the Exchange and can deputise for the secretary in all aspects set out by the rules.²¹¹ Although the reading of the Rules appears mandatory, not all secretaries have appointed a securities affairs representative and instead perform the duty themselves.²¹² Furthermore, both appointments require an announcement to the market.²¹³ Companies must also appoint a secretary within three months of either the IPO or the date of resignation or removal of the previous secretary.²¹⁴ To avoid the weakening of this prescribed governance structure, directors of listed companies cannot simultaneously hold the position of director and secretary, nor can a former member of the supervisory board, external legal counsel or external auditors be appointed to the role. Finally, the secretary cannot be dismissed without sufficient reason.²¹⁵ The 'sufficient' reason for dismissal presumably warrants a disclosure to the Exchange, and subsequent announcement to the market.

²¹⁰ Rule 3.2.7 of ChiNext Rules.

²¹¹ Rule 3.2.8 of ChiNext Rules.

²¹² This perhaps goes to the interpretation of the use of '*bixu*' and '*yinggai*'. Some scholars believe that the latter, although it appears to be mandatory, in reality it gives leeway.

²¹³ Rule 3.2.9 of ChiNext Rules.

²¹⁴ Rule 3.2.5 of ChiNext Rules.

²¹⁵ Rule 3.2.10 of ChiNext Rules. There is, as yet, no definition for 'sufficient reason', but it arguably means that the dismissal must be justified, especially as they are there to promote and maintain good corporate governance practice in a company.

1. Key Internal Governance Obligations

The board secretary carries most of the burden of ensuring that the company's internal control system for disclosures is compliant. The secretary has also been awarded primary responsibility for internal corporate governance and investor relations; as such, any reason for dismissal will highlight a problem in this area. This presents a double-edged sword in that companies will not want to dismiss their secretaries if they believe it will highlight internal governance failings that are likely to affect the share price. However, the company is then left with a secretary in whom the board may rightly or wrongly have no confidence.

B. Sponsors

ChiNext has a listing sponsorship system for shares and convertible bonds. Sponsors have obligations prior to, during and after the IPO of the company, which must be detailed under a sponsorship agreement to provide continuous supervision and guidance.²¹⁶ The ChiNext Rules require sponsors to:

...supervise and guide the issuing company in establishing, perfecting and implementing the corporate governance system, financial internal control system and information disclosure system...²¹⁷

The ChiNext Rules include the role of the sponsor in the internal governance system of ChiNext companies. Sponsors of ChiNext companies have supervisory and monitoring obligations that continue after IPO and can be extended indefinitely by the CSRC and the Exchange if there appears to be a corporate governance failing on the part of the company that the sponsors fails to report. Sponsors are authorised to supervise and guide the directors,

²¹⁶ Rule 4.2 of ChiNext Rules.

²¹⁷ Rule 4.6 of ChiNext Rules.

supervisor, senior management and controllers of the company.²¹⁸ The duration is from the remaining part of the year of listing and for the subsequent three full financial years. The Exchange can extend this period of supervision if defects or irregularities arise in the company's information disclosures, legal compliance, corporate governance and internal controls, or where there is a great regulatory risk as a result of significant changes in the de facto controller, board of directors or management.²¹⁹ This effectively acts as a deterrent because sponsors tend to earn most of their fees during the IPO period and not after. The opportunity cost of 'supervising' an errant listed client is the percentage of fees to be earned with a new pre-IPO client.

Under the ChiNext framework, sponsors also have several enforcement and whistleblowing obligations, which are enhanced due to the riskier profile of ChiNext listed companies. Firstly, it must report to the Exchange when it has sufficient reason to believe the issuer has violated the ChiNext Rules and must urge the issuer to clarify and or rectify within a certain period of time.²²⁰ Secondly, sponsors must also scrutinize other intermediaries and issue in a timely manner an opinion and report to the Exchange when it believes that a professional opinion issued about the company by an intermediary and its signatories contains false representations, misleading statements or material omissions, or other irregularities.²²¹ In order to control incidences of abuse of insider information, sponsors also have a negative obligation not to take advantage of any undisclosed information they obtained in the course of performing their duties under the ChiNext Rules, for the purposes of insider trading for themselves or for other parties.²²²

²¹⁸ Rule 4.6 of ChiNext Rules.

²¹⁹ Rule 4.2 of ChiNext Rules.

²²⁰ Rule 4.11 of ChiNext Rules.

²²¹ Rule 4.12 of ChiNext Rules.

²²² Rule 4.16 of ChiNext Rules.

The role of the sponsor also continues after the IPO of the company. Chapter Five provides an insight into how the regulators deal with a sponsor when in default of its obligations under the ChiNext Rules.

C. Heightened Information Disclosure Obligations for Particular Constituents

The disclosure regime on ChiNext reflects the regulators' experience of the last 20 years on the other markets and a realisation that the high-risk nature of ChiNext companies means that investors need sufficient and accurate information to make informed decisions. As mentioned earlier, originally, the intention was for professional investors to dominate ChiNext. The original regulatory framework of ChiNext reflected this. However, in reality, retail investors have dominated. Consequently, in the two years following the establishment of ChiNext, the CSRC and the Exchange revisions were made to the rules and new initiatives were started that were aimed at educating retail investors on investment strategy, company performance and corporate governance.

The disclosure framework on ChiNext is aimed at investor protection. As such, the ChiNext disclosure framework had high disclosure obligations with a relatively wider requirement on disclosure compared to other markets in China.²²³ The recipients of information on ChiNext include finance providers such as banks, lenders and creditors, and stakeholders in the company, which include employees, trade unions, governments, the general public and supervisory bodies (*jiandu jigou*).

Under ChiNext Rules, CSMEs must provide a management system for information disclosure.²²⁴ Similar to other listing rules of other equity boards in China, the ChiNext

²²³ Liu Junhai, *Xiandai zhengquanfa [Modern Securities Law]* (Beijing: Falü chubanshe [Law Press China], 2011): 132.

²²⁴ Rule 2.8 of ChiNext Rules.

framework requires all information to be true, accurate, complete, timely and fair. Directors, supervisors and senior management must guarantee this.²²⁵

Items and format for disclosure are detailed in the ChiNext Rules, namely those that require periodic disclosures within a prescribed period and ad hoc disclosures required on a timely basis. They bear some discussion in their own right, but they also form a key source of data and information employed in the case study analysis in the following chapters.

1. Periodic Reports

Periodic reports come in the form of annual reports, interim reports and quarterly reports.²²⁶ Periodic reports must be disclosed in accordance with deadlines prescribed in the Rules. Moreover, financial disclosures must be in accordance with the relevant accounting laws and rules. In particular, CSMEs must hold an annual reports briefing and shareholders must be informed of the time, method and main activities of the annual report briefing one month in advance.²²⁷ The company's basic business plan and financial report must be in accordance with accounting law's guidelines and accounting system rules. They must reflect the financial position, business results and cash-flow of the company on which a registered auditor has provided an opinion without reservation.²²⁸ Apart from the directors' report and the corporate governance report, one of the most important reports for appraising corporate governance in ChiNext companies, and China's listed companies in general, is the 'important items' report. The important items report contains disclosures about key events in the company and, notably, of related party transactions, guarantees by the company given to third parties, litigation and administrative sanctions against the company.

²²⁵ Rule 2.2 of ChiNext Rules.

²²⁶ Rule 6.1 of ChiNext Rules.

²²⁷ Rule 6.12 of ChiNext Rules.

²²⁸ Paragraph 20 of ChiNext Measures.

A noticeable problem with periodic reporting for ChiNext companies relates to the fact that, despite SMEs, they must provide quarterly reporting. Such frequent reporting for an SME can be onerous in terms of time and expertise; but, more importantly, it can present a distorted view of performance since the companies of a high-risk nature may not be performing especially well. The danger is that, despite the regulators promoting corporate governance, the focus on short-term reporting obligations may inadvertently push companies toward smoothing out, hiding or falsifying their financial reports.²²⁹

2. Ad Hoc Reports

Ad hoc items for timely disclosure include board and shareholder resolutions, supervisors' opinions, disclosable transactions, related party transactions, independent directors' opinions, share incentives plans, material events and acquisitions and equity changes during the year.²³⁰ Each resolution of the board of directors and board of supervisors must each be announced to the market, and of particular note is that, during voting, the number of abstentions and the reasons for objection and abstention must be stated in announcements.²³¹ Resolutions of shareholders' general meetings must not only be announced but where any proposal is overruled at the meeting, a full text of the legal opinion regarding the proposal must also be disclosed.²³² The rules also prescribe a list of transactions that ChiNext companies are required to disclose, but this is not non-exhaustive as the Exchange can include the transactions it deems appropriate.²³³ Disclosure is especially required where such transactions have reached the thresholds stated in the ChiNext Rules.²³⁴ For example, the granting of guarantees, a historic method of expropriation of value, is now

²²⁹ Chapter Five provides an example.

²³⁰ Rule 7.2 of ChiNext Rules.

²³¹ Rule 8.1.4 for board of directors and 8.1.6 for supervisors, of ChiNext Rules.

²³² Rule 8.2.6(5) of ChiNext Rules.

²³³ Rule 9.1 of ChiNext Rules.

²³⁴ Rule 9.2 of ChiNext Rules.

subject to timely disclosure after the board of directors has considered the transaction. The 2009 Rules prescribe the monetary threshold at which the company must guarantee transactions that must be submitted to the shareholders' meeting for review.²³⁵ The disclosure obligations will not apply where the transactions between a listed company and controlled subsidiary are included in the consolidated financial statement or transactions between its subsidiaries.²³⁶

In order to promote transparency of the shareholdings of controlling shareholders and that of directors, supervisors and senior management, the 2009 Rules require timely disclosure of both changes in equity holdings, share incentive plans and acquisitions on a timely basis. Thus, the annual report must contain details of such items for the year ended. The scheme must be in accordance with the Regulations on Option Incentives of Listed Companies (Trial) issued by the CSRC.²³⁷ The rules do not prescribe any maximum or minimum requirement, but schemes are subject to the approval of the CSRC.²³⁸

D. Mandatory Disclosures and Independent Opinions

In accordance with the general theme of self-disciplining directors, supervisors, senior management, de facto controllers, controlling shareholders and sponsors have obligations to make disclosures to the Exchange and market, either individually or as a group.

²³⁵ Rule 9.11 of ChiNext Rules.

²³⁶ Rule 9.16 of ChiNext Rules.

²³⁷ Rule 11.9.1 of ChiNext Rules.

²³⁸ Rule 11.9.4 of ChiNext Rules.

1. Controlling Shareholders and de Facto Controllers

Controlling shareholders and de facto controllers must disclose direct or beneficial interests that amount to 5% of the total outstanding shares of the company.²³⁹ For every incremental increase or decrease of 1% point, they must disclose their direct or beneficial interest.²⁴⁰ The company must be notified so that it can release a cautionary announcement. The onus falls on the board of directors of the company to report to the Exchange and make an announcement where a shareholder or de facto controller fails to do so.²⁴¹ Failure to comply by either of the parties may lead to disciplinary action under the ChiNext Rules. Controlling shareholders and de facto controllers also have disclosure obligations in the event of a takeover or the acquisition of their holdings in the company. However, as will be seen in the later chapters, there remains little opportunity for such transactions for a number of reasons, including a limited market for control on ChiNext.

2. Directors, Supervisors and Senior Management Disclosures

In keeping with the overarching Listing Rules of the Shenzhen Stock Exchange, directors, supervisors and senior managers bear the onus of declaring their interests in the company.²⁴² Such interests include direct and indirect shareholdings in the company, disciplinary actions imposed by the Exchange, training received in the securities business and other positions held in the previous five years. This last requirement goes toward to ensuring their professional suitability and there is, of course, little guarantee that the responsibilities of the post match the work experience.

²³⁹ Rule 11.8.1. Further detailed disclosure obligations for acquisitions are provided under Securities Law and paragraphs 16 to 22 of the Measures on the Administration of Acquisition of Listed Companies.

²⁴⁰ Rule 11.8.3 of ChiNext Rules.

²⁴¹ Rule 11.8.9 of ChiNext Rules.

²⁴² Rule 3 of ChiNext Rules.

There is also a catchall provision that requires the disclosure of other matters that must be declared.²⁴³ Prior to IPO, directors, supervisors and senior managers are obliged to inform the Exchange of any newly acquired shares, which are then locked up; i.e., trading is restricted in those shares for a specified period of time.²⁴⁴ Shares held by directors and officers are deemed important and, therefore, they are meant to report to the Exchange through their board secretary or the securities affair representative in a timely manner.

3. Board Secretary Disclosure Obligations

The secretary is responsible for corporate disclosures, which involves ensuring an appropriate management system for disclosures.²⁴⁵ Conversely, the secretary is responsible for ensuring that inside information remains confidential, which also includes identifying those with access to inside information. If such information leaks, the board secretary has a duty under the ChiNext framework to directly inform the Exchange and then make the relevant announcement in a timely manner.²⁴⁶ Moreover, the secretary's duties do not end with compliance; he or she must also monitor media coverage of the company to ascertain if reports are true or false, and then advise the board of directors to respond to the Exchange in a timely manner.²⁴⁷

4. Independent Director Opinions

Independent directors must provide the market with their independent opinion on the selection, appointment and dismissal of directors, the employment and dismissal of senior

²⁴³ Rules 3.1.2 of ChiNext Rules.

²⁴⁴ Rule 3.1.10 of ChiNext Rules. They are also known as 'restricted shares'.

²⁴⁵ Rule 3.2.2(1) of ChiNext Rules.

²⁴⁶ Rule 3.2.2(4) of ChiNext Rules.

²⁴⁷ Rule 3.2.2(5) of ChiNext Rules. This appears to assume that the secretary is not proactive in this duty but reactive in that it is a response to an inquiry by the Exchange. Arguably, this is no more onerous than on AIM or NASDAQ, except for the fact that it has been made an express duty.

executives and the remuneration of director and senior executives. To effectively carry out this responsibility among others, the ChiNext Rules provide independent directors with rights of information and working conditions similar to those of directors of the company.²⁴⁸

Neither the company nor the relevant personnel must refuse, obstruct, conceal or interfere with the independent director's performance of his role.²⁴⁹ This is of particular significance when considered that, according to the 2002 Code, the main role of independent directors is to represent the interests of minority shareholders and to ensure that their legitimate rights are not encroached on by either the directors and officers or controlling shareholders and de facto controllers. Compared to UK and US independent directors, the obligations of those in China, especially on ChiNext, are more far-reaching.²⁵⁰ Moreover, responsibility is on individual terms and not on collective terms, as is the case in the UK and the US where independent directors are not required to individually issue reports on certain operational matters of the company and its board of directors or when the independent director considers there to be potential damage to the interests of minority shareholders.

5. Sponsors' Independent Opinions

Where necessary, sponsors must also submit their independent opinions to the Exchange on any ad hoc report in which the company has disclosed matters on fund raising, related party transactions, trustee investment and external guarantees.²⁵¹ Sponsors are obliged to review information before or after submission to the Exchange.²⁵² This is an interesting addition, given that the UK's Alternative Investment Market (AIM) corporate governance system, in reality, substitutes the role of secretary with the role of sponsor. Thus, the ChiNext

²⁴⁸ Rule 3.1.15 of ChiNext Rules.

²⁴⁹ Rule 3.1.15 of ChiNext Rules.

²⁵⁰ See Fu, *Corporate Disclosure and Corporate Governance in China*, (2010).

²⁵¹ Rule 4.8 of ChiNext Rules. Submission must be within 10 business days of the publication of the ad hoc report.

²⁵² Rule 4.7 of ChiNext Rules.

framework provides for both an active board secretary and a proactive sponsor, thereby adding another layer of corporate governance scrutiny.

V. Evaluative Summary

Despite the above being the basic corporate governance framework of listed companies in China, ChiNext's framework differs in its emphasis on robust internal governance coupled with the mandatory disclosures and independent opinions discussed above. The internal trouble shooting and compliance mechanisms of ChiNext's regulatory framework fall on independent directors, board secretaries and the sponsors. Consequently, the traditional corporate governance mechanisms of the shareholders' general meetings, the Executive Board and the Supervisory Board seemingly have a more passive corporate governance role to play, despite their clearly stated internal governance obligations under Company Law. Two possible reasons account for these traditional mechanisms not being afforded more robust corporate governance roles under the legislative framework. One is that, because Company Law prescribes in detail the role of each of these mechanisms, the CSRC (and the Exchange) have either actively decided not to expand upon or perceive the fact that the existing abundance of secondary and tertiary legislation needs no augmentation.²⁵³ A second reason is that the board of directors and supervisory board perpetuated most of the mistakes and weaknesses of listed companies that Zhu Rongji was keen for China to avoid repeating on ChiNext.²⁵⁴ The focus on independent non-executives, board secretary and sponsors does not diminish the underlying perception embedded in Company Law and listing regulations of the conflict between shareholders and directors. Instead, it attempts to provide

²⁵³ For instance, Code of Corporate Governance of Listed Companies 2001, Rules on Shareholders' Meetings of Listed Companies 2006, and Guidelines for the Articles of Association of Listed Companies 2006.

²⁵⁴ See Zhu Rongji, "Zhu Rongji: Wanshan fengxian jizhi, jianli chuangyeban gushi [Improve the Risk Mechanism, Establish a Growth Enterprise Market]," Government. *Renminwang (People's Daily)*, (3 June, 2001), url: <http://www.people.com.cn/GB/jinji/35/159/20010306/409798.html>.

ChiNext regulators with readily identifiable parties that it would expect to have access to information about the company that is the board secretary and the sponsor. Arguably, some inspiration for the strengthening of the board secretary role and the enhanced obligations of the sponsor appear to be from the Hong Kong listed company system.

Equally, false accounting scandals such as Yin Guangxia and Hainan Qionghmin, among many others, have laid testimony to the limitations of the supervisory board corporate governance function.²⁵⁵ The debate arises because the supervisory board is largely seen as handicapped because it is made up of shareholder nominees and employees who have historically failed to be independent of and effectively monitor the board, which was subject to the control of the controllers. Moreover, there has historically been no requirement for supervisors to be financially adept since an important remit is to review corporate financial reports. However, it must be stressed that these circumstances and conclusions have largely arisen from research into SOEs and not privately controlled listed companies, as undertaken in this research.

On ChiNext, the objective of internal control systems is to ensure the effectiveness and result of business activities, and the Measures goes into some detail about how this should be set out. Internal control systems are divided into the internal management controls and the internal accounting controls. Instead, the Measures oblige the company, and, in effect, the board of directors and the board of supervisors, in order to implement an effective system of internal control.²⁵⁶ The system must reasonably guarantee that the company's financial report is reliable and that the company operates in accordance with the law, that it is operationally effective and that its results are such that a registered auditor has provided an opinion without reservation. Thus, although the dual board does not have detailed

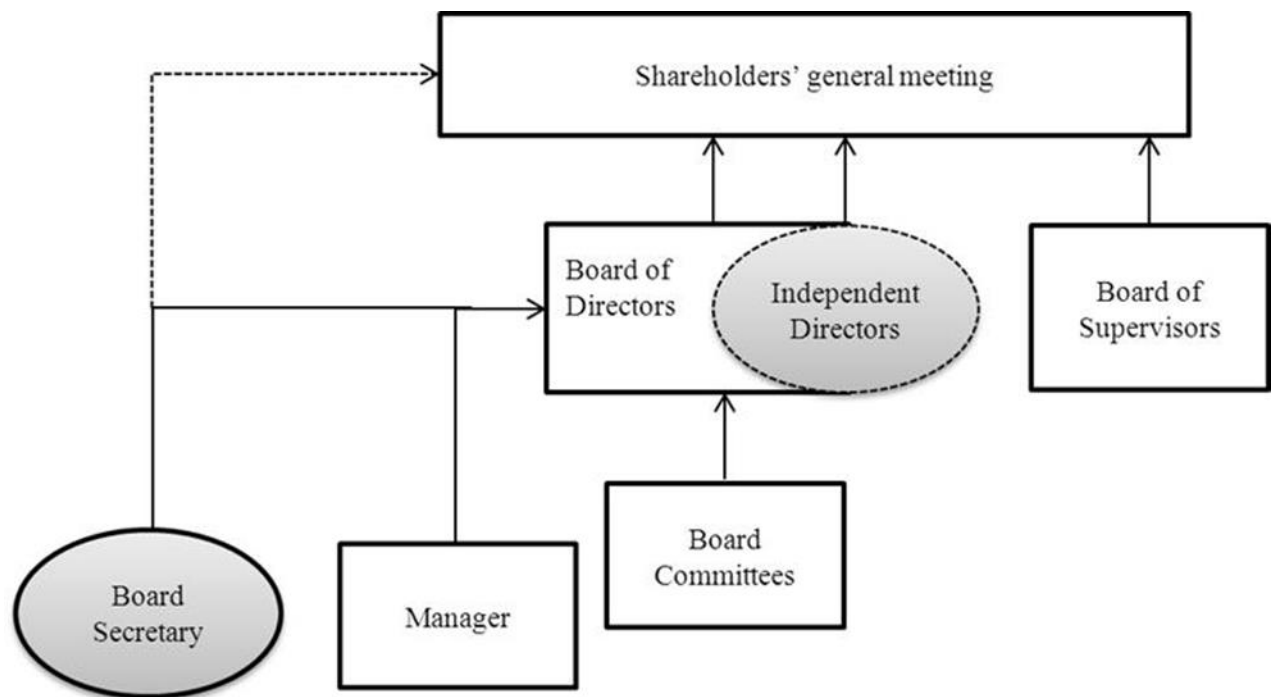
²⁵⁵ For a summary of these cases, see China Securities Regulatory Commission, “*Zhongguo ziben shichang fazhan baogao* [Report on the Development of China's Capital Markets]” (China Securities and Regulatory Commission, 2008), url: <http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/ebook/index.htm>.

²⁵⁶ Paragraph 21 of ChiNext Measures.

responsibilities under the ChiNext framework, they still carry the main responsibility for corporate governance at a strategic level.

Thus under the ChiNext framework independent directors, the board secretary and sponsors of the company take on corporate governance responsibilities on an operational level. Whether this translates in reality is another matter as will be discussed later in this thesis. The figure below represents the internal governance system (excluding the sponsors) imposed under the ChiNext framework.

Figure 4: Internal governance structure of companies listed under the ChiNext framework



The ChiNext framework, however ambitious, cannot increase the confidence of the equity markets in independent directors. There remains a persisting lack of confidence in the 'independence' and 'effectiveness' of independent directors. With no seemingly clear way of judging their actual effectiveness, negative performance and violations of the law, when publicised, are used as the benchmark for evaluating their contribution.

The enhanced role of the board secretary mirrors the UK and Hong Kong style of board secretary, whose duties extend beyond the administrative duties of keeping accurate records and ensuring appropriate and timely disclosures. The ChiNext framework now propels the Chinese board secretary role firmly into the realm of Chinese corporate governance by obliging them to ensure proper resources for directors, especially independent directors. The board secretary now has rights of access to information that otherwise can only be obtained by the chairman, chief executive or legal representative of the company. Thus, both internally and externally, the role of the board secretary has been enhanced on ChiNext. It does, however, stop short of the advisory role that the board secretary has in the UK, Hong Kong and US systems. A key issue remains as to how to measure the effectiveness of the board secretary on ChiNext.²⁵⁷

In terms of enforcement, the CSRC takes prominence, followed by the Exchange. The CSRC, through its IPO Review Panel, decides which companies to approve. Tellingly, the requirement for companies to be in the process, at least, of improving their corporate governance lends the CSRC a lot of discretion over and above the financial requirement regarding reasons for rejections. In terms of exit from the market prior to their revision of the ChiNext Rules in 2012, the CSRC was responsible for delisting companies. However, there was no clear procedure for final exit. Moreover, corporate governance was not one of the key reasons for delisting. The detail of the revised delisting rules importantly permit delisting based on corporate governance breaches by the Exchange and not the CSRC. These are two of the key changes in enforcement focus examined later in Chapter Six.

²⁵⁷ See V. Board Secretary” on page 229. This is a wider question that relates to the broader role of the company secretary.

Finally, the ChiNext framework lays emphasis on identifying members of management responsible for different aspects of corporate governance practice in listed companies.

In essence, the achievement of the ChiNext framework remains the complete restructuring of the management structure of SMEs listed on ChiNext, those applying for listing and those aspiring for the day. For example, CSMEs prior to listing have operational (as opposed to figurehead) boards of directors, independent directors and even audit committees. The years following the enactment of Securities Law in 1998 also saw a focus on encouraging and developing internal management control of China's listed enterprises.²⁵⁸ In 2001, China acceded to the World Trade Organisation and adopted the OECD Principles of Corporate Governance to improve corporate governance of its listed enterprises. The listed enterprises, being the most exposed to global investors and therefore global scrutiny, were and continue to be the focus of corporate governance reform. This was demonstrated by the flurry of corporate governance legislation that led up to China's accession to the World Trade Organisation. Spurred by the positive momentum of WTO membership, bold market-orientated corporate governance reform was initiated and implemented. The implementation of independent boards of directors and the adoption of the OECD Principles were examples. That year, the Establishment of the System of Independent Directors in Listed Companies Guiding Opinions was issued. Unlike the OECD Principles upon which the Corporate Governance of Listed Companies Code (the 'Code') is based, the Code provides, as mandatory basic principles of corporate governance, a basic code of conduct and professional ethics (moral standards) for directors, supervisors, managers and other executives in listed

²⁵⁸ Liu Junhai, *Modern Securities Law*, (2011).

companies.²⁵⁹ It was announced in 2011 that the Code was to be updated to reflect changes in domestic legislation and international best practice of the last decade.²⁶⁰

In terms of the internal controls system which forms an integral part of corporate governance and corporate reporting, the ChiNext framework adopts a mix of prescriptive approach and principle-based approach in its provisions. To some extent it builds on the Basic Standard for Internal Control (the “Basic Standard”)²⁶¹ which sets out the basic standards an enterprise (listed or otherwise) should adopt in relation to internal controls, internal environments, risk assessment, control activities, information and communication and internal supervision. However, to the extent to which companies actively comply with this standard and whether or not it is enforced remains unclear. Notably, neither Code nor the Basic Standard adopts a “comply or explain” approach even though they each have voluntary and principle-based provisions of corporate governance that effectively allow a modicum of discretion in compliance.²⁶² As will be seen in later chapters, despite the ChiNext framework being prescriptive in internal governance, there is considerable variation in corporate

²⁵⁹ Organisation for Economic Co-operation and Development and China Securities Regulatory Commission, *Corporate Governance of Listed Companies in China: Self-Assessment by the China Securities Regulatory Commission* (Paris: OECD Publications Service, 2011): 16.

²⁶⁰ *Ibid.*, 22.

²⁶¹ Jointly issued on 22 June 2008 by the Ministry of Finance, the CSRC, the National Audit Office, China Banking Regulatory Commission and China Insurance Regulatory Commission. It came into effect on 1 July 2009 for listed companies, and represents an attempt to introduce basic and uniform corporate reporting across all industries and capital markets. There has since been further tertiary legislation to improve internal control reporting, which can be found listed on the CSRC’s website: www.csrc.gov.cn.

²⁶² From a UK perspective comply and explain inherently assumes and requires the existence of a shared belief on what is good corporate governance. This may be the challenge that the regulatory authorities in China may have in creating, even though they have taken the first step in creating uniformity as demonstrated by the introduction of the Basic Standard. Indeed in the UK this uniformity or shared understanding is widely referred to as understanding the “spirit of the Code”. It also requires a uniformity of approach in regulations and enforcement by regulatory authorities. For a discussion of variations in regulatory approaches to corporate reporting and disclosures in China, see Miao Yanjuan, “Yingmei shangshi gongsi nekong xinxi pilu zhidu dui wo guo de qushi (The Enlightenment of the Institutions for Public Companies Internal Control Disclosure from UK and US).” (In an analysis of tertiary legislation and other rules, Miao finds that in relation to corporate reporting and enforcement the regulatory authorities take different approaches to the same matters. For instance, for internal controls both Stock Exchanges adopt a principle-based approach while the CSRC adopts a prescriptive approach. Equally, they have varying requirements regarding the production of internal audit reports: Shanghai requires a certified public account’s report, while Shenzhen only require the supervisory board and/or independent director to report.).

reporting on for instance cumulative voting, use of proxies, issue of third party guarantees and related party transactions. The ChiNext framework itself overwhelming operates a mandatory corporate internal governance and control and corporate reporting regime. However, it cross refers to the Code and other relevant legislation which are not mandatory. Also, tellingly, none of the regulatory decisions of the CSRC or the Exchange make reference to the standard.

Closing remarks

The underlying assumption of the ChiNext framework presumes that companies to be listed on ChiNext will have a separation of ownership and control to some degree. To some extent, the enhancement of the board secretary role attempts to mirror the role of the company secretary in the UK in particular, where there are separate responsibilities to constituents of the board that must be balanced with executive responsibilities. Evidently, the ChiNext framework appears to be well prepared to specifically deal with the mistakes and weaknesses in corporate governance practice on China's stock market in the last 18 years before the establishment of the ChiNext in 2009.

As well as prescribing an internal governance structure with enforcing mechanisms, the preceding chapter demonstrated that the ChiNext framework implicitly proposes that the bases of good corporate governance for the market consist of controlling conflicts of interest among corporate constituencies. In terms of ownership, two conflicts may arise. Firstly, a conflict of interest between managers and shareholders. Here, management of the company may be in conflict with a controlling shareholder, large shareholders or minority shareholders. Secondly, a conflict of interest may arise between shareholders; that is, conflict between different constituencies of shareholders for different reasons. Controlling shareholders may act self-interestedly to the detriment of minority shareholders or conflict may arise between

two or more equally large shareholders. To this end, the framework prescribes mechanisms to restrain both management and controlling shareholders, to protect both shareholders and the public, as well as to enhance transparency and disclosure to ensure continued investment and stability in the market. It also prescribes a uniform internal governance structure and mechanisms to enhance or enforce compliance, which will be examined in the next chapter.

As described in the preceding chapter, China's version of the shareholder-orientated system renders the shareholder general meeting the supreme decision-making organ in both theory and practice. Understanding the profile and dynamics of the ownership structure of Chinese companies is especially important, given the pervasive powers that such ownership has in superseding the board of directors. As stated in the previous chapter, the shareholders' meeting is the highest organ of the company, being more powerful than shareholders' meetings under the UK and US systems.²⁶³ China's two-tier board, comprising the Executive Board and the Supervisory Board, in both theory and practice is subordinate to the shareholders' general meeting, and is effectively subordinate to whomever potentially controls or greatly influences that general meeting.

With this in mind, the next chapter examines the shareholder patterns, the role of different types of shareholder and the implications for corporate governance practice for ChiNext listed companies.

²⁶³ This is because China's Company Law was introduced to ensure that the state, specifically as owner or controlling shareholder, retained key decision-making and veto powers. These rules apply generically to all joint-stock companies ('JSC'). This is not to say that the board does not have its own powers and the leeway to use others.

Chapter Three - Private Ownership and Corporate Governance

Practice on ChiNext

The preceding chapter demonstrated that, in essence, the ChiNext framework generally purports to deal with conflicts of interest from an agent-principal relationship perspective: between managers and shareholders and between the controlling shareholders and other shareholders. However, the effectiveness of any legal and regulatory framework depends on the issues it intends to deal with. Indeed, the agency issues that arise in practice tend to be determined by the type of ownership structure in a company; that is, whether it is concentrated or dispersed.²⁶⁴

This chapter, thus, presents the ownership structure of ChiNext and examines the role its constituents play in corporate governance. As the first step in this thesis in ascertaining corporate governance practice on ChiNext, this chapter will ascertain the extent to which shareholders of ChiNext listed companies engage in the governance of company. Divided into five sections, Section I examines who controls ChiNext listed companies, and includes identifying trends in share ownership based on a survey of the first 40 companies listed on ChiNext. Section II identifies and analyses the prevalent types of non-controlling controlling shareholders in the surveyed companies. Section III analyses the extent to which shareholders in CSMEs engage in company decision-making, and, importantly, assesses whether they protect themselves by being a check on controlling shareholders. Section IV presents an evaluative summary of the findings of the chapter.

²⁶⁴ J. C. Coffee Jr, "The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control," *Yale Lj* 111 (2001).

I. Who Controls ChiNext Companies? Trends in Share Ownership on ChiNext

The section aims to identify trends and examine the role of controlling shareholders in corporate governance. A quantitative approach based on China's Company Law has been adopted. China's Company Law offers a two-pronged approach for identifying the 'controlling shareholder' of a listed company. It may be:

...a shareholder whose shareholdings accounts for more than 50% of the total equity of a company limited by shares or a shareholder whose...shareholdings account for less than 50% but who holds the voting rights on the strength of its...shareholdings that are enough to have significant influence over resolutions of...the shareholders' general meeting.²⁶⁵

Both approaches may be referred to as the '50 % rule' and the 'significant influence rule', respectively. The overall Shenzhen Stock Exchange Listing Rules 2008²⁶⁶ ('SZ Rules') and the Measures for Regulating Takeovers of Listed Companies 2006 both mirror Company Law, but with both providing a nuanced approach.²⁶⁷ This thesis adopts the significant rule approach. For the empirical purpose of identifying trends in controlling share ownership, a controlling shareholder is deemed as having significant influence over resolutions of the shareholders' general meetings if an individual or group acting in concert controls or exercises directly or indirectly over 20 % of the total voting rights of a company.²⁶⁸ Indeed, many companies incorporated in China have controlling shareholders with over 50 % of the voting shares in practice. Of course, wholly state-owned companies remain the exception and

²⁶⁵ Article 217(2) of Company Law. The quote from Company Law has been edited to include only the provisions regarding joint stock companies, and to exclude those for limited liability companies. It is not clear whether the holding must be direct or an aggregate of direct and indirect holdings in the company.

²⁶⁶ See Rule 81 Shenzhen Stock Exchange Listing Rules 2008.

²⁶⁷ They each have four or five individual criteria to judge who is a 'controlling shareholder', including one that gives discretion to the CSRC and stock exchanges to determine who might be one.

²⁶⁸ Although it appears arbitrary in itself, it reflects the average minimum required to retain control just in case the rest of the block holders decide to unite their holdings in a fight for corporate control.

are dwindling in number.²⁶⁹ This also applies to CSMEs, with the average percentage of control of voting rights at 40.34% falling well below the 50% rule. The table below illustrates constituents of controlling shareholders in the first 40 companies listed on ChiNext.

Table 1: Survey of emerging trends in controlling share ownership trends of first 40 companies listed on ChiNext (the 'surveyed companies') as of 31 December 2009.

| | Percentage of surveyed by category of shareholder | Highest percentage controlling block | Average percentage holding in category |
|---|--|---|---|
| Family | 40.00% | 67.93 | 44.23 |
| Individual | 27.50% | 62.77 | 33.68 |
| Affiliated individuals ²⁷⁰ | 15.00% | 48.17 | 31.8 |
| State-private ventures | 12.50% | 63.85 | 42.41 |
| State only | 5.00% | 51.12 | 49.57 |
| Overall average for surveyed companies | | | 40.34 |

Source: Author's survey and analysis

As a representative snapshot of controlling share ownership on ChiNext, and unprecedentedly, the private sector overwhelmingly dominates one of China's equity markets with 82.50% of listed companies having private controlling shareholders. Family control dominates, closely followed by individuals and affiliated groups of individuals acting in

²⁶⁹ Liu Junhai notes that this requirement has less application in judging ownership of joint stock companies, and remains mostly a legacy from the last Company Law. Thus, the 50% rule symbolises a legacy from the 1980s when the state used the rule to assess ownership amongst state actors. See Liu Junhai, *Xin gongsifa de zhidu chuangxin: lifa zhengdian yu jieshi nandian (Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies)*, Di 1 ban (Beijing Shi: Falü chubanshe, 2006).

²⁷⁰ Refers to two or more individuals acting in concert so as to effectively control the company as one block of controlling shareholding.

concert at 40%, 27.50% and 12.50%, respectively; the state follows with state-private ventures at 12.50% and state-owned enterprises at only 5%.

The following sections present case studies to provide insight into corporate governance practice in the order of their dominance on ChiNext, namely families, individuals, affiliated groups and the state, sub-divided into state-private ventures and state-only controlling shareholders.

A. Family Ownership

On ChiNext, as illustrated above in Section I, the family as controlling shareholder is the largest form of ownership on ChiNext. It is also the fastest growing form of ownership. As well as being the most common form of ownership among surveyed CSMEs, families also, on average, have the highest controlling holdings at 40.00%.²⁷¹ This is also only second to state-ownership in having the highest average control of voting rights at 44.57%, with the highest incidence of control at 67.93%. This can be compared to the state sub-groups with 49.57% and 51.12%, respectively. This may be attributed to the prevalence of two or more family members as shareholders. Family share ownership patterns on ChiNext include combinations of spouses, parent-child(ren), siblings and extended family, in order of prevalence. Husband and wife partnerships, otherwise referred to as the ‘husband-wife army’ (*fuqibing*), due to their closeness and the resultant closed nature of their decision-making, are the most common pattern of family ownership in the sample and are, therefore, chosen as a typical case study below. Parent and child(ren) combinations represent the second most common, and are the most inclined toward an internal governance structure that reflects the Confucian family value of filial piety in terms of hierarchy and loyalty.

²⁷¹ See Table 1 on page 107.

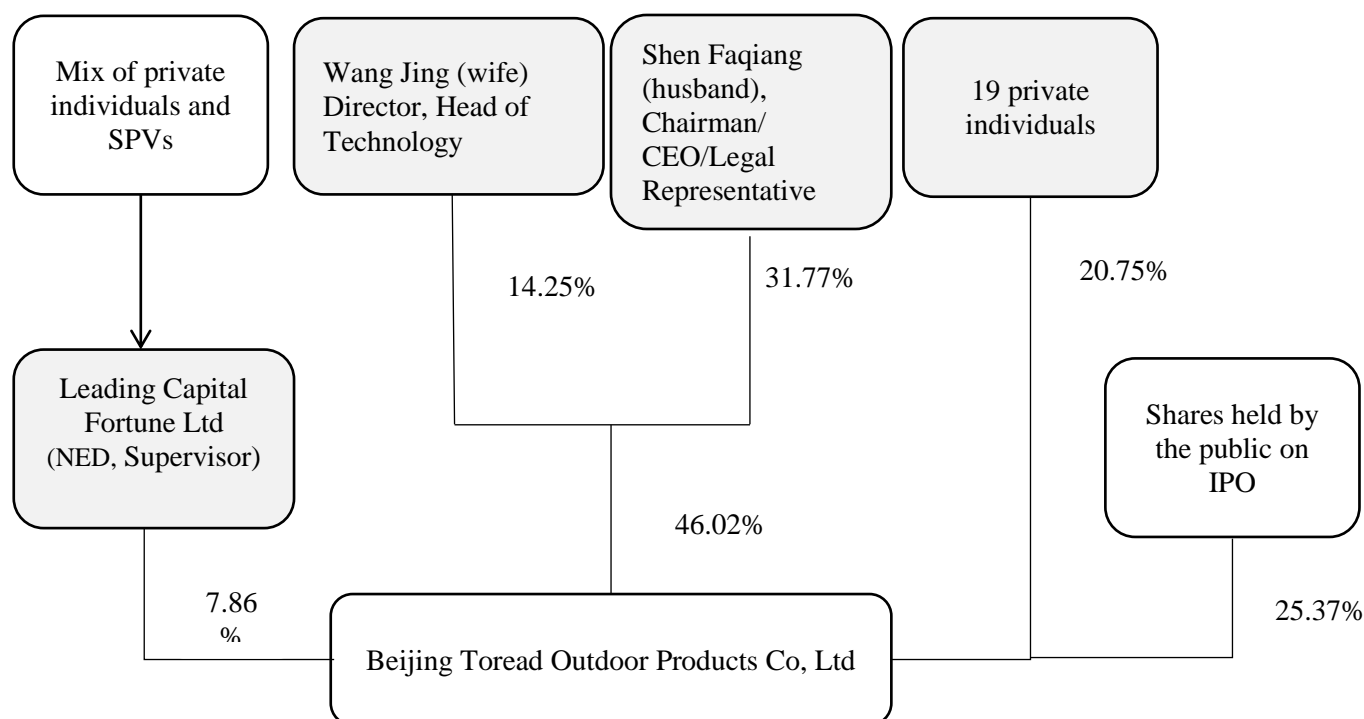
On ChiNext, each member of the family has his or her own direct holdings, in addition to holdings that may be jointly held through a special purpose vehicle. Parents have controlling or larger holdings, while the children have similar holdings, with the elder child having slightly more and so forth, in hierarchical order. Thus, there appears to be a sense of hierarchy even in share ownership that may not necessarily reflect capital contributions as provided for under Company Law. Sometimes, parents do not partake in the management of a company. Finally, sibling controlling shareholders commonly occur between brothers.

Case study: Husband and Wife Partnerships

Case study 1: The Husband and wife 'army' (fuqibing) – Beijing Toread Outdoor Products Co. Ltd.

Beijing Toread Outdoor Products Co. Ltd. ('Toread') illustrates a typical husband and wife partnership of direct ownership coupled with direct governance and management. Toread designs, manufactures and retails camping and outdoor equipment, mainly for China's domestic market. An innovative private enterprise start-up, established in January 1999, it converted to a joint stock company in August 2008 in preparation for listing on ChiNext. Typical to many private start-ups in China, prior to IPO, Toread was initially entirely privately financed by private individuals, and was then subsequently supported by a few short-term loans from banks. The figure below presents a snapshot of the share ownership structure of the controlling shareholders of Toread, identifying the pre-IPO investors in grey.

Figure 5: Husband and wife family controlling shareholders of Beijing Tread Out ownership structure



Source: Author's analysis

The above figure illustrates that, as of 31 December 2009 (post IPO in 2009), Shen and Wang, husband and wife, respectively directly held 31.77% and 14.25% of the voting rights in Tread. Together they controlled 46.02%. They count individually as the top two block holders, with the remaining eight of the ten top block holdings ranging in descending order from 7.86% to 1.18%, amounting to 23.78% of the total voting rights of Tread. The remaining 13 pre-IPO subscribers together hold 4.83%. Several thousands of different types of investor comprise the 25.37% held by the public, with the majority being individuals.

Several potential governance issues arise in Tread's ownership structure. Primarily, these comprise issues of checks and balances on the power and influence of this husband-

wife team as a controlling block holding. Together, they not only have controlling voting rights but also potentially exercise significant influence over the executive board and operational management. For instance, Shen concurrently holds the posts of chairman, general manager and legal representative. Therefore, he can individually, or acting with his wife, dominate shareholders' meetings and influence constituents on the supervisory board; he can also dominate the executive board as chairman and operational management as CEO. As legal representative of Tored, certain activities such as litigation in the name of the company cannot be undertaken without his agreement, so the abovementioned provisions regarding the ability of the company to litigate a violation of its articles can potentially be defeated if he is not in agreement. This gives him, as an individual, pervasive power and influence over every aspect of the company, and all backed by the assumption of key statutory roles as well as holding controlling voting rights.

Consolidating power and influence in the family, Wang also acts as executive director and head of technology controls. As an executive director, she poses a counterbalance to other executive and non-executives on the board, thereby strategically enabling mutual support in decision-making on the executive board. Her role as head of technology importantly controls access to price-sensitive and key information about the entire business. Thus, the division of business acumen and key technical skills between the husband and wife strategically enables them to retain control of all key internal management and control mechanisms as well as the supply of information. Tored has endeavoured and succeeded in maintaining a relatively simple and transparent share ownership structure, particularly by its controlling shareholders. It does not have a controlling pyramidal structure which avoids the main concerns related to pyramids such as self-dealing and opaque related party transaction. There is also relative transparency regarding the investors that employ special purpose vehicles such as Leading Capital Fortune Limited in the figure above.

In terms of the internal governance structure, although Shen and Wang monopolise the key strategic positions, most of the top ten shareholders in the company either sit as directors on the executive board or have been appointed as (deputy) managers. The company does have an empowered supervisory board because Leading Capital Fortune Limited has a supervisor representative appointed. This is in addition to the Moreover; under certain restrictive circumstances the articles of association expressly prohibit Tread from making external investments, sales or mortgages or pledge of its assets, third- party guarantees and certain related party transactions. The express inclusion of not only provisions under Company Law but also regulations issued by the CSRC and the Exchange in the articles means that action can be brought by the company for violation of its articles.

Notwithstanding this, as a family, they appear keen to emphasise their recognition of international corporate governance standards as testified by the fact that the board secretary is a UK chartered certified accountant who also holds the key role of head of finance.²⁷² The balance provided here of having a chartered professional as board secretary reassures that he will carry out his legal responsibilities for ensuring the circulation of information, especially to independent directors and the supervisory board, and regulatory disclosure of price-sensitive information. This plays some part in attracting institutional investors in the secondary market. As a typical husband and wife family business, the equity structure also reflects the fact that equity financing was primarily sourced from private non-financial institutions, specifically from private individuals, which Shen refers to as ‘partners’ in his introduction about the company. Four individual pre-IPO subscriber shareholders have maintained their investments in the company from the time of IPO to the publication of the company’s 2012 annual report. Noticeably, the institutional shareholders figured in the top

²⁷² In the UK, company secretaries of listed companies tend to be chartered company secretaries, chartered accountants and solicitors, in that order of prevalence.

ten holdings have changed in each annual report, demonstrating a lack of medium to long-term investment strategy in maintaining large investments. Conclusively, it is worth mentioning that the fact that Tread has not been the subject of any violation, or legal or regulatory disciplinary action and the constant inflow and outflow of large institutional investments testifies to the robustness of its corporate governance so far.

Insights and Analysis of Family Ownership

A few brief insights and analyses can be made that will be expanded upon in the evaluation section of this chapter and other parts of this thesis. Firstly, and as will be indicated in the other case studies, related party transactions occur frequently in privately controlled listed companies. Secondly, pyramidal holding structures in the surveyed companies were rare. Finally, although Confucian ethics of filial piety do not apply to husband-wife familial relations, they do apply to the other types, e.g., between parent-child, siblings, and extended family to some extent. This has implications for issues of entrenchment.

Firstly, the surveyed companies all displayed a clear rationale for the division of power and position among family members, striking a balance between ownership and control. In family-controlled companies on ChiNext, clear allocations of power and authority through appointments exist between family members. These divisions do not necessarily reflect the individual shareholdings of family members.²⁷³

Secondly, in terms of how they hold their interests, more than half of family-owned companies hold shares through special purpose vehicles. However, problems attached to the use of special purposes vehicles ('SPVs') by individuals and families arise where there is an absence of full disclosure of ownership. Of course, this problem is not limited to the use of

²⁷³ For example, in Enjoyor, where a wife still held key positions with only 0.76% of the total issued shares.

SPVs and remains a problem even in direct holdings, with some personages holding shares on behalf of others.²⁷⁴ Undisclosed shareholding potentially affects the reliability of related Party transaction identification and related disclosures, especially because of the enormity of its incidence. Failure to identify beneficial interests is directly linked to the problem of the *rumoured* insider trading, especially prior to IPO. The issue of insider trading is examined as a key challenge of ChiNext in the chapter on key challenges.

Parent-child and even sibling controlling ownership structures potentially present less risk, but more so where stronger Confucian filial piety applies rather than in situations of marriage. Again, as previously demonstrated, it appears that personal relationship management and negotiations account for continued investment by individual investors, either as direct subscribers or indirect investors through an SPV - the majority of whom are again undisclosed, as in the previous case study.

It bears noting here that the family and individual controlling shareholdings examined below have been treated as distinct for two reasons. Family and individual shareholdings have been distinguished from one another on the basis of two main points. Only individuals within the top ten shareholders of a company have been counted in the individual category, and, secondly, such individuals must be distinct from a family in having no relation on the executive board, supervisory board or in senior management.²⁷⁵ Most importantly, these two groups merit distinction specifically in the Chinese context because of the different impacts that social norms may have on a family compared to an individual. For instance, the Chinese family has rules that may act in much the same way as an internal governance system such as

²⁷⁴ Liu Junhai, *Legislative and Judicial Controversies*, (2006). This norm persists despite the drive to encourage the registration of shares.

²⁷⁵ For other examples of research that treats them separately, see Danny Miller et al., "Are Family Firms Really Superior Performers?" *Journal of Corporate Finance* 13, no.5 (2007): 829-58. See also, Vikas Mehrotra et al., "Adoptive Expectations: Rising Sons in Japanese Family Firms," *Journal of Financial Economics* (2013), url: <http://www.sciencedirect.com/science/article/pii/S0304405X13000287>.

filial constraints.²⁷⁶ Conversely, individuals have no such familial constraints but may be subject to constraints arising from ‘relationships’, that is, *guanxi*, which plays an important role in the funding of privately controlled companies.

B. Individual Controlling Shareholder

As demonstrated in Section I, 27.50% of surveyed CSMEs have individuals as controlling shareholders.²⁷⁷ Individual controlling shareholders founded their businesses either as a start-up or acquired them from the state by privatisation. Individual controlling shareholders exercise control over appointments and removals from the executive board and the supervisory board, as well as senior management and management decision-making.

In the surveyed companies, there was no separation of ownership and control as already indicated by the family ownership case study. In all surveyed companies with individual controlling shareholders, those shareholders held a combination of the multiple positions of chairman-CEO (or general manager or president), chairman-legal representative, or all three as chairman-CEO-legal representative. Consequently, individual controlling shareholders on ChiNext control not only the shareholders’ meeting but also the board of directors, and partake in the operational management of the company. Furthermore, most individual controllers hold the majority of their shares directly in the company. Others hold shares indirectly through an SPV, or a holding company within a group of companies that he or she ultimately controls, resulting in pyramidal holding structures.

Case study: Entrepreneur-founder

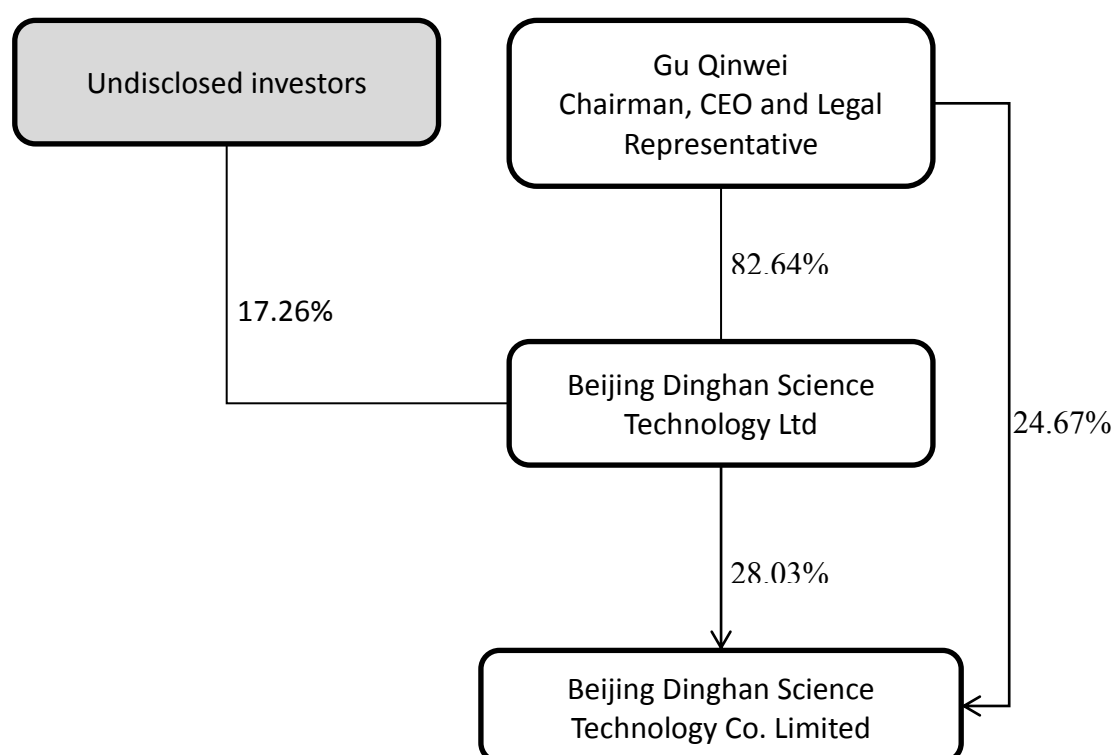
Case study 2: Case study – Dinghan Tech Limited

²⁷⁶ Later, in Chapter Six, it is argued that the Confucian tradition of *xiaoshun* (filial piety) plays an important role in family ownership and, therefore, has implications for corporate governance.

²⁷⁷ See Table 1 on page 107.

Dinghan Tech Ltd., one of the most concentrated individual ownership structures in the companies surveyed, illustrates innovative corporate governance initiatives in relation to the composition of the executive board. Dinghan, one of China's successful hi-tech private start-ups, founded in June 2002 by Gu Qinwei, engages in the production, sales, installation, maintenance and research and development of power supply systems used in China's vast rail transit system. The company converted to a joint stock company in December 2007 with a view to listing. Below is a diagram of the composition of Dinghan's executive board.

Figure 6: Beijing Dinghan Electric Technology Co. Ltd. ownership structure



On IPO, and as of 31 December 2009, the largest block holder and controlling shareholder was Beijing Dinghan Electric Technology LLC ('Electric'), a company that supplies Dinghan with services, including the sales and distribution of spare parts, held 28.03% of the shares. Electric is, in turn, controlled by Gu, who holds 82.64% of its issued share

capital. Equally, as the second largest block holder in Dinghan, Gu directly holds 24.67%. Accordingly, he controls 52.70% % of Dinghan.

Gu controls the company through the shareholders' meeting by exercising all of its powers,²⁷⁸ including making amendments to the articles of association, since he holds more than one half of the issued share capital.²⁷⁹ The other three largest block holders after Gu hold 7.01%, 2.52% and 2.38%, respectively. Although the senior management also hold shares, these holdings are on average under 2%. Neither other large shareholders nor shareholding members can individually or together act as a counterbalance to the controlling shareholder. Moreover, on IPO there were no venture capital or private equity investors in Dinghan. Nevertheless, several institutional investors that acquired shares from the market post IPO have relatively minor interests, with holdings ranging from 0.5% to 2%. As such, unlike many of the surveyed CSMEs, there is a lack of vested interest to spur on the monitoring of the company. Moreover, shares belonging to investors are free-floating, which means they were acquired on the secondary market. Consequently, investors can freely exercise their right to sell if dissatisfied with the performance or governance of Dinghan. The lack of venture capital investors and the low holdings of institutional investors may also indicate that there are no checks to Gu's control.

An illustration of Gu's ability to control Dinghan is found in the report of the company's 2009 annual general meeting ('AGM'). Here, the voting rights represented at the meeting were 68.69 %, with ten shareholders attending in person, Gu and his SPV amounting to two of those shareholders with a controlling holding of 52.70%. At the 2010 AGM, the voting rights represented were 59.09% with six shareholders present, while at the 2011 AGM 59.04% of voting rights were represented with only five shareholders present. Although

²⁷⁸ See Chapter Two on the extensive powers and autonomy of the shareholders' meeting under Company Law.

²⁷⁹ Article 104 of Company Law.

shareholder attendance of the annual shareholders' meeting has progressively diminished since IPO, this does not undermine the ability of the general meeting to be the forum of power as it merely reinforces the control of the controlling shareholder, that is, Gu. This control of the shareholders' meeting enables Gu to retain control over the company through his multiple roles as chairman, chief executive and legal representative. As chairman, Gu not only presides over the board meetings that convene shareholders' meetings but also has the authority to chair the shareholders' meetings himself. Additionally, he exercises the powers and remit expressed in Company Law, as well as those delegated by the executive board and in the articles of association.

As with the previous case study, there is no separation of ownership and control in Dinghan, and this raises the question of who or what presents a check and balance against the controlling shareholder. It appears that shareholdings have been extended to key members of management in order to allay potential conflicts of interest between Gu and senior managers of the company. A high number of management personnel hold individual shareholdings of up to 2% so that their interests align with Gu's. The implementation in 2011 of an executive share incentive scheme provides further evidence of this governance strategy through incentives that align the interests of management with those of the controlling shareholder. The incentives of senior management are driven by the need to retain talent, especially since Dinghan operates in a hi-tech industry. Thus, any action by Gu, as either controlling shareholder or through his multiple roles with the company, that proves to be detrimental to existing senior management may result in them leaving due to the damage to their interests.

Insight and Analysis

Notwithstanding the above, where there are no venture capital investors or significant institutional investors, the key challenge of individual controlling ownership structures

remains. In such circumstances, the role of sponsor provided for under the ChiNext framework in advising and monitoring the company, and ultimately whistleblowing the company to regulators, is of significance. Chapter Five thus examines the effectiveness of the sponsor as a mechanism in corporate governance monitoring and enforcement on ChiNext.

It is increasingly common on ChiNext for SPVs to be used by other investors as a convenient device for them to partake in a listed company without directly subscribing for shares. This raises the issue of transparency in ownership structures where these holdings remain undisclosed.

C. Affiliated Individuals as Controlling Shareholders

In the surveyed companies, the size of holdings of unrelated persons acting in concert tends to be closely or evenly distributed with no one shareholder holding a majority of voting rights that gives control of the company. Here, they are referred to as ‘affiliated individuals’ and tend to act pursuant to the articles of association, or a shareholder agreement or other undertaking.

As noted above in Section I, they comprise 15.00% of the surveyed companies.²⁸⁰ With the highest controlling holding at 48.17% and the average at 31.80%, this category of share ownership holds the lowest range of controlling blocks in any of the surveyed companies. Without the agreement to act in concert, all of these surveyed companies would otherwise be classified as widely dispersed companies with not one shareholder holding 20% or more of the total voting rights.

In all of the surveyed companies, affiliated individuals hold their individual shares directly. A small number also hold shares together through a special purpose vehicle, but this

²⁸⁰ See Table 1 on page 107.

indirect holding is only in addition to holding their shares directly.²⁸¹ One practical reason is that transparency remains crucial to ensure that none of them covertly takes control of the company or becomes a de facto controller without the knowledge of the other manager-owners. Since, as shareholders, they must act as a consortium, it becomes imperative that each knows the total voting rights. In terms of board decisions, there does not appear to be any tacit agreement to act in concert. This reflects the fact that, to a large extent, their board positions within their agreements require them to act in concert.

Most of these widely held ownership structures demonstrate that preference was given to employees during the privatisation process. This was perceived as the only way to overcome the problems, aptly described as ‘officials’ fear of making political mistakes, managers’ fear of losing power, and workers’ fear of losing jobs’.²⁸² Whether private start-ups or privatisations, the surveyed companies with no outright controlling shareholder each had all of the top or key shareholders agreeing to act in concert.

Case study: Covenants to Act in Concert

Case study 3: Wuhan Zhongyuan Huadian Science & Technology Co. Ltd.

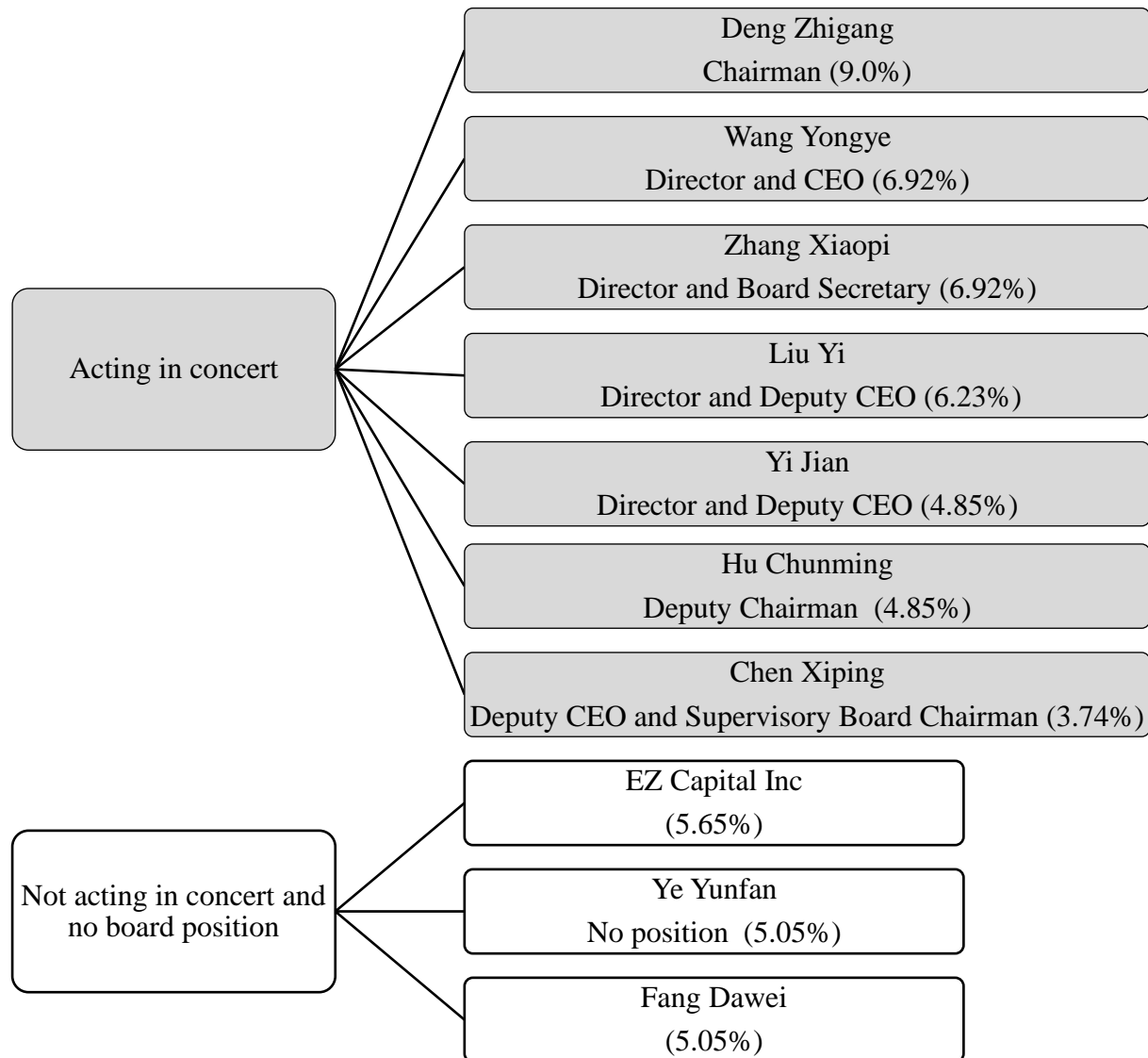
Wuhan Zhongyuan Huadian Science & Technology Co. Ltd (‘Zhongyuan’) presents an example of more than two people acting in concert. It is also exemplary of the hi-tech and innovative SME that ChiNext was set up to assist in funding. It engages in the manufacture, sales and service of intelligent record analysis and time synchronisation products, which it also researches and develops.

²⁸¹ From the manner in which these SPVs were used, it may be surmised that it was a convenient mechanism for income by way of dividends to be accrued by SPV from the listed company. In turn, such dividend income by the SPV in private ventures. In future, these SPVs will be investment vehicles that potentially create complex cross-shareholding on ChiNext in the event that the private companies they invest in are subsequently listed, which becomes significant because the ultimate investors already control one listed company.

²⁸² Tenev, Zhang, and Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*: 32.

The diagram below presents a snapshot of the top ten shareholders of Zhongyuan and their allotted roles in the internal governance of the company.

Figure 7: Multiple persons acting in concert - Wuhan Zhongyuan Huadian Science & Technology Co. Ltd.



Source: Author's analysis

Figure 7 shows that the top ten shareholders of Zhongyuan comprise nine individuals and one US venture capital investor, EZ Capital Inc., with individual shareholdings that range

from 3.74% to 9.00%. Consequently, no individual shareholder exercises control in terms of total voting rights, nor can they singly exercise the right under Company Law to requisition a shareholders' meeting since none of them holds 10% or more of the shares.²⁸³

All of the seven highlighted in grey agreed to act in concert on matters put before the shareholders' meeting.

Insights and Analysis

They act in concert having entered into shareholder agreements, also referred to as subscriber agreements, present agreements on the capital structure, corporate governance, and ownership structure, purpose of the company and details of the rights and obligations of each participating shareholder. The agreements usually also detail cost sharing, liability for breach of contract and a process for dispute resolution. For corporate governance purposes, these shareholder agreements become important because, where there is a conflict between its terms and that of the articles of association of the company, the agreement takes precedence over the articles, unless to the detriment of an innocent party, presumably minority shareholders.²⁸⁴

In line with other controlling shareholder types previously discussed, most, if not all, take an active role in the day-to-day management of the company by holding directorships and or management roles such as CEO or deputy CEO. Therefore, they have not only mutual protection in terms of shareholder meetings but also, to some degree, oversight and control of the day-to-day management of their investments. It does leave the question of protection of the other shareholders in the company.

²⁸³ See Section III. "How Engaged are Shareholders of ChiNext Companies?" on page 74.

²⁸⁴ See Liu Junhai, *Modern Securities Law* (2011): 36-37.

D. State as Controlling Shareholder

The state as controlling shareholder comes in two forms on ChiNext, and indeed on the other equity, either in a state-private partnership or where the state is the outright controlling shareholder. In this instance, this section presents a case study on state-private partnerships.

1. State-private Partnerships

State-private partnerships make up only 12.5% of the surveyed companies, with most of the partnerships existing between local government and individuals or families.²⁸⁵ The state may amount to a controlling shareholder regardless of how few of the voting rights it holds directly or indirectly, solely because of its sphere of significant influence where it enters into partnerships within the private sector. Sometimes the state has controlling interest in terms of the total voting rights it holds based on the 20% of voting rights threshold applied in this thesis. Other times, and more controversially, it holds equal or slightly less voting rights than its private sector partner, but because of its presumed and actual power and significant influence over resolutions of the shareholders' meeting and board of directors, it effectively becomes the controlling shareholder.

2. State Ownership on ChiNext

State ownership patterns are relatively transparent compared to private ownership structures in that they are readily traceable. This also applies to the 5% of surveyed companies that are effectively SOEs.²⁸⁶ Few SOEs with spin-offs have listed on ChiNext. This may be attributable to the fact that most such SOEs tend to be in old economy industries

²⁸⁵ See Table 1 on page 107.

²⁸⁶ Ibid.

and may find it difficult or are simply not interested in diversifying into technological development.

The only two state-owned ChiNext companies, CISRI Gaona Co. Ltd. and Siasun Robot Co. Ltd. are directly owned and controlled by research and educational institutes, namely, by the Chinese Academy of Sciences and the China Iron & Steel Research Institute Group, respectively. Education and research organisations dominate the SOEs listed on ChiNext because they can research and innovate products and services because of their intellectual resources. These organisations are located both at central and local government level. This also includes local branch affiliates of national level institutions as well as central and local government development agencies and commissions. The mechanisms for holding shares depend on the type of state-owned institution. State investment on ChiNext manifests itself in the guise of what may be broadly categorised as state-owned companies affiliated to central government state asset management bureaux, and state-owned companies directly controlled by local government.²⁸⁷ These are broad categories and subjective in so far as some SOEs may actually display characteristics belonging to both. When this occurs, the context and documents such as resolutions and websites help to ascertain the prominence of one characteristic over the other.

A case study of a state-private partnership is presented below.

Case Study: State-Private Joint Ventures

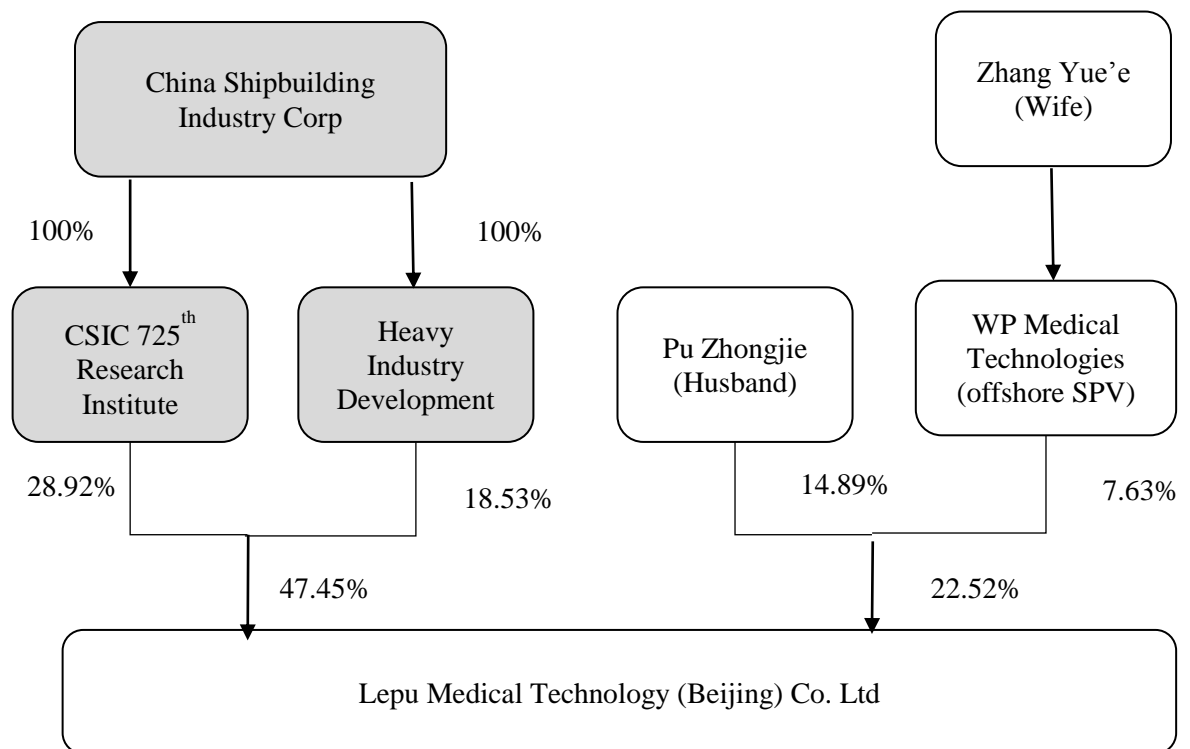
Case study 4: Case study of board of directors on a state-private joint venture

Lepu Medical Technology (Beijing) Co. Ltd. has five major shareholders and represents a unique ownership structure combining state and family ownership, in this case a

²⁸⁷ We loosely adopt the taxonomy of state-owned controlling shareholders employed by Chen, Firth and Xu. See, G. Chen, M. Firth, and L. Xu, "Does the Type of Ownership Control Matter? Evidence from China's Listed Companies," *Journal of Banking & Finance* 33, no.1 (2009): 173.

husband and wife combination. In this case study, both the state and private sector partner hold more than 20% of the total voting rights, and, thus, this presents an interest study on how the private partner protects its interests, and whether it or even the state can act as a mechanism to protect the investment interests of other shareholders.

Figure 8: Lepu Medical Technology (Beijing) Co. Ltd. state and private joint venture ownership structure



The company has few minority shareholders. The Research Institute holds 28.92%, while Heavy Industry Development (Heavy Industry Science Investment Development Co. Ltd.) holds 18.53%. Both the institute and the limited company are wholly owned by China Shipbuilding Industry Corp., a large state-owned enterprise. As such, state authorisation for investment and capital management falls directly under the supervision of central government. The third major block holder is a foreign entity, Brook Investment Ltd., which holds 17.98% (an SPV of Warburg Picus, a US investment company); fourth is Pu Zhongjie with 14.89%; and last is WP Medical Technologies Inc. ('WP Medical'), another foreign entity, holding 7.63%. Crucially, WP Medical is wholly owned by Pu Zhongjie and his wife Zhang Yue'e. Thus, Pu in fact controls 22.52% of the total share capital. However, the state remains the ultimate owner, with 47.45% control of share capital.

This means that the state ensures its control of the joint venture on three levels. First, with a controlling holding of 47.45%, it can control the AGM and, therefore, potentially the appointment of directors and supervisors. The second level of control relates to the board of directors. The third level of control is the board of supervisors, while the fourth relates to managers. However, Pu, with his own knowledge and expertise and the core technology used in the joint venture being held by WP Medical, potentially has control of the operational aspect of the business as a counterbalance to the state's control.

The company's legal representative, Sun Jianke, appears to be neutral, which means that he is probably more likely to bow to pressure from the state. For Pu and non-state investors, the risk arises when their interests are not aligned with that of China Shipbuilding. Strategically, Pu has safeguarded his position by acquiring free-floating shares. Thus, in the event of a misalignment or conflict of interests he can freely sell his shares, subject to the usual timing and volume restrictions for the management of enterprises. However, in the meantime, Pu uses the same shares to bolster his position at shareholders' meetings. The

management structure is also well thought out as neither the state nor Pu is entrenched due to the appointment of a neutral person who is salaried in the position of legal representative. Moreover, Pu heads the research department of Lepu, which, to some extent, counterbalances the power of the legal representative. A positive element for governance is that Pu's interests are more aligned to those of the minority shareholders than to the state, which is ultimate owner, whom he is likely to monitor closely for changes in direction and policy.

Insights and Analysis

Overall, controlling state holdings on ChiNext tend to be through SPV rather than direct. Individuals and families who enter into state-private partnerships also mirror this structure.

A key issue then remains as to how the state as controlling shareholder exercises control, and who acts as a check and balance to that control. The above case study has illustrated the power-broking among state investors and private partners in effectively protecting their interests in the distribution of roles in the internal governance structure. The state does so by appointing the head of the executive board, i.e., the chairman, along with a number of non-executive directors.

Despite this, unlike in other equity markets, state-ownership on ChiNext is especially low because most state-owned CSMEs are located in traditional industries. Nonetheless, other manifestations of the state on ChiNext appear in the guise of non-controlling shareholders, including institutions such as venture capital investors, social security funds and pension funds, which are by definition and in fact institutional shareholders mostly wholly owned or run by the state.

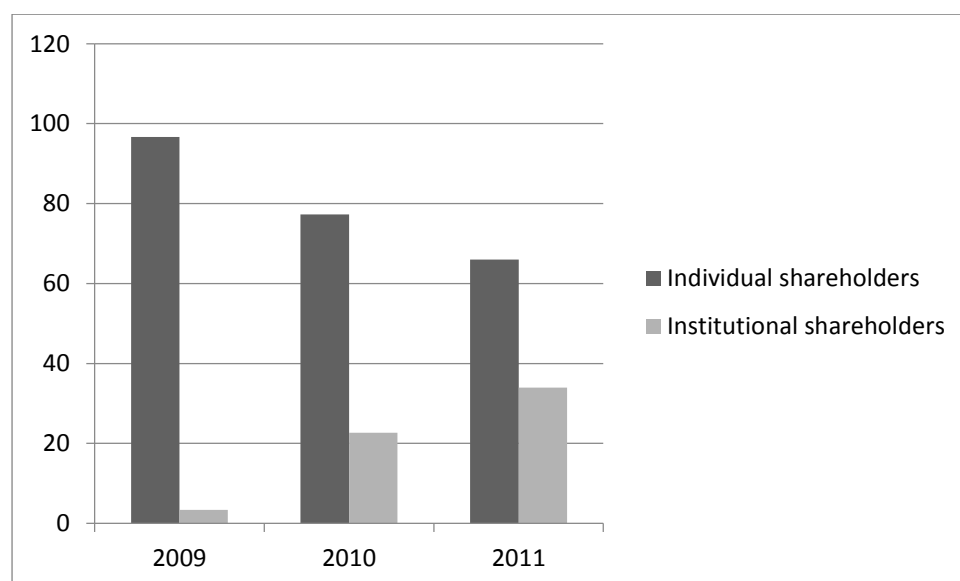
This Section has illustrated the profiles of controlling shareholders on ChiNext as well as the way in which they exert control through voting rights, and reinforce such control

through key executive board and senior management roles. This is also mirrored in state-private partnerships, with the private sector also ensuring that it protects its investment by having not only key roles but also strategic knowledge and skills that the state lacks. Therefore, the private sector partner becomes a key mechanism in the protection of shareholders' investments in the event that the objective of the state veers away from providing a return on investment.

II. Non-controlling Shareholders on ChiNext?

This Section examines the profile of non-controlling shareholders and their capacity to act as a corporate governance check and balance against controlling shareholders. The figure below illustrates, in the year ending 31 December, the number of institutional investors (which include venture capital and private equity investors) compared to individual investors investing on ChiNext.

Figure 9: Ratio of institutional shareholders to individual shareholders holdings in free-floating shares on ChiNext as of 31 December 2009, 2010 and 2011



*Source: author's analysis*²⁸⁸

Figure 9 shows an increase in the number of institutional shareholders as of 31 December from 2009 to 2011. In 2009, institutional investment only amounted to 3.54% of total free-floating shares on the market, which fell well below expectations given the original intention of policymakers for ChiNext to be a venture capital market patronised by venture capital, private equity and institutional investors with a small number of highly experienced individual investors. The two-year experience eligibility criteria imposed on individual investors failed to stem their investment inflow, but it became a positive outcome for the listed companies, since, as demonstrated, institutional investors waited some time before investing on the secondary market.

The Exchange has been keen to emphasise the increasing presence of institutional investors and their effective corporate governance role. According to the Shenzhen Stock Exchange 2012 Performance Report, activity by qualified foreign institutional investors ('QFIIs'), insurance companies, mutual funds, enterprise annuities, brokerage houses, brokers' collective asset management plans, Social Security Fund (the most active of SOE investors) and trust companies apparently held an average of 9.86% of the total investors. Thus, of a total of 1,538 companies on SZSE (that is the Main Board, SME Board and ChiNext), institutional investors held stakes in 449 companies. Equally, they attended the general meetings of 164 listed companies, i.e., 37% of meetings.²⁸⁹

However, the following analyses demonstrate a mixed picture and also depend on which investors are counted as institutional investors.

²⁸⁸ "Shenzhen Stock Exchange Market Performance Report of 2012," n.d.

²⁸⁹ The methodology of the survey does not indicate whether these general meetings are annual or interim. Nor does it state whether venture capital investors are included in this number. See Liu Jiacheng, Huang Jinggui, and Lin Tao, *Chuangyetouzi, Yunzuo Jizhi Yu Guoji Bijiao [Venture Capital Investment, Operational Mechanism with an International Comparison]*, 1st ed. (Hainan chubanshe, 2009).

A. Venture Capital Investors - Cornerstone of ChiNext Investment?

Venture capital investors ('VCs') are not generally referred to as institutional shareholders, primarily because they invest at the early stages of growth that offer high potential but high risk.²⁹⁰ Essentially, they are pre-IPO investors and, importantly, have a defined exit strategy, usually upon IPO. In general, the overriding objective of a venture capital investor is to successfully obtain a return on investments.²⁹¹ This assumes that the objective of such entities is to ensure the right share price and a smooth exit.

This does not strictly apply in China where two types of VC exist: those generally referred to as 'government-run VCs' ('*guanban VC*') and privately run VCs. Government-run VCs are usually readily distinguishable when they hold shares designated for state investors, either in the form of state-owned shares (*guoyou chigu*) or state legal entity shares (*guojia gu*).²⁹² However, some difficulty arises in distinguishing them from privately-run VCs because they sometimes hold their investment in non-state legal entities, thereby giving no indication of the ultimate ownership being the state.

Government-run and privately run VCs have different investment strategies and objectives. Nonetheless, overall, together VCs provided finance to 92.50% of surveyed companies with holdings ranging from less than 1% to as high as 20.25% of total voting rights. Revealingly, none of the VCs hold controlling shares in any of the surveyed companies. With such low holdings they do not overall present a key source of funding as may be expected. Technically, the higher the percentage of their holdings in the company, the

²⁹⁰ Working definition derived from William A. Sahlman, "The Structure and Governance of Venture-Capital Organizations," *Journal of Financial Economics* 27, no.2 (October 1990): 473.

²⁹¹ Sahlman, "The Structure and Governance of Venture-Capital Organizations."

²⁹² State-owned shares are specifically created by investment of state-owned assets from government organs authorised by the state. Importantly, the State Council is the ultimate owner (beneficiary) of such shares. They tend to be managed by SASAC. In contrast, state legal entity shares denote that the assets invested are by state-controlled enterprises; if they were invested by a private enterprise, they will be legal entity shares.

greater their interest and, therefore, the greater their ability and propensity to engage in and influence decisions at shareholders', executive board and supervisory board meetings.

1. Government-run Venture Capital Investors

Government-VCs do not have the return on capital as the fundamental basis for investment, whereas private VCs do.²⁹³ So-called government-run VCs generally dominate the venture capital industry, mainly because of their extensive access to funds. Likewise, there are also mixed reviews regarding their contribution to corporate governance and performance.²⁹⁴

Unsurprisingly, 52.5 % of the surveyed companies had state investment, whether in the form of state-owned shares or state shares, or just non-state legal entity shares. State shares figured as the most dominant avenue of investment. The holdings of government-run VCs are not very high, ranging from as nominally low as 0.03 % to as high as 18.47 %, which indicates that financing was not the sole priority for investing. Noticeably, when the pre-IPO subscribers register was compared to the publication of subscribers post IPO, a large volume of both state-owned share and state shares were subsequently transferred to other entities on IPO. The most identifiable beneficiary of the transfer was the Social Security Fund, which appears in several of the surveyed companies. Thus, government-run VCs cannot be entirely considered the cornerstone of financing for the surveyed companies. Nonetheless, from the research, they appear a key ingredient for a successful listing as their investment

²⁹³ Liu Jiacheng, Huang Jinggui, and Lin Tao, *Chuangyetouzi, Yunzuo Jizhi Yu Guoji Bijiao [Venture Capital Investment, Operational Mechanism with an International Comparison]*.

²⁹⁴ Chinese media is sceptical. Xin Shanglun, "Fengkuang Chuangyeban Touzi Caifu Shenhua Zhizaozhe: Dazao Chuanyeban 'Fubai Chanyesuo' [Mad Venture Capitalist Mythify Wealth: Creating ChiNext's 'Industrial Chain of Corruption']," News, *Dongfang Zaobao [Eastern Morning Paper]*, (29 October, 2010). This contrasts with the perspective that VCs, especially government-run VCs, enable performance and good governance. See, Ren Jiancheng and Ye Xiaobao, "Ningbo Shi Sheli Zhengfu Xing Chuangye Touzi Yindao Jijin de Duice yanjiu [Research on the Countermeasures of Funds Resulting from the Set-up of Government Venture Capital Firms by Ningbo City]," *Jingji Congkan*, no.5 (2011).

however nominal symbolises the rubber stamp of (local or central) government approval of the company.²⁹⁵ State-owned venture capitalist firms predominantly belong to state-owned banks such as China Construction Bank, which has a large number of investments in both listed and unlisted companies.

In terms of corporate governance, most government-VCs in the surveyed companies take a hands-off approach to their investment management. Most do not have any representation on either the executive board or the supervisory board. This hands-off approach complements their nominal investment strategy and holdings prevalent in most of the surveyed companies. They have also being generally criticised as not being interested in the governance of the companies in which they invest due to general apathy. Liu, Huang and Lin found that government-run VCs interests were not necessarily about shareholder value - they have other value system, and their interests do not necessarily align with minority shareholders, or generally with other shareholders who just want a return on their investment.²⁹⁶ The multi-layered agency relationships in the state-owned governance system also mean that decision-making and engagement at company level is inevitably infrequent even though they are VCs with a purview to provide a suite of funding and management advice. Additionally, of course, their ability to exit on IPO by transferring to other government-run financial institutions means that they have nothing to gain from the IPO process per se because they do not partake in the huge gains that accrue; hence, the apathy.

One noticeable trend from the survey was that few government VCs continue their investment after IPO, and this may be another reason why they do not tend to have

²⁹⁵ Obvious because the holding of state shares or state-owned shares is more or less a declaration of state investment, which can be contrasted with the increasingly common use of non-state legal entities to make investments that conceal the identity of the state as an investor. Thus, these categorisations are still important.

²⁹⁶ Liu Jiacheng, Huang Jinggui, and Lin Tao, *Chuangyetouzi, Yunzuo Jizhi Yu Guoji Bijiao [Venture Capital Investment, Operational Mechanism with an International Comparison]*, 321. (They further argue that the predominance of government VCs means less competitiveness and more partisan selection of companies funding.

representatives on either board. This largely reflects their low level of investment in these companies and the fact most government VC shares are transferred before or on IPO. In the case of the surveyed companies, most of the shares went to China's Social Security Fund.

2. Private-run Venture Capital Investors

In contrast to government VCs, privately owned VCs are in the minority, largely because their pool of funds for investment comes from private individuals, businesses and institutions. Domestic venture capital investors include Shenzhen Capital Group. Tianjin Datong Investment Group Co. Ltd., a privately owned shareholding industrial group on IPO, held 27.82% of issued shares in Chasesun. On ChiNext, venture capitalists are less involved in the management of the enterprises they fund. As such, their representatives are more likely to be on the supervisory board than the executive board.²⁹⁷ Private VCs, which appear to be locked in by share dealing rules under Company Law, have IPO as the only exit, unlike government-run VCs. Therefore, they have more of an interest in partaking in the management and internal governance of companies in which they invest.

Although private VCs tend to have larger holdings than their government counterparts, they do not take controlling holdings in any of the companies in which they invest, though they figure in the top ten block holders.

Venture capitalists remain subject to a certain amount of criticism and cynicism in the financial press, which may suggest a certain lack of understanding of this very 'capitalist' tool for economic development. Aside from the exceptions, most surveyed companies have benefited from venture capital, whether from the state or otherwise.

²⁹⁷Countries with lower levels of law and order tend to have a higher degree of venture capital. See Franklin Allen and Wei-ling Song, "Venture Capital and Corporate Governance" (The Wharton Financial Institutions Center, September 2002): 2, url: <http://knowledge.wharton.upenn.edu/papers/1115.pdf>.

Private VCs hold their shares directly or through SPV. However, the level of transparency stops at firm level compared to state VCs, which makes it relatively easy to trace the ultimate investor.

In terms of corporate governance, private VCs protect their investments by nominating representatives to sit on executive boards and sometimes supervisory boards. As such, they play a role in the management of the enterprise to ensure that they achieve their investment objectives, which is to ensure a return on their investment through IPO. As mentioned earlier in Chapter Two, the ChiNext framework emphasises good internal governance when a company seeks listing.

Private-run VCs definitely have more of an impact in corporate governance terms. Firstly, they tend to use non-executive directorships to monitor the management and protect their interests. Some also have supervisor representatives on the supervisory board. Their ability to sit on either the executive board or the supervisory board depends on the volume of shareholdings and their influence. Secondly, they appear to only invest in companies in which they can exercise some measure of influence. For instance, of the surveyed companies, private VCs were less likely to invest where one individual held more than 30% of the total issued shares in the company. One key reason for this, as observed by an interviewee knowledgeable about the VC industry in China, was that VCs find it difficult to monitor their investments where individuals are controlling shareholders because pre-IPO entrepreneur-managers are known to withhold information from and exclude external investors from key decision-making processes.²⁹⁸ Moreover, they embellish information.²⁹⁹ A registered public accountant who audited both listed and unlisted small and medium-sized companies also corroborated this view, observing that some companies tend to have different financial and

²⁹⁸ Interview 2012-12.

²⁹⁹ Interview 2012-12. Such views were also reflected by retail shareholders: Interview 2012-18; Interview 2012-19; Interview 2012-20.

other reports specifically produced for the consumption of the regulatory authorities, investors and for their own personal use.³⁰⁰ The confidence of entrepreneur-managers and other owner-managers comes in part from the fact that the small pool of good, investment-quality, hi-tech and innovative companies remains smalls, and, therefore, they are confident of their business idea and are likely to have a choice of VCs with which to engage.³⁰¹ It is well documented that, in unlisted companies, key decisions about the company are taken at an operational level with the controlling shareholder as chairman/CEO. VCs tend to have employee representatives who may not necessarily have the clout to counterbalance the strong personality of an owner-manager. Nonetheless, as their interests align with the entrepreneur-manager and CSMEs offer a good return on investment as well as prestige and heightened social status for the entrepreneur, entrepreneur-managers will do their utmost to ensure the success of their application for listing, which requires meeting certain performance and corporate governance conditions. A key observation is that most of the VC representatives on the board of directors of the surveyed companies tend to be senior, with some being chairpersons of the VC firm itself. This largely reflects the privately run VC.

Thus, it may be concluded that, as long as the listed company performs well financially and the VC receives dividends, it appears generally unconcerned. Here, it seems that executive board and supervisory board meetings are, at best, updating exercises. This correlates with Chen et al.'s recent findings regarding these institutional shareholders.³⁰² Post IPO, the role of VCs in corporate governance arguably becomes conflicted in that they are focused on their exit strategy.

³⁰⁰ Interview 2012-11.

³⁰¹ Interview 2012-12.

³⁰² Jian Chen et al., "Does Foreign Institutional Ownership Increase Return Volatility? Evidence from China," *Journal of Banking & Finance* 37, no.2 (February 2013): 660-69, url: doi:10.1016/j.jbankfin.2012.10.006.

B. Private Equity Investors

As with VCs, private equity investors ('PE') can either be state-owned or private and it can, therefore, be difficult to distinguish between the two. Few private equity firms invest on ChiNext because they continue to invest in traditional industries and companies that are mostly found on the main markets of Shanghai and Shenzhen due to the high-risk nature of ChiNext listed companies.³⁰³ A reason for not investing on ChiNext is that private equity firms in China traditionally choose medium to long-term investments with low to medium risks, which stands in contrast to the high-risk profile of ChiNext companies.³⁰⁴ The most active private equity investors also tend to be state owned rather than private. Hence, their concentration lies on main market listed companies, which entail a lower risk profile despite comparatively low returns.

Analysis of the profile and investment patterns of private equity investors in the surveyed CSMEs shows that, strategically, these investors differ from venture capital investors in that their investment periods do not really correlate with the funding requirements of CSMEs. That is, most private equity investors tend to invest up to a few months just before the listing of a company. In this regard, they cannot possibly have any influence on the governance structure of the company, apart from perhaps adding their own representative.

Guoxin H & S Investment Co. Ltd. ('Guoxin') provides a typical example of such a state-controlled private equity investor used as an investment avenue by local government, in this case Shenzhen local government. Guoxin holds investments in five ChiNext companies, which it made less than six months before their respective IPOs. It forms part of the Guoxin Group, and Shenzhen local government holds a controlling interest in Shenzhen Investment

³⁰³ Interview 2012-12.

³⁰⁴ Interview 2012-12.

Holding Co. Ltd., an investment company listed on the Hong Kong Stock Exchange, which, belonging to the Shenzhen local government, holds 40% of the issued shares of Guoxin. The CRC Trust, a wholly owned subsidiary of the Shenzhen Municipal Government State-owned Assets Supervision and Administration Commission, holds a further 30%. Thus, the total holding of Shenzhen local government amounts to 70%, with the remaining 30% distributed among various minority investors. With this very powerful background, any company with Guoxin investment will undoubtedly be more likely than others to obtain listing approval. Such power does not require direct representation on the board to influence the company.

Thus, private equity investors remain a small but influential fixture on ChiNext because many of them provide amounts to an alternative and indirect investment route for local government investment in China's equity markets. This perhaps signals a new form of investment and business strategy by local governments, whereby they can benefit from IPO overpricing, especially since they tend to invest just before IPO. They have gathered a rather bad reputation as being exploitative. Moreover, some have potential conflicts of interests whereby the same group of companies supplies both private equity and sponsorship services.

In terms of corporate governance, they do not appear to be active in any of the companies in which they invest, i.e., they do not take up executive board or supervisory board positions.

C. Institutional Shareholders

The preceding sections have demonstrated that venture capital and private equity shareholders both have focused exit strategies post IPO, and, because of the inevitably large returns made on IPO, do not need to pursue any corporate governance strategy. This section examines the profile of institutional shareholders on ChiNext and assesses the extent to which they can act as a counter-weight to controlling shareholders.

The constituents of institutional investors include asset managers, insurance companies, investment funds, social security funds, ordinary institutions, QFII and stockbrokers. Although they can also be grouped into state and private institutional investors, a more relevant distinction here is between domestic and foreign institutional investors. Moreover, institutional investors tend to be widely held with a mix of state and private investors, with sometimes complex pyramidal chains of ownership.

Overall, institutional investors remain depressed in both number and investment volume on ChiNext. The results from the surveyed companies suggest that they do not build substantial stakes, the reasons for which are discussed later in this section. Similarly, the surveyed CSMEs also reflect low investment from institutional investors in free-floating shares. There are various reasons for this. In terms of investment strategy, from the outset of their investment they have a medium-term strategy based on capital growth but are more focused on medium and long-term income growth. They are mainly concerned with generating income (pension funds) and the long-term prospects of the company.

One of the key findings in this chapter is that institutional investors (a narrow definition excluding venture capital and private equity investors) play a very limited role in corporate governance in the surveyed companies. As mentioned earlier, state policymakers and the CSRC expected the majority of investors on ChiNext to be majority institutional investors along with a minority of seasoned individual investors. But, as illustrated in Table 2, the reverse occurred, with individual investors instead dominating the volume and number of shareholders in the secondary market.

Table 2: Percentage of free-floating shares held by institutional investors on ChiNext

| | Year | 2009 | 2010 | 2011 |
|----------------|-------------|-------------|-------------|-------------|
| ChiNext | | | | |

| | | | |
|--|-------|-------|-------|
| Institutions ³⁰⁵ | 3.34 | 22.71 | 33.98 |
| Individuals | 96.66 | 78.29 | 66.02 |
| Average for Institutional Investors on | | 55.33 | 56.36 |
| Shenzhen Stock Exchange (including Main | | | |
| and SME Boards) | | | |

Source: Shenzhen Stock Exchange³⁰⁶

As this table (and the previous figure) illustrates, in the first three months of its launch there were only 3.34% institutional investors partaking in the secondary market of ChiNext.³⁰⁷ The table also shows incremental increases in institutional holdings on ChiNext year on year, with 2010 and 2011 increasing to 22.71 and 33.98%, respectively.³⁰⁸ However, this still falls below the overall average of over 55% across the boards of the Shenzhen Stock Exchange.

Whether an increase in institutional shareholders presents the capacity for increased corporate governance action remains to be seen. It may be that too much confidence and

³⁰⁵ The list includes asset managers, insurance companies, investment funds, social security funds, ordinary institutions, QFII and stockbrokers. Interestingly, the Shenzhen Stock Exchange also includes ordinary (i.e., non-financial) companies in its list, but their holdings are relatively negligible. See, Shenzhen Stock Exchange, *Shenzhen jiaoyisuo 2009 niandu gupiao shichang jixiao baodao* (Shenzhen Stock Exchange Market Performance Report of 2009) (Shenzhen: Shenzhen Stock Exchange, April 2010), url: <http://www.szse.cn/main/files/2013/02/28/148177440107.pdf>.

³⁰⁶ Compiled from Shenzhen Stock Exchange, *Shenzhen jiaoyisuo 2010 niandu gupiao shichang jixiao baodao* (Shenzhen Stock Exchange Market Performance Report of 2010) (Shenzhen: Shenzhen Stock Exchange, February 2011), url: <http://www.szse.cn/main/files/2013/02/28/148177440107.pdf>; *Shenzhen jiaoyisuo 2012 niandu gupiao shichang jixiao baodao* (Shenzhen Stock Exchange Market Performance Report of 2012) (Shenzhen: Shenzhen Stock Exchange, February 2013), url: <http://www.szse.cn/main/files/2013/02/28/148177440107.pdf>.

³⁰⁷ As of 31 December 2009.

³⁰⁸ There continues to be an upward trend in institutional holdings of free-floating shares on ChiNext, reaching 36.60% by the end of 2012. This was complemented by a proportional decline in individual shareholders to 63.40%. See, Shenzhen Stock Exchange, *Shenzhen jiaoyisuo 2012 niandu gupiao shichang jixiao baodao* (Shenzhen Stock Exchange Market Performance Report of 2012) (Shenzhen: Shenzhen Stock Exchange, February 2013), url: <http://www.szse.cn/main/files/2013/02/28/148177440107.pdf>.

expectation is being transferred to institutional investors regarding corporate governance without acknowledging the fact that they may not wish to engage with the company but merely wish to invest.

The low volume of QFIIs may also be attributable to perceived poor corporate governance on ChiNext due to unfamiliarity with family and individually controlled listed companies. This may fuel a short-term investment strategy. After all, empirical research suggests that QFIIs screen and improve the quality of the listed companies they invest in because they take a very rational perspective to investment and especially take the performance of companies into consideration.³⁰⁹ Naturally, this rational perspective will undoubtedly cause QFIIs to be reluctant to invest substantially and over the long term in listed companies in which they may feel marginalised, such as those controlled by families.

Nonetheless, the findings of this research correlate with the occurrence of short-term and low investment volume by QFIIs. The findings of this author's research from the surveyed companies is further evidence of this phenomenon. This may account for their current low investment on ChiNext and the resultant efforts of the CSRC and the Exchange to demonstrate improvements in the selection of companies, as well as the fact that corporate governance appears high on their agenda.

Institutional investors may be more confident that, however short or long term their investment strategy, their interests are aligned with the controlling shareholders who presently hold important appreciation in share value and income growth. In contrast, they actively monitor their investments in SOEs as a result of having more long-term investment strategies. The choice of long-term investment strategy and behaviour may reflect their sensitivity to appearing speculative in SOEs in which the government has tried constantly to

³⁰⁹ Teng Lili and Huang Chunlong, "Woguo QFII chixu tezheng yanjiu - jiyu xuangu pianhao yu chigu qixiande shizheng fenxi (Characteristics of China's QFII: an Empirical Analysis of Stock Selection Preferences and Holding Period Features)," *Touzi yanjiu (Review of Investment Studies)* 31, no.10 (2012): 84-97.

encourage long-term investment. With privately run companies, institutional investors can choose their investment strategies at will. Indeed, past research indicates that small retail shareholders have always chosen their investment strategies at will. Their highly speculative nature on ChiNext may be a result of the present social and economic atmosphere in China, where everyone is trying to capitalise on present opportunities because the future is unknown. This leads naturally to a discussion of the social and economic contexts in which ChiNext companies exist today. Promoting long-term investment strategies leads to more interest in the company by shareholders, which is the first stage before shareholders at all levels can be empowered to engage in the decision-making of the company. This results in more stability in the company and on the market. However, the problem is how to encourage institutional investors and retail investors especially to take part. For instance, recent empirical research on QFIIs presents no consensus as to whether or not QFIIs are long-term or speculative investors, which is of some significance since it is widely acknowledged that a long-term investment strategy usually comes with interest and activism in corporate governance. Empirical research suggests that QFIIs screen and improve the quality of the listed companies in which they invest.³¹⁰ However, an empirical study of QFII investments between 2005 and 2010, analysing QFII investment behaviour, finds that, overall, QFIIs take short-term investments as their main investment strategy.³¹¹ In contrast, some studies find that QFIIs play the role of long-term investor rather than speculator.³¹² However, these studies remain limited as, although a long-term investment or speculative strategy may be applied in one market, it may not necessarily be applied to others. There remains no research on this issue on ChiNext. Studies have also found that, for QFIIs, corporate governance rather than size of

³¹⁰ Ibid.

³¹¹ Ibid.

³¹² For example, Wu Weihua, Wan Difang, and Cai Di, “*Gejingwai jigoutouzizhe: touzizhe haishi toujizhe?* [The Qualified Foreign Institutional Investors: Are they Investors or Speculators?],” *Zhengquan shichang daobao* (*Securities Market Herald*), no.12 (2011).

firm or profit have a substantial impact on the investment decisions of both domestic and foreign institutional investors. The result is that institutional investors are probably a more realistic corporate governance mechanism because they have greater incentives in monitoring and the resources to do so. In terms of corporate governance, qualitatively, the results of this research suggest that institutional investors play less of a role in corporate governance, at least in the surveyed companies.

On examination of the top ten shareholders for 31 December 2009, 2010 and 2011, respectively, there was no stake building for a medium to long-term investment. There was no substantial change in the top ten block holders from the time of IPO. Correspondingly, there was also no substantive change in the constituents to include institutional investors as they do not and did not partake in the management of the company; that is, they do take an active interest in executive board or supervisory board roles. However, this is perhaps expected since many institutional investors do not build holdings large enough or for long enough for them to decide that they need a representative on one of the boards of a company to protect their interests.

The next section examines foreign institutional investors specifically because they are expected to have a positive influence on corporate governance.

1. Qualified Foreign Institutional Investors

Foreign institutional investors must be licensed as ‘qualified’ to invest in any capital market, including ChiNext and other permissible investments in China. This licensing makes them QFII. The QFII program was launched in 2002. QFIIs have long invested in the main Boards of the Shanghai and Shenzhen stock exchanges. All QFIIs in China tend to be large because of relatively high assets under management requirements, which appears to be a deliberate strategy to ensure that China gets the cream of international institutional

shareholders.³¹³ The main types of QFII include asset managers, insurance companies, securities companies, commercial banks and other institutional investors.

A key belief of the state and academics in China, as well as the key reason for establishing the QFII program, is that foreign institutional investors will naturally promote good corporate governance practices.³¹⁴ However, investment by foreign institutional investors' remains low overall in Chinese stock markets. On ChiNext, both their numbers and volume appear lower than expected by the CSRC. Rather, as discussed below, retail shareholders instead dominate ChiNext. QFIIs have more than tripled their investment presence on the Main Board rather than on ChiNext. For example, according to the Shenzhen Stock Exchange Market Performance Report of 2012, QFIIs held 1.83 and 0.68% on the Main Board and SME Board, respectively, but only 0.54% on ChiNext. This becomes even lower when compared to the fact that institutional investors overall hold 36.6% of directly held free-floating shares on ChiNext. As well as having only a small presence, there has been much media interest in the short positions and good profits made by QFIIs,³¹⁵ none of which brings to mind an investor eager to carry out the arguably onerous and expensive monitoring of their investments.

Studies find that, in turn, such international institutional investors screen and improve the quality of the listed companies they invest in because they take a very rational perspective

³¹³ See, CSRC, "Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors" (Chinese Securities and Regulatory Authority, 24 August, 2006), url: http://www.csrc.gov.cn/pub/csrc_en/OpeningUp/RelatedPolicies/QFII/201211/t20121108_216649.html.

³¹⁴ Jing Baixiang and Sun Lingli, "Guquan Fenzhi Gaigexia QFII Dui Woguo Zhengquan Shichang Fengxian Yingxiang de Shizheng Fenxi (An Empirical Analysis on QFII's Effect on China's Securities Market Risk in the Reform of Stock Structure)," *Guanxi Caijing Xueyuan Xuebao (Journal of Guanxi University of Finance and Economics)* 19, no.5 (October 2006): 25-27.

³¹⁵ Zhong Tian, "QFII tegu mingxi puguang 9zhi chuangyebangu ru 'fayan' [Clear and Detailed Expose of QFII's Holdings; 9 ChiNext Stocks Enter the 'Eye of the Law']," News, *Zhengquan ribao [Securities Daily]* (July 9, 2011), url: <http://stock.eastmoney.com/news/1424,20110907161301730.html>. See also, Ke Zhihua, "QFII de'er da fu jianchi dichan gu [QFII Huge Sell-off of Property Shares: Columbia University Loves ChiNext Most]." However, it is unclear whether they sold off their venture capital investment or the shares purchased in the secondary market, or both.

to investment and especially take the performance of companies into consideration.³¹⁶ Thus, the existence of QFIIs appears encouraging for corporate governance on ChiNext. However, examination of the surveyed companies indicates that only a handful of QFIIs actively invest on ChiNext, and mostly in free-floating A shares, like their domestic counterparts. Some of the most active QFIIs on ChiNext include Goldman Sachs (UK), Martin Currie Investment Management Ltd. (UK), Temasek Fullerton Alpha Investments Pte Ltd. (Singapore), and Columbia University (US), reflecting the increasingly international characteristic of the market.

Despite having a small presence in the ChiNext, there has been much media reporting of the good profits made by QFIIs, presumably because they have sold off.³¹⁷ Columbia University is an example that is known to have made the most lucrative investments on ChiNext in 2011.³¹⁸

Secondly, none of the abovementioned investors featured in the top ten holders. Media reports suggest that QFIIs take a more speculative position when trading in ChiNext equities.³¹⁹ Indeed, the low number of institutional investors engaging in ChiNext companies is unsurprising, especially in light of the research findings presented in Section III below.

Overall, in terms of domestic and private institutional investors, the research indicates that institutional investors and private equity firms do not want control over ChiNext companies. An interviewee also corroborates this, citing the lack of good-quality companies as a key problem, as well as the risky nature of investing in hi-tech companies. He reiterated that the IPO market has reached saturation because the limited number of good-quality

³¹⁶ Teng Lili and Huang Chunlong, “*Woguo QFII chixu tezheng yanjiu - jiyu xuangu pianhao yu chigu qixiande shizheng fenxi* (Characteristics of China’s QFII: an Empirical Analysis of Stock Selection Preferences and Holding Period Features).”

³¹⁷ Zhong Tian, “*QFII tegu mingxi puguang 9zhi chuanyebangu ru ‘fayan’* [Clear and Detailed Exposé of QFII’s Holdings; 9 ChiNext Stocks Enter the ‘Eye of the Law’].”

³¹⁸ Ke Zhihua, “*QFII de’er da fu jianchi dichan gu* [QFII Huge Sell-off of Property Shares: Columbia University Loves ChiNext Most].”

³¹⁹ Zhong Tian, “*QFII tegu mingxi puguang 9zhi chuanyebangu ru ‘fayan’* [Clear and Detailed Exposé of QFII’s Holdings; 9 ChiNext Stocks Enter the ‘Eye of the Law’].”

companies restricts the number of investments in such companies.³²⁰ Equally, another interviewee, also a member of China's investment community, added that, in reality, institutional investors are powerless against founders and entrepreneurs who monopolise and conceal information about the company.³²¹ The upshot of this is that individuals and families as founders or controlling shareholders possess an overall dominance through the monopoly of information, which has created a barrier to entry for institutional investors, at least before IPO. Post IPO, this trend of not taking up controlling holdings in companies continues, as purchases in the market tend to be speculative in nature.

This section then leaves a key question as to which group of shareholders presents a counterbalance to private controlling shareholders and in which ways. The previous section demonstrated that venture capitalist investors do have a role and can have an influence when they have positions on the executive board. The next section examines the role of the pre-IPO individual subscriber and their role.

D. Individual Investors

On ChiNext, individual investors comprise three kinds: employees; people who are not employees but who subscribe for shares when the company is private, i.e., pre-IPO individual investors; and, the largest section of investors, retail shareholders who invest at IPO or in the secondary market. This section examines each type of shareholder and the findings regarding their role in corporate governance.

³²⁰ Interview 2012-12.

³²¹ Interview 2012-11.

1. Employees

Over 50% of the surveyed companies had most members of management holding shares in the company. Share options have played a small role in compensation and aligning the interests of management with shareholders but it becoming increasingly with a strong trend. In 2009 none of the surveyed companies had a share option scheme before or immediately following IPO. But by the end of 2010 this had risen to 17.50% and then to 37.50%. Most plans are restricted to senior management, while others extended it to the middle management level. Moreover, on average the percentage of those that partake in the share option was less than 5% of the total number of employees, which reflects the cautiousness regarding dilution of holdings and the increasing need to attract and retain talent especially in hi-tech and innovative companies.

2. Individual Pre-IPO Subscribers

In most of the surveyed companies, individual pre-IPO subscribers (i.e., those who are not employees) hold small to large non-controlling interests in the company, usually less than 10% but on average greater than 1%. This is unsurprising given that, on average, more than 55% of the total issued shares of the company were restricted because they were mostly held by pre-IPO subscribers. It may also be a strategy by controlling shareholders to ensure that any individual non-controlling shareholder cannot, on his or her own, requisition a shareholders' general meeting, as discussed in the next section.

They tend to directly hold their shares in the company. Strict regulatory restrictions to the sale and purchase of shares by the company, as discussed in the previous chapter, apply to this group of shareholders. For instance, pre-IPO subscribers must not transfer any part of their holding during the first 12 months following IPO of the company. This indicates that they are more likely to have been shareholders in the company prior to IPO than holders of

shares acquired during IPO or from the secondary market. However, this cannot be the case because there is no restriction on these shareholders' ability to sell unless there are covenants attached to the issue of shares.

A key trend for pre-IPO subscribers in most of the surveyed companies is to partake in the management of the company, either as directors (executive and non-executive), supervisors, managers³²² or employees, as also indicated in the earlier case studies. Because of their personal stake in the company, pre-IPO subscribers are concerned by the enterprise's presentation and strategy, and about the return on their investment. Some of these investors monitor their interests on the supervisory board, but rarely on the executive board. Having said this, not all of them are prepared for a post-IPO medium to long-term investment, as demonstrated by financial media reports of the sales of their shares.

As proposed in Chapter Six, pre-IPO individual subscribers are arguably one of the most important yet overlooked mechanisms of corporate governance in privately controlled listed companies. Several factors expanded upon in Chapter Six contribute to this. In summary, they include their medium to long-term investment strategy, regulatory trading restrictions, directorships and *supervisorship*, and importantly, their role and influence as key providers of start-up funding to the company.

3. Retail Shareholders: Large and Small

A retail shareholder is an individual shareholder who buys and sells securities for his or her own personal account, and not on behalf of others or through an intermediary.

Overall, retail shareholders present the largest group of investors on ChiNext. Compared to venture, private equity and institutional investors, and employee and pre-IPO individual subscribers, they have relatively small shareholdings, on average far below 0.5% of the total share capital. Individual shareholders on ChiNext can be divided further into large

³²² Per the definition under Company Law.

retail investors and small retail investors due to their relatively different investments. The distinction made between pre-IPO individual subscribers indicates that they did not buy their shares on IPO or from the secondary market.

Large retail shareholders comprise a relatively small number of individuals who do not hold controlling interests but hold 1% or more of the issued share capital of a company. As of 31 December 2009, despite shareholdings as low as 0.01%, these individuals tend to figure in the top ten shareholdings of free-floating shares of companies. Although they are also minority shareholders, they have remedial rights under Company Law whereby they can exercise individually against directors and management.³²³ Large retail shareholders tend to hold 0.01% or more of the total share capital, and also tend to be less speculative investors. There is no way of knowing if the large retail shareholder shows speculative behaviour patterns as it is difficult to monitor individual share movements. Clearly, from the time of IPO to 31 December 2009 and the publication of the annual report, they remained the same, which amounts to at least a few months of investment and is in contrast to minority retail shareholders who are said to turn over shares on an almost daily basis.

Although small retail investors are the largest group of investors in terms of number, they are smallest in terms of their holdings. Thus, despite their abundance, their ownership on ChiNext remains highly concentrated. The ordinary retail shareholder who holds up to several tens of thousands of shares is the most recognised and often written about. In relation to issued share capital, they own a negligible minority in the company.

Despite retail shareholders being a representative group of minority shareholders that policymakers, the CSRC and the Exchange aim to protect, they have a limited role in corporate governance, as will be demonstrated later in Section III of this chapter, which examines the methods of shareholder engagement in the surveyed companies. Indeed, their

³²³ See Articles 152 and 150 of Company Law, together.

overall role in corporate governance is presently restricted to ‘voicing’ concerns through votes.

Nonetheless, the progressive decrease in retail shareholders’ holdings of 96.66% of free-floating shares on ChiNext in 2009 to 66.02% by the end of 2011 not only reflects regulatory authorities’ pro-activism in encouraging investment by institutions.³²⁴ Of course, the much-documented speculative behaviour of retail shareholders, as reflected, continues in media reports on ChiNext.³²⁵ But such behaviour, being transient in nature, cannot wholly account for the steady and significant decline of retail shareholders.

The decline seems to largely reflect a withdrawal of retail investors with potentially medium to long-term investment strategies from those companies to which they subscribed for the IPO. Two main factors contributed to this withdrawal: first, the market was such that initial gains made on and immediately following IPOs tended to be lost if holdings were not sold promptly.³²⁶ This follows from the seemingly inherent nature of the ChiNext IPOs to be overpriced. The problem of overpricing also reflects the negative narrative in the media about the newly listed companies, and the scepticism about their actual performance and long-term prospects.³²⁷ Correspondingly, there also remained uncertainty about the truthfulness of published financial reports, performance and proprietary technology claimed. In terms of corporate governance, the press especially believe that listing by companies is a ruse to gain

³²⁴ See, Table 2: Percentage of free-floating shares held by institutional investors on ChiNext.

³²⁵ For example, see Xinhua Guangzhou, “‘Sangao’ *yousuo* ‘tuishao’ - Chuangyeban qidai baituo zijin tuidong xing sanhu shichang [‘The Three Highs’ somewhat the ‘Recedes Fever’ - ChiNext Expects to be Rid of its Capital Funding Style Retail Market],” Government News, *Xin Hua*, (October 23, 2012), url: http://www.gd.xinhuanet.com/newscenter/2012-10/24/c_113471199.htm.

³²⁶ Interview 2012-8; Interview 2012-11; Interview 2012-12.

³²⁷ In a review on the third-year anniversary of trading on ChiNext, the online financial magazine concludes that the ChiNext market has made RMB billionaires of pre-IPO subscribers; however, secondary market investors are subjected to the vagaries of the decline profitability of many companies. See, Caijing wang, “*Chuangyeban: dangchu ‘zaofuban’ zhuanbian dagudong taoxian de ‘chouxueban’* [ChiNext: The Initially ‘Wealth-Creating Market’ Turns into ‘Blood-Sucking Market’ for the Largest Shareholder],” Financial News, *Caijing wang*, (16 October, 2012), url: <http://stock.caijing.com.cn/2012-10-21/112212708.html>.

funding from the public with no tangible long-term business strategy or sustainability.³²⁸ As will be illustrated in Chapter Five, most retail shareholders rely on the media for investigative analytical investment news, and journalists see this as part of their public obligation. Corporate governance as in issue was implicit in the responses from the interviews; however, the interviewees expressed their lack of trust.³²⁹

E. Foreign Investors

Both individual and institutional foreign investors can and do invest in A shares in ChiNext companies. However, only qualified (i.e., licensed) foreign institutional investors (QFIIs) can partake in placements, IPOs or just deal in ChiNext's secondary market, for example, such as Goldman Sachs and UBS Warburg. Foreign legal persons or individuals, public or private, can invest by making capital contributions in cash or assets, such as material goods or intellectual property rights, but this must take place prior to the public listing of a company, otherwise only licensed foreign institutional investors can do so. This complements China's general capital market policy of encouraging institutional and discouraging individual investors, as the latter is believed to pose problems for effective corporate governance. Thus, foreign ownership is low on ChiNext. Nonetheless, a key advantage of investing only in A shares is undoubtedly the better transparency, information asymmetry and liquidity in having one listed share class than on other boards where foreign investors invest only in B shares.

³²⁸ For example, see Shan Shui, "Chuangyeban cheng zhai tiaoban? (GEM: the Market for Benefit Transportation)," *International Financing*, January 2011. See also Xin Shanglun, "28 chuangyeban gongsi qunian zhengli fuzengzhang [28 ChiNext Companies post negative growth from last year]," *Financial News*, *DF Daily*, (3), <http://www.dfdaily.com/html/136/2011/3/30/586369.shtml>.

³²⁹ Interview 2012-08; Interview 2012-09; Interview 2012-18; Interview 2012-18; Interview 2012-18.

III.How Engaged are Shareholders of ChiNext Companies?

The preceding case studies have illustrated that controlling shareholders readily take up the roles of director and manager. This dominant trend toward owner-manager, whereby the controlling shareholder-owner directly manages the privately listed companies, is developed further in the next chapter on management structures. Shareholders have only one key avenue to engage with the companies in which they invest: the shareholders' meeting. But in addition to the opportunity to engage with the company, shareholders too would need to actively engage.³³⁰ This section presents the results of a documentary survey of shareholder resolutions disclosed to the Exchange between 2009 and 2012, examining the extent to which shareholders actually engage with the company. The chosen indicators for this purpose include the number of shareholder meetings held during the year and the business conducted, the attendance of AGMs and the percentage of total voting rights represented, the requisition of a shareholder meeting, the issue shareholder proposals at a shareholders' meeting, and the provision and use of proxy voting and online voting. Together, these indicators assist in analysing the opportunity given by the company to shareholders to partake through the ultimate organ of power, the shareholders' general meeting, and, vice versa, the willingness and ability of shareholders to engage by attendance or using the rights given under Company Law. Despite the obvious activism exhibited by shareholders in the instances described below, the results of the survey strongly indicate an overall decline in shareholder engagement.

A. Shareholders' Meetings as a Forum for Engagement

This section studies the extent to which shareholders in CSMEs engage in decision-making in the company through the attendance of meetings and exercising voting rights on

³³⁰ For a discussion of the "free-rider" phenomenon in China see part IV. Evaluative Summary on page 184.

company matters, including how they do so *ex ante*. It remains to be understood how shareholders at all levels engage in the decision-making process of the company with the tools provided under Company Law. There is an overwhelming trend toward concentrated private ownership structures and the pervasive power of controlling shareholders over every aspect of decision-making to the exclusion of other non-controlling shareholders. In essence, this section studies the potential controls on controlling shareholders available to non-controlling shareholders and whether they exercise these controls.

1. Board Convening Shareholder Meetings

A key issue with highly concentrated ownership is that, where possible, resolutions can be passed by the controlling shareholder without the need for the attendance of other shareholders. Company Law does not actually require a quorum of physical attendance. Instead, the law only provides the thresholds for passing ordinary and special resolutions.

Thus, the ChiNext framework emphasises the importance of the use of the shareholders meeting as a forum for shareholder engagement. The table below presents the number of shareholders' meetings, both annual and interim, held during the years 2009, 2010 and 2011, respectively.

Table 3: Annual and interim shareholders' meetings held by ChiNext companies

| Year | 2009 | 2010 | 2011 |
|-------------|-------------|-------------|-------------|
| <hr/> | | | |

| | | | |
|-------------------------------|------------------|-----|-----|
| Average number of | | | |
| shareholders' meetings | 2.4 | 1.4 | 4.7 |
| Highest number | 7 | 7 | 6 |
| Lowest number | 0 ³³¹ | 1 | 1 |

Source: Author's survey

The average number of meetings held by the surveyed companies doubled between 2009 and 2011. An increase in regulatory and practical requirements for the approval of corporate actions accounts for the increases across all surveyed companies. For instance, the most common agenda items in meetings from 2010 onwards were amendments to articles of association, the approval of material contracts, related party transactions and share incentive initiatives. All of these transactions require approval at a meeting of the shareholders under Company Law and the Listing Rules. In the table below, the survey examined the number of shareholders' meetings to ascertain, firstly, the extent to which companies within the first year of IPO were making decisions that required shareholder approval. There is a positive correlation between the number of extraordinary shareholders' meetings and the high number of supervisory board meetings. This suggests either that the supervisory board may have advised that certain issues must go to the shareholders' meeting, or that the supervisory board should test the waters before specific proposals and projects are put before a meeting of shareholders. All of the companies surveyed declared holding an AGM for the year, although public announcements for such meetings on ChiNext were not available.

³³¹ The surveyed company failed to hold an AGM in accordance with Company Law. This highlights an enforcement issue, in that, presumably because the surveyed company was 'theoretically' still a private joint stock company at the time, the CSRC (or the Exchange) has little jurisdiction to enforce or sanction the company. In this respect, any effective action falls to the shareholders requisitioning a meeting under the company's articles of association or Company Law. The literature indicates that shareholders in private companies tend to pursue matters that have a monetary impact on their rights.

During 2009, Beijing Ultrapower Co. Ltd. held a total of seven shareholder meetings – one annual shareholders’ meeting and six interim shareholders’ meetings. There was an increase in shareholder participation in approving and authorising sensitive matters such as the award of share incentives related to party transactions and the issuance of bonds to individuals and third-party companies. These were the main reasons for the interim meetings. For the owner-manager of an SME who makes unilateral decisions, this represents an overhaul of the decision-making process. It also signals a willingness to comply and engage with other shareholders. It especially signifies the emphatic role that the Exchange and the CSRC are taking in engaging in a more company-specific manner, which ensures compliance with the form if not the substance of the law.

2. Requisition of Shareholder Meeting

Under Company Law, with a minimum of 10% of the voting rights, a shareholder has the right to act individually or collectively to convene a shareholders’ meeting when both the executive board and supervisory board fail to do so.³³²

During the period 2009 to 2011, an examination of both interim shareholder meetings for the surveyed company showed that none were requisitioned by either shareholders or the supervisory board of the company. This amounts to an important right for minority shareholders, despite ample opportunities to flex their voting power in the light of a few management scandals. For example, during the period 2009 to 2011, no such meeting was called by shareholders, despite various highly publicised scandals, some resulting in new regulations, such as the resignation of directors and senior managers, challenges to the

³³² Article 102 of Company Law. This provision has been the source of some criticism because it excludes minority interests. Gan Peizhong recommends a range of 5% to 8 % as an alternative. See Peizhong Gan, *Qiyue yu gongsi faxue [Jurisprudence on Enterprises and Companies]* (Beijing: Beijing daxue chubanshe, 2012): 220.

authenticity of proprietary intellectual property, and various episodes of serious disciplining or sanctioning of companies by the regulatory authorities

A practical reason for shareholders not requisitioning shareholders' meetings may be because most shareholders hold less than 10 % of the total voting rights. Thus, any requisition will require them to identify potential allies and then mobilise them. Moreover, once convened, due to the minority of their votes, the passing of their proposed resolutions for which the meeting was convened cannot be guaranteed. As passing of shareholder resolutions require 50 % or more of the total voting rights, they will undoubtedly need the support of the controlling shareholder, who may be reluctant given that most controlling shareholders also lead the executive board as chairperson. Thus, the use of the requisition can present an upward struggle that may antagonise the controlling shareholder and still prove futile.

Indeed, large individual shareholders who are not interested in the day-to-day management curtail such problems by taking on non-executive director roles. As such, they have more leeway to propose matters as any other business at executive board meetings, as well as direct contact with the controlling shareholder.

B. Increased Meetings Equal Increased Shareholder Engagement?

The rising number of shareholders' meetings described in the preceding section positively indicates increased compliance with Company Law and other legislation. However, it does not necessarily equate to increased shareholder engagement. It does demonstrate at least the effort made by the executive board to comply with Company Law in convening meetings for relevant decisions.

Company Law does not require a quorum. Instead, total voting rights at the meeting must be enough to pass ordinary business, which requires 50% or more of the total voting

rights. This means that a controlling shareholder alone can attend a convened meeting and preside over the meeting in his role as chairperson once he controls 50% or more of the total voting rights. Of course, this rarely occurs.

The majority of surveyed companies on average have more than 7,000 registered shareholders, including natural and legal persons; yet physical attendance is low.

Table 4 illustrates the increasing decline in the attendance of AGMs by minority shareholders. This is because attendance has fallen faster and by bigger proportions than the volume of total issued shares represented at the meeting.

Table 4: Percentage of companies with shareholders physically present at AGMs³³³

| Number of shareholders present | percentage attendance in surveyed companies | | |
|--|--|-----------------|-----------------|
| | AGM 2009 | AGM 2010 | AGM 2011 |
| 10 or less | 30.51 | 47.46 | 52.54 |
| 11 to 20 | 32.20 | 25.42 | 33.90 |
| 21 to 30 | 16.95 | 13.56 | 10.17 |
| 31 to 40 | 13.56 | 5.08 | 1.69 |
| 41 to 50 | 3.39 | 0.00 | 1.69 |
| 51 to 60 | 3.39 | 3.39 | 0.00 |
| more than 61 | 0.00 | 5.08 | 0.00 |
| Average number present | 19.56 | 17.41 | 12.12 |
| Average percentage of total voting rights represented at AGMs³³⁴ | 66.55 | 59.46 | 55.97 |

Source: survey

³³³ For the years ending 31 December 2009, 2010 and 2011, the AGMs were actually held in 2010, 2011 and 2012, respectively.

³³⁴ Analysis based on review of disclosed AGM resolutions.

At the 2009 AGMs, 69.49 % of the surveyed companies had more than ten shareholders present compared to 52.54 % at the 2010 AGMs and 47.46 % at the 2011 AGMs. The lowest AGM attendances in 2010 and 2011 had just two shareholders – a quorum to convene, even though across the board the average was 17.41 and 12.12 %, respectively. This indicates the potential for extreme variation in attendance across companies. Indeed, a good example of the possibility of consistently good attendance is Anhui Anke Biotechnology (Group) Co. Ltd., which consistently had over 50 shareholders in attendance at each AGM. This is remarkable and occurred despite the company having one shareholder who controlled 29.92 % at IPO and throughout the three years.

In the surveyed companies, on average, few minority shareholders attend AGMs and are unlikely to cast their votes unless online electronic voting is available, as will be illustrated later in the chapter. From the low numbers of attendance and the high percentage of total issued share capital represented at the meetings, it would appear that mostly controlling shareholders and majority shareholders are now in attendance. Indeed, year on year, the average number of shareholders increases faster than the average percentage of the issued share capital present at a meeting.

Only two surveyed companies experienced an increase in the total voting rights represented at an AGM. One recorded a corresponding increase in shareholders, namely Chase Sun Pharmaceutical Ltd. Moreover, only 17 shareholders representing 63.97 % of the total issued share capital attended this company's 2009 AGM. This figure dropped dramatically by 50% to nine shareholders at the 2010 AGM, but without a corresponding drop in the total issued share capital represented, which was stable at 63.62%. However, the 2011 AGM experienced another surge with shareholder attendance more than tripling to 31%, but again with only a comparatively small increase in the issued share capital represented at 65.05%. Clearly, this demonstrates that incremental increases tend to be in relation to

minority shareholders, especially as Chase Sun does not have an outright controlling shareholder, but rather is widely held by individuals holding shares directly or using SPV. Another point of note is that, exceptionally, on IPO, Chase Sun did not have and continues not to have any institutional investors in its top ten shareholders. All such shareholders are individuals.

The lowest attendance of an AGM was for Beijing CISRI Gaona Ltd., the 2010 AGM of which was attended by only two shareholders, with 54.06% of total voting rights represented, namely CISRI the controlling shareholder with 48.02% and another SOE holding 6.04%.

C. Voting: One-share-one vote

Voting is one of the three fundamental rights of a shareholder, the other being the right to sell and/or sue. Voting in China is increasingly important, as demonstrated when, in 2005, Company Law introduced the concept of shareholder democracy (*gudong zhuyi*) as imperative for the advancement of corporate governance in China.³³⁵ Listed companies only have one class of share, namely ordinary shares, otherwise referred to as A shares, which rank *pari passu*. Thus, much scholarship is devoted to the study of participation of shareholders and voting, especially empirical evidence.³³⁶ In China, voting has begun to matter more as a result of the corporatisation and privatisation of many of the operating arms of many SOEs,³³⁷ and the emergence of the private sector, as indicated earlier.

³³⁵ Liu Junhai, *Legislative and Judicial Controversies*, (2006): 188.

³³⁶ For empirical studies, see Chen, Firth, and Xu, "Does the Type of Ownership Control Matter?". See also He Jun, "Shangshi gongsizhili jiegou de shizheng fenxi [An Empirical Analysis of Corporate Governance Structures of Listed Companies in China]," *Jingji yanjiu (Economic Research Journal)*, no.5 (1998): 50-57. Zi Zhong'en et al., "Zhongguo shangshi gongsizhili jiegou de shizheng yanjiu (An Empirical Study on Chinese Listed Firms Corporate Governance)," *Jingji yanjiu (Economic Research Journal)*, no.2 (2005): 81-91.

³³⁷ Chen, Firth, and Xu, "Does the Type of Ownership Control Matter?"

On ChiNext, controlling shareholders do not necessarily monopolise the votes and, in fact, on average require the support of other shareholders with larger holdings. To pass an ordinary resolution, one half or more of the total voting rights is required for ordinary business. Equally, a special resolution requires two-thirds of the total voting rights in the company for special business such as amending the articles of association. Thus, when the average holding of controlling shareholders in the surveyed companies is 40.34%, all will need the buy-in of other shareholders to pass an ordinary resolution, with the exception of two companies that have the state and a family as respective controlling shareholders. Correspondingly, even more buy-ins will be needed for a special resolution, with the exception of one company with a family controlling shareholder. Thus, in practice, controlling shareholders in the surveyed companies do not have unfettered control of the company, as they too have to negotiate and create allegiances. But, less optimistically, this point highlights a corporate governance issue if the interests of the controlling and large shareholders are aligned, but, importantly, not aligned with those of the minority shareholders. This means that the interests of minority shareholders may be side-lined, which is exacerbated by the low physical attendance of shareholders' meetings by shareholders in general. Consequently, the use of voting mechanisms such as cumulative, proxy and online voting that effectively enfranchise shareholders, especially minority shareholders, becomes important.

1. Cumulative Voting on ChiNext

Cumulative voting presents a key exception to the one-share-one-vote rule, which otherwise sees controlling shareholders and their allies dominating the voting.³³⁸ Article 106

³³⁸ English language literature on cumulative voting in recent years has been sparse. For a general overview of recent literature on the practice (or avoidance) of cumulative voting in the US, the UK, Germany, Japan, France

of Company Law gives joint stock companies the option of adopting cumulative voting systems in their articles of association or by resolution at a shareholders' meeting in respect of the election of directors and supervisors. It nonetheless sets out the use of cumulative voting for the election of directors and supervisors, the formula simply being that each shareholder has voting rights equal to the number of directors or supervisors to be elected. Crucially, Company Law also permits the concentrated use of all cumulative voting rights by a shareholder, thus, clearly tailored at empowering minority shareholders in concentrated ownership structures. It has been a source of some debate, and is gaining support even before its inclusion in Company Law.³³⁹ Very early on, China's Code of Corporate Governance³⁴⁰ imposed mandatory cumulative voting on listed companies where a controlling shareholder holds 30% or more of the total voting shares in the company. However, the perennial problem of limited enforcement arises. Firstly, the CSRC has a reputation for weak enforcement. The CSRC encourages companies listed on ChiNext to embrace cumulative voting, especially for the election of independent directors, and makes efforts to explain the process to shareholders and stakeholders.³⁴¹

A review of enforcement of cumulative voting in the surveyed companies revealed in published results of ad hoc company 'self-inspections' ('*zicha*') ordered by the CSRC

and Italy, see Reinier H. Kraakman, ed., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd ed. (Oxford; New York: Oxford University Press, 2009): 90-92.

³³⁹ For example, see Wang Jijun, "Gufenyouxian Gongsi Leiji Toupiao Zhidu Yanjiu [Cumulative Voting System in Joint Stock Companies]," *Zhongguo Faxue (Chinese Legal Science)*, no.8 (1998): 83-87. (Argues the importance of adopting cumulative voting for the protection of minority shareholders as an effective mechanism to control on controlling shareholders.) cf Frank H. Easterbrook and Daniel R. Fischel, "Voting in Corporate Law," *Journal of Law and Economics* 26, no.2 (June 1, 1983): 395-427, url: doi:10.2307/725110.

(Acknowledges the advantages of using minority shareholders gaining some protection through cumulative voting, but nonetheless points out the persisting controversy with shareholders with less votes (i.e., less capital contributions) being given an advantage over those with higher capital contribution). Of course, the 'balancing' effect of cumulative voting depends on the formula used, and how concentrated or dispersed is the ownership structure of the company in question.

³⁴⁰ See China Securities Regulatory Commission and State Economic and Trade Commission, "Code of Corporate Governance for Listed Companies in China," (2001), para. 31.

³⁴¹ Chapter Five illustrates this encouragement reflected in the type of questions asked in survey questionnaires sent to companies regarding corporate governance practice. One example is the CSRC Xiamen Office publication on the matter.

undertaken between January 2010 and December 2011.³⁴² On analysis, most of the surveyed companies (of this thesis) subject to the CSRC survey expressly undertook in their published response to employ cumulative voting in future selections of directors as a whole. Tellingly, many surveyed companies did not include supervisors in this undertaking, with only a small minority including independent directors. This reveals a lack of uniformity in implementation and even a lack of understanding as to whether to comply with Company Law, which requires directors and supervisors alike, or the Code, which primarily focuses on the election of independent directors. The problem with cumulative voting lies in its complexity, not in terms of formula but rather in terms of how votes should be cast by minority and controlling shareholders alike.

In practice, however, most of the surveyed companies had not yet implemented cumulative voting in the election of their present tenure of directors and supervisors, who were largely appointed before the companies were converted to joint stock companies, or were not yet listed, so that the Code did not apply at the time.³⁴³ This clearly indicates that some surveyed companies did not adopt Company Law's permissive option into their articles of association. However, post IPO they appear willing because it is likely that they fall under the mandatory requirement of the Code. More interestingly, even surveyed companies with an aggregate controlling shareholding of less than 30% of total voting rights also indicated a willingness to adopt cumulative voting. Whether or not companies in practice apply cumulative voting in the selection of independent directors and other position on the boards of directors and supervisors remains to be seen. The delay in the implementation of cumulative voting may also be attributable to the fact that the ChiNext Measures require

³⁴² Information sourced from public disclosures made by surveyed companies compiled from individual company disclosure records searched on <http://chinext.cninfo.com.cn/newmarket/gszx.html> and using Chinese language search engines such as baidu.com.

³⁴³ Invariably, from 2012 onwards, it will be interesting to see how many implement it as most of the tenures of the boards would have expired.

companies not to have had any changes to the boards in the two years prior to IPO, with most of them renewing their three-year tenure on the executive board at least two years before IPO, when the company is still private. On analysis of the prevailing minority shareholdings in surveyed companies, cumulative voting has a potentially empowering effect when the minority block is not highly dispersed into very small holdings.

Notwithstanding the above, the lack of attendance and voting of shareholders at meetings in ChiNext companies compared to the number of registered shareholders per company remains a problem. The next section analyses the use of proxies by shareholders where they are unable to attend or cast their votes themselves.

2. Proxy Voting

Proxy voting remains an important facility for minority shareholder representation and enables them to cast their vote while avoiding the costs of attendance or even lack of adequate information. Article 107 of Company Law generally provides for the provision of proxy voting, but it is permissive rather than mandatory. In fact, the law does not expressly state the mechanism for authorising proxy voting for joint stock companies; that is, whether by inclusion in the articles of association or by resolution at a shareholders' meeting.³⁴⁴

With such vagueness, it is unsurprising that the results of the examination of mandatory disclosures of resolutions for AGMs held in 2009, 2010 and 2011 demonstrate that the use of proxy voting in surveyed companies is limited. Two types of proxy were examined, categorised here as 'external proxies', i.e., external representatives chosen by shareholders including corporate proxies, and 'internal proxies', i.e., internal representatives such as independent directors. Most of the external proxies were corporate, such as

³⁴⁴ This is in contrast to express provisions for limited liability companies. Some scholars believe that this was intended by the lawmakers to permit choice for joint stock companies. See Gan, *Qiye yu gongsi faxue [Jurisprudence on Enterprises and Companies]*, 2012. An alternative perspective was that the lawmakers perhaps intended that regulations relating to public listed companies would naturally fill this gap.

institutional shareholders, and their attendance was demonstrably low. A negligible number of internal proxies were chosen during those years. No minority shareholders in surveyed companies utilised this facility during AGMs held for 2009, 2010 or 2011. Thus, not only do shareholder meetings suffer from a lack of attendance in person but also limited use of proxy voting by shareholders as a whole. A practical method to improve voting by shareholders has been the encouragement of online voting, discussed in the following section.

3. Online Voting

Online voting is arguably the most efficient way of enfranchising and giving a voice to minority shareholders, especially since almost half of China's population use the Internet. The CSRC provides for the voluntary use of online voting or any other convenient method to enable shareholders to take part in voting in listed companies.³⁴⁵ Gan Peizhong believes that online attendance with the ability to pose or ask a question by text or email should be permitted as a way of increasing the voice of shareholders, especially that of the minority.³⁴⁶

As demonstrated in Table 5, only 5% to 10% of surveyed companies provided online voting to their shareholders in 2010 and 2011. Online voting was not available at the 2009 AGMs because the companies were not listed.

Table 5: Percentage of surveyed companies using online voting at annual general meetings

| | 2009 AGM | 2010 AGM | 2011 AGM |
|--|---------------------|---------------------|---------------------|
| | | | |

³⁴⁵ For full details, see generally Chapter IV (and rule of CSRC, “*Shangshigongsi gudong dahui guize* [Rules Regarding Annual General Meetings of Listed Companies]” (Chinese Securities and Regulatory Authority, 16 March, 2006), url: http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/ssgs/gszl/201012/t20101231_189783.html.

³⁴⁶ Gan, *Qiyu gongsi faxue* [Jurisprudence on Enterprises and Companies], 2012: 224.

| | | | |
|--|---|-------|------|
| Percentage of CSMEs using online voting at AGMs³⁴⁷ | - | 10.15 | 5.08 |
|--|---|-------|------|

Source: author's survey

Already, the provision of the facility by surveyed companies to shareholders is a declining trend. Although over 10% of CSMEs used online voting in 2010, that number abruptly halved to just over 5% in the following year. Due to the controversial nature of providing a service, it was difficult to obtain reasons for the sharp fall in provision. It is also of note that those companies that provided an online voting service for the 2010 AGMs did not do so for the 2011 AGMs. As to reasons, it may simply be that these companies experimented and then decided not to provide the service. Cost is an unlikely reason, since the initial set up cost of the facility tends to be more expensive than its maintenance. A cynical analysis may be that companies removed the online voting due to the potential reputational risk and impact of minority shareholders voting in abstention or rejection of resolutions. Indeed, all companies that provided online voting were subjected to shareholder voting action ranging from abstentions to outright rejection of resolutions. This rarely happened in any of the companies that did not provide online voting.

Also of note is that all of the surveyed companies that provided online voting were privately held with a mix of ownership of individuals or group of individuals. For example, the highest voting turnout of all was achieved by Beijing Ultrapower Software Co. Ltd. at its 2010 AGM, where 82 shareholders voted. Of that number, 71 voted online and 11 attended in person. The representation of total issued share capital of these voters was relatively low at

³⁴⁷ Details of online voting was gleaned from a review of the AGM resolutions published by companies published on the Shenzhen Stock Exchange website: www.szse.gov.cn.

52.96%. Nevertheless, this is arguably a high proportion considering that none of the shareholders had a controlling shareholding, with the maximum being 13.93%.

Although the relative numbers of shareholders that vote online remain relatively low overall, the benefit of online voting in enfranchising cannot be understated since the largest turnout of shareholders for voting took place in those surveyed companies that provided online voting for shareholders. With an evident trend in decline in attendance by minority shareholders, online voting becomes especially important. However, what is certain is that controlling shareholders increasingly dominate shareholders' meetings.

The use of online voting is an excellent way of promoting so-called corporate democracy. However, it is not mandatory under the ChiNext framework or any corporate law or rules.

4. Use of Shareholders' Meetings by Scrutinisers

Company Law does not expressly require the attendance of independent scrutinisers. However, under article 22, shareholders have the right to apply to the court to make ineffective any shareholders meeting resolution within 60 days of its passing if content or procedure relating to the resolutions was in violation of the law, administrative procedures, or damages the interests of the company or shareholders.

Scrutinisers perform three functions. First, scrutinisers verify that registered shareholders were in attendance in actual fact: one of the key problems in China is that it is commonplace for individuals to borrow someone's name and identity card to open up trading accounts (done for a host of reasons, including privacy), and yet still want to attend and vote in person at meetings.³⁴⁸ Secondly, they confirm that the voting results including proxies. Finally, scrutinisers confirm that the business of the meeting was duly executed. The ChiNext

³⁴⁸ Liu Junhai, *Legislative and Judicial Controversies*, (2006), 187.

framework requires the scrutiniser to publish an independent opinion confirming these three matters, among others.

At the AGMs of the surveyed companies, each company's external lawyer performed the function of scrutiniser and published an independent report on the proceedings and results of the meeting. The corporate governance issue comes in the form of a potential conflict of interests because the company's external legal counsel cannot be defined as 'independent'. They are on a retainer from the company. Moreover, external legal counsel tends to have close links to management since most SMEs such as those listed on ChiNext tend to have small in-house legal departments. In individual and family-controlled listed companies the external counsel in reality acts as the 'family lawyer' and so is not the most appropriate independent scrutiniser.

D. Shareholder Proposals at General Meetings

A shareholder's right to make a proposal at a shareholders' meeting presents a potentially strong curb on the pervasive authority of controlling shareholders over shareholders' meetings. It also serves as an indicator of shareholder activism.

Article 103 of Company Law permits a shareholder, or a group of shareholders together, holding 3% or more of the total voting rights in the company to make provisional proposals for deliberation at a shareholders' meeting. Proposals must be submitted in writing to the executive board at least 10 days prior to the shareholders' meeting, the executive board has no discretion in the matter. They must, within two days of receipt of the proposal, notify all other shareholders and make a mandatory announcement to the market. The proposal is then placed as an agenda item for consideration at the shareholders' meeting. Sometimes the amended notice and agenda of the shareholders meeting is included in the announcement to the market.

Table 6 illustrates the percentage of companies in which shareholders invoked their right to propose resolutions at an annual shareholders' meeting.

Table 6: Percentage of shareholders in attendance at meetings with attendance

| | 2009 AGM | 2010 AGM | 2011 AGM |
|--|---------------------|---------------------|---------------------|
| Percentage of CSMEs where shareholders proposed a resolution at AGM | 6.78 | 6.78 | 5.08 |

Source: author's survey

Examining the annual shareholders' meeting in particular, 11 proposals were made in 11 different companies for the years ending 31 December 2009 (four proposals), 2010 (four proposals) and 2011 (three proposals), respectively. For 2009, almost 7% of the surveyed companies had shareholders issue article 103 proposals. This figure remained the same for 2010 but then fell to 5% in 2011. However, and paradoxically, six of the total 11 proposals considered at AGMs were by controlling shareholders, and another four by pre-IPO individual subscribers. Surprisingly, only one legal person, in this case a venture capital investor issued a proposal; no institutional investors issued any. It remains unclear as to whether better corporate governance, antipathy or disaffection caused this decline. All the shareholder proposals identified arose only in privately held companies.

Although Company Law article 103 empowers minority shareholders by curtailing the controlling shareholders' monopolisation of control over shareholders' meeting agendas, proposals made by controlling shareholders include amendments to articles of association and the nomination of candidates as directors, including independent directors, as well as the

introduction of share incentive schemes, including giving the board extensive authority to implement and award share incentives.

Non-controlling shareholders appear ready to use the shareholder right to propose corporate-governance-related matters at a shareholders' meeting. For example, Netac Ltd. illustrates the use of this right by two pre-IPO individual subscribers acting together within a few months of the company's listing on ChiNext. Two of Netac's shareholders, Deng Guoshun and Cheng Shaohua, acting in concert, controlled 39.63% of the total issued share capital. A relatively small block holder, Wang Quanyang, who directly held a total of 11.52% of issued shares, proposed a resolution for the approval and implementation of a 'system for safeguarding against controlling shareholders and related parties misusing company share capital'. The resolution was unanimously passed at the 2009 AGM. Perhaps also revealing is that Wang holds a non-executive director post in the company, which may indicate that the controlling shareholder, who also happens to be the chairman of the company, gave his tacit approval. This is perhaps evidenced by the fact that the resolution was passed.

However, the implications of this right seem different when it is actually controlling shareholders that make article 103 proposals. While these examples stand as positive examples of shareholder engagement in companies by both controlling and minority shareholders, there remains the danger of shareholder actions being isolated and infrequent occurrences. Results from the survey demonstrate a clear decline in non-controlling shareholder engagement overall.

Despite the paradoxical use of article 103 by owner-managers, the provision still remains a strategically important mechanism for non-controlling and minority shareholders for two reasons. Under China's Company Law, the executive board's role is merely procedural in being the appropriate forum to receive the proposal and then circulate it as an

agenda item to all shareholders.³⁴⁹ That is, it has no discretion whatsoever to review, negotiate, amend or even approve such a proposal. This potentially proffers an immense amount of power in the hands of shareholders. However, the key issue remains as to how to small and medium sized shareholder can effectively utilise it in an ownership structure which is relatively and commonly dispersed below the controlling shareholder level. Moreover, as the Netac example above demonstrated, tacit approval by the controlling shareholder may be required since ultimately the proposal will be put before the shareholders' meeting. The next section examines how controlling shareholders in ChiNext companies purport to impose self-regulation by using covenants and undertakings. Thus, the key benefit for corporate governance and shareholders as well as stakeholders is that, through the analysis of shareholder proposals in China, the state of shareholder engagement and relations with the board can be unveiled.

IV. Evaluative Summary

The previous section have presented the results of this research, and due to the expanse of the topics examined, this section builds on the results and comes together by identifying and providing context to the key points and themes raised. They include share ownership patterns and the corporate governance issues they raise, the use of voting and the mechanisms that potentially present a check and balance on controlling shareholders.

The surveyed companies all have concentrated ownership structures with a family, individual or group of persons or the state as controlling shareholders. Apart from the ownership structure of the state shareholder, there is no strong trend in the use of pyramidal

³⁴⁹ Some CSMEs revised the initial notice with the added item while others merely made a single announcement of addition. Currently, there are no studies on the effect of the use of shareholder proposal rights on the company. Nonetheless, depending on the contents of the proposal and who it has been made by, there may be some reaction by the market in the form of other investors and analysts, as well as, perhaps, scrutiny from regulators.

structures. Most hold shares directly and occasionally through SPV so that there is only one intermediate legal entity between the ultimate shareholder and their investment in the surveyed company. This contrasts with the complex pyramidal structures found in other equity markets in China. Empirical evidence has highlighted the negative effects of pyramidal structures in giving controlling shareholders proportionally larger cash-flow rights.³⁵⁰ This is a widespread phenomenon in countries with concentrated ownership of listed companies, especially where family ownership dominates, such as in Europe, especially Italy.³⁵¹ Thus, as will be seen in Chapter Five, the CSRC has been especially vigilant in refusing listing to companies that have ‘muddled ownership structures’.

However, shareholder engagement through attendance of and voting at general meetings remains relatively low in the surveyed companies, resulting in controlling shareholders effectively monopolising shareholders’ meetings. The use of cumulative voting has been adopted by most surveyed companies in their undertakings with the company, but has yet to be used in practice. However, even if used, the low turnout of minority shareholders will effectively undo the process. The current provision of online voting really bodes well for the effectiveness of cumulative voting in practice for the appointment of independent directors, and, indeed, for other positions on the boards. However, this relies on the provision of this method of voting by companies. The results of this research indicate that companies will only provide online voting of this type if it is a mandatory requirement. At the moment it only has regulatory permissive force under the auspices of the CSRC. Since it is not a Company Law provision, it is more a privilege than a right for shareholders as there is

³⁵⁰ Wang Lijun, “Jinzida, guanlianjiaoyi yu gongsi jiazhi - jiyu woguo minying shangshigongsi de shizheng yanjiu (Pyramid Control, Related Party Transaction and Corporate Value),” *Zhengquan shichang daobao* (Securities Market Herald), no.6 (2006): 18-24. (In a survey of 329 privately held listed companies between 2002 and 2004, he also finds third-party transactions such as guarantees, using company funds and third-party procurement where controlling shareholders were prevalent.)

³⁵¹ See, Luca Enriques and Paolo Volpin, “Corporate Governance Reforms in Continental Europe,” *Journal of Economic Perspectives* 21, no.1 (2007): 117-40.

no legal recourse if online voting is completely withdrawn by companies, despite it being the most convenient method of participation by minority shareholders. Indeed, the surveyed companies that stopped providing online voting were those that witnessed a relatively high number of ‘against’ votes by minority shareholders. This indicates that companies may be sensitive to opposition and will avoid giving a forum for such opposition if to do so is within their power. Tellingly, empirical studies attest to the importance of online voting in listed companies, where they find that those votes tend to represent the opinion of small and medium-sized shareholders.³⁵² The take up of proxy voting also remains woefully low and may perhaps be linked to lack of understanding of its uses, and, where understood, a lack of confidence in internal proxies. The irony is that both of these mechanisms cannot be a ‘voice’ of minority shareholders if they are not used.

The effectiveness of controlling shareholders, both state and private, in their role in corporate governance has traditionally been met with scepticism, with their ownership perceived as ‘unfettered’.³⁵³ However, this has since being dispelled with empirical evidence, it suggests that private companies (especially family-controlled listed companies) are better managed than those that are widely held.³⁵⁴ An influential empirical study of companies listed in China undertaken by Xu Xiaodong and Chen Xiaoyue also indicates that, when the controlling shareholder is not the state, the performance and the spirit of corporate governance in companies improves.³⁵⁵ On ChiNext, controlling shareholders in the surveyed companies, regardless of their type, appear to be corporate governance savvy, and this

³⁵² Li Wenjing, Kong Dongmin, Liu Shasha, and Xing Jingping, “Zhongxiao gudong jinneng ‘da bianche’ me? - Laizi Shenjiaosuo shehui gong zhong gudong wangluo toupiao de jingyan zhengju (Do Minority Shareholders Only Act as ‘Free Riders’? Evidence from Public Shareholders Online Voting of Shenzhen Stock Exchange).” *Jinrong yanjiu (Journal of Financial Research)*, no.3 (2012): 152-63.

³⁵³ Feinerman, James, “New Hope for Corporate Governance in China?” *The China Quarterly* 191 (September 2007): 590-612.

³⁵⁴ For details, see Enriques and Volpin, “Continental Europe,” 122.

³⁵⁵ Xu Xiaodong and Chen Xiaoyue, “Diyi da gudong dui gongsizhili, qiye yeji de yingxiang fenxi (Analysis on the Largest Shareholders Impact on Corporate Governance and Performance),” *Economic Research Journal*, no.3 (2003): 6474, 93.

appears to be a direct consequence of the corporate governance elements of the IPO application process. For instance, such controlling shareholders are more aware of ownership structures in avoiding pyramids, and make various undertakings to the company that effectively regard the use of company funds and certain types of related party transactions.

Thus, the occurrence of a large gap in holdings controlling shareholders and second largest shareholders also occurs in the surveyed companies, but on a lesser scale than on the other equity boards in China.³⁵⁶ This results in the ownership structure below the controlling shareholder level being widely dispersed. The implications for corporate governance are that even would-be shareholder activists may have a difficult task in garnering enough support for a proxy contest where required. Having said this, most of the privately held surveyed companies have three or four shareholders that can together control 10% or more of the voting rights, which means, at least, that they can either requisition a shareholders' meeting or issue a shareholder proposal.

Key to this chapter has been the demonstration that controlling shareholders do not have unfettered voting control of the company. However, they do have the ability and influence to build and maintain alliances with other large shareholders to pass both ordinary and special resolutions at shareholders' meetings, which may not necessarily be in the interest of minority shareholders. The case studies also demonstrate the dominance of owner-managers in the privately held surveyed companies. Additionally, as John Coffee observes, in such instances of concentrated ownership, an independent board may not suffice as a check on a controlling shareholder; therefore, alternative mechanisms will be required.³⁵⁷

The results of this chapter indicate that there are alternative mechanisms for checking the controlling shareholder, at least in the privately held surveyed companies. They are the

³⁵⁶ Ibid.

³⁵⁷ John C. Coffee, *Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between "Lumpers" and "Splitters,"* SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, 2 February, 2010), url: <http://papers.ssrn.com/abstract=1532922>.

venture capital investors and the pre-IPO individual investors, but both must employ the boards as well as shareholders' meetings to be effective against controlling shareholders. This moves away from the natural inclination that institutional shareholders are the most effective mechanism. As demonstrated earlier, institutional investors on ChiNext largely invest in the secondary market with short and medium-term strategies. Furthermore, even when they have a long-term view, such as the Social Security Fund, they rarely have representatives on the executive board or supervisory board. This can be contrasted with venture capital investors who take a longer term view, have advisers and even occasionally make use of shareholder proposals to nominate a representative to one of the boards. In terms of the effectiveness of venture capitalists in corporate governance on ChiNext, this thesis finds them to be an effective mechanism. Of course, the limit to their effectiveness as a corporate governance mechanism lies in the fact that, post IPO, their exit strategy comes into force. Sometimes this has resulted in unfavourable effects on the share price, resulting in unfavourable financial media reports,³⁵⁸ when, objectively, the VC is merely divesting so that it can invest in other burgeoning enterprises. Having said this, there remain mixed assessments about the role and effectiveness of government-VCs in particular. Liu and Huang argue that the predominance of state-owned VCs means less competitiveness and even the partisan selection of companies to fund. Moreover, they have less discernible value systems than shareholder value. Therefore, their interests may not necessarily be aligned with minority or even other shareholders who want a return on their investment. In addition, the multi-layered agency relationships in state-owned companies means that decision-making and engagement with

³⁵⁸ For example, see Xin Shanglun, who presents convincing observations about the nature of venture capitalists as unsatisfactory and irresponsible corporate governance mechanisms because they keenly embrace their opportunity to exit from companies on IPO. Xin Shanglun, "ChiNext's 'Industrial Chain of Corruption,'" (29 October, 2010).

companies at ground level is sparse.³⁵⁹ Nonetheless, it appears that the trade-off seems to be that government-VCs invest in the early stages that private VCs tend to avoid due to the higher risk profile.³⁶⁰

The other, and perhaps most important mechanism that presents a check on controlling shareholders in the surveyed companies is the pre-IPO individual investor. This investor may not necessarily have a large holding, but this is not the only thing that acts as a check on the controlling shareholder. Rather, their economic *guanxi*, emanating from them providing funding for the business, makes them influential. It is the combination of all three factors that makes them potentially the most effective source of protection for shareholders if their interests are or can be aligned with those of minority shareholders.

Lowering the cost of voting also empowers shareholders, for example, by making online voting and proxy voting available. Again, these devices are limited in effectiveness in that they merely perform the task of making known the opinions of the other shareholders. This brings the differences in objectives and direction of the firm to analysts who will deduce what they will. Disclosure on the market of such differences may impact the share price where it is known that there is strategy conflict. Furthermore, minority shareholders can be protected from controlling shareholders by ensuring that there are strict limits in deviation from the one-vote-per-share rule.

Non-attendance of shareholders' meetings and not partaking in online voting are arguably symptomatic of a short-term investment approach. Corporate governance vis a vis

³⁵⁹ See, Liu Jiacheng, Huang Jinggui, and Lin Tao, *Chuangyetouzi, Yunzuo Jizhi Yu Guoji Bijiao* [Venture Capital Investment, Operational Mechanism with an International Comparison]. Cf Ren Jiancheng and Ye Xiaobao, "Ningbo Shi Sheli Zhengfu Xing Chuangye Touzi Yindao Jijin de Duice yanjiu [Research on the Countermeasures of Funds Resulting from the Set-up of Government Venture Capital Firms by Ningbo City]." (Ren and Ye argue that government-VCs have a stabilising effect and are key to early-stage investment since most private VCs prefer to invest in the later stages because this presents less risk.)

³⁶⁰ See, Ren Jiancheng and Ye Xiaobao, "Ningbo Shi Sheli Zhengfu Xing Chuangye Touzi Yindao Jijin de Duice yanjiu [Research on the Countermeasures of Funds Resulting from the Set-up of Government Venture Capital Firms by Ningbo City]." (Using Ningbo City as a case study, Ren and Ye argue that government VCs have a stabilising effect on companies and are key to early-stage investment since most private VCs prefer to invest at later stages because any earlier is too risky.)

protection of their interests becomes less of an issue for such investors because they are speculative. This phenomenon is not limited to China, but was identified by John Coffee over 20 years ago when he found that institutional shareholders undertook a control trade-off in favour of retaining liquidity. Consequently, the regulatory framework did not account for the sole reason for lack of institutional investor engagement in monitoring and decision-making in companies.³⁶¹

On ChiNext, like other equity markets on in China, there remains an underlying assumption that institutional shareholders carry out a better governance role of monitoring and advising the companies in which they invest. But this assumption relies on two further assumptions. One seems to be that the institutional shareholder has an inherent interest to carry out a governance role. From this research on ChiNext, it appears that institutional investors that have short-term investment strategies tend to neither have motivation nor inclination to get involved in the management of the company. Institutional investors still remain relatively low on ChiNext. For instance, in the first year of its operation, institutional shareholders only invested in three types of company on ChiNext, namely media and culture, electronic and mechanical equipment. The range of investment was also small, ranging from 0.01% to 3.56%.

The other assumption linked to the first is that the company invested in is relatively large with relatively normal levels of investment risk. Companies with high risk and high return may never be the type that institutional investors choose for a long-term strategy. After all, why expend such time and resources on a company in which the risks are high and a relatively quick return can be made in the short term?

³⁶¹ See, John C. Coffee, "Liquidity versus Control: The Institutional Investor as Corporate Monitor," *Columbia Law Review* 91, no.6 (1 October, 1991): 1277-1368, doi:10.2307/1123064. This is not to say that the Chinese experience is similar, but it gives some insight especially for the argument made in this thesis that comparison of corporate governance issues and remedies may not be helpful as countries go through different stages.

For hi-tech, innovative and high-return SMEs publicly listed, the type of institutional investor and the timing of the investment bears on the robustness of its internal governance structure. The venture capital investor remains best positioned for such companies as those listed on ChiNext. Crucially, because the timing is pre-IPO, they can be very influential in ensuring that the company has the right internal governance structure and external governance compliance. Their incentive will be the returns once the company is listed. The only issue that may hamper this process is where substantial returns on investment are made on listing regardless of the performance or the corporate governance of the company. As discussed earlier, currently, this has been the phenomena on ChiNext due to the current system for IPO pricing, which is now in the process of reform.

The above demonstrates that perhaps the type of institutional investor and the timing of investment may be important.

In China, many corporate law scholars believe that the key problem with medium and small shareholders in listed companies remains the free-rider phenomenon, and not necessarily speculative behaviour by the shareholders.³⁶² However, the question is whether these two issues are mutually exclusive. Analysis of the survey results points to the fact that these two issues may be inter-related.

Empirical research by Xu and Wang over a decade ago reveals that, in contrast to institutional investors, China's small retail shareholders tend to have a short-term approach to investment and they have little positive effect on the performance or corporate governance of listed companies in China. They also rarely attend shareholders' meetings.³⁶³ Nonetheless, this research demonstrated that, where online voting was provided, voting by minority

³⁶² Gan Peizhong and Wang Dongmei, *Feishangshi gufen gongsi yunying yu zhili falu zhidu yanjiu [Research on the Operational and Governance Legal Framework of Non-listed Joint Stock Companies]* (Beijing: Falü chubanshe [Law Press China], 2012), 125.

³⁶³ Xiaonian Xu and Yan Wang, "Ownership Structure and Corporate Governance in Chinese Stock Companies," *China Economic Review* 10, no.1 (Spring 1999): 75-98, doi:http://www.elsevier.com/aps/find/journaldescription.cws_home/620160/description#description.

shareholders increased greatly. Moreover, shareholders appeared more vocal with dissenting votes appearing on resolutions where voting was by proxy or in person. This can be attributed to the lower costs in time and expense compared to physically attending meetings. At present, the provision of online voting remains voluntary, that is, it is only recommended by the regulatory authorities. The results of this research demonstrate that, if mandatory, and given a certain degree of marketing to and training of shareholders, online voting may reduce the free-rider phenomenon. There is, as yet, no research relating to shareholder activism on ChiNext; but why turn up if one's vote is ineffective?

Empirical evidence supports the notion that family-controlled companies are better managed than those widely held companies because as dominant shareholders they have the power and incentive to both motivate and discipline management.³⁶⁴ The rationale being that, because shareholders are so dispersed, they cannot co-ordinate to share monitoring and control costs, thereby allowing managers to take benefits or act to the detriment of shareholders.³⁶⁵ Thus, individual and family owner-managers eliminate the vertical agency problem of managers appropriating shareholder.

Family control fails to protect the interests of other shareholders from abuse, whereas controlling owners are also the managers, as is often the case on ChiNext, and generally in China's SMEs. On ChiNext there have been many media reports of alleged expropriation of minority shareholders,³⁶⁶ the details of which are unsubstantiated due the lack of disclosure. Internal management mechanisms on ChiNext are limited by the fact that controlling families cannot be ousted by replacing the board of directors. They are entrenched by self-representation and/or appointing directors on the board of directors and supervisors. As there

³⁶⁴ Randall Morck, Daniel Wolfenzon, and Bernard Yeung, "Corporate Governance, Economic Entrenchment and Growth," *National Bureau of Economic Research Working Paper Series* No. 10692 (August 2004), url: <http://www.nber.org/papers/w10692>. Ibid.

³⁶⁵ Jensen and Meckling, "Theory of the Firm."

³⁶⁶ See Zeng Fubin, "Wangsu Keji Share Option Plan"; Ye Tan, "Who Are the Vermin of ChiNext?"; Ge Jia, "ChiNext First Reductions in Executive Shareholdings."

is at present no market for control on ChiNext, they cannot be challenged by outside investors. There is unlikely to be a market for control any time as ChiNext is the government's policy market, focused on financing selected companies as its key economic development objective. Takeovers, mergers and acquisitions and such market behaviour are likely to jeopardise that by making the market less regulated. Nonetheless, this raises the concern of how to protect the interests of outside investors who are likely to move away from ChiNext, back onto the more traditional markets. This will be a priority for the government once the market starts to lose confidence, thereby risking an important source of financing of industry.

Closing Remarks

This chapter demonstrated the trends in ownership structure on ChiNext characterised by the diminishing role of the state as controlling shareholder. The private sector in the form of private controlling shareholders comprising individuals, families and groups of individuals now dominate one of China's equity markets. The role of the state as shareholder through VCs and PE investors also appears limited, which indicates a diminishing role for political influence.

Moreover, with the emergence of owner-managers, a more complicated corporate governance issue than 'principal-principal' agency problems arises. The merging of separation of ownership and control means that private controlling shareholders are potentially more powerful since, as managers, they literally do not have an ultimate interest to account to other than themselves. This contrasts with SOEs where strides have been made by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) to make management not only accountable to the state but to the shareholders. Finally, the use of SPV may present a problem for identifying related party transactions or undesirable transactions for the sole benefit of the controlling shareholder to the detriment of

the company and shareholders. This is expanded upon in Chapter Four, but the next chapter first examines the role of the executive board, the supervisory board and independent directors in presenting a check and balance to owner-managers.

Chapter Four – Internal Governance Mechanisms on ChiNext

The preceding chapter demonstrated that although the predominance of concentrated ownership in China's listed companies continues, families, individuals and groups of individuals have emerged as the controlling shareholders of these companies rather than the state. Thus, the key question here is how effective the board is as an independent counterbalance against controlling shareholders who also take part in the management of the company.

It is well documented and recognised by the regulators that due to China's predominantly highly concentrated share patterns it has suffered from the prevalence of 'insider control'.³⁶⁷ In recent years there has been much debate about how best to improve the effectiveness of the executive board in particular.³⁶⁸ At company level, insider control manifests itself in three ways. First, by decisions being arbitrarily made by certain individuals, with resolutions of the board being procedural rather than strategic thereby alienating the board of directors in its decision-making role.³⁶⁹ Second, the power and influence of certain individuals as or representing controlling shareholders is such as to diminish the independence of the board in decision-making.³⁷⁰ Last, exercise of control and influence over the supervisory board which effectively alienates its constituents and its castrates its monitoring function.³⁷¹

However, as will be demonstrated, the results of this chapter indicate that ChiNext listed companies present a marked improvement in the corporate governance functionality

³⁶⁷ Hu Ningfei, "Shangshigongsi dongshihui zhili bibing [Corporate Governance Malpractice of the Board of Directors of Listed Companies - An Interview with Shanghai Stock Exchange Head of Research Centre, Hu Ruying]," *Dongshihui [Directors & Boards]*, no.4 (2009): 48-50.

³⁶⁸ Liu Junhai, *Legislative and Judicial Controversies*, (2006).

³⁶⁹ Gao Wuqing, "Wanshan zhongguoshi guoyou qiye dongshihui zhidu [The Perfection of Chinese-style Board of Directors in State-owned Enterprises]," *Qiye yanjiu (Business Research)*, no.11 (2012): 14-17.

³⁷⁰ Guo Hongye, "Zhongguo Dongshihui Zenme Le? [What Is Wrong with the Chinese Board of Directors?]," *Dongshihui [Directors & Boards]*, no.4 (2009): 41-42.

³⁷¹ Gan Peizhong, *Qiye yu gongsi faxue [Jurisprudence on Enterprises and Companies]* (Beijing: Beijing daxue chubanshe, 2012).

and effectiveness of internal mechanisms. Of course, there remains much to be improved in term of corporate reporting upon which the substance of this thesis relies upon. Adopting an institutional approach, this chapter examines specific indicators of board effectiveness such as the size and composition of the executive board and supervisory board, the number of meetings held and attendance, which assist in determining the nature of internal governance and the effectiveness of the executive board and supervisory board, independent directors and board secretary in their functions as envisaged under both Company Law and the ChiNext Rules. Again, case studies and examples provide insights into company level corporate governance.

I. Emerging Management Structure Trends on ChiNext

As indicated in the previous chapter, the first noticeable trend in management structures in ChiNext companies is the dominance by private owner-managers. That is, in 82.50% of the surveyed companies, the controlling shareholders held key positions on the executive board and senior management.³⁷² The case studies in the preceding chapter also illustrated this trend toward the merging of ownership and control in the surveyed companies. The remaining 17.50% of surveyed companies comprised state-private ventures and SOE controlling shareholders. In the former, the private partners, either individually or as a family, sit on the executive board along with representatives of the SOE(s), while in the latter, SOEs appoint representatives on the executive board. SOEs also have representatives sitting on the supervisory board in some of the surveyed companies. Inevitably, this means that there remain varying degrees of separation of ownership and control due to the state appointing its representatives, or, as in semi-private companies, a mutual appointment of industry or management professionals. Of course, the participation of private non-controlling but major

³⁷² See Table 2: Percentage of free-floating shares held by institutional investors on ChiNext, page 133.

block holders in semi-private companies limits the extent of separation of ownership and control. Nonetheless, executive board and key management positions both have management and industry professionals appointed to the executive board and senior management team.

This lack of separation of ownership from management raises certain concerns. Foremost are the type of corporate governance issues that arise from owner-managed listed companies. This leads to questions as to whether China's corporate law and corporate governance laws and rules, which historically purported to deal with issues arising in listed SOEs where ownership and control are separate, can actually be effectively applied to private owner-managed listed companies. Bearing in mind that it was concluded in Chapter Two that the ChiNext framework aimed to deal with 'agent-principal' conflicts, which do not wholly arise where no separation of ownership and control arises. Prior to examining the aforementioned issues, this chapter first examines the nature of internal governance mechanisms.

II. How Engaged is the Board in Decision-making and Monitoring?

A fundamental corporate governance issue of how engaged the board is arises in both concentrated and dispersed ownership structures, whether with one-tier or two-tier board structure. The controversy remains on how best to judge the engagement of the board of directors (executive board). On ChiNext, ensuring the increased engagement of the executive board in decision-making and monitoring of management remains a key objective of the Measures and Rules discussed earlier.

This section examines the extent to which the board is able to perform its functions effectively where controlling shareholders in concentrated ownership structures or affiliated-individuals in an otherwise widely held ownership structure actively participate in the running of the business, as described above.

However, first, a summary of the remit of the board is required in order to highlight decisions that are specifically reserved for the board and *not* intended for delegation to individual directors or members of senior management unless expressly mandated by the board.³⁷³

Company Law requires the board as a whole to engage in ten main functions in addition to those functions and powers specifically bestowed under the articles of association of the company.³⁷⁴ The executive board is responsible to the shareholders' general meeting (SGM) and for convening SGMs where it reports its work to shareholders, and then implement SGM resolutions. The executive board decides on business and investment plans and formulates the basic management system of the company. It further formulates plans for the financial budget and final accounts, for profit distribution and making up losses, for increases and reductions to the registered share capital or for the issuance of bonds and formulation of plans for merger, division, dissolution or transformation of the company. In addition, the board may appoint the members of the liquidation committee of the company. Finally, the executive board appoints, dismisses and remunerates the manager of the company. Of course, as will be seen, some of these functions are delegated to other constituents of the board of directors, notably to board committees.

A. Size and Composition of the Executive Board

This section examines the size and composition of boards of directors in line with literature that perceives it as key effective board decision-making.³⁷⁵ Company Law makes

³⁷³ Article 104(10) of Company Law.

³⁷⁴ Article 104 of Company Law.

³⁷⁵ Some research has indicated the importance of the size of the board; that is, the smaller the better. See, David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors," *V Governance: An International Perspective* no.1 (2005): 150-76. (As boards increase from small to medium in size the incremental costs are greater than if they increase from medium to large.) Cf Jeffrey L. Coles, Naveen D. Daniel, and Lalitha Naveen, "Boards: Does One Size Fit All?" *Journal of Financial Economics* 87, no.2 (2008):

two stipulations regarding the size and composition of the executive board. In size, the executive board can have between five and 19 directors, which must include a chairman, with at least one-third of the board comprising independent directors.

1. What Dictates the Composition of the Executive Board?

In terms of composition, Company Law recognises the general term ‘director’ (*dongshi*),³⁷⁶ and specifically independent directors (*dulidongshi*) because of the specific role afforded in corporate governance. However, in practice, execboards of listed companies in China, including those listed on ChiNext, companies also broadly comprise executive directors (*shixingdongshi*) and non-executive (or external) directors (*feishixingdongshi*) as well as independent directors. State-owned enterprises also have Chinese-styled external department directors (*waibudongshi*), though this is not necessarily the case in semi-private companies.

Company Law further distinguishes between the chairman of the board and other directors. However, there remains no guidance in the ChiNext Framework on whether the chairman’s role is executive or non-executive.³⁷⁷ In practice, chairmen of listed companies in China are rarely regarded as non-executive or even independent on appointment because they tend to take an interest in the day-to-day management.³⁷⁸ This correlates with the fact that nearly all of the surveyed companies had the controlling shareholder or representative (in the case of SOEs) appointed as chairperson of the executive board. Moreover, most of them

329-56. (Small outsider-dominated boards are not necessarily optimal because some types of company may benefit from an advisory board role and, therefore, a bigger board.)

³⁷⁶ The distinction and terminology largely reflects Hong Kong listed company practice, and also UK listed company practice, which historically influenced Hong Kong’s listed company practice.

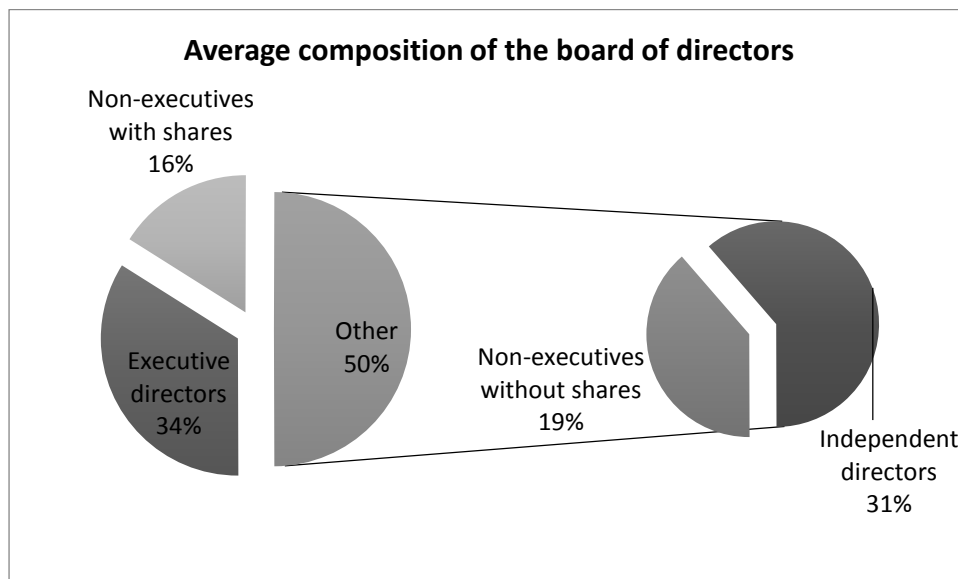
³⁷⁷ SME Board of the Shenzhen Stock Exchange, for its purposes, expressly regards all chairmen of the board as executive, which effectively means they are expected to be familiar with the company’s operational and internal governance controls in the event of a problem.

³⁷⁸ ChiNext Interview 2013-3.

concurrently hold the position of legal representative.³⁷⁹ Thus, in listed companies in China the chairperson importantly remains the first and main port of call for any corporate actions.

The figure below offers a snapshot of the composition of the board of directors on ChiNext referred to in the parts that follow.

Figure 10: Average composition of the board of directors



The table below further presents the main constituents found in the surveyed companies (to the exclusion of external department directors) with a synopsis of ownership and control in ChiNext companies by examining the constituents of the executive board that are shareholding.

³⁷⁹ This preference continues the historical role before the amendment of Company Law in 2004, when the chairman was automatically the legal representative of the company, which meant that in the event of a sanction or litigation of the company the chairman was an automatic party. See, article 113 of Company Law 1993. Company Law, when amended in 2004, removed this automatic requirement so that the chairman, a director or the manager of the company can be appointed the legal representative. For an example of the legal representative in a state-private venture, see Case study 4: Case study of board of directors on a state-private joint venture, page 120. See, generally, Ma Taiguang, *Dongshi zeren zhidu ya jiu* (*The System of Director's Responsibility*), Di1ban ed. (Beijing: Faluu chubanshe, 2009).

Table 7: Ownership and control of the executive board of surveyed companies

| | Executive | Non- executives with Shareholding | Non- executives without shareholding | Independent Directors |
|--|------------------|--|---|----------------------------------|
| Percentage of executive board with type of director on 31 December 2009 | 100% | 57.50% | 70% | 100% |
| Average number on board of directors | 3.40 | 1.61 | 2.00 | 3 |

Source: Author's survey

As illustrated above, most executive directors have holdings in the company or represent shareholders or creditors. In the majority, they directly hold these shares and represent their own personal interests.³⁸⁰ Those non-executive directors without shareholdings tend to contribute in terms of expertise or contacts or they act as a counterbalance, presumably in favour of controlling shareholders. However, the aforementioned determinants apply mostly pre-IPO. Post IPO, the composition of ChiNext executive boards has remained fairly stable. Directors tend to be contracted for a fixed three-year tenure with the average being over three years. Moreover, any increase in directors will likely require a proportionate increase in independent directors since all listed companies must always have one-third of the constituents of the board as independent. Equally, any decrease in the size of the board may amount to a waste of resources where the board has more independent directors than required

³⁸⁰ For example, see Case study 3: Wuhan Zhongyuan Huadian Science & Technology Co. Ltd., page 116.

under law. Thus, the associated costs of recruitment and remuneration may deter any increase or decrease in size.

a. Shareholding Executive Directors

The executive boards of the surveyed companies are dominated by executive directors with an average representation of 34%. Most executive directors hold the role of manager or deputy manager, also referred to as ‘general manager’ or ‘chief executive’. As mentioned earlier in Chapter Three, although the role reports directly to the board of directors, it remains powerful in its own right due to its statutory remit.³⁸¹ Executive directors take part in the operational management in roles such as chief executive, general manager and vice president (president tends to be the equivalent of chairman). Crucially, they also typically earn a salary.

Just under 85% of the total number of executives in the surveyed companies as a whole either directly or indirectly hold shares or represent shareholders in the surveyed companies.³⁸² The remaining 15% do not have any shareholdings and can be described as professional managers with a high wage to compensate. More evident of the general prevalence of owner-managers on ChiNext, 80% of controlling shareholdings in the surveyed companies were controlled either directly or indirectly by executive directors. The prevalence of the owner-manager becomes more apparent in that the average number of shareholding executive directors per board is 2.85 directors, compared to the overall average of 3.40 executive directors (including those without shareholdings).

There are some anomalies where directors have executive positions in the company but are not compensated. Although there is not much information available, there is some indication that the assumption of the executive role is to enable the person holding it to

³⁸¹ Article 119 of Company Law.

³⁸² Author’s survey.

exercise the powers of that position, which a non-executive director is unable to do. For instance, with an executive position they are able to interact relatively freely with members of staff and even attend operational and senior management meetings to which non-executive directors do not have access. These hybrid executive directors commonly own shares in the company.³⁸³ There are also those that have an executive position and are paid nominal wages in that they earn a lot less than the non-executive directors. Of course, it may be the case that they are altruistic but this is highly doubtful when their wages are compared to those of other executive directors. Moreover, the number of other executive directorships indicates that they are less likely to be able to take part in the daily running of the company in reality. These types of quasi-executive are difficult to gauge in terms of their function and, therefore, interest in the company. Corporate governance is about transparency and accountability. On one hand, such directors may be useful as a very active internal monitoring at below board level; however, this is only the case if they represent or have in mind the interests of the shareholders and stakeholders and not just their own interests. This is mostly down to personality and, therefore, not easy to judge.

b. Non-executive Directors: Shareholding and Non-shareholding

The surveyed companies each have a mix of shareholding and non-shareholding non-executive directors. Due to the dominance of controlling shareholders in executive director positions as explained in the preceding section, it may be expected that non-controlling shareholders will equally dominate non-executive appointments in order to oversee their investments.

³⁸³ For example, an assistant general manager with no function indicated is not paid a salary by the company but is still not on the board. See Case study 1: The Husband and wife ‘army’ (fuqibing) – Beijing Tread Outdoor Products Co. Ltd., page 105.

However, this was not the case. Instead, the more dominant trend on ChiNext is to have non-executive directors who neither have nor represent shareholdings in the company. That is, 70% of the surveyed company executive boards comprised non-executive directors ('NEDs') without shares compared with 57.50% of boards having NEDs with shareholdings. Those without shares were more likely to be remunerated. In terms of skills and expertise, NEDs with shares did not necessarily have industry-specific experience or networks as their shareholding was sufficient to justify their appointment. On ChiNext, NEDs (also termed external directors) are not independent and participate in the operational running of the company. It was found that most NEDs in the surveyed companies either represented personal shareholdings in the company or those of others, and very few received remuneration from the company. Clearly, on ChiNext, shareholding NEDs sit on the board in order to represent and monitor their interests in the company.

A number of individuals are appointed as non-executives, although they have no shareholdings in the company. There may be two reasons for appointments that do not fall under either category. One is that the *guanxi*, i.e., the contacts and influence that they have in industry or government, is an important driver in their appointment. Another reason, which is more probable, is that this sort of non-executive director appears to be appointed to act as a buffer or to neutralise the balance of power for the executive directors. Such a buffer is needed against the increasingly powerful independent directors whom executive directors must not and do not want to be seen as directly interfering with. As demonstrated below, independent directors on ChiNext boards are gradually morphing into a collegiate of their own, which sees them less as individual independent directors. Moreover, this institution is further enhanced due to their very strong right to information from the company, and also their external regulatory responsibilities to publish their opinions on certain matters affecting the company.

c. External Department Directors and Employee Representative Directors

Only one ChiNext company has so-called external department directors, and it is an SOE. The norm of external department directors did not arise from Company Law or corporate governance rules but rather out of SOE practice. External department directors are representatives from entities in the same group of companies or state departments. So they are ‘external’ directors in so far as they are not employees of the company; so in reality they are synonymous with non-executives, except that the term is used mostly in state-related listed companies.

One key breakthrough of Company Law, when revised in 2004, was that it permitted the appointment of employee representatives on the executive board.³⁸⁴ However, none of the surveyed companies have appointed any, and instead mandatory employee representation to the supervisory board remains the norm.³⁸⁵

2. What Dictates the Size of the Executive Board on ChiNext?

Company Law in general only stipulates that boards of listed companies have between five and 19 members.³⁸⁶ Similar to most regulatory regimes, the ChiNext framework does not specify an optimum size for the SMEs listed on its market.

Analysis of the surveyed companies indicates that the average size of executive boards on 31 December 2009 was approximately 8.9 members with a range of six to 13 directors. From 2009 to 2011, it remained stable with no changes, with all surveyed companies keeping the same number of directors in 2011 as they had in 2009. The largest number of directors was at Anke Bio with 13 members, and the smallest was Toread with six

³⁸⁴ Article 109 of Company Law.

³⁸⁵ Zhao Wanyi attributes this norm to defects in the mechanisms for the appointment of employees’ representatives through the workers’ congresses and other forms of union, as well as the fact that such representation is optional in privately held companies, which amount to the majority of companies in China, whether listed or not. See Zhao Wanyi, “*Lun zhigong (laodongzhe) zai gongsizhili zhong de diwei he zuoyong* (On the Status and Function of Labours in the Corporate Governance),” in *Gongsizhili zhuanlun (Studies on Corporate Governance)*, eds. Gan Peizhong and Lou Jianbo, Di 1 ban, *Jingji faluncong (Series of Economic Law)* (Beijing shi: Beijing daxue chubanshe, 2009): 149-169.

³⁸⁶ Article 109 of Company Law.

members. On ChiNext, most privately owned and privately run companies have smaller boards. Large boards tend to be in state-owned companies and this is largely a reflection of multiple state interests within state-owned companies.

The size of the executive board in the surveyed companies is driven by financing considerations (i.e., shareholder representation), legislation (e.g., minimum number of independent directors) and practicalities of operation. Despite the flexibility to increase their board size after IPO, the size has remained stable from IPO to the end of 2011. Most privately owned and privately run companies have small boards, while SOEs, despite being SMEs, on average have large boards and tend to be in state-owned companies. This reflects parties with multiple interests and sometimes disparate interests participating in state enterprises with each wanting to protect their interests. Several dynamics contribute to the size and stability of the boards in ChiNext companies. One is that Company Law requires a quorum of more than half of the members before a meeting is quorate.³⁸⁷ Naturally, the more directors on the board the more likely the meetings are to be quorate, even if one or two members are absent.

3. How Engaged is the ChiNext Executive Board?

Decision-making is increasingly taking place in the boardroom in ChiNext companies, rather than arbitrarily by owner-managers, as may be feared. The table below presents an illustration of the number of meetings held by the executive board in a given year.

³⁸⁷ Article 112 of Company Law.

Table 8: Number of meetings of the board of directors during the year of surveyed companies

| ChiNext companies Percentage | | | |
|---|-------|-------|-------|
| Number of board meetings during the year | 2009 | 2010 | 2011 |
| 2 times | 3.39 | - | 1.69 |
| 3 to 5 times | 38.98 | 1.69 | 5.08 |
| 6 to 8 times | 11.86 | 40.68 | 38.98 |
| 9 to 11 times | 5.08 | 42.37 | 30.51 |
| 12 or more times | 1.69 | 13.56 | 23.73 |
| Average number meetings of ChiNext companies | 6.1 | 8.9 | 9.0 |

Source: author's survey

In 2009, the average number of meetings of boards of the ChiNext companies surveyed was 6.1 meetings, which exceeds the minimum of two per year required under Company Law by three times.³⁸⁸ By 2010, the average number leapfrogged to 8.9 meetings. The lowest number of meetings was five and the highest was 14, indicating a positive trend toward increased decision-making at board level, which is a positive indicator for the engagement of the whole executive board in the decision-making process. Thus, the number of meetings of executive boards in ChiNext companies is gradually increasing, and moving very much toward the number to be found in China's top 100 listed companies.³⁸⁹ A key

³⁸⁸ Article 111 of Company Law.

³⁸⁹ This can be compared with annual surveys undertaken by Proviti. See Proviti, 2009 *nian Zhongguo shangshigongsi 100 qiang gongsizhili pingjia* [2009 Corporate Governance Evaluation of China's Top 100 Listed Companies] (Proviti, 2009), url: <http://www.proviti.co.uk/zh-CN/Documents/Insights/file%207.pdf>; Proviti, 2010 *nian Zhongguo shangshi gongsi 100 qiang gongsizhili pingjia* [2010 Corporate Governance Evaluation of China's Top 100 Listed Companies] (Proviti, 2010), url: <http://www.proviti.co.uk/zh-CN/Documents/Insights/CN-2010-Corporate-Governance-Survey-Report.pdf>; Proviti, 2011 *nian Zhongguo shangshi gongsi 100 qiang gongsizhili pingjia* [2011 Corporate Governance Evaluation of China's Top 100

driver of this increase in meetings for CSMEs is the number of projects put before the board for approval as a result of the large surpluses they achieved on IPO.

As noted previously in Chapter Three, the number of meetings does not necessarily indicate engagement of the board or good corporate governance. Consequently, the agenda items indicate the efficiency of the board process, which in itself is an indicator of good corporate governance or efficiency, both of which are interlinked. For instance, in an expectedly busy year for decision-making prior to IPO, Bolton Belt Ltd. had the lowest number of meetings at two, while Huayi Brothers Ltd. had the highest at 12. On close examination of the published resolutions of each company, in just one meeting, in July 2009, Bolton's board passed ten resolutions relating to its IPO. In contrast, in four separate meetings during the period 3 November 2009 to 23 December 2009, Huayi passed six resolutions, five of which were related to its IPO while the other was for the approval of an operational funding proposal. Just from the numbers, Huayi appears to have an engaged board. In terms of its board process, Bolton appears more efficient in getting the right items on the agenda at one meeting, thereby minimising the number of meetings. Equally, Huayi also appears more transparent and accountable in terms of engaging the board in the decision-making process about a funding proposal. There is no evidence of Bolton doing so during 2009. Thus, examining figures is not a wholly reliable practice.

Nonetheless, considering the fact that ChiNext companies are SMEs, they are performing remarkably well for their size and resources compared with the top 100 listed companies in China, where the average number of meetings is 10.52. The majority of

Listed Companies] (Protiviti, 2011), url: <http://www.protiviti.fr/zh-CN/Documents/Insights/CN-2011-Corporate-Governance-Survey-Report.pdf>.

| | 2009 | 2010 | 2011 |
|--|-------|-------|------|
| Top 100 listed companies in China | 10.52 | 10.52 | 9.52 |

companies tend to have between 6 and 11 meetings a year. The figures demonstrate that 2010 saw an increase in transactions. What is most noticeable is that there is an increase in the number of companies that have over 12 meetings a year.

4. Who Selects and Appoints Constituents of the Executive Board?

The selection and appointment of directors on the board as mentioned earlier seems determined by the resources they contribute rather than at the impulse of controlling shareholders.

Company Law requires all listed companies to have selection and appointment procedures for directors. But neither Company Law nor the ChiNext framework require the establishment of a nominations committee. Nonetheless, some CSMEs have gone a step further than legally or regulatory required by voluntarily establishing nominations committees. Thus, surveyed companies indicated the existence of a nominations and appointments committee in their annual reports. However, none indicated whether or not meetings were held or the terms of reference. The danger is that it becomes a box ticking exercise. A few surveyed companies had new appointments to the executive board, but not through the committee. For those that appointed new directors, the published resolutions do not indicate by whom they were nominated or even the use of cumulative voting.³⁹⁰

a. Executive Directors

In terms of who selects and appoints executive directors, inevitably the controlling shareholders dominate the selection and appointment process. As indicated by the case studies in Chapter Three, executive directorships tend to be monopolised by the families,

³⁹⁰ The example from Chapter Three was identified because the appointment was proposed under article 103 of Company Law right of proposal.

individuals and affiliated groups of individuals who founded the surveyed companies. In addition to the aforementioned cluster of controlling block holders, there are non-controlling shareholders, either as employees³⁹¹ who have contributed to the capital of the company, whether monetarily or in terms of intellectual property or other property, or investors who subsequently take on both a directorship and a managerial role at the company. Thus, a clear trend for non-controlling shareholders or their representatives being availed of the opportunity to sit on the executive board is illustrated, and, effectively, the non-controlling shareholders have the opportunity to oversee their investments. Indeed, by the same token, some appointments of family members to the executive board may not entirely be a matter of skill and expertise or because of the funding they provide, but a combination of both, plus the fact that family representation on the board permits control of the board due to Chinese family rules of loyalty and hierarchy manifested in the Confucian tradition of *xiaoshun* (filial piety).³⁹² Notably, family members are more likely to be executive rather than NEDs; so they are either hands on or just remain shareholders. This suggests that controlling shareholders may not have carte blanche over the selection and appointment of directors on the executive board. This is especially important evidence that CSME executive boards may not just be decorative, as the literature indicates for other listed companies.³⁹³

b. Non-executive Directors

The pool from which NEDs are appointed to the surveyed companies comes from four main sources: those who hold shares directly in the company, those who represent shareholders, those who represent creditors and those selected for their connections or

³⁹¹ This commonly occurs in management buy-outs of former SOEs. See Stoyan Teney and Chunlin Zhang, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (Washington, D.C: World Bank, 2002), chap. 3.

³⁹² See Chapter Six for an analysis of the implications of *xiaoshun* for corporate governance.

³⁹³ See Chapter Six analysis for a discussion on the implications of such relationships for corporate governance.

expertise. The selection and appointment process of the first three is clear as it is directly linked to the capital contribution (or finance in the case of a creditor such as a bank) complemented with shareholder agreements and covenants.³⁹⁴ Non-controlling shareholders tend to nominate themselves or representatives as directors using their right under article 103 of Company Law to make proposals at a general meeting to be convened.³⁹⁵

Most venture capital and institutional shareholders have representatives with whom they have a contractual relationship, either employment or other. Examples include Goldstone Investments, which held 5.40% of the share capital of Siasun Robot Ltd. Appointments tend to be based on pre-IPO agreements. Again, some shareholders are able to nominate themselves or others to the board, which may not be commensurate with their voting rights, for example, where they only hold 1-2% or more of the share capital. They are naturally given the opportunity to represent their interests via the board of directors.

However, the study finds that some individual non-executives holding less than 3% of the share capital hold directorships. Some NEDs have holdings of less than 3% of the share capital, which seems less easy to explain. There are two explanations proposed for their directorships. One explanation is that they may have obtained support from other shareholders in selection and election; but this still requires the support of the controlling shareholder to be elected since, as demonstrated in Chapter Three, their control ranges from 30% to 67%. A more plausible explanation may be found in the Chinese tradition of *guanxi*, i.e., ‘relationships’ that simply require reciprocity.³⁹⁶ That is, at start-up, funding for private enterprises tend to be difficult to obtain. In addition to or at the risk of potentially less

³⁹⁴ The prevalence of shareholding agreements between controlling and non-controlling shareholders in CSMEs is evidenced by the incidence of voluntary covenants discussed in the preceding chapter.

³⁹⁵ See Chapter Three, Section III on “Shareholder Proposals at General Meetings” on page 161.

³⁹⁶ See earlier discussion in Chapter One under the theoretical framework, page 38.

attractive sources of informal finances,³⁹⁷ entrepreneurs and founders as controlling shareholders rely on informal private finance from individuals in their family or network.³⁹⁸ In the surveyed companies, clearly as well as capital and income appreciation, those that offered finance at start-up are also rewarded with non-executive directorships that afford the opportunity to also monitor their investments. As such, appointments occur usually on incorporation or when shareholders increase their holdings, but in any event pre-IPO. Chapter Six expands this discussion and proposes that social norms play an important role in corporate governance in so far as that they align the interests of controlling shareholders with non-controlling shareholders, with the exception of small retail shareholders. They may even act as a monitoring and self-enforcing check on the power of controlling shareholders.

B. How Professional is the ChiNext Executive Board?

The examination of the skill and expertise of constituents of the executive board indicates the level of professionalism. Company Law, the Measures and the Rules do not expressly state any particular requirement on the skill and expertise of NEDs themselves, though there are requirements for independent directors, which are discussed in more detail below. This has translated into the recruitment of more professionals and academics on executive boards. The survey indicates that most NEDs, especially independent directors, have a master's or higher qualification, with PhDs or MBAs being the most common. In order to avoid falling foul of the requirement for skill and expertise on the board, most NEDs are recruited from academia. However, in reality the eligibility of qualification of directors

³⁹⁷ Informal finance comprise 'small, unsecured, short-term loans [...] households, individuals or small entrepreneurial ventures...' Meghana Ayyagari, Asli Demirgüç-Kunt, and Vojislav Maksimovic, "Formal versus Informal Finance: Evidence from China," *Review of Financial Studies* 23, no.8 (1 August, 2010): 3049, doi:10.1093/rfs/hhq030. They note that informal finance relies on relationships and reputation to monitor and enforce repayment.

³⁹⁸ See, generally, Neil Gregory and Stoyan Tenev, "The Financing of Private Enterprise in China," *Finance and Development* 38, no.1 (2001): 14-17. Ayyagari, Demirgüç-Kunt, and Maksimovic, "Formal versus Informal Finance."

sitting on ChiNext privately held executive boards largely relate to their personal shareholdings or their nomination by a shareholder. Ironically, it remains more in SOEs that education (in addition to the necessary political gravitas) appears to be of most importance.

Company Law proscriptively details individuals not eligible under articles 147 and 149. Accordingly, appointments announcements to the market only state that the appointee does not fall into any of the articles. No biographic detail is given except the position on the board, which defeats the same announcements stating that the information is honest and complete. They include those with limited civil ability or a criminal conviction in the last five years. Individuals are prohibited from companies that were liquidated or were bankrupt in that last three years, or had a business license revoked in the last three years and where they were found personally liable, or if they defaulted on a debt. There is strict application of Company Law and ChiNext Measures to prevent such individuals from being directors of companies listed on ChiNext. China's corporate governance rules make specific mention of the type of experience required. Otherwise, this matter by default falls within the discretion of the board of directors and SGM.

C. Board Committees

As stated in Chapter Two, the ChiNext Measures only require the establishment of an audit committee. The establishment of remuneration and nomination and review committees is optional. Thus, it is of significance to point out that most companies on ChiNext have set up four sub-committees reflecting the requirements of the Main Board Listing Rules. They include a strategy committee, an audit committee, a remuneration and appraisal committee and a nomination committee. A few companies have made the remuneration committee and appraisal nomination committee into one.

The ChiNext framework makes it mandatory for all CSMEs, regardless of size, to use the tripartite committee structure. ChiNext companies increasingly use sub-committees such as audit, remuneration and nomination and appraisal, predominantly composed of independent directors. There remains no express mandatory requirement under Company Law, the Code or ChiNext framework for companies to establish sub-committees of the board.

Overall, the study demonstrates that, except for the average size, board committees number three, with independent directors in the majority and chairing the committees. A few companies have four members with three independent directors represented. Thus, independent directors are always in the majority.

Most of these companies have appointed a senior member of management with relevant expertise. Overall, ChiNext companies have embraced the use of the audit committee despite no mandatory requirements under Company Law, the Code or ChiNext regulatory framework. The increasing number of audit meetings indicates that overall there must be added (commercial) value to the company by having an audit committee, or at least an increased perception of it being a key indicator of the level of corporate governance oversight in the company.

1. Audit Committee

The ChiNext Rules requires the submission of a special opinion of the audit committee after it examines the company's periodic corporate reports such as annual and quarterly reports.³⁹⁹ The audit committee is, for all intents and purposes, subordinate to the executive board, even though its constituents are a majority of independent directors. Moreover, the audit committee is voluntary and not mandated under Company Law or any tertiary legislation. This is in contrast to the supervisory board, which transforms itself into an

³⁹⁹ Rule 6.10(2) of ChiNext Rules.

almost executive arm of the shareholders' meetings where one or more shareholders or their representatives sit on it. The audit committee theoretically poses less issues with conflicts of interest because it is made up of a majority of independent directors. However, as pointed out in Chapter Two and discussed in the next section, the 'independence' of independent directors remains a key source of controversy and debate. The audit committee is selected because it is widely recognised as one of the key indicators of effective internal governance. All companies have gone beyond the mandatory requirement in having sub-committees, especially the audcom. Most companies have reported the details of the business of audit committees. This reporting is especially important in light of the potential overlap between the remit of the committee and the board of supervisors. Due to the reports that they have to produce as a collegiate, one can conclude that the independent directors are a body of their own. Moreover, the audit committee has no policy approval as all decisions are put to the board of directors.

There is less disclosure about the remuneration committee. There is, however, a potential for conflicts of interest in that the supervisory board also examines remuneration, including share incentive, which is the remit of the company. The question is which takes precedence, the remuneration committee composed of a majority of independent directors or the supervisory board composed of shareholder (representatives) and employees? There is a clear pattern of convening nomination and appraisal committees where the survey companies had directors or senior management who resigned. New appointments tend to be disclosed by independent directors in their appointments.

Conclusively, the case study above not only points to a wider problem of directors' resignations for the purpose of drawing on their investments but also the reputational dangers of having a director who is perceived to have done so, as illustrated below.

D. Corporate Conduct

The matter of corporate conduct does not only apply to the executive board but also the supervisory board and senior management such as the company secretary. However, the ramifications of undesirable corporate conduct at executive board level justify its discussion here, especially before the case study, which provides a company-level example of the issues that arise. Regulating corporate conduct remains a key challenge of Company Law and corporate governance. The amendment of Company Law in 1999 introduced the mechanism for piercing the corporate veil under certain circumstances. Importantly, the amendment imposes liability where a shareholder abuses his rights and causes loss to the enterprise. Equally, controlling shareholders, de facto controllers, directors, supervisors or senior executives of the enterprise were liable to compensate the company if their abuse of rights has caused loss to the company.⁴⁰⁰ The 2005 Company Law amendment brought more comprehensive reforms by regulating related party transactions, providing for information rights for minority shareholders and the supervisory board, and reinforced the power of the supervisory committee.⁴⁰¹ It further imposes a fiduciary duty of loyalty and diligence on directors, shareholders, supervisors and senior managers, and in effect, shifts away from criminal and administrative penalties to private ordering. The law also provided for a more general meeting, so that interim and ad hoc general meetings can be used to constrain the board and managers. However, what happens where corporate conduct becomes undesirable yet is not in violation of any legal duty and has no criminal implication? Such is the case with the scandal of directors and officers resignations that occurred soon after IPO of their companies.

⁴⁰⁰For a detailed exposition see Bradley C. Reed, "Clearing Away the Mist: Suggestions for Developing a Principled Veil Piercing Doctrine in China," *Vanderbilt Journal of Transnational Law* 39 (2006): 1643.

⁴⁰¹ See, Feinerman, "New Hope for Corporate Governance in China?" (September 2007), 607.

1. A Grey Area: Directors and Officers Resignations soon after IPO

The present state of ChiNext is that many directors and officers tend to resign from companies within a few months of IPO. Many of the resignees hold key positions such as chairman, chief executive (or general manager). There are various reasons for such resignations, but it became a scandal when two years in a row a noticeable trend of executive resignations emerged. Investigative reports and surveys by the media indicated that these resignations allegedly took place to avoid stock exchange restrictions on cashing out on time restricted pre-IPO shares.⁴⁰² As of 31 May 2011, there were 327 resignations of directors and senior management from 224 companies listed on the market. This amounts to 8.6% of the total 3,800 directors and senior managers in ChiNext companies.⁴⁰³ On examination of the 327 resignations, Ni finds that the main reasons given include job transfers (*gongzuo diadong*), retirement (*tuixiu*), end of tenure (*renqi jiemian*), simply resignation (*cizhi*), new employment (*jiepai*), health and personal reasons. Personal reasons ranked the highest, amounting to over a third of stated reasons, followed by job change at a quarter, while the other reasons were evenly distributed.⁴⁰⁴

Although this may not appear to be a high number, when considered in context of the resignations occurring within the first six months of IPO, it naturally rings alarm bells, especially with China's financial press.⁴⁰⁵ Importantly, the resignations bear more significance given the strategic role in the companies – though it must be noted, if not

⁴⁰² For example see, Liu Guofang, Shi Guangyao, and Cao Chuhua, "Chuangyeban Gaoguan Cizhi Mizhu [The Puzzle Surrounding the Resignations of ChiNext Executives]," *Capital Markets*, no. 11 (2010): 40–43. See also 21yi shiji, "Chuangyeban Gaoguan Zhe Liangnian: Cizhi Gonggao Chaoguo 170fen [Senior Management on ChiNext in the Last Two Years: Resignations Exceed 170]," Financial News, *Yicai Wang*, (October 9, 2011), <http://www.yicai.com/news/2011/10/1124237.html>.

⁴⁰³ Ni Bingbing, "Chuangyeban Shangshi Gongsi Gaoguanli Lizhi Taoxian Wenti Fenxi [An Analysis of the Problem of Senior Executive Resignations from ChiNext Listed Companies]," *Shangye Wenhua [Business Culture (first Half)]*, no.12 (2011): 97.

⁴⁰⁴ Ni Bingbing, "Chuangyeban Shangshi Gongsi Gaoguanli Lizhi Taoxian Wenti Fenxi [An Analysis of the Problem of Senior Executive Resignations from ChiNext Listed Companies]."

⁴⁰⁵ For example, Liu Guofang, Shi Guangyao, and Cao Chuhua, "Chuangyeban Gaoguan Cizhi Mizhu [The Puzzle Surrounding the Resignations of ChiNext Executives]," *Capital Markets*, no.11 (2010): 40–43.

reassuringly, that only a few resignees were board secretaries. Nonetheless, the resignation scandal raises the issue of how to distinguish between opportunistic and undesirable conduct, and how to regulate if indeed it is to be regulated against. A discussion of fiduciary duties and their suitability falls beyond the remit of this thesis.⁴⁰⁶ However, some thoughts are expressed with regard to this in the next chapter.

Notably, none of the state-owned companies had any of their directors and senior managers resign, and a few reasons can be given for this. Firstly, directors and managers of SOEs rarely hold shares in the listed companies as demonstrated on ChiNext. Secondly, reputational and career sanctions may act as a deterrent. The State and the Party have their own norms for directors and officers, and, importantly, have their own enforcement mechanism, most notably the Central Commission for Discipline Inspection of the Communist Party of China (*Zhongguo Gongchandang Zhongyang Jilu Jiancha Weiyuanhui*), which is extremely powerful and has been responsible for rooting out the corruption and malfeasance in Party cadres.⁴⁰⁷ If enough minority shareholders were to report ‘*jubao*’ of a director or officer, then at the very least there would be an investigation, which, even if it amounted to nothing, would be a signal to the Party and the director or officer concerned to be careful. Thus, this system has the capability of dealing with matters that are not violations of the law but may bring the Party into disrepute. For SOEs and other enterprises in which the Party plays an important role, the Commission for Discipline Inspection plays a key corporate governance role as a norm creating and enforcing organisation. This system does not exist for companies that fall out of the remit of the Party and State, that is, privately held companies.

⁴⁰⁶ But for detailed discussions on fiduciary duties generally and in China see, Margaret M. Blair and Lynn A. Stout, “Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law,” *University of Pennsylvania Law Review* 149, no.6 (1 June, 2001): 1735-1810, doi:10.2307/3312898. Kingley T. W. Ong and Colin R. Baxter, “A Comparative Study of the Fundamental Elements of Chinese and English Company Law,” in *Comparative Corporate Law: United States, European Union, China, and Japan: Cases and Materials*, ed. Larry Catá Backer (Durham, N.C: Carolina Academic Press, 2002).

⁴⁰⁷ Of course, investigations and prosecutions of suspect party cadres are carried out confidentially and are importantly separate from legislation and law enforcement. Only when they get to trial do they become public.

The small number of SOEs listed on ChiNext does not pose a factor because the resignations were not only a phenomenon on ChiNext but also on other exchanges. Indeed, some commentators have described it as ‘individuals’ effectively behaving like venture capitalist and private equity investors in having an exit strategy.⁴⁰⁸

This issue harks back to a major theme of this thesis, that, in general, China’s model of corporate governance has its roots in SOEs and, therefore, works on a macro level incompatible with ChiNext companies where the relationship with the State and Party disciplinary machinery remains distant. ChiNext companies and companies with their particular features on other boards of the stock exchange need more company-specific supervision in corporate governance.

Case study: To Resign or Not to Resign

Case study 5: Wangsu Science & Technology Co. Ltd.

Wangsu Science & Technology Co. Ltd. (‘Wangsu’) was one of the first CSMEs listed on ChiNext on 3 November 2009. Wangsu, like most companies listed on ChiNext, has a mixed ownership structure of founder-owners, institutional investors, individuals and employees who are subscribers, and then the general public who make up retail investors and other institutional investors. It has no overseas investors. There is no state-ownership, and none of the members of either the boards of director or supervisors are members of or affiliated to the Party.

The troubles of Wangsu started shortly after listing, on 9 March 2010, when Wangsu’s President, Qing Peng, unexpectedly resigned, first citing personal reasons but then

⁴⁰⁸ See media reports that coincide with the first anniversary of listings, which symbolises the lifting of trade restrictions for non-controlling shareholder subscribers. Ge Jia, “ChiNext First Reductions in Executive Shareholdings.” See also, Xin Shanglun, “*Fengkuang Chuangyeban Touzi Caifu Shenhua Zhizaozhe: Dazao Chuanyeban ‘Fubai Chanyesuo’* [Mad Venture Capitalist Mythify Wealth: Creating ChiNext’s ‘Industrial Chain of Corruption’],” News, *Dongfang Zaobao* [Eastern Morning Paper], (29 October, 2010).

citing dissatisfaction with the company's 2009 results. This was apparently the only clear justification for the steep fall in performance and the resignation of some of the senior management.⁴⁰⁹ However, these accusations remain unsubstantiated and neither ChiNext nor the CSRC have taken action. To compound matters, on 3 November 2010, when the share dealing ban on subscriber shares was lifted, East Shenzhen Fiscal Fortune Venture Capital Management Co. Ltd. sold half of its holdings in the company.⁴¹⁰ This was followed by further trades by Shenzhen Capital Group Co. Ltd. and Shenzhen Innovation Capital Investment Co. Ltd., both venture capital investors. The financial media strongly criticised the large volume trades made by the venture capital investors, as if forgetting that the main purpose of venture capitalism was to ultimately exit and reinvest in another burgeoning enterprises. The problem here is that such criticisms ignorantly perceived this as a corporate governance violation, when in fact it was a matter of investment strategy and the choice of the company to employ venture capitalism in its funding structure. Wangsu's reputation hit a low when its executive management also tried to cash in and sell their shares. Wangsu investors were not the only catalysts that led to share prices rising dramatically. ChiNext then announced a ban on share dealing in any shares that had risen above 5% of the opening price. Nonetheless, the press questioned the speed with which Wangsu's major shareholders were cashing out.⁴¹¹ The press insinuated that companies like Wangsu amounted to financial and

⁴⁰⁹ Liang Yu, "Fupai lingdie chuangyeban Wangsu Keji bei 'shazhu' [A Return to Trading on ChiNext Results in Slump - Wangsu Keji 'Duped']," Financial News, *Stockstar*, (June 27, 2010), <http://stock.stockstar.com/SS2010062730006385.shtml>. Chen Dao, "Wangsu keji 'bianlian' [Wangsu Technology's Turns Adverse]," News, *YCWB*, (25 March, 2010), url: http://www.ycwb.com/ePaper/ycwb/html/2010-03/25/content_783057.htm.

⁴¹⁰ Ge Jia, "ChiNext First Reductions in Executive Shareholdings."

⁴¹¹ Li Tong et al., "Zhaiqu chuangyeban (Cash out from GEM)," *Shangjie (Business Review)*, December 2010, <http://china.eastview.com/kns50/detail.aspx?dbname=CJFDTEMP&filename=SJZG201012021&filetitle=%e6%a6%a8%e5%8f%96%e5%88%9b%e4%b8%9a%e6%9d%bf>.

business white washes and were packaged for listing (*beibaozhuang*) so that the original investors could use the stock market as their path to wealth.⁴¹²

Wangsu poses the perennial agency problem of the expropriation of value by majority shareholders. Wangsu is typical of problems existing but with no evidence of wrongdoing. Indeed, the only regulatory action was to ‘stabilise’ the market by imposing a share dealing ban on all ChiNext listed shares that appreciated above 5% of the opening market price. Nonetheless, the trick as one financial commentator noted was to ensure to deal just before the ceiling. Thus, such sanctions are inadequate for company-specific compliance but effective in ensuring China’s policy of ensuring that the market does not overheat itself.

Wangsu’s failure to make a timely disclose of its results exacerbated the media and market’s perception of it. This was then compounded by the resignation its chairman Peng Qing so soon after IPO. The media accused Peng of being in league with ‘crazy venture capitalists’.⁴¹³ It created a lack of confidence in the company and its senior management. The company’s performance and its products were as widely reflected in media reports.⁴¹⁴ However, a fundamental malaise in China’s corporate governance is the lack of transparency and, therefore, paucity of information on the exchange. Consequently, alleged wrong-doings remain just that. Secondly, the lack of investigative enthusiasm by both ChiNext and the CSRC hampers enforcement.

⁴¹² The evidence is the fact that executives and large shareholders have sold out. See Zeng Fubin, “Wangsu Keji Share Option Plan”; See also Ye Tan, “Who Are the Vermin of ChiNext?”; *ibid.*; Ge Jia, “ChiNext First Reductions in Executive Shareholdings.”

⁴¹³ Xin Shanglun, “ChiNext’s ‘Industrial Chain of Corruption,’” (29 October, 2010).

⁴¹⁴ Chen Dao, “Wangsu keji ‘bianlian’ [Wangsu Technology’s Turns Adverse],” News, YCWB, (March 25, 2010), http://www.ycwb.com/ePaper/ycwb/html/2010-03/25/content_783057.htm. See also Liang Yu, “*Fupai lingdie chuanyeyeban Wangsu Keji bei ‘shazhu’* [A Return to Trading on ChiNext Results in Slump - Wangsu Keji ‘Duped’],” Financial News, *Stockstar*, (27 June, 2010), url: <http://stock.stockstar.com/SS2010062730006385.shtml>.

Insight and analysis

There is a trend to make corporate governance issues out of normal market behaviour. Perhaps this is down to the application of a socialist mentality to capitalist behaviour. Only with better disclosure rules and the use of second order institutions on ChiNext can we find out the true corporate governance answers to the following questions. Was there a breach of any (fiduciary) duty in Peng Qing resigning? It raises the question of the limitation of the law in not being able to deal with grey areas where there is no clear breach of law. Was there a breach of fiduciary duty in the executive management selling their shares once the ban was lifted? Conclusively, the mandatory rule of boards composing a third of independent directors does influence the size of the board, with easy multiples being chosen. Research illustrates that the higher the number of non-executives, the greater the potential for diverse interests on the board. This is true of companies that are either state owned or have a significant state interest. Companies can be further distinguished in terms of who is leading the management of the organisation. The following factors are taken into consideration: the ownership, and the identity of the person in the role of CEO. Interestingly, the position of CEO is more of an indication of power in the company than the role of chairman.

III. How Independent is the ChiNext Board of Directors? Independent Directors

In this section, three key areas are gauged to ascertain the effectiveness of the independent non-executive directors ('INEDs') in the surveyed companies. One is the level of independence they bring to the board, thereby balancing out the power and influence of manager-owners. Another is the effectiveness of their representation of minority interests. The last is the quality of the independent opinions they provide about the company. Opinions are perhaps the most difficult to gather empirical evidence on, as they require the disclosure of engagement with minority shareholders. Also, as indicated in chapter Three, a large proportion of minority shareholders have short-term investment strategies and, therefore, do

not appear to engage with the company. Unfortunately, this can only be assessed retrospectively when it transpires that the opinion does not reflect the negative reality of the company's performance or corporate conduct of its controlling shareholders, directors, supervisors and senior management. Interestingly, the majority of the board have an independent director who is also an active member of the Party. By active, they tend to hold positions such as secretary, deputy secretary of grassroots, academic or local Party organisations.

Within this, INEDs mandatorily comprise one-third of the executive board as a whole, 50% or just under where the board number is not a multiple of three; most boards tend to be a multiple of three, composed of 6, 9 or 12, or 15 as the highest.⁴¹⁵ These multiples indicate that in most companies (especially those that are entrepreneur-owned or family-owned with little or no interest held by an investment company) a multiple of three seems to be conveniently chosen as the board size, with nine members being the most common.

A. Who are the INEDs in ChiNext Companies?

In accordance with the Guiding Opinion, INEDs must be independent, and independent is defined as:

...a director who does not hold any position in the company other than director and who has no relationship with the listed company engaging him or its principal shareholders that could hinder his making independent and objective judgments.⁴¹⁶

Academics of professorial level overwhelmingly comprise the body of INEDs in the surveyed companies, with business and law-related academic disciplines dominating. The

⁴¹⁵ See Establishment of Independent Director Systems by Listed Companies Guiding Opinion issued by the China Securities Regulatory Commission on 16 August 2001, (the "Guiding Opinion on Independent Directors").

⁴¹⁶ Article 1 of Guiding Opinion on Independent Directors.

exceptions tend to be industry experts in areas specific to the company. The choice of a professor already lends prestige and gravitas to that knowledge. Any other means of recruitment and selection used by independent agencies may be quite taxing on the time and resources of an SME. One interviewee holding independent directorships explained that the choice in engaging academics was not only because of their availability but also because of their capacity to digest copious amounts of board and committee papers.⁴¹⁷ Equally, academics have (at least in theory) the ability to learn new subjects due to their learning culture. So, for instance, law academics and economics academics sitting on the same board tend to share their knowledge as relevant to examining board papers.⁴¹⁸

The case study later in this section raises the issue of INEDs vigilantly carrying out a level of due diligence before accepting a position, at least to protect their reputations.⁴¹⁹ The speed of resignation by Wang, the chairman of Wangsu,⁴²⁰ suggests that there was due diligence but that it was somewhat too late for him to extract himself from the scandals and controversies that befell these companies. The research suggests that, due to the heavy workload of being an independent director, individuals who already have a full-time vocation may only be reasonably expected to have up to two independent director roles at the same time.

The remit, that presents the prescribed role and responsibilities of the independent director of a ChiNext company, is listed simply but has very wide implications in terms of impact on the company. This makes the role exceeding challenging if a full-time professional independent director wishes to have more than two appointments. It means that they are likely to spread themselves thinly. It may be worthwhile to recommend to companies that in the selection of INEDs they may need to impose (not prescribe) a limit of up to two roles for

⁴¹⁷ Interview 2013-6.

⁴¹⁸ *ibid.*

⁴¹⁹ See

⁴²⁰ See preceding case in Section II above.

those candidates in full-time positions. Conversely, individuals who have independent directorships as their main vocation may be allowed more. The latter ensures that the positive of sharing and propagating good corporate practice is at least continued through the professional INEDs.

B. Skill and Experience

To fulfil their role effectively in protecting the interests of minority shareholders, INEDs are required to have ‘operational expertise’ (*yunzuo zhishi*) and be familiar with the relevant laws, administrative law, rules and regulations.⁴²¹ They must have at least five years legal, economic or other experience of being an independent director.⁴²² They must also be appointed in accordance with any other requirements provided by the articles of association of the company.

There is no formula for assessing whether a director is independent. However, the Guiding Opinions indicate that those directors that are not deemed to be independent. A director is not considered independent under Chinese law under the following circumstances. Firstly, they are not eligible where they are related to the company or its personnel through direct kin or important social networks in the last year. Kin refers to direct relatives such as parents, children and siblings, while important social networks include in-laws. The rules are very detailed to counteract China’s cultural natural inclination to privilege Confucian relationships, i.e., filial links, at the potential expense of those that are at arm’s length. Whether or not they are effective is another matter, which the case studies will demonstrate. Secondly, they should not hold more than 1% of the total issued share capital of the company or, alternatively, they must not be listed within the top ten natural person shareholders of the

⁴²¹ Zou Jian, *Zhongxiaoye chuangyeban shangshi shiwu* [Small and Medium-sized Enterprises on ChiNext: Listing Practice]: 139.

⁴²² See, Guiding Opinion on Independent Directors.

company in the last year. Thirdly, they must not directly or indirectly have a position in an organisation that holds more than 5% of the company's total issued share capital or be a direct relation of such person in the last year. Fourthly, they must not have provided financial, legal, consultancy or other services to the company or the industry to which the company belongs. Fifthly, they do not meet the criteria for the type of personnel stipulated in the articles of association of the company. Finally, the CSRC has recognised someone else for the role. This effectively allows the CSRC to intervene in the internal management processes of any company where it sees fit.

C. Bringing Independence to ChiNext Board

In concentrated ownership, especially where the company is privately-run in China, the number of meetings and attendance of independent directors are important indicators of the extent to which decisions are arbitrarily taken by the board. The table below illustrates the percentage level of attendance of INEDs of executive board meetings held during the year in the surveyed companies.

Table 9: Average percentage attendance of board meetings of ChiNext listed companies by INEDs

| | 2009 | 2010 | 2011 |
|--|--------|--------|--------|
| Average percentage attendance in surveyed companies' board meetings | 89.00 | 86.90 | 89.80 |
| Highest attendance | 100.00 | 100.00 | 100.00 |
| Lowest attendance | 80.00 | 61.00 | 88.00 |
| Average attendance of audit meetings | 0.00 | 100.00 | 100.00 |

Source: Author's survey

The table shows that attendance of INEDs at executive board meetings was on average above 90%, which equates to INEDs missing 0.3 meetings. Indeed, it is the 'not'

independent constituents of the board that have a low attendance rate. The survey demonstrates an overall increase in putting more decisions to the board and ensuring that there is a spirit of 'independence' and accountability. This has little to do with the strict internal governance requirements of companies. The companies surveyed were particularly eager to demonstrate the 'independence' of their executive boards in annual reports.

Predictably, in 2009, the year of IPO, the attendance rate for INEDs was at its highest with 80% of the surveyed companies having 100% attendance at meetings by INEDs. In 2010, the percentage of companies with 100% attendance fell dramatically by 50%, with 2011 only registering a slight increase at 57%. The high attendance in 2009 can be attributed to the strict internal governance requirements of the IPO Review Panel before they granted permission. Clearly, members of the board made efforts to ensure that their attendance was optimum before, during and immediately after application for IPO as the panel reviews all types of internal governance documents, including board and shareholder resolutions. Without detracting from the positive nature of the results, they cannot be taken for granted to wholly reflect the independence of the executive board. For instance, in one surveyed company, an INED sent a proxy in his stead to attend a meeting. This surely defeats the whole point of an INED, who has presumably gone through vigorous scrutiny to ensure his independence as well as appropriate skill and expertise.

Equally, the surveyed companies ensured to comply with the requirement of having an independent opinion disclosed to the market to demonstrate that information and projects were duly laid before the two internal monitoring bodies, namely the INEDs at board and committee meetings and the supervisors at supervisory board meetings.

D. Monitoring and Provision of Independent Opinions

As discussed in Chapter Two, under the ChiNext framework INEDs provide their opinion on the following areas of selection, appointment and dismissal of directors, employment and dismissal of senior executives and remuneration of director and senior executives; as such, SMEs do not need a remuneration committee. To effectively carry out each of its roles, the ChiNext Rules provide INEDs with rights of information and working conditions similar to those of directors of the company.⁴²³ Neither the company nor relevant personnel must not refuse, obstruct or conceal or interfere with the independent director's performance of his role.⁴²⁴ This is of particular significance when considered that, according to the Code, the main role of INEDs is to represent the interests of minority shareholders and ensure that their legitimate rights are not encroached on by either the directors and officers or controllers. Compared to UK and US INEDs, the obligations of those in China, especially on ChiNext, are far more reaching. Moreover, responsibility is on individual terms and not in the collective terms, as is the case in the UK and US where INEDs are not required to individually issue reports on certain operational matters of the company and its board of directors or where the independent director considers there is potential damage to the interests of minority shareholders.

Case Study - How many are too many independent directorships

Case study 6: Wang Kaitian

A persistent matter of debate in China concerns who can be an independent director.⁴²⁵ Therefore, this case study details the scandal of Wang Kaitian, an accounting

⁴²³ ChiNext Rule 3.1.15.

⁴²⁴ ChiNext Rule 3.1.15.

⁴²⁵ The leading voice in this debate remains Cheng Siwei who opposes academics and economists being independent directors due to a lack of commercial acumen. See Jiang Guocheng, “Cheng Siwei: Bu Zancheng Jingji Xuejia Daliang Danren Gongsi Dulidongshi Cheng Siwei: Bu Zancheng Jingji Xuejia Daliang Danren

academic at Nanjing University, who, at one point, was concurrently independent director of four companies, two of which were listed on ChiNext.⁴²⁶ Unfortunately for him, each of these companies attracted controversy in terms of their performance and internal governance. Consequently, the financial media then raised questions of the effectiveness of INEDs and what, in reality, is a practical number of boards to sit on concurrently, using Wang as a case in point.

On ChiNext, Wang was director of Wangsu and resigned on 18 March 2010, soon after Peng's resignation on 9 March 2010, and less than six months since the listing of Wangsu.⁴²⁷ The other was Goldengreen, which, under extreme circumstances, had its listing licence revoked due to inaccuracies in its prospectus regarding its core business patents, China's so-called 'patent-gate' (*zhuanli men*).⁴²⁸ The SME board company was Nanjing Textiles Import & Export Corp. Ltd. Shortly afterward, Wang was named in the IPO prospectus of Nanjing Sciyeon Automation Group Co. Ltd. as an independent director. The company was already engulfed in controversy about its level of debt, a rare phenomenon for a privately controlled listed company.

The first issue raised here is that clearly in each of these companies an obligation to publish an independent opinion regarding each of their problems arose; however, it was not carried out. Due to the paucity of information regarding the treatment of independent directors, ambiguity emerges regarding whether the independent directors themselves are

Gongsi Dulidongshi [Cheng Siwei: Disapproves of Economists Being the Majority of Independent Directors],” Government News, *Xin Hua*, (7 January, 2006), url: http://news.xinhuanet.com/stock/2006-01/07/content_4022625.htm. Guan Xiaofeng, “*Gongsi Zhili: Beijingshi Fayuan Shenli Gongsi Jiuzheng de Jidian Sikao* (Corporate Governance: Some Trials on Company Disputes by Courts in Beijing),” in *Gongsizhili Zhuanlun (Studies on Corporate Governance)*, eds. Gan Peizhong and Lou Jianbo, Di 1 ban (Beijing: Beijing da xue chu ban she, 2009), 223-32. (Believes professionalising the role of independent director, similar to that of auditors, is the way forward.)

⁴²⁶ See Yicai wang, “*Wang Kaitian: Dudong Zhuanyehu Shougu Duo Jia de Wenti Gongsi* [Wang Kaitian: The Independent Director Specialist Employed by Many Problem Companies],” News, *Yicai.com*, (14 May, 2013), url: <http://www.yicai.com/news/2010/04/333507.html>.

⁴²⁷ See the Wangsu case study on Case study: To Resign or Not to Resign 212.

⁴²⁸ The next chapter presents a case study of this company, which had its listing license revoked.

failing or whether the mechanism for independent opinions is failing them. Furthermore, the integrity, accuracy and completeness of the information provided to INEDs may not be adequate for them to make informed decisions. This may be due to the controlling shareholders and management screening and vetting information that is relayed, meaning that they are making decisions based on misinformation. This leads to the next issue of how best to supply INEDs with information. Under the law and Rules, there are provisions that provide information rights. However, there needs to be a management insider responsible for this, and the ChiNext Measures and ChiNext Rules have nominated the board secretary in this important role, which is examined in the next section. The case study further raises important concerns about who should be an independent director and whether INEDs are disproportionately blamed for the woes and misfortunes of the company of the board on which they sit. There does not appear to be any discussion about the independent director in relation to expectations of the role in practice.

E. Attendance as an Indicator of Effectiveness?

It is a challenge to ascertain the effectiveness of INEDs in contributing to the independence of the board. The proxy used here is the average attendance by INEDs, which is based on the total number of board meetings and their attendance either in person or by electronic and online means such as video conferencing. However, it excludes attendance through proxies because INEDs are selected for their personal independence, perspectives and experience, which, by virtue of their crucial role in corporate governance of the company, is not transferrable. Thus, attendance by proxy is taken as non-attendance. Below is a table indicating the attendance of INEDs in the first 40 companies listed on ChiNext, providing their average attendance over three years for the period 31 December 2009 to 31 December 2011.

Table 10: Percentage attendance of executive board meetings by independent directors (INEDs) in surveyed companies

| | Number of meetings and INEDs' attendance - to demonstrate independence on the board | | |
|---------------------------|--|-------------|-------------|
| | 2009 | 2010 | 2011 |
| Average attendance | 91.1 | 88.8 | 93.3 |

Source: Author's survey

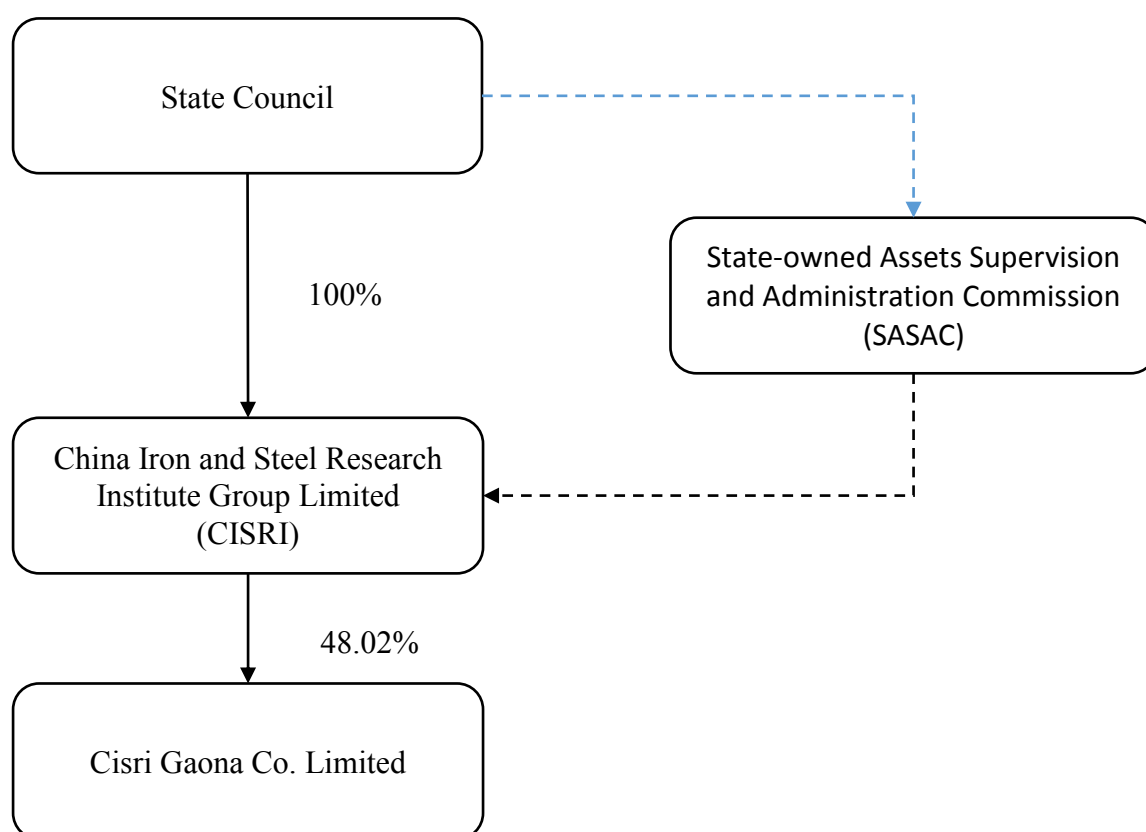
The table demonstrates that the INEDs are very devoted, with most attending in person. As indicated earlier, the only anomaly arose when an independent director had a proxy attend in his stead. Attendance fell a little from 91.1% to 88.3% from 2009 to 2010, and then dramatically rose to 93.3%. Conversely, the dramatic rise in 2011 may be attributed to the ad hoc corporate governance-focused (self) investigations issued by CSRC regional offices on companies, which focus on board effectiveness and attendance, among other matters, as examined in the next chapter.

Case Study – Independent Directors in SOE Group Structures

Case study 7: Varying notions of independence in an SOE

CISRI Gaona Co. Ltd. ('Gaona') presents an example of a ChiNext company in which all the directors, especially the INEDs, supervisors and senior management, have concurrent or past positions with the company's controlling shareholder. China Iron and Steel Research Institute Group Ltd. ('CISRI'), a wholly owned limited liability research and investment company of the State Council, indirectly controls 48.02% of Gaona. Established in 1952, Iron and Steel started as a regional research work unit (*danwei*) and transformed into an enterprise when, in 1999, the central government designated it as one of China's large science and technology enterprises.

Figure 11: State-owned ownership and asset management structure of CISRI Gaona Co. Ltd.



Source: Annual report and author's interpretation⁴²⁹

In 2000, CISRI underwent the corporatisation process to be registered as a state-owned limited company. In 2004, it fell under the auspices of the newly established SASAC. In May 2009, the SASAC transformed CISRI into a wholly state-owned company (*guoyou duzi gongsi*). Importantly, wholly state-owned companies do not have shareholders' meetings, and instead a state asset management entity, in this case SASAC, performs all the functions ordinarily empowered to the shareholders' meeting under Company Law.⁴³⁰ SASAC supposedly monitors and manages CISRI and at the same time indirectly controls the shareholders' meeting of Gaona. For example, SASAC's policy on the selection, nomination

⁴²⁹ The arrows indicate equity shareholdings while the dashed lines indicate administrative and supervisory hierarchy.

⁴³⁰ In terms of the size and composition, the board of directors mirrors that permitted from limited liability companies under Company Law. An asset management company can delegate its shareholder functions to the board of directors of the company.

and appointment of directors, supervisors and senior management applies to Gaona even if it does not have direct holdings in the company. In the annual report of the company, the State Council is referred to as the de facto controller, although SASAC has closer control.

Insight and analysis

This section demonstrates the practical limitations of SASAC in enforcing certain corporate governance practices such as ‘independent’ directors who are independent of the parent company. Secondly, the appointment of the same independent director on the listed parent company to the listed subsidiary is arguably in violation of the ChiNext principle that companies must be ‘independent’ of external influence, be it the executive board and supervisory board, assets, employees and so on.⁴³¹ The IPO Review Panel did not perceive it as an issue, and this raises the question of how it applies the principle of independence. From the perspective of the company, the rationale appears to be that the independent director of the parent company board should and can be independent at both parent and subsidiary level. Moreover, it enhances the INEDs’ knowledge of the key companies and businesses of the group, which will enhance board judgment and decision-making. The problem here is that it effectively morphs the role of the independent director to an almost ‘internal audit’ function representative of the parent company. This singularly undermines the role of INEDs to provide their independent skill and expertise that should be specifically for the benefit of the listed company, rather than for its listed parent or the group as a whole. Indeed, what might be for the benefit of the parent or the group may not necessarily be for the benefit of the listed company. One can understand the challenges of finding appropriate INEDs at that level.

⁴³¹ See Chapter Two.

IV. Supervisory Board

As part of China's two-tier board system, the supervisory board monitors the executive board. Since corporate governance took a foothold in China's policy making in the early 2000s, there has been much debate on how the supervisory board fits into China's corporate governance system⁴³², its suitability and its effectiveness. Indeed, the supervisory board is notoriously referred to as 'deaf man's ears' (*longzi de erduo*) because it has failed to live up to expectations as an effective monitoring mechanism of the executive board.⁴³³

In contrast, the supervisory boards of the surveyed companies, unexpectedly, do appear to provide monitoring and oversight envisioned under Company Law, which results from the increased appearance of shareholders and 'external supervisors' on the supervisory board. There are three types of supervisor in ChiNext companies, namely shareholders or their representatives, employee representatives and what can be referred to as external supervisors. The first two are provided for under Company Law and within ChiNext regulatory framework, while the external supervisor appears to be a bottom-up innovation out of pragmatic need.

The table below illustrates this from 2009 (pre-IPO) to 2011.

Table 11: Average number of meetings of supervisory board of surveyed companies

| | Average number of meetings per year | | |
|----------------------|-------------------------------------|------|------|
| | 2009 | 2010 | 2011 |
| Board of supervisors | 2.4 | 5.6 | 6.3 |

⁴³² Xi, *Corporate Governance and Legal Reform in China*, 2009. (Examines the path dependence of the Supervisory Board existence in spite of heavy criticism.)

⁴³³ Gan Peizhong, *Qiyue yu gongsi faxue [Jurisprudence on Enterprises and Companies]*.

Clearly there has been a marked increase in the matters put before the supervisory board, as indicated by the increase in the average meetings held year on year. The increased activity by the supervisory board suggests an important role as a corporate governance mechanism. There is a trend of increased activity by the supervisory board of ChiNext companies, which suggests that it is an increasingly important corporate governance mechanism. One of the main reasons for this increase is the matching of increases in meetings of the board; after all, the supervisory board is meant to monitor the board. Another reason is the board using the supervisory board as an 'independent' eye or rubber stamp on certain types of project that need shareholder approval such as share incentives and related party transactions. Interestingly, share incentive schemes, generally perceived as a matter for the remuneration committee, are also reviewed by supervisory boards of the surveyed companies. In SOE companies on ChiNext, the constituents of the supervisory board suggest that they are mostly used as a mechanism in companies with state ties.

A. Composition and Appointment

The other constituents stated under Company Law are shareholders or their representatives. A key criticism of the supervisory board is that it is not independent enough of the controlling shareholder with the dominance of employees and shareholders. The lack of independence is the crux of the problem with supervisory boards so that, no matter what initiatives are taken to improve or powers given, it remains ineffective because it is not

independent of the controlling shareholder. The problem is most prominent in non-listed companies.⁴³⁴ However, this appears to be a criticism arising from the examination of listed SOEs and unlisted joint stock companies.

1. Shareholder and Employee Supervisors

The shareholder constituent largely dictates the size of the board: the higher the number of shareholders on the supervisory board the more employee representatives are required.

Under Company Law employee representatives must represent at least one-third of the number of members on the supervisory board. The employee is usually an elected official of the trade union, especially if the company has factories. Likewise, where there are no shareholder constituents, the supervisory board is largely dominated by employee representatives, including non-union representatives. The further away companies move from traditional industries, where trade unions are, the less effective that the supervisory board will be in its current form as a representation of employees. The powers of the trade union are acknowledged and potent when represented on the supervisory board. However, where there is no representative of the trade union on the supervisory board, it means that the employee appointment does not speak with any authoritative voice or backing that will make other supervisors or the board of directors listen. Significantly, as employees make up the majority of constituents on the supervisory board, it means that their agreement will most likely be required because half of the board's vote is required to adopt a resolution.⁴³⁵

⁴³⁴ Gan Peizhong and Wang Dongmei, *Feishangshi gufen gongsi yunying yu zhili falu zhidu yanjiu* [Research on the Operational and Governance Legal Framework of Non-listed Joint Stock Companies].

⁴³⁵ Article 120 of Company Law.

2. Bottom-up Innovation: External Supervisors

Although Company Law only provides for shareholders or their representatives and employee representatives on the supervisory board, in reality there are also supervisors who do not fall into either category. These supervisors can be referred to as external supervisors. Many of the surveyed companies have external supervisors. They are so called because, firstly, they are neither current shareholders nor current employees of the company. Some are retired former employees while others are retired professionals from the same industry. They may have other indirect relationships with the company by virtue of having interests in the same industry, but they do not exist under any legal or regulatory provision; therefore, no obligation arises to disclose in detail their (possibly indirect) relationships with the company. Although there is no requirement under Company Law, external supervisors sit on the supervisory board. One observation from the survey was that external supervisors appeared where individual shareholders or their representatives sat on the supervisory board. This raises questions regarding their function, that is, whether they provide an independent skill and expertise, or whether they function as a counterbalance to any shareholder views on behalf of the controlling shareholder.

B. Size of the Supervisory Board

Company Law requires that the supervisory board can be any size, as long as its composition is such that at least one-third of its constituents are employee representatives. It is this statutory requirement that mostly drives the nature of compliance in most companies on ChiNext. Naturally in line with the ethos of statutory minimum compliance, the average size of supervisory boards on ChiNext is three members. SOE companies are more likely to have larger supervisory boards, but meetings are not necessarily as many. The size merely

reflects the various interests – shareholders and stakeholders – that one SOE company has. It also reflects the politics of different departments of the same agency.

C. Skill and Experience

Company Law and the ChiNext framework do not expressly state the type of skill and expertise that supervisors require. However, shareholder and external supervisors alike in the surveyed CSMEs tend either to have investment experience and qualifications or business or industry experience relevant to the CSME. Nonetheless, few supervisors have the professional finance or legal knowledge implicitly required in the terms of reference of the supervisory board, including, in particular, examination of financial affairs of the company and supervision of acts of management that violate laws.⁴³⁶ Moreover, the remit of the supervisory board involves annually issuing an independent opinion on the performance of the financial year, verifying the truth, accuracy and comprehensive nature of the company's finances. This includes a declaration that the board and senior management and controlling shareholders have not acted in a manner that causes damage or loss to the company or its shareholders. Consequently, the constituents of the board also require some modicum of gravitas and influence to carry out these duties, especially in relation to conducting an investigation and engaging an accountancy firm if they believe the company's circumstances appear abnormal.⁴³⁷ Thus, the key role here is that of the external supervisor who is not (apparently) affiliated to the shareholders or, if an employee, more familiar with the strengths and weaknesses of the organisation. As an industry expert, they are also able to consciously benchmark the company's performance within its comparator group. The role that employees play on the supervisory board or how they report back is not very clear. Company Law and

⁴³⁶ Article 54 of Company Law.

⁴³⁷ Article 118 of Company Law.

regulations do not expressly state the type of skill and expertise that supervisors are required to have. This makes us question the liability of the supervisors for misstatement, especially since the majority are usually employees. There will have to be some analysis in terms of their liability as supervisors and whether there is some limit to their liability because they are employees. However, there appears to be no literature dealing with this.

On ChiNext, the supervisory board appears to take a much more active role in monitoring and vetting the work of the board of directors. There are two consequences. Firstly, the supervisory board is seen as a concentrated version of the shareholders' meetings without the inconvenience. Another is that the board can feel confident in its policies once they have been passed. In most ChiNext companies the supervisory board appears to take the role of second in command to the general meeting. There is a definite trend in increased activity of the supervisory board. It is performing like an executive of the shareholders' meeting. The supervisory board is again more influential because of its constituents. Where shareholders and their representatives are in the majority, the supervisory board becomes a better mechanism for corporate governance. This does not necessarily make it a better mechanism for corporate governance. The power of the supervisory board lies where it is composed of shareholders and their representatives. They appear to be more powerful in privately owned enterprises than in state-owned or supported enterprises, the reason being the usual conflicts of interests that arise on such a board.

For SOEs, results from the case study indicate that the supervisory board plays a key role in succession training. Controlling and majority state shareholders tend to consolidate power in the company by having both representatives on the board of directors and on the board of supervisors. In this schism, the board of supervisors remain subordinate and not equal in hierarchy to the board of directors. As discussed in Chapter Three, directors (with the exception of the chairman) tend to serve only one three-year tenure, unlike in privately

controlled listed companies examined. At the end of the tenure, it is not uncommon for the supervisors to be ‘promoted’ to the executive board, evidenced by their appointment and a new person being appointed to the supervisory board.

V. Board Secretary

This section examines the type of board secretary necessary to carry out the enhanced role under the ChiNext framework. Under Company Law all listed companies in China must have a board secretary with the role designated as senior management level.⁴³⁸ In contrast, under Company Law the role has more of a procedural focus in preparing for board and shareholders’ meetings, keeping company records, managing materials relating to shareholders and handling straightforward information disclosure matters.

As discussed in Chapter two, the ChiNext framework, however, increases the corporate governance responsibilities of the role by awarding it information rights, making it responsible for the circulation of information to the board, especially INEDs, making it responsible for investor relations, and, importantly, imposing a duty of disclosure of price-sensitive information and other certain types of information to the Exchange. These duties require judgment calls in first identifying price-sensitive information and liaising with INEDs and investors.

The perceived importance of secretaries in ChiNext companies cannot be overstated, as demonstrated by the devotion of 15 sub-rules detailing their obligations and responsibilities.

To appraise the effectiveness of the board secretary of ChiNext listed companies, four aspects of the role prove important: their selection and appointment, skill and expertise,

⁴³⁸ Article 124 of Company Law

quasi-independence from the executives and controlling shareholders and their disclosure obligations discussed below.⁴³⁹

A. Selection and Appointment

The results of a survey of 40 companies revealed that only a minority of board secretaries have an accountancy or law qualification in higher education or university.

In China, the Party and at central and local government level, the title of secretary is one of power and influence due to its close proximity to the leaders and control over records of meetings and information.

In ChiNext companies, the role of board secretary is one of prestige and respect given the close proximity of the role to that of the chairman, CEO and other directors. Board secretaries are privy to all board discussions and major transactions. Although they do not have any authority, they wield influence by virtue of being gatekeeper to the board. Their prestige is thus because they are privy to the decision-making process of the board. It is, therefore, not surprising that the drafters of ChiNext Rules perceive the board secretary as a strong enough role to award external disclosure obligations in addition to the disclosure obligations that the company has by virtue of being listed. For all intents and purposes, in ChiNext companies, the fact that the board secretary is a member of the management team is important because that avails the position and power to carry out previously mentioned obligations under China's corporate governance laws and rules. However, there is potential controversy in whether or not the role in reality is independent. This largely depends on the interpretation of the laws and rules. At present, there are two interpretations of the role of

⁴³⁹ The role of the company secretary has largely being underated with extant literature on how to measure the effectiveness of the role. Nonetheless, it may be anecdotally and generally concluded that the ability of a company to effectively navigate through the complexities of corporate governance is at the very least anecdotal evidence of the effectiveness of the company secretary who facilitates the process under the oversight of the board (including the chief executive and finance officers).

board secretary as senior management and each has implications for the benchmark in assessing the independence of the board secretary, which is very much required. One interpretation is that the post of board secretary is of itself a senior management role within the organisation. The alternative interpretation is that the board secretary role is one that must be chosen from senior management or that it is senior management by virtue of its holder being one of the senior managers of the company. The choice of interpretation has implications for the independence of the role. So far, most ChiNext companies have subscribed to the latter interpretation, therefore, choosing the company secretary from the ranks of directors.

The selection of the board secretary from existing executive directors weakens the efficacy of the relationship with the board secretary, and can result in the executives or the controlling shareholder being able to waylay the secretary before any report is made to the regulators. Another point of note is that board secretaries are unlikely to be controlling shareholders of the company. In the surveyed companies, only three companies out of 40 have a board secretary who is also a controlling shareholder – and, importantly, they are joint controllers.

B. Skill and Expertise

Although Company Law does not indicate the necessary skills and expertise, the ChiNext Rules require a board secretary to have the,

necessary financial, management and legal expertise for performing his duties, have good professional ethics, and have obtained the certificate for secretaries issued by the Exchange.⁴⁴⁰

⁴⁴⁰ ChiNext Rule 3.2.4. In the UK and Hong Kong and most commonwealth countries, the Institute of Chartered Secretaries and Administrators is a non-governmental professional awarding body that requires the passing of professional examinations at the equivalent level of ACCA and CIMA.

Only ChiNext Rules have such a requirement. A key issue, then, is what amounts to expertise in this context; however, there remains little guidance in the ChiNext Rules. Despite an unequivocal requirement for expertise provision, when surveyed, the expertise and education of board secretaries in the surveyed CSMEs do not suggest any uniform compliance in ensuring that there is financial, legal or management expertise. Under Company Law, the very narrow remit of company secretaries means that they do not require knowledge of corporate governance, or company law or financial management. No credible way exists to measure the good professional ethics of those appointed as board secretary. In 2012, only 52.50% of board secretaries in the surveyed companies had obtained the required practice certificate awarded by the Exchange before or immediately after taking office.⁴⁴¹ This amounted to a two-year delay in the remaining 47.25% obtaining a practice certificate, which to some extent reflects its relative unimportance as a priority, not only for companies but also for the Exchange itself. It also illustrates the perennial issue of law on paper and law in action.

In terms of qualifications, some board secretaries have financial expertise such as China-certified public accountants while a small number have an Executive Master's in Business Administration (EMBA). Few secretaries have legal, governance and compliance. This may be because the demand for such expertise means better opportunities available with more lucrative pay. Thus, the majority of appointees tend to have general managerial expertise primarily obtained through experience.

Among the companies where the board secretary is not chosen from the ranks of the board of directors there is a growing trend in recruiting graduates of EMBA, which indicates that even below board level the dual combining of roles may still be required – this is perhaps more of a cost-efficiency strategy as well as to aid access to information. Less than half of the

⁴⁴¹ Author's survey.

surveyed companies have a board secretary that attended the special training provided by the Exchange. The publication of attendance does not appear to encourage those missing the qualification. But their level of skill and expertise is still unknown.

C. Quasi-independent Role

As discussed in detail in Chapter Three, under ChiNext Measures and ChiNext Rules, the role of the board secretary is enhanced by awarding it information rights, making it responsible for investor relations, and, importantly, imposing a duty of disclosure of price-sensitive and certain types of information to the Exchange. This disclosure obligation has more of a whistleblowing element when the words of the rules are read plainly. The obligation requires and presumes a certain level of independence from the influence of the board and senior management of the company. In order to carry out this obligation effectively, the board secretary will require a certain level of objectivity and independence from the board secretary. Unfortunately, the study demonstrates that, in reality, the role of the board secretary is not one of independence and cannot exercise the objectivity required for it to be an effective corporate governance whistleblower. One half of the board secretaries of the surveyed companies were also executive directors of the companies. It is, thus, highly unlikely that such a board secretary will whistle blow a matter that he or she is involved with by virtue of his or her directorship. Common sense dictates that it is better to take the risk because, in the end, when caught out, he or she will also be culpable as part of the board of the company.

The seniority of the role strategically provides a certain measure of independence. Thus, it appears that the intention behind China's corporate governance laws and rules is that the board secretary is independent of the board. Here lies the contradiction in that over 50% of surveyed companies selected an executive director as board secretary. There are practical

reasons for this difference in the plain reading. In China, the higher up the hierarchy a person is the more power and influence they wield. The survey and case study below indicate that the only way a board secretary can effectively be independent, enhance communication between the board and shareholders and, importantly, exercise the right to information is by holding a concurrent senior management position. Such roles include executive director, general manager (or assistant) or head of finance. Indeed, in several of the surveyed companies, the board secretary is also the deputy chairman, in reality and effect outranking all staff and fellow board directors except for the chairman of the board. Consequently, through this concentration of power and influence, the board secretary in China is arguably more powerful and more influential and, therefore, more independent than perhaps a board secretary without a position on the board. Indeed, it must be remembered that, apart from the one-day training session provided by the Exchange, anyone can be appointed board secretary once they have five years' work experience.

D. Disclosure Obligations

As the disclosure obligation of board secretary to some extent amounts to an obligation to whistle blow, it presumes a certain level of independence from the influence of the executive board and senior management of the company. That is, a certain level of objectivity and independence is required of the board secretary to report unfavourable internal governance matters to the regulators. In order to assess the potential for relative objectivity and independence of the board secretary on the board, the percentage of company secretaries who also held the position of director of the company is examined.

The study revealed that one half of the board secretaries of the surveyed companies also held executive directorships of the company. The survey of 40 companies from 2009 to 2011 suggests that, on average, over 50% of board secretaries are also executive directors

with some holding posts as senior as deputy chairman. Moreover, as executive directors they tend to have responsibility over a key business unit of the company since the study demonstrates that the board secretary may not be an effective corporate governance whistle blower. It is expected that this managerial gravitas makes them more powerful and influential on the board and among their colleagues. But the flipside is that they are arguably less independent in crucial circumstances when the board as a whole may be culpable. However, the plain reading of Company Law, ChiNext Measures, Listing Rules and the Rules and Regulations regarding the Work of Board Secretaries ('Board Secretary Rules') match the former interpretation that the role of board secretary is of itself a senior management post. However, in practice the seniority of the secretary depends on the position in the hierarchy, which, in turn, affects the ability to carry out duties, especially in terms of controversial aspects.

Case Study – A Senior Management Role?

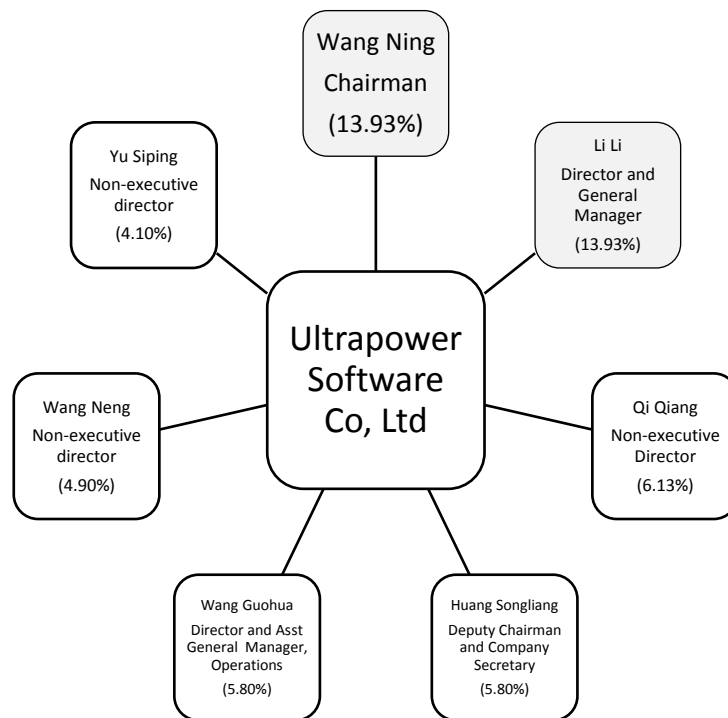
Case study 8: Empowering the role of the board secretary

Beijing Ultrapower Software Co. Ltd. (Ultrapower), a company with multiple individual owners, is an illustrative example of a holder of the role of board secretary being selected from the pool of executive directors of the board. Thus, Huang Songlang, the board secretary, is also deputy chairman of the board. For all intents and purposes he reports directly to the chairman. In terms of qualification, he has five years' work experience, though none were previously related to the regulatory and compliance work, but he has attended the training program for board secretaries provided by the Exchange. In line with growing trends in China, Huang has an EMBA from a US university. Thus, his eligibility is without doubt.

Ultrapower has an above average sized board of 11 members. Six of them are executives, including Huang, with one non-executive director and four independent directors.

As illustrated in the diagram below, all six executive are major shareholders in the company, which indicates that ownership and control is concentrated on the board of directors.

Figure 12: Ultrapower Software Co. Ltd. ownership structure



The non-executive director sits on the board and is rightly a major shareholder, taking an active role in decision-making and monitoring his investments in so far as board meetings allow. The ownership structure also includes several institutional shareholders in the form of banks, each holding less than 2% of total issued shares. There is a supervisory board of three members who are all employees. None have any financial qualifications or experience but are chosen from engineering and administration departments of the company. Although this a stereotypical demonstration of the weakness of supervisory boards in the internal governance structure, it is of note that one of the independent directors, Wang Keming, was awarded the Golden Award for Listed Companies.

Three observations can be made from this case study about the selection and role of the board secretary in Ultrapower and more generally on ChiNext. First, in order to perform

its obligations, it is not enough that the board secretary is declared as senior management under corporate governance laws and rules. Huang's appointment to deputy chairman testifies to the fact that the only key influential roles on the executive board are chairman and CEO. The role of deputy chairman effectively empowers Huang to collate information required from (subordinate) executive directors and circulate it to other constituents, importantly, the independent directors. Second, the role of board secretary is used by many companies in balancing out power where there is no outright controlling shareholder of the company. Thus, Huang's appointment may be construed as a strategic method of providing an entrenched executive with an alternative appointment. In comparison to other members of the board who have a technical, business or finance position. Research into the company suggests that Huang is instrumental in modernising the company, which is a former state-owned SME privatised in the mid to late 1990s. He relatively recently joined the company, in 2007 compared to other executive directors have worked in the company for a range of ten to 15 years, his 6.13% holding in the company readily accounts for his immediate seniority despite his late entrance into the company. However, it does mean that since corporatisation Huang has effectively entrenched himself on the executive board. He is unlikely to forfeit the opportunity that being an executive affords in decision-making and the monitoring of his investments, as well as the remuneration.

Insights and analysis

A key insight from this Section is the general trend in listed companies on ChiNext to appoint not a chartered company secretary, qualified lawyer or accountant as board secretary, but business management generalists. This indicates the extent to which the private listed company environment holds business management and commercial experience more useful than regulatory professional experience. Moreover, as there is no precise professional qualification expected or expressed under legislation or regulation, it naturally falls on

business culture to dictate the skill and experience of the board secretary. This also may simply reflect the (lack of supply in the) market for the other professionals.

As discussed earlier, the express requirement under the ChiNext framework that the board secretary be a member of senior management has two interpretations: that the board secretary is chosen from an existing body of senior management or that the role of board secretary in itself is a senior management role. From the surveyed companies, it appears that many companies have taken the former interpretation. Hence, the earlier indication in this section that the role of the board secretary will conflict especially as regards its disclosure obligations to the regulators. By virtue of their non-speaking yet active attendance through minute taking, the board secretary can observe and assess the temperament of the board and others in attendance. This skill is lost in part when the role is annexed to another executive role. The board secretary has an inside perspective, but from an observational point of view.⁴⁴²

VI. How Engaged is the Management Structure of ChiNext Companies?

This section examines how engaged overall the above constituents are in the internal governance of the surveyed companies. Before proceeding with the findings from the surveyed companies, some historical context is required in order to highlight internal governance. The question of how engaged the executive board, supervisory board and senior management are in decision-making is important not only for corporate governance purposes

⁴⁴² The role of the ChiNext board secretary can be contrasted with the UK system of company secretary where most are chartered company secretaries and therefore their quasi-independence is assured by their obligations and integrity required of the Institute in ensuring that they act in the interest of the company and not one particular constituent of the company. However, it still remains that the role has limitations since it is still a member of management and usually the reporting line is to the chief executive officer. Nonetheless, a recent report on the role of the company secretary in the UK finds that chartered secretaries are better suited professionally in facilitating an effective board. For further details see Andrew Kakabadse and Nada Kakabadse, “The Company Secretary” (ICSA and University of Reading Henley Business School, 2013), <https://www.icsa.org.uk/products-and-services/knowledge-and-guidance/research/the-company-secretary-report>.

but also to ensure that the executive board (and its committees) and the supervisory board fulfil their internal governance roles as prescribed under Company Law.

Research and the media have identified two phenomena that detract from effective independent decision-making of the executive board and its committees and the supervisory board of companies listed in China, namely the ‘*yibashou*’ (i.e., ‘a good hand’), and ‘*yigeren shuole suan*’ (‘a law onto himself or herself’).⁴⁴³ There are subtle differences in the way each type execute their decisions which can be simplistically explained as the former relying on experience rather than expertise or professionalism, while the latter execute their own agenda creating or disregarding rule. Both types refer to a person in the guise of chairman, CEO or controlling shareholder who concentrates power in their person.⁴⁴⁴ The chairman achieves this by controlling the board or the majority of the board of directors while CEOs do so by the flow of information in the company and to the boards.⁴⁴⁵ As illustrated in Chapter Three, controlling shareholder influence by either being chairman or CEO or appointing or supporting whoever holds these posts.

A. Increased Engagement in Decision-making

Partaking in decision-making and the monitoring of managers becomes very important in companies where the controlling shareholder also manages the company. As an indicator, the increasing number of executive board meetings convened in the surveyed CSMEs suggests progressively more use of the board meeting as the arena for the decision-making of CSMEs. Company Law only requires a company to have at least two meetings a

⁴⁴³ The implication for corporate conduct are further discussed on page 329ff.

⁴⁴⁴ Gi [Ji] Guanglin, “*Guanyu Zhongguo Tese Dongshihui Zhidu de Yanjiu* [Regarding Research on Chinese-Style of the Board of Directors System],” ed. Wu Shaohong, *Anhui Ligong Daxue Xuebao (Journal of Anhui University of Science and Technology (Social Science))* 12, no.4 (December 2010): 40.

⁴⁴⁵ Gi [Ji] Guanglin, “*Guanyu Zhongguo Tese Dongshihui Zhidu de Yanjiu* [Regarding Research on Chinese-Style of the Board of Directors System].”

year.⁴⁴⁶ In 2009, the average number of meetings of boards of ChiNext companies surveyed was 6.1 meetings, more than three times the statutory minimum. By 2010, the average number increased to 8.9 meetings, with a marginal average increase in 2011 to 9.0 meetings.⁴⁴⁷ The lowest number of meetings was five and the highest was 14, therefore, indicating a positive trend toward increased decision-making at board level. Nonetheless, the number of meetings does not necessarily indicate the engagement of the board or good corporate governance. Consequently, the agenda items indicate the efficiency of the board process, which in itself is an indicator of good corporate governance and efficiency, both of which are interlinked.

Table 12: The average number of meetings of the boards of directors and supervisors and audit committee per year of surveyed companies

| Year | 2009 | 2010 | 2011 |
|-----------------------------|-------------|-------------|-------------|
| Board of supervisors | 2.4 | 5.6 | 6.3 |
| Audit committee | 1.1 | 2.1 | 3.0 |

Source: Author's survey

The common items on the agenda demonstrate compliance with corporate governance laws in putting certain matters to the board. In 2009, board agendas commonly included approval of IPO documentation, proposals for convening shareholders' meetings for authorisation of the board to carry on matters relating to IPO, share capital increases, engagement of advisers, set up of subsidiaries and conversion to a joint stock company.⁴⁴⁸ By

⁴⁴⁶ Article 111 of Company Law.

⁴⁴⁷ See Table 8 on page 191.

⁴⁴⁸ The lower meetings average may also be attributable to companies only recording the meetings held as newly incorporated or converted joint stock companies.

2010, published resolutions regarding increased share capital, incentive plans, and large contracts dominated. The 37% leap in meetings in 2009 from 2010 suggests spending on projects of money raised on IPO, as well as the incentivising of existing members of management at different levels.⁴⁴⁹

Moreover, on average, not less than 80% of executive board members attended these meetings, with the highest attendance reaching 100% throughout the year in some surveyed companies.⁴⁵⁰ This indicates increased engagement as these figures exceed the minimum quorum of half or more required under Company Law.⁴⁵¹ The increasing attendance of executive board meetings demonstrates the willingness of owner-managers to be less arbitrary in decision-making. This remains especially poignant in family-held CSMEs where other members of the board tend to have less or no holdings in the company. In turn, it also implicitly, if not explicitly, demonstrates the occurrence of a certain amount of monitoring of owner-managers, and consequently the implicit, if not explicit, monitoring of managers.

A key question would be how engaged the executive board members are, especially the independent directors, in remuneration matters. However, few of the surveyed companies actually disclosed details of their remuneration committee or its meetings. On face value, this may be an indication of the limited role of the board as a whole, and independent directors specifically, in considering and advising on remuneration, with such decisions left to the controlling shareholder in his or her multiple roles on the executive board.

B. Confucian Ideals and Board Governance

As discussed earlier in the chapter, there is much debate in general about the skills and expertise of the constituents of the executive board and the supervisory board. One key

⁴⁴⁹ This resulted from an examination of board resolutions announced on the market.

⁴⁵⁰ Author's survey.

⁴⁵¹ Article 112 of Company Law.

issue that has emerged of late is the recognition that, in practice, when selecting constituents of the executive board, the ability to be erudite remains favoured over professionalism.

1. Erudite vs Professionalism

Acknowledging the favouring of a broad education compared to professionalism remains crucial to understanding the dynamics of most Chinese boards, especially in understanding corporate governance practice on ChiNext; in particular, the preference for a broad education rather than a professional one is prevalent in state-owned and semi-private companies. Indeed, in terms of understanding this approach the European humanist movement presents the closest analogy, with Faust as an example of an erudite individual as close to that which the Chinese require of their directors. This is why, given a choice of professions, they will choose the law or accountancy because these are the closest in practical need for corporate governance.

The inability to disclose big problems and transparently discuss them appears to be a recognised problem of Chinese boards.⁴⁵² Consequently, venture capital investors and other institutional investors remain reluctant to invest in a company in which the founder/entrepreneur undertakes multiple roles. As one interviewee put it, institutions will be reluctant to invest unless it is clear that, even without any monitoring input on their part, they will make a handsome return on IPO; this is almost guaranteed, given the pricings system on ChiNext.⁴⁵³ Gao Wuqing warns that the qualifications of the board of directors cannot be assessed in terms of scholarliness or profession.⁴⁵⁴ He argues that broad learnedness remains more valued over professional qualifications. Indeed, this notion is arguably reflected in the

⁴⁵² Gi [Ji] Guanglin, “*Guanyu Zhongguo Tese Dongshihui Zhidu de Yanjiu* [Regarding Research on Chinese-Style of the Board of Directors System]”: 39.

⁴⁵³ Interview 2012-12.

⁴⁵⁴ Gao Wuqing, “*Wanshan zhongguoshi guoyou qiye dongshihui zhidu* [The Perfection of Chinese-style Board of Directors in State-owned Enterprises].”

fact that legislation still, at all levels, makes no requirement of qualifications for being a director. Nor can one find a perfect match of qualification. The companies that do adopt accountants and lawyers tend to be export-focused companies where the influence of foreign corporate governance systems and international corporate governance systems demand an almost mirror image of integrity.

Hitherto, most efforts in controlling or deterring undesirable conduct focused on SOEs that are publicly listed on China's equity markets.⁴⁵⁵ Consequently, the focus has been on how the state as de facto controller effectively controls the controlling shareholder (in effect its representative in the company) to limit interference and expropriation from the company.

2. Dual and Multiple Management Roles

As demonstrated in Chapter Three, controlling shareholders tend to partake in management. In turn, this chapter has indicated that they tend to take on two or more concurrent roles, the most prevalent combination being the chairman-CEO. Interestingly, the assumption of multiple roles is not necessarily counter-balanced by INEDs, rather by NEDs that have shareholdings in the company. These multiple roles on the executive board and in management by controlling shareholders cannot be divorced from the phenomena of the expert and sole decision-maker, which illustratively manifest themselves in the multiple statutory roles controlling shareholders have as chairman and manager. As such, protection of their interests only explains part of the reason for the multiple roles, even where they may not have professional managerial experience or acumen to be a CEO. One of the legacies of China's SOE culture remains the leadership style of SOEs manifested in the mantra of the

⁴⁵⁵ Chang Xiaoyan and Wen Yajuan, "Gongsizhili Jiegou Wanshan de Falu Sikao [Legal Thoughts on the Perfection of the Management Structure of Companies]," Government, *Zhongguo Faxuewang [China Law Website]*, (30 April, 2009), url: <http://www.iolaw.org.cn/showNews.asp?id=18331>.

‘one leader system’, which derives from the state administrative leadership system (*zhengfu xingzheng lingdao tizhi*) of the socialist big family culture that continues in the board room.⁴⁵⁶

The implications for corporate governance are twofold. Company Law 1993, before it was revised in 2005, also reflected this cultural phenomenon, with the chairman having powers of veto and casting votes among other pervasive statutory rights. Most of its statutory powers were either removed or watered down in what at least on paper amounts to the democratisation of the board. This means in practice that all of the directors, whether independent or otherwise, are part of the ‘chairman’s team’, despite Company Law and regulations carving out a specific monitoring role for INEDs.

On ChiNext, despite the multiple roles taken by owner-managers, there remain limits to their authority. The circumvention of their authority does not arise from the effectiveness of INEDs but rather from the effectiveness of shareholding NEDs who attend board meetings in order to protect their interests.

C. Undesirable Corporate Conduct

Controlling shareholders in privately held companies monopolise the managerial role of the CEO to ensure continued control of all aspects of the day-to-day management of the company. This emerges at a time, perhaps ironically, when overly powerful managers in SOEs have been relatively successfully reigned in. Also, almost all managers holding the post of general manager or CEO in SOE CSMEs and in most semi-private CSMEs surveyed have a management or business professional. It is usually the chairman who remains a figurehead appointment from the state and politically influential, limiting the political influence of the

⁴⁵⁶ Gao Wuqing, “*Wanshan zhongguoshi guoyou qiye dongshihui zhidu* [The Perfection of Chinese-style Board of Directors in State-owned Enterprises]”: 16.

manager outside of the company. Secondly, almost all CEOs in SOE CSMEs and all CEOs in semi-private CSMEs also hold shares in the company, from as little as 0.01% to the heights of over 20% or more of the issued shares.

This ensures that their interests become aligned with those of the controlling shareholders. This shareholding is less for the sake of aligning interests than it is a tangible incentive for such individuals to manage the company or partake in the joint venture. Indeed, private individuals are unlikely to directly benefit economically from the variant goals such as performing public duty and effecting political gain through the success of the company, although these may be by-products of their success that they can exploit when appropriate. Thirdly, the boards of directors and supervisors tend to be dominated by external department directors and supervisors (excluding the employee appointees of the company). As demonstrated in Chapter Five, in SOEs only one executive director sits on the board while the rest are non-executive, independent or external department directors.

Arguably, the choice of the erudite over professionalism means that it becomes difficult to require a code of conduct across the board, even on a company-specific level.

D. Independence of the Board

In corporate governance, the independence of the board of directors from insider and controlling interests remains a key issue, whether in concentrated or dispersed share ownership or unitary or two-tier board systems. All corporate governance systems strive to ensure and improve the independence of the board so as to avoid insider control, as does China's. Hence, the appointment of INEDs has become a key element of law and policy around the world and in China.⁴⁵⁷ Having said this, each country takes its own approach to

⁴⁵⁷ Donald C. Clarke, "The Independent Director in Chinese Corporate Governance," *Delaware Journal of Corporate Law* 31, no.1 (2006): 127.

measuring independence on the board of directors and defining an independent director. In the US and the UK, an independent prima facie board has the majority of the directors defined as independent.

1. INEDs: Ineffective for Listed SMEs?

A key finding from this chapter is that INEDs may not be as effective as NEDs, especially shareholding NEDs in listed SMEs. As noted earlier in Chapter One, the literature on corporate governance mechanisms largely focuses on the role in large listed enterprises where there is a separation of ownership and control. The privately held surveyed companies on ChiNext do not have any separation of ownership and control. Generally, there remains dissatisfaction with the role of INEDs as they are perceived to be too susceptible to the control of controlling managers.

As illustrated earlier, on ChiNext and in China generally, the board comprising a minimum of one-third of INEDs amounts to an independent board. On ChiNext, most companies keep to this ratio, with just a few having more. The same also applies in the top 100 companies listed in China.⁴⁵⁸ Interestingly, this research finds that some listed companies engage the same INEDs as their listed parent company. This leads to the question of how INEDs are defined. Of course, there have been mixed results in both qualitative and quantitative studies. Much research has taken place regarding the role of INEDs as it is

⁴⁵⁸ Professional corporate governance agencies now operate in China and benchmark companies. See Protiviti, *2011 nian Zhongguo shangshi gongsi 100 qiang gongsizhili pingjia [2010 Corporate Governance Evaluation of China's Top 100 Listed Companies]*; Protiviti, *2010 nian Zhongguo shangshi gongsi 100 qiang gongsizhili pingjia [2010 Corporate Governance Evaluation of China's Top 100 Listed Companies]*; Protiviti, *2009 nian Zhongguo shangshigongsi 100 qiang gongsizhili pingjia [2009 Corporate Governance Evaluation of China's Top 100 Listed Companies]*. (Over the three years most companies kept to the ratio of one-third of directors deemed independent.) For an LLSV focussed assessment of corporate governance in the top 99 companies listed (based on revenue) in Greater China (Shanghai, Shenzhen and Hong Kong stock exchanges) between 2005 and 2006, using around 64 proxies to indicate effectiveness of corporate governance, see Lu, Zhong, and Kong, "Corporate Governance Assessment on the Top 100 Chinese Listed Companies."

symbolic of the independence of the board.⁴⁵⁹ Unsurprisingly, empirical evidence based on a survey of privately held companies listed in China between 2004 and 2010 suggests that the higher the number of controlling shareholders, the less independent the board is likely to be.⁴⁶⁰

2. More Effective: Shareholding NEDs

As demonstrated in the surveyed companies, the vast majority of NEDs are shareholders or their representatives. In privately held companies, in much the same way, controlling shareholders represent their interests, especially on the executive board; non-controlling shareholders mostly comprising pre-IPO subscribers, i.e., individual, venture capital and private equity investors, also represent their interests on both boards.

NEDs are not necessarily independent. However, they contribute to the effectiveness of the board with their skill and expertise all the more when they do not hold shares because they tend to be accomplished in the industry in which the company operates.

3. Persistence of Communist Party of China in CSMEs

The previous section examined independence in relation to the controlling shareholder. This section examines the independence of the boards and the management in relation to the Party-state. One to the key areas of research in recent years with regard to executive boards in China has been their relationship with the Party-state.⁴⁶¹ This thesis takes a broader approach

⁴⁵⁹ Peng Wenge and Qiu Yonghong, “*Cong zhengquanjiaoyisuo de shijiao kan dulidongshi zhidu de wanshan* (Improving of Independent Director System from the Perspective of a Stock Exchange),” *Zhengquan shichang daobao* (Securities Market Herald), no.2 (2007): 36-43.

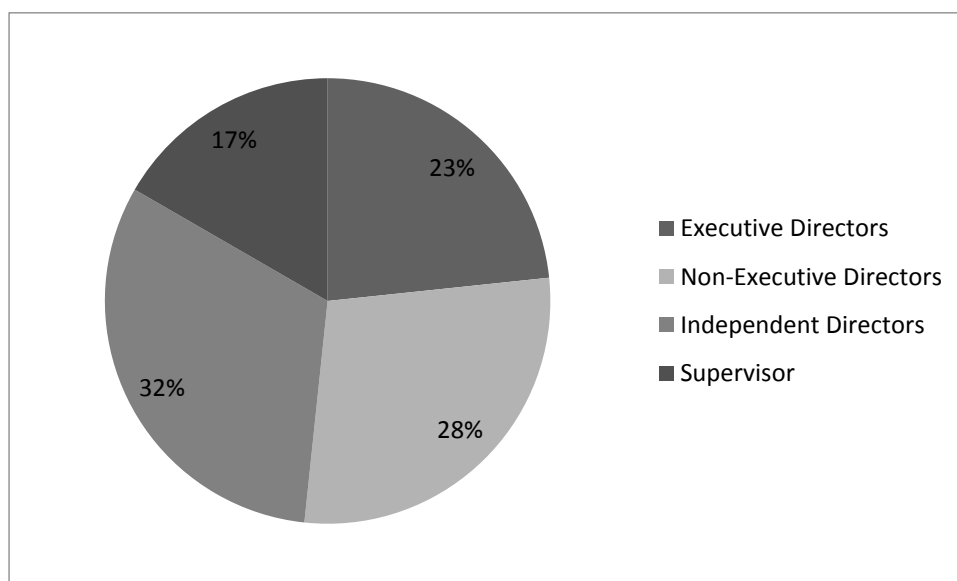
⁴⁶⁰ Xu Qifan and Xu Ming, “*A minying gongsi dulidongshi zhidu de kongufang xiaoying yanjiu* (Study on the Controlling Shareholders Effect on Independent Director System of A-share Listed Private Firms),” *Jinrong fazhan yanjiu* (Journal of Financial Development Research), no.2 (January 2013): 70-74.

⁴⁶¹ Joseph P. H. Fan, T. J. Wong, and Tianyu Zhang, “Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China’s Newly Partially Privatized Firms,” *Journal of Financial Economics* 84, no.2 (May 2007): 330-57, doi:10.1016/j.jfineco.2006.03.008. (A survey of 790 companies that underwent IPO

by examining the prevalence of Party members since they will not only include current and former members of central and local government but also those from the private sector that have taken on membership.⁴⁶² Naturally, such relations become of primary importance to assist in understanding the motives behind appointments and decision-making.

Chapter Three demonstrated that, although the State, only holds a controlling interest in 5% of the surveyed companies, it still holds varying interests in most of surveyed companies through government-VCs and SPVs. Equally, members of the Communist Party of China ('the Party') remain strongly represented in the surveyed companies, with 62.50% of companies having directors with current membership of the Party. The chart below shows the distribution of Party members in the 40 surveyed companies as of 31 December 2009.

Figure 13: Communist Party of China members on board of directors



Source: Author's survey

between 1993 and 2001 found that those companies with politically connected CEOs underperformed. They used a narrow definition of 'politically connected' as meaning a current or former officer of the central or local governments or the military.)

⁴⁶² For an examination of the relationship between private sector entrepreneurship and membership of the Party, see John Garrick, ed., *Law, Wealth and Power in China: Commercial Law Reforms in Context*, Routledge Contemporary China Series (Milton Park, Abingdon, Oxon ; New York: Routledge, 2011).

In order of dominance of membership of the Party, INEDs dominate with 32%, followed by NEDs with 28%, executive directors with 23%, and supervisors with 23%. There is a suggestion that the more institutional investors and investment companies represented in the company, the more likely it is that the company does not have or does not indicate who is a Party member. This puts into perspective the arguably slow but nonetheless decreasing spiral of memberships on China's dynamic listed SMEs. Perhaps this is a sign of the times and a result of the government's initiatives in wanting to promote private enterprise and innovation.

Close analysis indicates that Party membership prevailed in the surveyed companies that are based in traditional economy industries such as machinery, metals and non-ferrous metals, petrochemicals, printing and paper, petrochemicals and pharmaceuticals. There is bound to be greater Party membership as these companies tend to be SOEs or privatised. Moreover, these industries are also more regulated and, therefore, not only industry experts are required on the board as a necessity but also those that have Party connections within the industry. Moreover, these industries, except for pharmaceuticals, do not require innovations.

In contrast, so-called new economy industries such as IT, media and electronics have directors or supervisors who are members of the Party. On the one hand, the stark difference between Party membership of those in traditional industries and those in the new economy indicates that membership may only be needed where business is relatively highly regulated, to the extent that Party connections are likely to be of assistance. Moreover, most new economy surveyed companies are start-ups and, therefore, do not have the Party legacy that remains in SOEs and privatised companies. This may be because they mostly fall within the core of China's strategic industry enterprises and, therefore, merit is almost enough to gain them the listing and then the funding. For example, the surveyed companies in the heavy machinery industry have the highest concentration of Party members in each company. Over

a quarter of the companies have three or more Party members who are executives, non-executives, INEDs or supervisors. However, the full picture remains slightly incomplete because the survey depends on disclosure of Party membership in biographies in the companies' annual report. For instance, some surveyed companies in the new economy industries deliberately do not disclose the Party membership of their boards' members. This may be intentional to divorce themselves from links with the Party-state. This indicates that being a member of the Party is not as important as may be thought or compared with companies on other markets.

Predictably, those surveyed companies with the highest number of Party appointments were SOEs and privatised companies. As mentioned earlier, privatised companies on ChiNext were mostly management buy-outs with the ultimate owner(s) providing the bulk of capital or know how. These managers, during their time in SOE employment, are members of the Party as a matter of course, especially in the industries that require factories where the Party structure is even more pronounced and all staff are unionised, or even in the bottom-heavy companies where the majority of the workforce and jobs are semi-skilled.

Closing Remarks

The key issue raised at the beginning of this chapter was how effective the executive board in particular will be in monitoring not only controlling shareholders but also, importantly, owner-managers. A key finding in this chapter is the ability for private companies to innovate the corporate governance mechanism, such as the introduction of external supervisors. The chapter has provided further insights into the dynamics of internal governance, where non-controlling shareholders protect their investments by either taking on executive director or senior management roles, or acting as NEDs. Thus, the presence of individual shareholders, in particular, within the management structure acts as a monitoring

mechanism. In particular, most of these ‘shareholding managers and directors’ in the surveyed companies are further empowered by the strong *guanxi* between them and the controlling shareholder that flows from them being early providers of funding for the business at start-up, thus, becoming a key mechanism in shareholder protection, assuming their interests are aligned with other shareholders. Venture capital and private equity shareholders also have a presence on the executive board, but not proportionate to the amount or number of companies in which they invest. This is because the large majority are run by the government and tend not to hold executive board or even supervisory board roles. Independent directors appear efficient in carrying out their obligations by attending meetings and issuing independent reports. The only problem is that their independent reports are always favourable, even when the company clearly has governance or performance problems. A case study in the next chapter illustrates this problem.

Chapter Five – Enforcement Mechanisms on ChiNext

The expropriation of company funds has historically been a problem with controlling shareholders more than with management. A continuous body of literature attests to the weak corporate governance enforcement practices of Chinese stock markets.⁴⁶³

This chapter assesses the extent to which a legacy of weak compliance and enforcement has transferred to ChiNext. The chapter is divided into five sections. Section I assesses the trends in compliance by companies and its constituents with regard to disclosures, related party transactions, third-party guarantees and insider trading. Section II examines enforcement by the CSRC and the Exchange on ChiNext. Section III examines the roles of the press and how it supports (or hinders) the regulators. Section IV introduces China's public whistleblowing system as a mechanism of corporate governance and assesses its role in ChiNext. Finally, for a comprehensive analysis, Section V examines the role of private ordering.

I. Trends in Corporate Governance Compliance

Chapter Two demonstrated that the ChiNext framework focuses on regulating disclosure and particularly related party transactions, the issue of guarantees by companies and insider dealing. It hopes to achieve this by reinforcing the role of INEDs and empowering the board secretary. Following on, this section assesses compliance by companies and the effectiveness of regulators and ChiNext framework in these areas, with the key focus on illustrating the trends rather than an evaluation of the law. This examines two key corporate governance issues, namely related party transactions and guarantees.

⁴⁶³ For example, Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008). See also Pistor and Xu, "Governing Stock Markets in Transition Economies."

A. Disclosure Compliance

Strengthening disclosure compliance has always being a particular challenge for the regulatory authorities in China, especially the publication of false information. Disclosure obligations, though existent under law, were lax in compliance by companies and lax in enforcement by the CSRC. Donald Clarke notes that, from 2002 to 2007, the CSRC issued 211 punishment decisions (*chufa jue ding*), of which less than half related to disclosure violations by listed companies or their directors, officers or supervisors.⁴⁶⁴ An especially big problem was the publication of false information, illustrated by the 1997 national scandal of Hainan Qiongmin Yuan Modern Agricultural Development Co. Ltd. The company declared, among other matters, a capital surplus of US\$79 million in its 1996 annual report that caused its shares to rocket by 1,059%.⁴⁶⁵ The CSRC found the company guilty of false accounting.

Unsurprisingly, from the outset, there has been a stricter approach to disclosures required from ChiNext companies than from companies listed on other boards in China. All of this suggests an increasing ability, with some success, in the regulators' achievement of their key goal of protecting small and medium-sized investors in China's capital markets. The prospectus as the most important document for IPO contains the requisite disclosures. It is then for the Exchange to review the periodic reports published by CSMEs against the requirements of the ChiNext Rules. For corporate governance purposes, the annual reports of ChiNext companies provide the most comprehensive information. All companies have also adopted quarterly reporting.

On review of the annual reports for 2009, 2010 and 2011, all surveyed companies declared their related party transactions, guarantees to third parties, takeover and merger activities, litigation and arbitration actions as well as administrative sanctions incurred each

⁴⁶⁴ Donald C. Clarke, "The Ecology of Corporate Governance in China," *SSRN eLibrary*, The George Washington University Law School (29 August, 2008): 42.

⁴⁶⁵ China Securities Regulatory Commission, "*Zhongguo ziben shichang fazhan baogao* [Report on the Development of China's Capital Markets]": 175.

year – the latter two are discussed in more detail below. A comparative review of the annual reports published in 2009, 2010 and 2011 also indicates a marked improvement in the detail of disclosure. Disclosure in all surveyed companies was uniform, with all companies providing information on these areas, among others. However, there remains the danger of using templates and such reports becoming a box ticking exercise. The production of detailed annual reports also has costs in terms of collation of information as well as the cost of publication. ChiNext companies, on the whole, provide uniform information in accordance with the ChiNext framework when in compliance with mandatory provisions.

1. False Accounting

The focus was made with the purpose of protecting investors' rights and interests, raising the quality of accounting and auditing standards, and improving the transparency and disclosure of public companies. A well-known case that highlights Cheng Siwei's misgivings relates to false records and accounting to the listed company, Yin Guangxia. The external auditors, Shenzhen Zhongtian Accounting Firm, issued a favourable audit report for the company even though, from the period 1999 to 2000, it announced a false profit of US\$89.6 million based on fabricated purchase and sale contracts, export declaration forms, tax-free documents, financial bills and value-added tax invoices.⁴⁶⁶ It was not uncommon for enterprises of small, medium and large sizes to produce an audit report within just a few days of carrying out the site audit of the enterprise.⁴⁶⁷

⁴⁶⁶ Ibid, 176.

⁴⁶⁷ Tenev and Zhang, *Corporate Governance and Enterprise Reform in China*, 121.

2. Uniformity in Disclosures, Timeliness and Quality of Disclosures

There is uniformity and timeliness in most aspects of disclosures. However, there appears to be confusion when it relates to permissive aspects of disclosures such as an audit report. The audit disclosure aspect of annual reports displays disparate levels of reporting across the board from 2009 to 2011, suggesting persistent confusion regarding the requirements.

Difficulty remains in judging the quality of disclosure. Nonetheless, the audit committee report presents an example of form over substance. Some surveyed companies replicated the tables of audit framework found in large listed companies such as Baoshan Steel, but with little explanation of the implementation or results. Other surveyed companies merely stated the existence of an audit function and confirmed that the internal control system of the company complied with relevant laws and rules. Another set of companies rightly outlined the audit policy, then specified fees paid to external audits for non-audit-related consultancy.

Tellingly, this disparate reporting persisted over the three consecutive annual reporting periods reviewed, i.e., 2009 to 2011. It suggests that neither the CSRC nor the Exchange recognises this as an issue or that it is the least of their problems. However, this is not so, because, based on such reporting, the CSRC and the Exchange have been able to identify various violations of the ChiNext framework. There may be some argument that not imposing very strict disclosure obligations may facilitate better infringement detection as companies cannot necessarily follow a script that acts as a veil. This may be because such disclosure is not mandatory but permissive, in so far as it relates to an audit report. Companies only need to confirm the functioning of the internal control systems. If so, this undermines the function of presenting an audit report and, arguably, companies are better off not volunteering to disclose such details if they do not understand how to do so.

There appears to be a vicious cycle of corporate reporting leading to corporate governance issues. For instance, the ChiNext framework requires quarterly corporate reporting on results. But this rule was adopted from the Listing Rules originally geared at large state-owned and privatised enterprises established in their sectors. Such reporting has been to the benefit of the State and institutional investors keen to keep an eye on their investments. However, quarterly reporting poses a problem for hi-tech and innovative SMEs. Firstly, it exaggerates underperformance and this is reflected by the constant media reports each quarter analysing why a company did well in the last quarter.⁴⁶⁸ It is not plausible for a growing company to constantly have updates on technological developments or exploitation of proprietary intellectual property. There remains evidence that this may lead to the resignation of shareholding senior managers, so that they can pre-empt any downward spiral in the share price. An example is Wangsu, where several executives left the company for the purpose of cashing in on their shares earlier when it became evident that the company was having problems in clarifying the proprietary and competitive nature of its technology. Media reports were scathing and unrelenting in accusations that the company was engaging in fraud, which affected the share price.⁴⁶⁹

There remains some issue with the quality of disclosures. ChiNext Rules do not specifically provide for the quality of disclosures overall. Specific requirements for audited annual reports require an appointed Certified Public Accountant⁴⁷⁰ to ensure that a company's audited annual report conforms to the quality control standards and national accounting standards.⁴⁷¹ However, the level and success of regulatory monitoring of disclosures remains

⁴⁶⁸ But this merely mimics the reporting calendar found in the US and UK.

⁴⁶⁹ Pi Haizhou, "Wangsu Keji Chiguquan Jili Yiyun [Doubts and Suspicions about Wangsu Keji's Share Incentives]," *Faren*, no.1 (2011): 62-63.

⁴⁷⁰ That is, an accountant that is certified by the Chinese Institute of Certified Public Accountants, which exists under the guidance of the Ministry of Finance. See www.cicpa.org.cn.

⁴⁷¹ Rule 6.7.

unclear with regard to ChiNext, which arguably requires even more monitoring due to the hi-tech and innovative nature of these companies.

2. Specialised Disclosure for Hi-tech and Innovative Industries

ChiNext companies present a relatively high level of transparency. The disclosure methods on ChiNext reflect Company Law and Securities Law requirements. The improved disclosure on ChiNext has not occurred in a vacuum. However, there remains much controversy in the accounting malpractices of Chinese companies listed domestically and abroad. Conjecture, rumour and truth persist in the media, with some companies referred to as ‘companies packaged for listing’ (*‘baozhuang gongsi’*). As demonstrated in the previous chapter, although the regulators attempt to deal with the issue, enforcement against perpetrators appears alarmingly low. It is either that this presents a true picture of the level of violation or that the media and other stakeholders are being alarmist in their noisy and continuous cautioning in media reports. Indeed, the development of China’s Accounting Law attests more to the latter.

Accounting legislation in China presents the backbone of disclosures in periodic reports of all listed companies in China. In 1985, the first Accounting Law⁴⁷² of contemporary China was promulgated to apply to all enterprises. It laid out the framework for accounting standards and subordinate legislation, as well as implementing certain international accounting standards. The autonomy of enterprises from the state and the encouragement of investment from state organs and individuals, as well as growing numbers of foreign-domestic joint ventures brought demand for financial disclosures to aid the

⁴⁷² Adopted by the Ninth Meeting of the Standing Committee of the Sixth National People's Congress on 21 January, 1985. Amended in accordance with the Decision on Revising the Accounting Law of the People's Republic of China adopted at the Fifth Meeting of the Standing Committee of the Eighth National People's Congress promulgated on 29 December, 1993. Revised at the 12th Meeting of the Standing Committee of the Ninth People's Congress on October 31, 1999 and promulgated by Order No.24 of the President of the People's Republic of China on 31 October, 1999.

monitoring of investment. To enhance disclosure in listed enterprises, the statutory accounting system for listed enterprises was issued in the Provisional Accounting Standards for Joint Stock Limited Enterprises by the Ministry of Finance in 1992. However, this did not stem the tide of earning manipulations through related party transactions and there were calls for more detailed accounting standards.⁴⁷³ The 2005 amendment of Accounting Law incorporated, consolidated and expanded the financial disclosures, especially under Company Law and Securities Law and other complementary provisions. It also ensured that Accounting Law in China conformed to the International Accounting Standards in another step toward the internalisation of China's enterprises and stock exchanges.

Recent and continued dialogue between the US and China in relation to accounting implicitly suggests that Chinese regulators unwittingly acknowledge the deficiencies of China's accounting practices and disclosures, specifically because China wishes to facilitate the ability of its emerging financial institutions to partake in the lucrative US financial markets. Although this issue may not appear directly to affect or reflect ChiNext companies, there are clear similarities in the types of home grown new economy company that seek listing in the US that can be found on ChiNext. The only difference is that they decided to list abroad.

B. Related Party Transactions

Related party transactions ('RPTs') have become the most common method of (controlling) shareholders expropriating company funds.⁴⁷⁴ Problems arise where, for instance, the transaction price is negotiated, influenced or even set by the shareholder that the

⁴⁷³ Indeed, today, there is much debate about corruption, especially corrupt officials (*tanguan*). See Zhang Qianfan, "Sixing Buzu Yi Zhenshe Tanguan [Death Sentence Does Not Deter Corrupt Officials]," Financial News, *Cajing Wang*, (2 January, 2012), url: http://blog.caijing.com.cn/expert_article-151521-32437.shtml.

⁴⁷⁴ Peizhong Gan, *Qiyue yu gongsi faxue [Jurisprudence on Enterprises and Companies]* (Beijing: Beijing daxue chubanshe, 2012): 59.

company purports to transact with. Here, the benefit of the discount transfers solely to controlling shareholder or de facto controllers of the shareholder's company. This was the most popular method used, especially in SOEs. The main piece of regulation for related party transaction is Chapter X of the Administration of the Initial Public Offering and the Listing of Share Measures 2006 issued by the CSRC, which builds on the limited RPT provisions laid down in Company Law.⁴⁷⁵ China has taken the middle ground where RPTs are allowed, but to a prescribed maximum with board and shareholder approvals required. For instance, where the transaction with a related party amounts to more than RMB 3 million (approximately £300,000), a board resolution or shareholder meeting resolution must approve it.

The ChiNext framework seeks to limit the number of RPTs undertaken and builds on the aforementioned law and regulation. The issue of RPTs has been put under the shareholder protection section because research demonstrates that such transactions tend to be with parties related to controlling shareholders and sometimes de facto shareholders. Related parties of ChiNext companies can either be with legal persons or natural persons.⁴⁷⁶ Under the ChiNext Rules, RPTs include:⁴⁷⁷ transactions in which an obligation to disclose arises; purchasing raw materials, fuels and power; selling products and commodities; providing or accepting labour services; selling by consignment or selling on commission; and co-investment between two related parties. It also includes any matters that would lead to the transfer of resources or obligations through agreement.⁴⁷⁸ Further detail given on the type of legal persons and organisations that are deemed to be related parties is important for ChiNext

⁴⁷⁵ Further guidance was issued to supplement the cavities of the 2005 revisions to both Company Law and Securities Law. They include the Listed Companies' Articles of Association Guidance 2006, the Listed Companies' Shareholders' Meetings Rules 2006 were issued. In the same vein, the Takeover of Listed Companies Regulations 2007, which, in particular, set the disclosure obligations that related to indirect purchases amongst other provisions and related legal liability. The Listed Companies' Information Disclosure Regulations 2007 introduced further information disclosure requirements for an initial public offering. It details information obligations in the publication of an IPO prospectus, periodic reports, ad hoc reports, information disclosure management, supervision and legal liability.

⁴⁷⁶ ChiNext Rule 10.1.2.

⁴⁷⁷ ChiNext Rule 9.1.

⁴⁷⁸ ChiNext Rule 10.1.1.

companies due to their source of funding.⁴⁷⁹ Of note is that a listed company under common control of SASAC is not deemed to be a related party relationship unless the chairman, CEO or more than half of the directors of the company are also directors, supervisors and senior management of the other company.⁴⁸⁰ This is one of the most important areas for regulation given the occurrence of concentrated ownership and the rise in family ownership.

With no clear guidelines for disclosures, confusion and difficulties in ascertaining which CSMEs are compliant or in violation arise. Indeed, some surveyed CSMEs declared all RPTs, and some did not disclose themselves as having RPTs if they fell within the limit permitted under law. Nonetheless, the fact that the Measures make this a pre-IPO condition means that companies or their controlling shareholders must put their transactions in order. The regulators are interested in the RPTs in so far as they have the potential to distort the profitability (*chixu yingli nengli*) of the CSMEs. Thus, paragraph 14, among other requirements, as a condition of IPO, provides that all issuers must ensure that their business revenues or profits of the last year are not a result of being heavily dependent on an RPT or a large undefined customer.⁴⁸¹ This further complements the requirement for CSMEs to be ‘independent’ (*dulixing*).⁴⁸²

It is not clear whether VC investors are the force behind the low occurrence of RPTs in the surveyed CSMEs. VC and institutional investors seem particularly concerned about the potential for RPTs; consequently, there appears to be less of an occurrence in the companies in which they invest.⁴⁸³ All of the surveyed CSMEs that have venture capital, private equity or institutional investors with disclosable interests, which is more than 5% of the total issued share capital, had no RPTs whatsoever, at least in 2009, the year of IPO.

⁴⁷⁹ ChiNext Rules 10.1.3 to 10.1.7, inclusive.

⁴⁸⁰ ChiNext Rules 10.1.4 and 10.1.5(2)

⁴⁸¹ Paragraph 14 of the Measures.

⁴⁸² Paragraph 18 of the Measures.

⁴⁸³ Interview 2012-12.

There appears little violation of RPT provisions in Company Law, Securities Law and the ChiNext framework. However, this does not mean that it does not occur, only that it remains undetected. This is not to reduce the achievements already displayed by ChiNext companies in the reduced number of RPT and the almost full disclosure of those that have undertaken such transactions. Highly concentrated ownership in China inevitably leads to more probabilities of violating laws relating to RPTs.⁴⁸⁴ Indeed, RPTs have become the most common method of (controlling) shareholders cashing in on company funds.⁴⁸⁵ That said, Professor Gan cautions that RPTs may not always necessarily be detrimental to small and medium-sized shareholders of a company, listed or otherwise. Problems arise where, for instance, the transaction price is subject to negotiation but influenced or even set by the shareholder with whom the company purports to transact. Here, the benefit of the discount is transferred to the shareholder's company. In this circumstance, certain preventative measures such as independent external valuations may be helpful. It is worth mentioning that without uniform disclosure being enforced there remains difficulty in gathering information about RPTs and drawing comparisons, such that disclosure is not uniform. All the more so because disclosed board and shareholders' meeting resolutions only indicate those transactions that are presented at the meetings for approval.

C. Guarantees

Company Law prevents a company from taking on the liability of other companies through investment or guarantees without the approval of the board of directors as a whole or the shareholders at a general meeting.⁴⁸⁶ The directors, in turn, have further individual

⁴⁸⁴ Hu Ruyin in an interview, as quoted in Hu Ningfei, "Shangshi gongsi dongshihui zhili bibing [Corporate Governance Malpractice of the Board of Directors of Listed Companies]," *Dongshihui [Directors & Boards]*, no. 4 (2009): 48.

⁴⁸⁵ Gan, *Qiyu gongsi faxue [Jurisprudence on Enterprises and Companies]*, (2012): 59.

⁴⁸⁶ Article 16 of Company Law.

obligations that are actioned once the company has listed. For instance, independent directors must ensure and make a report to the effect that the interests of minority shareholders have not been compromised. This is probably the most important monitoring organ on the board of directors. Where a listed enterprise seeks to provide security for a third party, the Regulating Provisions of External Security by Listed Companies Circular promulgated in 2006 mandates for approval by shareholders at a general meeting.⁴⁸⁷

Prior to IPO, a company must specify the authority and process by which it awards external guarantees.⁴⁸⁸ No illegal guarantees must have been granted to the company's controllers or any enterprise under their respective control. These rules make sense for family-owned and state-owned companies. There are also limits to the type of investments or guarantees that can be given by a company.⁴⁸⁹ Moreover, where the guarantee is to be granted to any shareholder, de facto controller or their related parties or a shareholder under the control of a de facto controller, the Party must not participate in the vote. A total of 50% of the voting rights held by shareholders at the meeting are required to approve a guarantee.⁴⁹⁰

The ChiNext framework aims deter (as opposed to control) the issue of guarantees by listed companies to subsidiaries and third parties. Guarantees present one way in which those in control of a listed company can obtain private benefits of control or otherwise expropriate value from the company and its shareholders. The CSRC expects that, prior to application for listing, CSMEs have provisions in their articles of association that clearly lay down the limits on the authority to grant guarantees and a process for auditing compliance. As a mandatory

⁴⁸⁷ The Circular was pursuant to Article 21 of Company Law. See Guoli Liu, "Economic Development, Political Stability and Social Harmony: Can All Good Things Come Together?" in *China in Search of a Harmonious Society*, eds. Sujian Guo and Baogang Guo (Lanham, MD: Lexington Books, 2008): 414-415.

⁴⁸⁸ Paragraph 23 of ChiNext Measures.

⁴⁸⁹ Paragraph 15 and 16 of ChiNext Measures.

⁴⁹⁰ ChiNext Rule 9.1.

rule, controlling shareholders, de facto controllers and other controls must not have been granted or be granted guarantees that violate the law.⁴⁹¹

An examination of guarantees awarded to internal subsidiaries and external parties did not indicate a consistent trend in the rise or fall in guarantees. Instead, similar to RPTs discussed above, there again appears to be an odd trend in there being a fall in guarantees in one year and a rise in another, as illustrated in the Table 13.

Table 13: Percentage of companies disclosing an engaging in RPTs and issuing guarantees surveyed

| | 2009 | 2010 | 2011 |
|----------------------------------|-------------|-------------|-------------|
| | % | % | % |
| RPTs | 82.5 | 70.0 | 77.5 |
| Issued guarantees ⁴⁹² | 12.5 | 10.0 | 10.0 |

Source: Author's survey

Clearly, between 2009 and 2010, the number of companies issuing *any* guarantee fell by 40%, but then in 2011 there was a steep rise of 57.14%. On closer examination, of the surveyed companies, those CSMEs that issued guarantees in 2009 did not do so in 2010. However, the majority of those that had issued guarantees in the previous two years continued to issue, and in 2011 four companies added to the tally with first-time issue guarantees post IPO. For example, Huayi Bros' issue guarantees as and when the listed company's wholly owned subsidiaries require it for a broadcasting project, which only occurred in 2009 and 2011.

⁴⁹¹ Paragraph 23 of ChiNext Measures.

⁴⁹² Percentage of companies that issued guarantees to subsidiaries and third parties.

D. Insider Trading

The process of buying and selling shares was rife with insider trading behind the counter deals with no benchmark for corporate conduct on directors and officers.⁴⁹³ Taking a wider view, prosecution for insider trading and market manipulation has increased due to the legislative developments. In 1997, the Criminal Law first promulgated in 1979 was amended to recognise insider dealing and market manipulation as offences.⁴⁹⁴ A further corporate-governance-related amendment was made in 2006 that detailed further offences, including disclosure breaches, non-disclosure of major information and breach of trust and damage of a listed enterprise's interest, as well as leakage of insider information.⁴⁹⁵ These changes reflected the need for complementary criminal offences to reinforce the importance of corporate governance under the amended Company Law and Securities Law. The amendment of the Criminal Law demonstrated the gravity with which China's leaders would deal with anyone who compromises the economic ascension of China.

The ChiNext Rules particularly endeavour to deal with the problem of inside information leakage and also *guanxi*. Prior to any information disclosure, the directors and officers of the company, and insiders must minimise the scope of access to such information.⁴⁹⁶ The controlling shareholder and de facto controllers each have an obligation to maintain confidentiality.⁴⁹⁷ Moreover, to avoid the frequent instances when the controller

⁴⁹³ See, Hongming Cheng, "Insider Trading in China: The Case for the Chinese Securities Regulatory Commission," *Journal of Financial Crime* 15, no.2 (9 May, 2008): 165-78, doi:10.1108/13590790810866881.

⁴⁹⁴ Zhonghua Renming Gongheguo. The Law was first adopted by the Second Session of the Fifth National People's Congress on 1 July, 1979 and amended by the Fifth Session of the Eighth National People's Congress on 14 March 1997. The amended version entered into force 1 October, 1997. The Law has subsequently been amended by six times in December 1999, August 2001, December 2001, December 2002, February 2005 and June 2006.

⁴⁹⁵ Organisation for Economic Co-operation and Development and China Securities Regulatory Commission, *Corporate Governance of Listed Companies in China*. The CSRC has highlighted the importance of cracking down on insider trading. See China Securities Regulatory Commission, "Jiada chachu lidu yanda neimu jiaoyi [A Vigorous Crackdown on Insider Dealing]," *China Securities Regulatory Commission Official Bulletin*, no.11 (2010).

⁴⁹⁶ Rule 2.9 of ChiNext Rules.

⁴⁹⁷ Rule 2.10 ChiNext Rules.

is more powerful than the enforcing regulatory officer, the rule further requires that controllers must not only actively clarify any media report or rumour relating to it, but must do so with accuracy, hence, narrowing any leeway for ignoring or omitting to disclose matters relating to their interests in the company when pertinent. The ChiNext Rules also empower the Exchange to counter the persistent problems of the past, whereby participants in a company were politically more influential than the regulatory department.

Directors, supervisors and senior managers and anyone privy to insider information must ensure that the scope of people privy to such information remains limited.⁴⁹⁸ The same rule requires timely disclosure by the company (via the board secretary) once any subsequent leak, market rumour or unusual share movement occurs.

Initial funding for SMEs was scarce as banks were either riddled with bad debts or focused on the large SOEs. The rules were already inadequate for promoting better protection of minority shareholders and improved oversight by the board of directors in low-risk manufacturing ventures, not to mention potentially high-risk ventures. The common view remains that insider trading on Chinese equity markets is rife.⁴⁹⁹

The Exchange has been particularly focused on cracking down on insider information, with the passing of inside information within families, especially between spouses. This may be because they are easier to identify. The main sanction given for insider trading is a notice of criticism (*tongbao piping*).

⁴⁹⁸ Rule 2.9 of ChiNext Rules.

⁴⁹⁹ China Securities Regulatory Commission, “*Jiada chachu lidu yanda neimu jiaoyi* 加大查处力度 严打内幕交易 [A Vigorous Crackdown on Insider Dealing],” *China Securities Regulatory Commission Official Bulletin* no.11 (2010).

II. Reality Enforcement of Corporate Governance on ChiNext

As discussed in Chapter Two, the ChiNext framework attempts to deal with two general issues. One is to ensure optimum disclosure for an efficient and sustainable market. The other is the protection of small and medium-sized shareholders. As will be seen later in this chapter, enforcement action has focused on those activities deemed to undermine these objectives, in particular, false recording and insider dealing.

This section examines the key method used by the regulatory authorities to aid the monitoring and discovery of violations of corporate governance rules, or indeed monitoring RPTs and guarantees. Thus, the key objective of the ChiNext framework includes strengthening disclosure, deterring the expropriation of company assets, insider dealing, market manipulation and false accounting, as discussed below. Notably, the ChiNext framework does nothing toward increasing the direct liability of directors, senior managers, supervisors and controlling shareholders.

The CSRC has declared controlling shareholders and de facto controllers to be the key perpetrators of expropriation of company funds, and this has swayed their focus of regulation to permit listing and the regulation of listed companies on ChiNext.⁵⁰⁰ The Measures stipulate, as a pre-requisite for listing an internal control requirement, that issuing companies must rigorously (*yange*) manage their funds.⁵⁰¹ This is another provision that remains even after approval for listing. These laws work together with Accounting Law, Negotiable Instruments Law and Industry Accounting Regulations.

In carrying out enforcement on ChiNext, one key challenge for the CSRC remains that of obtaining information about the corporate governance practice of companies. That is,

⁵⁰⁰ For instance, the CSRC reported that listed company assets were expropriated by controller shareholders and de facto controllers of listed companies in 2001 amounted to just under US\$4 billion and reached a peak in 2003 at US\$7 billion. See China Securities Regulatory Commission, “*Zhongguo ziben shichang fazhan baogao* [Report on the Development of China’s Capital Markets].”

⁵⁰¹ Article 22 of the Measures.

discovering which companies to investigate or sanction for violations. Sources of information about company conduct to the CSRC include examination of the annual reports and announcement of companies, public whistleblowing (*jubao*) on the company or its constituents, employees, press tip-offs directly to the regulators and press exposés, as well as its surveys and investigations. The press facilitates a less formal sourcing of information, which better protects informants.

A. CSRC and Enforcement Tools on ChiNext

On ChiNext, the CSRC focuses most of its efforts on monitoring and supervising the internal corporate governance of companies listed on ChiNext. Before IPO, it does so through its Review Panel's approval and rejection of applications for listing. After IPO, its regional offices, through monitoring, inspection and investigation, ensure that internal corporate governance complies with regulations. Thus, on ChiNext, the CSRC takes on an anticipatory enforcement role. This role of pre-emptive intervention exists alongside its authority to enforce Company Law and Securities Law against companies in violation. The following sections outline the key methods of regulation and enforcement employed by the CSRC on ChiNext.

1. Approval and Rejection of Listing Applications

When applying for listing on ChiNext, in addition to complying with revenue and profit thresholds, companies need to display corporate governance compliance with Company Law and the Measures. However, the problem remains for the CSRC to reconcile the low business performance and corporate governance of companies listed on ChiNext, which is reflected in the Panel's decision, below.

Enforcement Decision/Action 1: Rejection of a listing application on ChiNext

Shanghai Haohai Biological Technology Co. Ltd. engages in the research, development, production, supply and sales of bio-pharmaceutical products. It applied for listing on ChiNext, but, on 28 September 2012, the IPO Review Panel announced that less than five of the panel members approved the application.⁵⁰²

The Panel refused the application because of potential future disputes arising from the ownership structure and its lack of independence (the occurrence of RPTs, as well as being in competition with its major customer). In its decision, the Panel noted two key issues. First, most of Haohai's business came from a company called Shanghai Qisheng Shengwu Corporation ('Shengwu'). In addition, three of the notable shareholders at Shengwu were also shareholders in Haohai. Second, a key material used in Haohai's production came from another company called Shandong Furui Da Shengwu Yiyao Corporation ('Furui'). However, Furui was also a key competitor of Haohai in certain product lines. In respect of each matter, the Panel decided, first, that the entangled relationship of shareholder and customer between Haohai and Shengwu would give rise to significant disputes in ownership and control rooted in pricing. In terms of Haohai and Furui, the competitive nature of their production lines would potentially put Haohai at risk since Furui is a key supplier. The relationships were such that the Panel believed they raised questions regarding the full extent of disclosures and explanations by Haohai. Therefore, the Panel rejected the application, basing its decision on paragraph 14 of the Measures.

The decision illustrates the full extent to which the CSRC holds corporate governance as important. It does so through the Panel's decision on corporate governance issues, notably not permitting listing for companies in which there may be a dispute amongst shareholders

⁵⁰² See ChiNext IPO Review Panel, "Guanyu Buyu Hezhun Shanghai Haohai Shengwu Keji Gufen Youxian Gongsi Shouci Gongkai Faxing Gupiao Bing Zai Chuangyeban Shangshi Shenqing de Jueding [Regarding the Refusal of Authorisation of Shanghai Haohai Biological Technology Limited's Application for the Initial Public Offer on ChiNext]" (2012): 1382. Government, *China Securities and Regulatory Commission*, (19 October, 2012), url: http://www.csrc.gov.cn/pub/zjhpublish/G00306202/cyb/201301/t20130109_220277.htm.

arising from RPT to the detriment of the company and other shareholders. It also reflects an agenda to track and keep in check potential cross-shareholdings in companies that have RPTs.

In terms of keeping relatively clean ownership structures, Chapter Three illustrated how the regulatory authorities have managed, with relative success, to keep the occurrence of complex pyramidal structures.⁵⁰³ More importantly, none of the sample private companies have cross-shareholdings. SOEs within the sample have SASAC as controlling shareholder or a representative SPV. One of the key reasons for this lack of cross-shareholding and the small number of corporate pyramidal structures may be attributed to the regulatory requirement that the companies be independent. This has some implications for the locating of this emerging type of private concentrated ownership, which does not appear to follow the orthodoxy of complex pyramidal ownership structures and cross-shareholding by listed companies. This is especially magnified in family-held companies. As stated earlier, one of the most effective mechanisms for the empowerment of shareholders is the market for control. It can be effective both in concentrated and dispersed ownership structures.

Recently, a survey of applications for IPO by an online financial news provider indicated the top ten recurrent reasons for rejection of an application by the IPO Review Panel. In order of frequency, they include unclear or disputable ownership structures, fluctuating company performance, over-dependence on a controlling shareholder, evidence of false accounting, immature business model or transformation, lack of innovativeness, investment attraction and longevity, unclear use of capital to be raised or lack of need for funding, fake issuer (company) or falsification of the scale of presence in the market or market share, incomplete disclosure or unrealistic research figures or serious whistleblowing

⁵⁰³ See Chapter Five, Section IV. Evaluative Summary on page 165.

matter by a competitor.⁵⁰⁴ Conclusively, over 50% of recurrent reasons for rejections directly relate to corporate governance matters.

The rejection and refusal of listing applications by far comprise the most common sanctions employed by the CSRC in relation to corporate governance violations of the Measures. The CSRC publishes its reasons for the rejection of applications for listings on its website. In doing so, it unequivocally portends the types of company that will be rejected (if not listed). Moreover, the publication of rejections also forms part of the general move toward increased transparency in the listings process. In August 2013, for the first time, the CSRC also published the total applications for the year. It included companies that had applications accepted, those under review, those rejected and those on the waiting list for review.

An analysis of the reasons for the rejection of applications suggests that corporate governance issues dominate. The CSRC rejects outright applications that do not meet the standards laid out in the Measures. There also appears to be room for some discretion as in some cases some companies' applications appear to meet the standard, but because of suspicious circumstances the IPO Review Panel rejects it. The number of companies rejected because of poor disclosure compared to other infractions is indicative of this strict approach. It suggests that, as well as company performance, the corporate governance practice of the companies plays a deciding factor in the success of the application process. The most common basis for rejection includes unclear or disputable ownership structures. Of particular

⁵⁰⁴ See, "25% *chuangyeban gongshi shangshiqian bei jubao* [25% of ChiNext Companies have Jubao Prior to Listing]," *Entrepreneur [Chuangyezhe]* (2011), url: <http://money.163.com/11/0412/16/71F0HP1G00252EEK.html>>.

note appears to be the wariness of the CSRC in permitting the listing of companies that already form part of listed or unlisted groups of companies.⁵⁰⁵

The CSRC remains keen to demonstrate the reasons for listing rejections more so in order to ensure that companies and their sponsors become aware that demonstration of good company performance is now a given requirement. However, corporate governance issues may cause a rejection of an application. Thus, through its IPO Review Panel, the CSRC plays a key role in corporate governance as a norm creator on ChiNext, crucially indicating what it deems as corporate governance irregularities that may not necessarily violate any law or rules per se. Through the application review process it creates further corporate governance norms not necessarily found in the Measures, Company Law or Securities Law.⁵⁰⁶ The publication of the companies applying for listing may also be seen as a direct response to criticism from the press and investors of the number and undesirable quality of companies that pass the application process.

a. Removal of IPO Application from Waiting List

The CSRC also ‘removes’ applications of companies from the waiting list before they come under review of the panel. Between January and June 2013, the CSRC removed 134 companies from the list before they reached the IPO Review Panel. However, no reasons are specified in the list regarding the removals, that is, removals by the CSRC or those voluntarily removed. In addition to removal from the list, the CSRC has authority to refuse to process a company’s documents if it decides that the company has violated one of its

⁵⁰⁵ For an insight into the CSRC’s general policy in discouraging backdoor listings that used to be the norm with SOEs, see “Chuangyeban Bu Zhichi Jieke Shangshi [ChiNext Does Not Encourage Backdoor Listings],” May 28, 2013, <http://www.ccstock.cn/chuangye/cybyaowen/2011-12-16/A654781.html>.

⁵⁰⁶ Indeed, to some extent some of these irregularities remain recognised flaws, in the legislation of which companies and their advisers seek to take advantage, for example, ownership structures that include the same shareholders as in the Haohai decision, page 256.

provisions. Thus, the removal of an application from the list does amount to the refusal to process an application for IPO on ChiNext.

b. Suspension and Withdrawal from IPO

The CSRC can suspend an approved IPO and has done so on ChiNext. The main issues that may lead to suspension include the discovery of contradictions or inaccuracies in the prospectus and listing applications or failure to amend a disclosure to reflect a dramatic change in a company's circumstances.

2. The Soft Approach: Opinions, Inspections, Investigations and Orders

On ChiNext, during the year, CSRC local offices carry out surveys and onsite spot inspections of company books and corporate conduct. The audits and spot inspections sometimes result in correction orders being issued. Whether or not these correction orders amount to formal remonstrations remains unclear. Indeed, only a few companies disclosed these correction orders in their annual reports under actions by the regulatory authority. Disclosure appears to depend on the gravity of the corrections required and whether the CSRC indicates a requirement to publish in any order it issues, which it can.

With the rising importance of corporate governance as a state policy, the CSRC must demonstrate to the State Council its success in fulfilling its role in not only developing the securities markets but also protecting shareholders, the majority of whom remain individual local Chinese. The CSRC also uses these surveys to gather information about compliance used in producing reports to the government on the actions it has taken and its success in the protection of shareholders. Nonetheless, the CSRC must balance protecting shareholders with ensuring that ChiNext companies have leeway to undertake the business that allowed them to be the chosen few to be listed on the Exchange. This may be a reason for the emphasis on

using soft enforcement tools. This sense of responsibility feeds through to the CSRC local offices that carry out the surveys and investigations, as well as disciplinary actions against companies registered in their regions. The table below details the number of self-investigations disclosed by the first 40 companies listed on ChiNext.

Table 14: (Self) investigations imposed by CSRC on ChiNext companies as disclosed in annual reports of surveyed companies

| | 2009 | 2010 | 2011 |
|---------|---------------------------------|------|------|
| Source: | Number of investigations | | |
| | 0 | 10 | 2 |

*author's survey*⁵⁰⁷

In 2010, the CSRC local offices carried out ten surveys and three onsite investigations. All were issued correction orders with all pertaining to corporate governance 'irregularities'. Although the CSRC correction orders remain undisclosed, CSMEs (and other listed companies) are obliged to disclose all CSRC actions, including remedial actions by the company in the annual report. The results of corrective orders published by companies include those relating to ownership structure, the use of cumulative voting at shareholders' meetings and attendance of independent directors at both board and shareholder meetings.

Each office monitors and supervises all companies domiciled in their regions and this includes the issue of notices of self-inspection, (paper) audits and onsite investigations and the implementation of sanctions against companies domiciled in their region.

CSRC Enforcement - Notice of Onsite Inspection

For example, on 12 May 2011, the CSRC Supervisory and Administrative Section Jiangsu office issued a Notice of Onsite Inspection to Wuxi Boton Belt Co. Ltd. ('Boton'). On 18 May 2011, less than a week after the notice, CSRC Jiangsu visited the offices of Boton,

⁵⁰⁷ Information from review of ChiNext company disclosures of surveys and correction orders from the internet.

which resulted in the issue of a rectification opinion to the company and an undertaking by the board of directors as a whole, supervisors and senior management to study and implement the remedial opinions.⁵⁰⁸ From the disclosure made by Boton to confirm its compliance with the correction order, clearly the scope of the inspection focused mainly on corporate governance issues. The approach equals the process of a review of a listing application. It included inspection of Boton's internal controls, the system for independent director's annual reports on their work, the formulation of an audit committee and terms of reference, corporate governance status quo, information disclosure, shareholdings of directors, supervisors and senior management, the previous year's business performance, the system for personnel privy to inside information, the establishment of responsibility for serious errors in annual reports and its implementation, capital funding and surplus capital funding situation and the company's ability to adapt to changes in the market.

a. Supervisory Opinions and Correction Orders

CSRC local offices issue supervisory opinions⁵⁰⁹ (*jianguan yijian*) and correction orders (*zhenggai yijian*) to companies registered within their jurisdictions. Supervisory opinions require remedial action or disclosure on specific aspects of a company's corporate governance practice. These opinions state, in unequivocal terms, the problems found and give the company a directive and period of time in which to correct them. However, the CSRC rarely announces the details of correction and supervisory orders. Nonetheless, listed companies are obliged to publish any remedial actions undertaken to comply with them, or recommendations, as is more often the case. Issued by CSRC local offices, correction and supervisory orders may result in an investigation.

⁵⁰⁸ The issue of recommendations by external auditors to a company's management seems the closest analogy, the difference here being that management has no choice but to concede and implement as a matter of regulation whether or not they agree. Again this remains an area that lacks transparency.

⁵⁰⁹ Also referred to as a supervisory order.

An order of self-inspection (*zicha*) often precedes an onsite inspection by the CSRC. The relevant local office of the CSRC first notifies the company of a spot check or survey, which tends to be carried out within a week. The notification contains details of the aspects of corporate governance that are subject to spot checking. In essence, this amounts to completing a survey-type questionnaire, the responses to which are then published to the market.⁵¹⁰ The CSRC rarely publishes the correction orders or supervisory opinions; however, companies are obliged to publicly disclose their responses to the questionnaires. It remains unclear why the CSRC does not publish the orders but rather leaves this to the company to disclose in a ‘correction implementation report’, or, less obviously by the disclosed board, resolutions regarding corrections made pursuant to a CSRC correction order or supervisory opinion.

b. Surveys

Surveys tend to have 20 to 40 questions on various corporate governance matters, including ownership structure and implementation of cumulative voting. The surveys tend to be randomly issued to various companies. These surveys perform three functions. One function is that it allows the CSRC to less labour-intensively monitor internal governance and to pre-empt violations, in pursuance of its duty to protect investors. It also enables the CSRC to glean information on the compliance of companies with not only mandatory laws and regulations but also best practice, which the CSRC wishes to promote. Lastly, the information from the survey also forms the basis of reports by the CSRC to the State Council regarding its own function and achievement in terms of corporate governance.

⁵¹⁰ This may be the closest to comply or explain because, once explained, the CSRC does make its recommendations, which may be to urge the company to comply regardless of their explanation.

In 2010, the CSRC used a random survey to assess the level of corporate governance compliance in ChiNext companies. It was a corporate governance survey for which all ChiNext companies were required to supply information. The results of the survey also culminated in further investigations where there was indication of irregular corporate governance practices. Investigations have always, in theory, being a mainstay of administrative enforcement. During 2010, the local offices of the CSRC each carried out ad hoc investigations of ChiNext companies registered in their jurisdictions. These investigations were a result of a combination of spot checks or were based on information, for instance, from the survey and complaints (*jubao*) by shareholders and stakeholders. Between 31 December 2009 and 31 December 2011, 12 companies were subjected to ad hoc investigation by presiding local offices of the CSRC. The form of investigation is similar in structure to the IPO review process. In all of the investigations, remedial reports (*gaizheng baogao*) were issued. The dramatic fall to only two⁵¹¹ indicates that the ad hoc investigations were perhaps more planned and based on information about each company's internal governance. Equally, it may simply indicate an overall improvement.

3. The Hard Approach: Fines, Suspensions and Bans

a. Fines

The CSRC plays an active role in meting out fines to companies and individuals pursuant to article 193 of Securities Law. Fines for companies range from RMB 300,000 to RMB 600,000 (GBP 30,000 to GBP 60,000), while for individuals it ranges from RMB 30,000 to RMB 300,000 (GBP 3,000 to GBP 30,000). The CSRC rarely imposes fines on its own. They tend to issue a warning along with a fine.

⁵¹¹ See, Table 14: (Self) investigations imposed by CSRC on ChiNext companies as disclosed in annual reports of surveyed companies on page 261.

Enforcement Action - CSRC Fine

As of December 2012, the management and sponsor or only one company on ChiNext have been fined by the CSRC and they received the maximum punishment as a warning against the falsification of records. Wanfu Biotechnology (Hunan) Agricultural Development Co. Ltd. is principally engaged in the research, development, production and sales of rice deep-processing products, and remains the only company that the Exchange has referred to the CSRC for further sanctions, having already being issued two public condemnations and one notice of public criticism by the Exchange. This time, the CSRC issued fines and bans on the sponsor, Ping'an, and its representatives. The CSRC fined Ping'an double the sum of the professional fees it made from the IPO of the company, that is, RMB 25,550,000. It further issued a warning and fined Ping'an's three representatives the maximum fines under Securities Law of RMB 300,000, and revoked their eligibility to trade in the securities market and their eligibility to represent a sponsor, as well as issuing lifetime bans for engaging in the securities-related profession. The Exchange issued a warning to Ping'an Securities, withheld its listing fees payment of RMB 25.5m due from Wanfukesheng, imposed a double fine, and a three-month suspension of Ping'an's license to be a sponsor. Ping'an's representatives, those responsible for the relationship with Wanfukesheng, and key personnel were each fined RMB 300k. They each also had their eligibility as representatives of sponsors cancelled and their licenses to engage in the securities market cancelled, in addition to lifetime bans from China's equity markets. The personnel of the sponsor who assisted in the IPO of Ping'an did not avoid punishment as they were issued warnings, a RMB 100k fine and cancellation of their securities eligibility.

b. Suspension and Banning from Capital Markets

The banning of an individual symbolises the severest sanction as the ban does not only relate to the market in which the violation was committed but pervasively China's capital markets as a whole. Increasingly, the CSRC bans individuals in relation to their corporate governance violations and not only in relation to general Securities Law infractions such as fraud. Under article 233 of Securities Law, the CSRC has authority to ban individuals from involvement in activities related to the stock market or from being a director, supervisor or senior manager of a listed company. So far, on ChiNext, there has been only one reported case of the banning of an individual by the CSRC, and that was the ban of the controlling shareholder and chairman/Chief Executive of Wanfukesheng.⁵¹² A ban tends to be imposed when the violation involves large sums of money, continuous denial by the accused or persistent offending by the individual. Thus, the CSRC tends to look not only at the seriousness of the consequences of the violation but also the culpability of the accused. It acknowledges that many investors and participants in the stock market in China may not be aware of the law or may just be naïve, which is evidenced by the numerous initiatives being taken to educate investors as well as the senior management of ChiNext companies. The issue of self-regulation notices to companies may not appear to be a serious sanction; however, by virtue of the fact they are issued by the CSRC (local office) makes it a serious sanction. Any subsequent investigation and finding of culpability means that the sanction of banning or court proceedings may be imposed against the company or its personnel. A ban by the CSRC can be appealed or challenged by judicial review under China's Administrative Law. However, it remains unlikely as companies do not like court cases because of the expense. Moreover, the CSRC's decisions are rarely challenged by judicial review. A review of bans

⁵¹² See, CSRC, "Zhongguo Zhengjianhui Shichang Jinru Juedingshu (Yi Shengze) [CSRC Decision to Ban from Capital Markets (Yi Shengze)]," Official, *China Securities and Regulatory Commission (CSRC)*, (31 July, 2012), url: http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201211/t20121119_217020.htm.

suggests that the most frequent tenures for bans include three, five, eight and ten years. The bans do not pertain to just one market but to all of China's capital markets in any senior management or advisory capacity. Bans, therefore, rank as the highest sanction against an individual, and are perhaps worse than civil litigation, which may not necessarily result in a ban. No punishment other than a warning accompanies a ban, unless a disgorgement is made or an account for profit is requested.

Before an individual can be a participant in China's capital markets, they must undergo the approval process of the CSRC, which then publishes the results on its website. Although the CSRC does reject individuals, there is no clear indication of the numbers or which companies, and the stock exchange to which their applications related. Thus, it remains unclear whether any potential participants in the ChiNext market have been rejected.

This section has demonstrated that the CSRC focuses on and directly intervenes at company level in regulating the internal corporate governance of companies. It also tends to emphasise a soft line approach, using its monitoring and supervisory powers rather than sanctioning and disciplining.

4. Challenges of the CSRC

Increased expertise and streamlined running of capital markets in China remains a key challenge of the CSRC. It has been acknowledged that a previous lack of expertise and immaturity of the market resulted in a chaotic state.⁵¹³ As early as 1992, in one of its reports, the State Council admitted this failing and demanded improvements in expertise.⁵¹⁴ Although the national stock exchanges were established in 1991, it was only in March 1998 that the last

⁵¹³ China Securities Regulatory Commission, *Zhongguo ziben shichang fazhan baogao [Report on the Development of China's Capital Markets]* (Beijing: China Securities Regulatory Commission, 2008), <http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/ebook/P020090315493496092493.pdf>.

⁵¹⁴ See State Council, "Guowuyuan guanyu jinyibu jiaqiang zhengquan shichang [Notice on Improving on Strengthening of the Holistic Administration of Capital Markets]," *Falu tushuguan [Law Library]*, (17 December, 1992), url: http://www.law-lib.com/law/law_view.asp?id=55541.

vestiges of ‘independent’, ‘local government’ and ‘informal’ unauthorised exchanges engaged in the trading of unlisted companies and considerable assets was finally effected.⁵¹⁵ In those days, corporate governance still did not figure as an aspect of stock market regulation. Over a decade later, there appeared little improvement in 2004 when the State Council demanded it.⁵¹⁶ However, by this time, corporate governance had become a fixture on the regulatory agenda, and the CSRC had gradually re-built its reputation. Thus, it takes violations that potentially also bring it into disrepute very seriously.

The CSRC has had a number of scandals associated with its Listing Review Panel, the most damaging being that of the Xin Dadi scandal that resulted in the suspension of listing for ten months while the CSRC investigated not only the company and its advisers but also the IPO Review Panel. Xin Dadi Shengwu Keji Ltd. was the first company that was discovered to have obtained listing based on false disclosures. The media played a key investigative role, affecting the length of the suspension of trading and the resultant purge of the IPO Review Panel members, and, crucially, a new policy of increasing the participation of external experts on the panel. Indeed, one of the main aims of the ChiNext framework is to increase regulatory expertise. This is done in two ways. The CSRC has increased the number of its personnel who are experts not only in regulation but also in the various industries that ChiNext companies fall within. This better positions them to assess the merits of IPO applications as well as post IPO performance. Indeed, as illustrated in Chapter Six on enforcement, the CSRC and the Exchange may decide and subject some companies to the same level of assessments and review used during the pre-IPO process, and take action

⁵¹⁵ See The Plan to Consolidate and Restructure the Unregulated Stock Trading Markets 1998 and The Plan to Consolidate and Liquidate the Securities Trading Centres 1998. See China Securities Regulatory Commission, “*Zhongguo ziben shichang fazhan baogao* [Report on the Development of China’s Capital Markets]”: 168.

⁵¹⁶ China State Council, “*Guowuyuan guanyu tuijin zibenshichang gaige kaifang he wending fazhan de ruogan yijian* [Guiding Opinion of the State Council on Promoting the Reform and Opening Up and Stable Development of Capital Markets],” Legal news, *Falu tushuguan* [Law Library], (31 January, 2004), url: http://www.gov.cn/gongbao/content/2004/content_63148.htm.

against them where the listed companies have failed. Suzhou Greenwood is an extreme example and, arguably, a scapegoat as it was effectively delisted by revocation of its listing license. This approach aims to combat the problem of packaged companies, but obviously failed to some extent as demonstrated by the Xin Dadi scandal. It does, however, attempt to allay concerns, especially the constant clamouring in the financial media. Hence, the increasing transparency of the CSRC and the Exchange in relation to the actions and sanctions against companies in violation of the ChiNext framework, Company Law, Securities Law and other corporate governance rules and standards. However, there has been some opposition. Shenzhen Venture Capital Association president, Wang Shouren, argues that the audit requirements in preparation for IPO are too onerous and believes the real focus should be on whether a company has continued innovation, growth and standardised internal governance. If it does not, then the delisting regime should be swift in getting rid of such companies.⁵¹⁷

The CSRC has also become more sensitive and reactive to financial media reports and public opinion, clearly reflected in the speed with which it reacts to criticism scandals. A key area has been the increase in transparency keenly directed at countering criticism, especially from the press, regarding the quality of companies being listed. A prominent corporate governance activist magazine reported that the IPO Review Panel, on average, approved over 80% of applications made to the CSRC, which it believed contributed to the high number of underperforming companies. This thereby implied that the policy considerations in promoting ChiNext as a market precede the protection of shareholders. Of course, the CSRC, without choice, took three actions to counterclaim that policy consideration rather than investor protection took precedence. Firstly, it now publishes the list of companies applying for listing

⁵¹⁷ Xinhua Guangzhou, “‘Sangao’ yousuo ‘tuishao’ - Chuangyeban qidai baituo zijin tuidong xing sanhu shichang [‘The Three Highs’ somewhat the ‘Recedes Fever’ - ChiNext Expects to be Rid of its Capital Funding Style Retail Market],” Government News, *Xin Hua*, (23 October, 2012), url: http://www.gd.xinhuanet.com/newscenter/2012-10/24/c_113471199.htm.

in a given period, noting the reasons for rejections. Secondly, it published advice reminding and encouraging investors to be better advised and aware of investment risks and be prepared for losses. Finally, the CSRC has increased the basic eligibility qualification of people who can partake in investment on ChiNext. They have to sit a short test before they can open a trading account.

5. Issue of Uniformity in Enforcement

The CSRC local offices carry the brunt of enforcement of corporate governance norms set out by the CSRC. There does not appear to be any specific uniformity in the survey or spot inspection initiatives by the CSRC. A review of the remedial reports published by companies suggests that the local offices initiate and dictate the surveys and spot inspections of companies that belong to their regions. The differences in the use of the law, regulations and rules used in issuance of correction orders for a spot inspection suggest that these enforcement initiatives are not directives from the main CSRC.

As identified earlier, a key problem with disclosures and their enforcement remains the lack of uniformity, which ultimately can only cause uncertainty. Only the surveys of 2010 and 2011 appear uniform. It remains unclear as to how this lack of uniformity in the citation of rules affects the implementation of corporate governance, if it does so at all. Significantly, it demonstrates the relative autonomy of the CSRC offices at local level. It also indicates a certain measure of discretion from the local offices.⁵¹⁸ Some commentators believe that not enough has been done to increase the profile of corporate governance, which they perceive as both an important and sensitive aspect of China's capital markets.⁵¹⁹

⁵¹⁸ There exists literature that illustrates the potential of enforcement discretion at local level that influences regional difference in the levels of compliance with corporate governance laws and rules.

⁵¹⁹ See Hu Ningfei, "*Shangshigongsi dongshihui zhili bibing* [Corporate Governance Malpractice of the Board of Directors of Listed Companies - An Interview with Shanghai Stock Exchange Head of Research Centre, Hu Ruying]." (Hu Ruying believes that concentrated ownership, the legacy of yesteryears, intermediaries taking

B. Role of Shenzhen Stock Exchange

As suggested earlier, on ChiNext the Exchange takes on a more punitive role in dealing with corporate governance infractions of companies and individuals on ChiNext than the CSRC. The Exchange plays a dual role on ChiNext as both a watchdog and punisher of companies that transgress, their internal governance structures, controlling shareholders and advisers. The next sections examine the key tools availed by the Exchange in enforcing the ChiNext framework.

1. Issue, Suspension and Revocation of Listing License

The Exchange does not have unilateral authority to delist a company. However, it can summarily suspend or revoke a listing license. Company Law and Securities Law provide for delisting rules; however, the detail is left to the CSRC. Indeed, the first effective delisting of a company on ChiNext was through a revocation of its listing licence rather than through a listing regime initially. However, a detailed delisting regime was only introduced in January 2011. There has been no delisting since its introduction. Perhaps this testifies better compliance by ChiNext companies, or, cynically, only that companies have many ‘second chances’ to improve. In a calculated effort to give listing companies and their advisers a reminder of the robustness, the Exchange summarily revoked the listing licence of Suzhou Goldengreen Technologies Ltd. due to key disclosure failures. Article 26 bestows the CSRC with authority to cancel or suspend listing where it is discovered that the issuer has not complied with the law and legal process.⁵²⁰ Examined below is the first and only company that has had its listing cancelled by the Exchange for lack of disclosure, which, depending on

short positions, i.e., voting with their feet rather than their hands, and general cultural on the stock market hamper corporate governance.) See also Cui Qinzhi, “*Dui Woguo Gongsizhili Jiegou de Fali Fenxi* [A Jurisprudential Analysis of the Corporate Governance Structure of China],” Government, *Zhongguo Faxuewang*, (19 January, 2006), url: <http://www.iolaw.org.cn/showArticle.asp?id=1239>. (Calling for greater scrutiny of controlling shareholder powers and the protection of minority shareholders.)

⁵²⁰ Article 26 of Securities Law.

one's perspective, may or may not amount to a corporate governance issue; it does for the purpose of this thesis.

Case study 9: Suzhou Goldengreen Technologies Ltd.

On 26 February 2010, Suzhou Goldengreen Technologies Ltd. ('Goldengreen') received its final approval for listing from the CSRC. On 18 March, Goldengreen made disclosures to the market regarding the legal status of five existing patents and two applications regarding its core technology. However, the disclosures proved false because, on 24 February, just before IPO, the State Intellectual Patent Office had notified Goldengreen that four of its five patents were revoked. These patents were not only used in all of Goldengreen's product but encompassed the company's uniqueness. Initially, the sponsors of Goldengreen were asked by the CSRC to investigate. As a result of a media tip-off and an ad hoc spot check by the regulators on 11 June, the CSRC ChiNext Issuing Audit Committee ('CCIAC') commenced a retrospective due diligence exercise of Goldengreen's IPO application. The committee found two issues. Firstly, the five patents and two pending patents' legal statuses were not true. Secondly, most of Goldengreen's products used four of the terminated patents, while 50% used the fifth patent. The decision of the committee on 13 June encompassed two aspects: one related solely to the company while the other related to intermediaries. Indeed, it transpired that Goldengreen assumed that, once listed, it was able to convince the patents authority to reinstate the revoked patents. However, clearly, between 24 February and the CSRC investigation on 11 June it failed to do so. In terms of corporate governance, the independent directors were only appointed to the board on 8 March 2009. As there were only so many board meetings they were undoubtedly handicapped in knowing about the problem. Moreover, the revocation of patents may not have been a matter they were likely to know about as this is an operational matter.

Goldengreen had its listing license withdrawn with directions to reimburse investors the issue price plus interest in accordance with Securities Law. Thus, the company

reimbursed investors RMB 20 million at the IPO price of RMB 20,080. Those responsible for signing the prospectus were subjected to supervision by the CSRC, which included attending supervisory talks (*jianguan tanhua*) and putting up warning notices (*chushi jinshi*) about them. In addition, the CSRC banned each person from signing or taking part in an IPO for 12 months. Although short, the ban signified a loss of reputation. In terms of the intermediaries, the lawyers, the firm and its representative lawyers were sanctioned to attend supervisory talks and warning notices about them were issued. They were also banned from engaging in IPO activities for 12 months. The CSRC committee's decision to cancel Goldengreen's listing was in accordance with article 26 of Securities Law.

Goldengreen raises many issues relevant to this chapter. It raises issues not only about disclosing but about the quality of disclosure. Here, Goldengreen did not expressly deceive regarding the current legal status of the patent, but it did so implicitly. Equally, the fact that this implicit deception was caught by the media rather than the CSRC committee raises questions about the CSRC's level of expertise and comprehensive nature of due diligence pre-IPO. Another issue relates to achieving a balance between performance and good governance in companies seeking a ChiNext listing. Sometimes the overemphasis on company performance can be to the detriment of companies with good governance. But the new listing regime indicates that a balance will be drawn in that, once a company has good corporate governance, delisting may be avoided by ensuring minimal performance. However, no matter how well a company may perform it may still be delisted where it has three public criticisms imposed within a 36 month period. In terms of enforcement, Goldengreen demonstrates stricter enforcement than any exchange. Indeed, it is only the third company to ever have its listing license withdrawn. Other issues pertain to the role of the board and other members of senior management in ensuring good governance. It was the media that originally revealed the inconsistencies in Goldengreen's disclosures and which prompted the CSRC to

take action. The due diligence exercise by the CSRC demonstrates the increase in both professional and specialist advisers. Commentators such as Zhao Chunhua noted in the Securities Daily that the CSRC's dealing with Goldengreen demonstrates a determination to protect the legal rights of investors and the principle of the strict supervision of companies.

Based on the detailed listing regime in operation on ChiNext, it may be argued that the delisting of Goldengreen may have been an excessive response in its arbitrary and perhaps too speedy revocation of the listing license. Alternatively, it may be that the response to Goldengreen remains proportionate, the problem being that the new delisting regime has less bite and overly extends a process of exit that needs to be swift and uncompromising for those in violation of the laws and rules. It may have less bite because ChiNext, after all, amounts to the Chinese government's policy of promoting domestic industry and consumption in which delisting needs to be avoided unless the company's continuous floating on the market becomes indefensible.

2. Soft Approach: 'Greetings' and 'Admonishment' Telephone Calls

The CSRC takes a 'paternal' and coercive approach to enforcement by encouraging companies to take responsibility for their own corporate governance performance.

Administrative actions include the so-called 'greetings' telephone calls (*wenhoudianhua*) and admonishment calls (*quanjie dianhua*). Greetings telephone calls, in practice, involve the CSRC central or local offices telephoning to check on the company with no particular purpose in mind but to raise awareness that the regulator continues to monitor even after IPO. Key contacts for the regulators include the legal representatives, executive directors, and board secretaries and securities representatives of companies or whoever is identified as such by the regulator. Greetings calls may include conversation updates on the internal governance of the company post IPO. The first call amounts to an enquiry but the

second becomes a warning. In contrast, admonishment calls specifically demand a certain conduct. This type of inquiry by the CSRC dictates whether the central or local offices make the next call. The CSRC central office does not only call listed companies but also other participants in the market, including advisers and investors. CSRC local offices narrowly focus on companies listed on ChiNext.

Both greetings and admonishment calls are not well received by some market participants. They consider these telephone calls to be theatrical and predict that they will become unsustainable as the number of companies on ChiNext increases. One of Shenzhen Stock Exchange's large account holders revealed that even before 3 November 2009, the first day of trading of ChiNext, several investors received greetings calls from the Exchange in which it was stated that purchases of new shares should not exceed 10,000 shares. Those that went over this number of purchases received admonishment calls.⁵²¹

These calls demonstrate the adoption of a pragmatic company-specific approach by the CSRC borne of a realisation that the companies, especially newly listed companies, cannot be left on their own. Although time and resource intensive, this approach perhaps drives the lower than expected number of sanctioned companies and illustrates the success of a pragmatic company-specific approach to regulation.

However, this criticism may be too harsh and does take into consideration that such calls are made by the CSRC local office. Moreover, the call facilitates the creation of a more positive and interactive relationship between the company and the regulators. This becomes a particularly important relationship given the cynicism that private individuals, who now head these companies, have for officialdom. These telephone calls also complement the principle of self-regulation whereby companies can, for instance, request the temporary suspension of

⁵²¹ For an account of the different types of disciplinary telephone call, see Kuang Zhiyong, "*Chuangyeban Chaozuo de 'Miaoshu Youxi' Chufa Jieshi Yuelaiyue Yan* [The ChiNext 'Cat and Mouse' Hype: More Rigorous Measures]," *First Financial Daily (Shanghai)*, (31 December, 2009), url: <http://money.163.com/09/1231/02/5RR24J2F00253B0H.html>.

trading in the company's shares. The regional offices of the CSRC implement the pragmatic company-specific approach to regulation.

The next step up from an admonishment call becomes the correction order and supervisory order, from which the resulting corrective actions must be published by CSMEs. These are further discussed under reputational sanctions in the next section.

3. Hard Approach: Public Condemnation and Notice of Public Criticism

Public condemnation remains the strongest sanction against a company, other than suspension and delisting from the market, or other than a ban against a person. However, the CSRC make less use of public condemnations. As will be demonstrated further, the use of such enforcement has increasingly become the purview of the Exchange under its self-regulatory powers. The CSRC reprimands but uses lower sanctions such as warnings, mostly verbal. Except for serious violations of Company Law or Securities Law, the regulator appears to have developed more of a company-level supervisory role through its local offices.

a. Notice of Public Criticism

The Exchange issued four notices of criticism for insider dealing and dealing within prohibited trading periods between 2009 and 2012. Examples of the types of infraction that occurred on ChiNext are as follows:

Trading in a Prohibited Period

On 7 March 2012, the Exchange issued Gu Zhenqi, a director of Staidson (Beijing) Biopharmaceuticals Co. Ltd. (300204), with a notice of public criticism because of his violation of dealing in the company's shares during prohibited trading periods by directors, supervisors, senior management of the company and their spouses. In this case, the decision was based on finding a violation of paragraph 3.7.13 of the ChiNext Operational Standards.

On 6 January 2012, Staidson announced that performance had substantially improved, with projected net profits increasing by 70-90%. That same day, without his knowledge, Gu's wife bought 4,300 at RMB 56.86 per share of the company's shares. Crucially, the night before, Gu had happened to shared price-sensitive information with his wife, particularly stating that the company's results were better than 2011, and so amounted to a good investment. The public criticism issued pursuant to rule 17.3 of the ChiNext Rules does not facilitate an account for profits. Nonetheless, under Company Law, the company and board of directors must disgorge the offender of any profit made, that is, the difference between the purchase and any gain made. As such, Staidson and its board of directors had a duty to ensure that Gu accounted for any profits to the company. Notice of criticisms are publicised with a summary of decisions on the ChiNext pages of the Shenzhen Stock Exchange website.

In another example, the Exchange issued Bai Li, a member of the supervisory board of Liaoning Julong Financial Equipment Corp. (300202), with a notice of criticism because her husband traded during a prohibited period. The published decision did not mention whether she had knowledge; however, Bai was also found to be in breach of her duties to comply, including fiduciary and due diligence duties,⁵²² which was not so in Gu's case. Her duty here was to ensure that she and her spouse were aware of the trading prohibitions and comply with them.

Dealing in Breach of the 25% of Shareholding per Annum Rule

A breach of a covenant, for instance, expressed in a company's listing prospectus may also result in the issue of a notice of criticism and the entering of name(s) onto the *dang'an* ('performance and attitude record'). Thus, earlier, on 17 January 2012, the Exchange issued Guo Shen, a director of Lanzhou Haimo Technologies Co. Ltd., with a notice of public

⁵²² Rule 3.1.5 of ChiNext Rules.

criticism for failure to comply in good faith and due diligence with ChiNext laws and rules.⁵²³

In this instance, Guo was found to be in breach because he had exceeded the 25% per year limit for directors wishing to deal in shares they hold in the company. Guo held 7.37% of shares directly and another 8.40% through a SPV, with an aggregate holding of 15.77%. Between 20 May and 5 September 2011, the SPV sold shares in the company but the aggregate sale amounted to more than 25% of Guo's aggregate holding, and was, therefore, in breach of the ChiNext Rules.

The cases above demonstrate the Exchange's focus on ensuring that management in companies and their families comply with the ChiNext Listing Rules.

b. Public Condemnation

Public condemnation⁵²⁴ as an enforcement tool of the Stock Exchanges in China has been in existence since 1999. However, only ChiNext has formulated specific rules on its application. During the period 2009 to 2012, only five public condemnations were issued. They either related to illegal RPTs or the publication of false information and records, which demonstrates the severity with which such violations will be dealt.

Illegal Related Party Transaction

In one of the first investigations by the Exchange, a public condemnation was imposed for three counts of illegal RPTs.

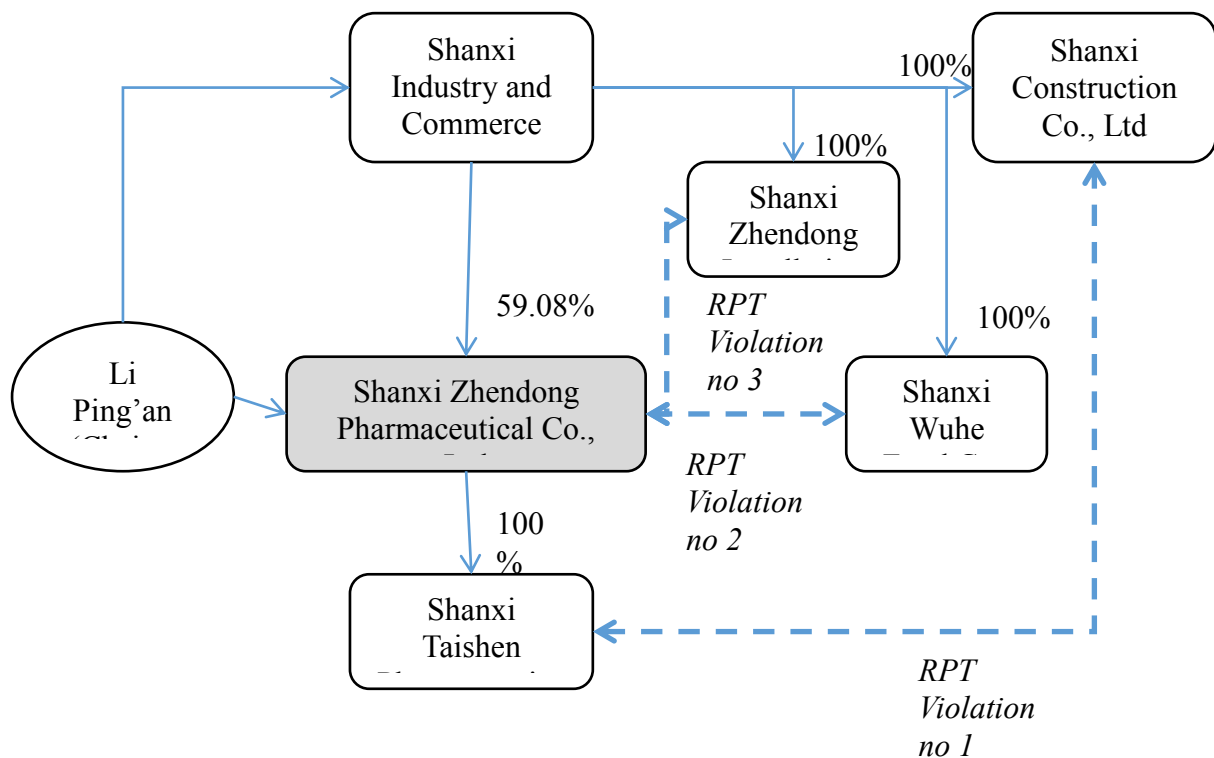
⁵²³ Rule 1.4 of ChiNext Rules.

⁵²⁴ In this thesis, 'public condemnation' is preferred to 'public criticism'. Firstly, 'condemnation' is closer to the semantic and translation than 'criticism' (*piping*) in the Chinese language, with the latter holding less force. Secondly, public condemnation as an enforcement tool has a higher reputational impact than the word 'criticism' implies in the ChiNext Rules and the Public Condemnation Rules themselves. This approach contrasts with Liebman and Milhaupt's translation of the term *gongkai qianze* because they reflect the reputational effects of using them. See Liebman and Milhaupt, "Reputational Sanctions in China's Securities Market," (1 May, 2008): 947 at fn. 66.

As illustrated in the figure below, the first violation arose when Zhendong Pharmaceutical Co. Ltd. ('Zhendong Pharmaceutical'), through its wholly owned subsidiary Shanxi Taishen Pharmaceutical Co. Ltd. ('Taishen'), entered into a car manufacturing contract with Shanxi Construction Co. Ltd. ('Construction'), a wholly owned subsidiary of Shanxi Industry and Commerce Co. Ltd ('Industry and Commerce'), which, in turn, is the controlling shareholder of Zhendong Pharmaceutical, holding 59.08% of total issued shares. Crucially, Taishen paid Construction RMB 107.6m, of which a deliberate overpayment of RMB 30m was included; this is identified as 'violation 1' in the diagram below. Construction only reimbursed this overpayment in April 2012.⁵²⁵ The second violation also occurred in 2011; this time, Zhendong Pharmaceutical entered into what would have been a regular (as opposed to illegal) RPT with Shanxi Wuhe Health Products Co. ('Wuhe') to the value of RMB 291,600, but, in fact, Zhendong Pharmaceutical paid Wuhe RMB 6.5m. The Exchange concluded that, even when objectively taking into consideration the debts (based on the end of term value, so including interest) owed by Zhendong Pharmaceutical to its controlling shareholder, Industry and Commerce, the RPT still amounted to an appropriation of RMB 3.836m. The final violation, again in 2011, was similar to the preceding transaction, except that Zhendong Pharmaceutical entered into a contract with Shanxi Zhendong Installation Co. Ltd., another wholly owned subsidiary of Industry and Commerce, and paid it RMB 8.343m for goods.

Figure 14: Illegal RPTs by Shanxi Zhendong Pharmaceutical Co. Ltd.

⁵²⁵ The published Shenzhen Stock Exchange decision on its website does not give the exact date of the initial infringement only when the monies were repaid. But it is fair to say at least four months elapsed before repayment.



Source: Author's impression

The Exchange decided against each of the parties separately and also awarded separate public condemnations to Shanxi Zhendong Pharmaceutical Co. Ltd. ('Zhendong Pharmaceutical') listed on ChiNext: its chairman and de facto controller, Li Ping'an; its director and chairman of Shanxi Taishen Pharmaceutical Co. Ltd., its wholly owned subsidiary, Liu Anping; its company secretary and head of finance, Tai Zhengguo; one of its independent directors, Chen Qun; and another head of finance, Zhao Yanhong.

The company was found to be in breach of violation on all counts paragraph 1 of the Notice Concerning Some Issues on Regulating the Funds between Listed Companies and Associated Parties and Listed Companies' Provision of Guaranty to Other Parties, which in summary prohibits a wide range of transactions between listed companies, their controlling shareholders and related parties. It also gives the regulator discretion to decide a breach. The company was further found to be in breach of rule 4.1 of the ChiNext Rules for failing in its duty to act in good faith and with due diligence in complying with the relevant laws and rules.

It was also in breach of both paragraph 6.9 of the ChiNext Guide to Operational Standards ('ChiNext Operational Standards') detailing provision for the true and fair use of company funds, and paragraph 7.3.9 detailing provision for the board of directors to take legal action, protect property and take measures to either avoid or minimise loss to the company arising from RPTs misappropriation or transfer of company funds or other resources causing loss or likely to cause damage to the company. The Exchange also issued the controlling shareholder, Li Ping'an, with public condemnation based on his breach of good faith and due diligence as a director,⁵²⁶ breach of his respective declarations and undertakings as a director and de facto controller of the company to comply with laws, rules and articles of association of the company,⁵²⁷ as well as violation of the ChiNext Operational Standards prohibiting controlling shareholders and de facto controllers from using RPTs, guarantees or other methods to directly or indirectly misappropriate company funds, assets causing harm to the company and interests of other shareholders.⁵²⁸

In addition, the Exchange ordered remedial action, which included the setting up of measures regarding the scope of RPTs and the use of capital funds of the company by the controlling shareholder. The controlling shareholder, Industry and Commerce, was further obliged to undertake not to use the company's capital funds.⁵²⁹ The names of all parties were recorded on a 'good faith file' (*chengxin dang'an*).⁵³⁰ The Exchange considered its decision lenient because it took into account that the RPT did not result in serious consequences, although, from the annual report of 2011, it was discovered to have existed for approximately

⁵²⁶ Rule 1.4 of ChiNext Rules.

⁵²⁷ Rules 3.1.5 and 3.1.7 of ChiNext Rules.

⁵²⁸ Paragraph 4.2 of the Guide to ChiNext Operational Standards ('ChiNext Standards').

⁵²⁹ Regardless of whether a covenant arises directly as a result of enforcement action, its violation will also be a violation resulting in the issue of another public condemnation.

⁵³⁰ In practice, the Shanxi CSRC local office and the Exchange's Supervisory Office keep a record of the names, now published online in Chinese language on the Shenzhen website:
<http://www.szse.cn/main/disclosure/bulliten/cxda/cxday/>

six months. Upon investigation, the Exchange further discovered that those culpable lacked knowledge on the illegality of RPTs using capital funds of the company.

The violation was discovered by the Exchange during its examination of annual reports published by companies on ChiNext.

The Exchange also directed the whole company to undergo training on ‘law abidance’, as was done in Zhendong case when appropriate. It must be noted that Zhendong Pharmaceutical, incorporated in 1993, is one of the oldest companies to be listed on ChiNext and arguably reflects the listing strategies that have taken place in the last 20 years on China’s stock markets. That is, a parent company prepares (packages) a subsidiary for listing so that it can benefit from cash raised. On ChiNext, the CSRC and the Exchange do not care for complicated group structures or for companies that are not independent because of the possibilities of illegal RPTs, illegal guarantees and insider trading. Although it remains a wonder that the IPO Review Panel permitted the listing of Zhendong Pharmaceutical, since, arguably, it did not meet the requirement for being an independent company, there may be policy considerations. For example, the pharmaceutical industry remains one that China wishes to enter, but barriers to entry remain extremely high as demonstrated by constant negotiations and trade agreements with the UK, which do not result in the exchange of information.

The regulatory authorities appear clear on the type of behaviour they want to deter from developing on ChiNext. The case of Zhendong Pharmaceutical illustrates some of the anathemas of the CSRC and the Exchange, which include illegal RPTs and pyramid structures. Given the IPOs Review Panel’s strictness in not listing companies that had a holding company, it is surprising that the company was listed and perhaps reflects a loosening of the rules to ensure it reaches its quota of IPOs on ChiNext.

C. New Delisting Regime to Suit Profile of ChiNext Companies

To incorporate a new and detailed delisting regime, among other amendments, the ChiNext Rules were revised and reissued to take effect from 1 May 2012 (2012 ChiNext Rules). The whole of Chapter 13 of the 2012 ChiNext Rules, as in the previous version, lays out the new delisting regime encompassing initial suspension from trading (part I), relisting (part II) and then delisting (part III) and the conditions precedent for each.

The ChiNext Listing Rules were revised to include a detailed delisting regime aimed at delisting companies that violate the key pressure points of the regulators discussed above in Section I: disclosure of information, RPTs, guarantees and insider trading. Indeed, the introduction of detailed Listing Rules was partly a reaction to the effective delisting of Goldengreen by revoking its listing license. The Committee applied the broad principles of the law in sanctioning Goldengreen and demanding reimbursement to investors. Thus, the main objective of the Exchange in implementing a new listing regime is to protect investors. This is described effectively because, at the time, there was no detailed delisting process for ChiNext companies; consequently, the CSRC's only recourse was to action the Exchange's revocation of the company's listing license.

Undoubtedly, corporate governance practice on ChiNext focuses on the protection of shareholders, though that protection does not necessarily equate to delivery of shareholder value as the paramount objective for corporate governance practice and enforcement on ChiNext. Instead, the stability and long-term sustainability of ChiNext and the companies listed on it are important engines of growth in China's remodelled economic growth model, mainly based on SME domestic productivity. This cannot be achieved without the continuous investment of individual large and retail shareholders who together hold 62% of the total investment on ChiNext. However, if these investors feel or perceive that private controlling shareholders within ChiNext companies have free reign to do as they please to the detriment

of other investors, then there may be a perception of an emergence of a feudal corporate society that somewhat mirrors or reminds public investors of Chinese society prior to the Mao era, when money and influence dictated the application of the law rather than justice and equity.

The milestone represented in the ChiNext delisting regime manifests in the theoretical possibility of a company being delisted for persistent corporate governance transgressions. The key delisting features of the ChiNext regime include direct delisting with a short delisting regulation period, and no more so-called advance warnings of delisting; instead, a company will be relegated to a designated ‘delisting market’.

1. Suspension of Listing

There are five potential instances in which a ChiNext company may have its listing suspended. Three instances relate to the veracity of the financial statements of a company, while the other two allow the Exchange some discretion in the kind of circumstances in which a suspension may be imposed: firstly, where significant errors or false records exist in previous financial statements that resulted in consecutive losses in the previous three years;⁵³¹ secondly, where significant errors or false records in the company’s financial statement have resulted in a negative audit opinion;⁵³² thirdly, when a company has failed to make appropriate and timely disclosures to the market regarding the periodic audited financial statements⁵³³ (this provision also includes a failure to disclose financial statements and related audit report in accordance with the ChiNext timetable⁵³⁴ or failure to amend or correct significant errors or false records in the financial statements required by the CSRC or the Exchange within the given deadline⁵³⁵); fourthly, the Exchange has discretion where it deems

⁵³¹ Rule 13.1.1 (2) of ChiNext Rules as amended in 2012 (‘ChiNext Rules 2012’).

⁵³² Rule 13.1.1 (3) of ChiNext Rules 2012.

⁵³³ Rule 13.1.1 (4) of ChiNext Rules 2012.

⁵³⁴ Rule 12.4 of ChiNext Rules 2012.

⁵³⁵ Rule 12.6 of ChiNext Rules 2012.

the company has committed a significant violation of the law or rules;⁵³⁶ last is a catchall provision that the Exchange can impose a suspension where it deems fit.⁵³⁷ So corporate conduct here may not necessarily be illegal, nor does it need to have resulted in serious consequences, which is the usual benchmark for judging the serious nature of a violation of ChiNext rules. So far, no companies have been subject to a suspension in listing.⁵³⁸ If a company is unable to meet the conditions for relisting then it will be delisted.⁵³⁹

2. Delisting Process on ChiNext

The key provision in the Listing Rules that lays open a delisting for persistent corporate governance infraction is rule 13.3.1 (16), which states that any company that has three public criticisms within a 36 month period will be delisted. The provision does not specify the type of public criticism; therefore, in theory, any type of public criticism can make up the tally of three, but it must be a condemnation that the company has imposed on it. So far on ChiNext, three public condemnations have been imposed on companies and certain members of their management for corporate governance infractions relating to illegal RPTs,⁵⁴⁰ false financial records,⁵⁴¹ and false financial records together with failure to disclose significant change in the company's circumstances.⁵⁴²

Jiangsu Pacific Precision Forging Co. Ltd. ('Precision Forging') presents an example of a company that already has two public condemnations and this was imposed within a short period of six months. Consequently, Precision Forging may only have one last change before it receives delisting orders. However, the question then remains of how far the Exchange and

⁵³⁶ Rule 13.1.1 (10) of ChiNext Rules 2012.

⁵³⁷ Rule 13.1.1 (11) of ChiNext Rules 2012.

⁵³⁸ This is the case as of 1 May 2012 to date.

⁵³⁹ Rule 13.3.1 (13) of ChiNext Rules 2012.

⁵⁴⁰ Decision to Impose Public Condemnation on Shanxi Zhendong Pharmaceutical Co. Ltd. (300158) and Concerned Parties, Shenzhen Stock Exchange, 25 May 2012.

⁵⁴¹ See Decision to Impose Public Condemnation on Jiangsu Pacific Precision Forging Co. Ltd. (300258) and Concerned Parties, Shenzhen Stock Exchange, 3 March 2013 case decision.

⁵⁴² See, Decision to Impose Public Condemnation on Jiangsu Pacific Precision Forging Co. Ltd. (300258) and Concerned Parties, Shenzhen Stock Exchange, 22 November 2012.

indeed the CSRC will carry out the threat of delisting once three public condemnations have been imposed on a company. Precision Forging is also an example of the Exchange holding fire on delisting and instead escalating the issue to the CSRC. Indeed, this indicates that it will be more likely that, on the achievement of a second public criticism, a company may be given one final chance, because, rather than making a decision on a third transgression, the Exchange will refer it to the CSRC, which will decide on a punishment. This effectively means that the company will not be delisted on three transgressions, but maybe four or even more, depending on how much time the Exchange sees fit to escalate a case to the CSRC, rather than deal with it. The intention is, presumably, to avoid responsibility for the issue of a third public condemnation, which, according to the guidance, results in automatic de-listing from ChiNext. There are a few plausible reasons for these positions. Firstly, the Exchange does not want to delist a company that the CSRC has not itself investigated and has found to have committed violations. This can be viewed from two perspectives. It may be seen as the Exchange giving the CSRC notice of companies that will potentially be delisted, in effect, giving the CSRC an opportunity to investigate and punish the violating company. Or it may simply be that the Exchange remains subordinate in power to the CSRC and, therefore, does not want to or cannot in practice exercise control over the exit of companies from ChiNext. Secondly, the CSRC has the ability to impose penalties pursuant to Securities Law, which the Exchange appears unable to do, or, at least, there is neither a rule nor precedent that permits it to do so. Thirdly, ChiNext remains a market crucial to China's current economic model. The companies listed arguably present the best of strategic industry enterprises that wish to list on ChiNext, for which the CSRC must report directly to the State Council. This process, to some extent, mirrors the culture of the Party in relation to the National People's Congress, where the latter as lawmakers still revert to the Party for guidance in relation to final decisions.⁵⁴³

⁵⁴³ For another analogy relating to the board and supervisory board, see Chao Xi, *Corporate Governance and*

Finally, delisting a company from ChiNext will set a precedent that others must follow and, therefore, in practice the Exchange needs to confer with the CSRC to ensure a uniformity of approach or that it implements the rules in accordance with the policies of the CSRC.

The Exchange must be sure of its approach and that the company's listing on ChiNext is untenable. This becomes even more important since the Chinese Special Treatment ('ST') regime permits companies to continue listing but warns investors that they 'may' be delisted soon. This system does not apply on ChiNext. As stated earlier, the delisting regime does not allow for such uncertainty and companies can be delisted within a few months. Here, again, the Exchange may be perceived as having powers in theory, but in practice the process of delisting becomes more protracted.

3. Delisting Regime and Public Condemnation Rules

Any company that has three public condemnations within a 36 month period will be delisted from ChiNext. In recognition of the occasional key roles intermediaries play in corporate governance, the Exchange's remit to impose sanctions also extends to sponsors, registered accountants and auditors, lawyers and other securities firms. However, the Exchange can only sanction them in so far as they have failed in a specified duty or obligation under a provision that falls within the remit of the Exchange. For example, the Exchange issued the sponsors of Precision Forging with public condemnation for failure to supervise, investigate and report the corporate governance issues of Precision Forging to the Exchange in a timely manner.⁵⁴⁴

Legal Reform in China (London: Wildy, Simmonds & Hill Pub, 2009).

⁵⁴⁴ See Sub-section 1. Delisting Regime on ChiNext on page 312.

4. Overlap in CSRC and Exchange Roles?

Not on ChiNext, as it appears the CSRC and Exchange have complementary rather than undifferentiated regulatory roles for the market. They have decidedly split their function, so that the Exchange becomes more of a quasi-state entity to meet demands for independent regulators. The role of the Exchange in corporate governance on ChiNext appears less in relation to company-level monitoring as with the CSRC, but appears to take more of a sanctioning approach. That is, the Exchange appears to carry out punitive enforcement. This may be attributed to the fact that the Exchange remains the first port of external enforcement mechanism on ChiNext. The CSRC takes more of a remedial enforcement process, which seems odd as it should be the final port of enforcement within the ChiNext framework, to which the Exchange escalates a matter. But, as mentioned earlier, the CSRC's intervention at company level pertains to its self-interest in ensuring control in discovering any corporate governance infractions by companies since it approved them for listing.

The CSRC's current capacity builds in other matters such as external relations with overseas securities regulatory authorities. It is also building capacity at local level through its local offices to understand the dynamics of corporate governance on a regional basis.⁵⁴⁵ Another capacity-building exercise is the apparent dominance of the Exchange in punitive enforcement actions, which also demonstrates the CSRC's encouragement of self-regulation by the stock exchanges. As discussed below, this manifests in more enforcement action by the Exchange and increased authority to delist companies. The CSRC appears to be taking a reflective approach.

The Exchange also embraces this capacity building as demonstrated by the publication of its first comprehensive report on enforcement, not only on ChiNext but also on

⁵⁴⁵ There is growing awareness of the variation in regulatory compliance according to region, which the CSRC appears to be monitoring.

the Main Board and the SME Board of its stock exchange. This, perhaps, signals a new era for enforcement whereby the CSRC and the Exchange do not duplicate roles in practice. However, as indicated above, this does not appear to be the case due to the company-level interest the CSRC takes in ChiNext companies. Nonetheless, they still seem to complement one another, though it remains unclear the extent to which both regulators communicate about companies, not only since CSRC local offices are geographically far from the Exchange but also in terms of administrative reporting lines. One apparent issue in the regulation of corporate governance of ChiNext companies as indicated above remains the unclear demarcation in the remit and authority of the CSRC and the Exchange. Overall, the CSRC takes a very cautious and conservative approach to activity that may jeopardise the stability of the market.⁵⁴⁶ It asserts control where it considers it to be required; hence, the unexpected areas in which the CSRC may take control but which might ordinarily be under the remit of the Exchange, such as, in this case, delisting.

D. Missing Link: Role of Intermediaries in Enforcement: Sponsors

Sponsors, registered auditors and lawyers are intermediaries with corporate governance obligations under the ChiNext framework. From the above, it can be seen that there is an increasing focus on and expectation of intermediaries as enforcers or contributors to good governance. The focus of enforcement appears to be on emphasising the role of intermediaries. The Goldengreen case exemplifies the CSRC's increasing scrutiny of intermediaries. There have been four occasions when intermediaries have been specifically sanctioned on ChiNext, with three relating to the same company, Goldengreen. Some commentators suggest that the real problem relates to the honesty and conscientiousness of

⁵⁴⁶ Interview 2012-07; Interview 2012-16.

intermediaries. Some recommend that publication of their expert opinions is the way forward; however, this is already the case on ChiNext.

Commentators believe that improvements in the conduct of securities professionals, such as lawyers, sponsors and brokers, play a key role in improving the integrity of the market.⁵⁴⁷ This integrity is particularly important in light of the increasing trend toward the owner-managers internal governance structure, which presents new challenges, especially regarding conflicts of interest.

1. Gatekeepers - (Ir)reputable Intermediaries

There has been much written about the importance of intermediaries (otherwise described as gatekeepers) in corporate governance in literature in general⁵⁴⁸ and those focused on China.⁵⁴⁹ Gatekeepers are defined by John Coffee as

...reputational intermediaries who provide verification and certification services to investors... The professional gatekeeper essentially assesses or vouches for the corporate client's own statement about itself or a specific transaction.⁵⁵⁰

Examples of gatekeepers include independent auditors who verify a company's financial statements, securities analysts who evaluate the company or a specific transaction or lawyers who provide services. In emerging economies, market intermediaries that provide credible information are either underdeveloped or missing.⁵⁵¹ For instance, security analysts supply information to shareholders on the performance and governance of listed companies; equally, investment banks identify and assess targets for corporate control, while high-end

⁵⁴⁷ Xiao Zuoping, Xu Lingyu, and Chen Yuwei, "Zhongji Suoyouquan Jiegou Dui Shenji Dingjia de Yingxiang (The Impact of Ultimate Ownership Structure on Audit Pricing - Empirical Evidence from China's Listed Companies)," *Securities Market Herald*, no.11 (2011).

⁵⁴⁸ John C. Jr Coffee, "Understanding Enron: It's about the Gatekeepers, Stupid," *Business Lawyer (ABA)* 57 (2002, 2001): 1403.

⁵⁴⁹ Clarke, "The Ecology of Corporate Governance in China," (29 August, 2008). Ibid.

⁵⁵⁰ Coffee, "Understanding Enron": 1405.

⁵⁵¹ Nathaniel H. Leff, "Industrial Organization and Entrepreneurship in the Developing Countries: The Economic Groups," *Economic Development and Cultural Change* 26, no.4 (1978): 661-75.

head-hunters supply information on the track records of top executives.⁵⁵² Where strong market institutions such as the aforementioned are missing, it is more costly for not only minority shareholders but also controlling shareholders to gather reliable objectives to assess top management opportunism.⁵⁵³

As discussed in Chapter Two, sponsors have monitoring and disclosure obligations under the ChiNext framework. They also have an obligation under Securities Law not to take advantage of undisclosed information obtained in the course of performing their duties under the ChiNext Rules, for the purposes of insider trading for themselves or for other parties. On ChiNext, the conduct of gatekeepers has fallen below par, as evidenced by the disciplinary action issued by the Exchange, as well as media reports and media reports (though unsubstantiated).

This section has examined the ways in which the Exchange carries out its regulatory and punitive function. Clearly, it does not have the resources in expertise and capacity to continuously be on ground level investigating, at times, vague leads on corporate governance infractions. Thus, the media plays a key role in gathering the evidence of violations, which cannot always be gleaned from documentary evidence. As one interviewee, a registered public accountant and auditor, based on experience opined, in dealing with domestic SMEs in China there remains a persistent culture in companies having two or more sets of accounts. One set contains the ‘real’ figures for the consumption of the owner(s) and ‘insiders’⁵⁵⁴ of the

⁵⁵² Xiaowei Rose Luo and Chi-Nien Chung, “Filling or Abusing the Institutional Void? Ownership and Management Control of Public Family Businesses in an Emerging Market,” *Organization Science* 24, no.2 (2013): 591-613. Ibid.

⁵⁵³ Andrei Shleifer and Robert W. Vishny, “A Survey of Corporate Governance,” *The Journal of Finance* 52, no.2 (1 June, 1997): 737-83, doi:10.2307/2329497.

⁵⁵⁴ Here, ‘insider’ specifically refers to those who control the company and who are deemed to be worthy of sharing the company’s ‘real’ financial information.

enterprise while other sets of accounts contain embellishments for the purposes of investors and regulators.⁵⁵⁵

The low number of such sanctions correlates with the overall low figures reported by the Shenzhen Stock Exchange. There continues to be criticism of these low figures by the press. Interestingly, jurisdictions with higher numbers of ChiNext companies reassuringly have a correspondingly higher number of sanctions and actions. Further insight into these sanctions and actions can be gleaned from the geographical locations of the companies.

III. Role of the Press

It is well acknowledged that the financial media play an important role in capital markets,⁵⁵⁶ especially in corporate governance.⁵⁵⁷ The media plays an indispensable role as a corporate governance mechanism on ChiNext and on other equity markets in its capacity as investigator, watchdog and whistleblower because of its capacity to penetrate deep at firm level and below. Clearly, taking on these multiple roles inevitably gives rise to concerns of the rule of law. In fact, media agencies in China remain mostly owned or supported by the state, whether in central or local government. This section defines the role of the media in corporate governance practice on ChiNext.

Unique to China, the financial media has three roles. Firstly, it provides financial news on companies, whether as independent analysts or part of a public relations project of companies or the regulatory authorities. Secondly, a large proportion of the media in general reside within China's political and legal framework with a formal troubleshooting and

⁵⁵⁵ Interview 2012-11.

⁵⁵⁶ Brian J. Bushee et al., "The Role of the Business Press as an Information Intermediary," *Journal of Accounting Research* 48, no.1 (2010): 1-19. (The press plays a role in reducing information problems.)

⁵⁵⁷ Alexander Dyck and Luigi Zingales, *The Corporate Governance Role of the Media* (National Bureau of Economic Research, 2002), url: <http://www.nber.org/papers/w9309>.

watchdog role in providing public opinion supervision ('POS') ('*yulun jiandu*').⁵⁵⁸ Finally, media agencies provide avenues by which public whistleblowing (*jubao*) can be made by any member of the public anonymously or confidentially regarding the actions of public officials and companies. In enforcement of corporate governance, information about company-level practice remains key for enforcement authorities to monitor, supervise and, where appropriate, punish those that violate corporate governance laws and rules.

At firm level, the media amount to a powerful corporate governance mechanism for sourcing information through not only formal networks such as company and industry functions but also more importantly through snippets gathered and shared in very informal and confidential settings where regulators have no reach.⁵⁵⁹ Some of the most active media agencies in relation to ChiNext include *ifeng.com*, an online magazine, and *Boards and Directors*, both an online and a print magazine. Journalists gather information through attendance of company and industry functions, snippets gathered and shared in corridors by affected parties. Importantly, unlike the regulators, the press has access to informal sources of information. Journalists also cultivate internal sources within companies at various levels.⁵⁶⁰ External sources include rival companies and public whistleblowing.⁵⁶¹

The financial media, in particular on ChiNext, and the media in general play an important role in exposing corporate governance malpractice. A typical example of the role of the media in corporate governance on ChiNext relates to the resignation scandals of directors, supervisors, company secretaries and senior management. Various media agencies have carried out exposés on individual companies.⁵⁶² For example, Sina Finance, a privately owned media agency that crucially sources information mostly from state news media such as

⁵⁵⁸ See Benjamin L. Liebman, "Watchdog or Demagogue? The Media in the Chinese Legal System," *Columbia Law Review* 105, no.1 (January 2005): 1-157.

⁵⁵⁹ Interview 2013-05.

⁵⁶⁰ Interview 2013-03.

⁵⁶¹ Interview 2013-04.

⁵⁶² See also Liu Guofang, Shi Guangyao, and Cao Chuhua, "The Puzzle Surrounding the Resignations."

the *People's Daily* and *Xinhua* from other sites, has unprecedentedly assumed for itself a watchdog role in relation to ChiNext. So in 2010, to celebrate the one-year anniversary of the establishment of ChiNext, it also ran an extensive analysis of directors, supervisors, company secretaries and senior management who had resigned, analysing their reasons and labelling them as either resigning for good reason or to exploit their shareholdings.⁵⁶³ This was the beginning of the 'director-senior management resignation' ('*gaoguan cizhi*') scandal, and it continues.⁵⁶⁴ Similarly, it was also the media that exposed Suzhou Goldengreen Technologies' failure to have registered its core proprietary patents disclosed in its listing prospectus; now famously referred to as 'patent-gate' ('*zhuanli men*'), it led to the effective delisting of Goldengreen by revocation of its license to list.

A. Media and Corporate Governance

The media's role in popular opinion supervision makes China's media particularly powerful. On ChiNext, the financial and corporate media remain active in investigative journalism and uncover corporate governance misconduct and scandals. This section discusses the latter two roles. The media acts as a mechanism for better corporate governance of ChiNext companies for fear of reputational sanctions in the form of bad publicity and a scandal that may ultimately affect achieving listing approval pre-IPO or a good share price

⁵⁶³ Sina Finance, "*Chuangyeban Gaoguan Cizhi Hu* [Pool of Resignation of ChiNext Listed Companies' Top Officials]," News, *Sina.com.cn*, (26 October, 2010), url: <http://survey.finance.sina.com.cn/result/50340.html?f=1>. Interestingly, it also included a two-question netizen survey first asking participants to choose what they felt was the most likely reason for the resignations of directors. Out of four options, 82% chose the option that the resignations were due to directors and senior management being 'venture capital' investors. The second question was whether netizens will invest on ChiNext, and 72% chose the option that they 'will not since even directors and senior management do not have much confidence'.

⁵⁶⁴ As a reflection of this persisting issue, each year an analysis is made. See 21yi shiji, "*Chuangyeban Gaoguan Zhe Liangnian: Cizhi Gonggao Chaoguo 170fen* [Senior Management on ChiNext in the Last Two Years: Resignations Exceed 170]," Financial News, *Yicai Wang*, (9 October, 2011), url: <http://www.yicai.com/news/2011/10/1124237.html>. See also, Xia Fang, "*Chuangyeban chengzhi gaofa qu 99 jia gongsi 117 wei gaoguan cizhi* [ChiNext has Become a Resignation District - 117 Senior Executives from 99 Companies Resign]," Financial News, *Zhengquan ribao (Securities Daily)*, (19 June, 2012), url: http://zqrb.ccstock.cn/html/2012-06/19/content_302575.htm.

post IPO. It also acts as a mechanism for better regulation by providing the regulatory authorities with information, access to which their limited resources do not allow them. Moreover, it also has a lobbying element in bringing to the attention of regulatory authorities loopholes and flaws they may wish to turn a blind eye to. Media investigations into resignations by directors, supervisors, company secretaries and senior management have presented in-depth analysis for resignations and unrepentantly identifying those whom it is believed resigned from companies to take advantage of loopholes in legislation. Interestingly, one of the journalists interviewed noted that competitors of listed companies remain a source of information.

B. Public Opinion Supervision and Corporate Governance on ChiNext

Apart from the literal translation into public or popular opinion supervision, there remains no precise definition of *yulun jiandu*. Sinologists agree that it ‘...connotes the use of critical media reports to supervise government officials’.⁵⁶⁵ The former definition of *yulun jiandu* can be expanded upon to include the exposure of official wrongdoing or inaction, demand for arrest or harsh punishment of alleged criminals, writing confidential internal reports on unfairly decided cases to Party-state leaders, and referring popular complaints to government actors. Chinese scholars also ideally perceive *yulun jiandu* as an integral part of contemporary China society used for the construction of a ‘harmonious society’.⁵⁶⁶ Thus, it is with very strong mandates that the media is able to execute its obligations under POS.

On ChiNext public opinion supervision entails exposing corporate misconduct and malpractice. In terms of ChiNext, research demonstrates that public opinion supervision extends to listed companies, their constituents, i.e., directors, supervisors and senior

⁵⁶⁵ See Yuezhi Zhao and Wusan Sun, “Public Opinion Supervision: Possibilities and Limits of the Media in Constraining Local Officials,” in *Grassroots Political Reform in Contemporary China*, eds. Elizabeth J. Perry and Merle Goldman, Harvard Contemporary China 14 (Cambridge, Mass: Harvard University Press, 2007).

⁵⁶⁶ See also Liu Miaowei, “*Jiaqiang yulun jiandu shi goujian zhengzhi wenming de jichu* (Strengthening Popular Opinion Supervision is the Foundation for Constructing a Political Civilisation),” *Shaoguan Xueyuan Xuebao* (*Journal of Shaoguan University*) 27, no.11 (November 2006): 77.

management. Effectively, in the role of public opinion supervisor, the financial media morph into corporate governance investigators, whistleblowers and watchdogs. Journalists gather information by attending shareholder meetings. It is also not rare for journalists to be invited to attend actual board meetings of companies.⁵⁶⁷ Although at the invitation of the company, journalists still expose where they think there to be appears a problem. Indeed, the journalists interviewed all perceive the role of the media as an indispensable societal (more than a financial advisory one) in monitoring and revealing corporate governance practice on ChiNext.

C. The Press, Public Whistleblowing, CSRC and Exchange

Of the three institutions of the state, the media remains the most effective and experienced in sourcing information and investigative reporting. The media works with the CSRC and the Exchange on an informal basis to identify issues and companies of corporate governance concern.⁵⁶⁸

1. CSRC Reaction to Media Exposés

The CSRC issued the Special Checks on 2012 Financial Statements of Enterprises Subject to IPO Review with the aim of carrying out checks on companies undergoing the IPO application review process. Again, this may be seen as a reaction to the media/press, which, to date, have been more proactive in their exposés of companies that appear eligible on paper but with dubious credentials in practice. This remains a keen example of how the press plays a key role in influencing CSRC behaviour. This attests to the relative authority and influence of the press in China, even in regulatory frameworks in which it does not have a formal or recognised role.

⁵⁶⁷ Interview 2013-03.

⁵⁶⁸ Interview 2013-04.

In this chapter, from a process-based perspective, we examine further how and why the media in China carries out its de facto role as a corporate governance institution. Perhaps one of the most important roles the media has played is in the disclosure of nefarious or dubious dealings of CSRC officials in the IPO application review process. This becomes a corporate governance issue because the listing of companies that may not be eligible because of false information ultimately has an impact, to the detriment of shareholders. The CSRC tries to avoid a recurrent scenario of the past, mostly used by SOEs. Companies are given (loaned) by their parent company or related company for the sole purpose of achieving listing. Ordinarily, they do not have any substantial business activity but crucially they are effectively a vehicle by which, once listed, the parent or related company can benefit through intra-group transactions from the capital market funding by the backdoor. Although the Measures in themselves should effectively deter companies, it appears that some merely adapt their modus operandi so that they cannot be detected on paper. The press, being on ground, have been successful in piercing through the paper screen. Hence, this new initiative by the CSRC intends to devote 300 experts to undertaking checks of all companies that apply for IPO. This may amount to a deterrent of sorts, but it remains unclear what the penalty will be for violation; it may be a rejection. Perhaps the CSRC also issues penalties to companies that waste its time and resources and recoup some of the financial resources used in checking the violating company's financial books.

D. Limitations of the Media in Corporate Governance

The media does have its limitations in corporate governance. Firstly, it has no legal mandate in corporate governance enforcement, and is not even part of the process. Secondly, as a result, of the first, it raises potential rule of law issues. The third limitation are issues concerning potential conflicts between being newsworthy and carrying out investigative

journalism.⁵⁶⁹ Fourthly, with all of its ground level connections, as one journalist noted, the media cannot really know the inner workings of the board or the company. Journalists rely on public complaints and snippets of information gathered in professional and industry circles, which, to all intents, remain circumstantial.⁵⁷⁰ Fifthly, conflicts of interest arising where competition between media agencies exist means that reporting may be in terms of that which is deemed newsworthy rather than investigative journalism. The liberalisation and commercialisation of the media has been blamed for this conflict.⁵⁷¹ Finally, protection of whistleblowers remains a keen problem.⁵⁷² In terms of ChiNext and other markets, the pervasive powers of controlling shareholders as well as the hierarchical structure means that whistleblowers' anonymity cannot be guaranteed, resulting in the loss of their jobs, and, in the worst but rare cases, violence to the person.⁵⁷³ Undoubtedly, the pitfall of demonising the innocent also arises.⁵⁷⁴ This may be attributed to the on-going ideological struggle to accept capitalistic market behaviour because of the overt display of individualism and profit-seeking. There also remains the inescapable fact that no matter how much investigation is done, it remains very difficult to know what happens in board rooms.

⁵⁶⁹ Ye Guocheng, “*Zenyang Rang Yulun Jiandu Chengwei Zhu Xuanlu - Bianjizhe Guancha Kan Qiyebao Ruhe Zuohao Yulun Jiandu* (How Can Popular Opinion Supervision Be Made the ‘Main Melody’: An Investigative Look By a Journalist into How Commercial Newspapers Can Be Effectively Carry-Out Popular Opinion Supervision),” *Wugang Zhenggong Bao (Military Steel Work Periodical)*, (July 2009): 34-35.

⁵⁷⁰ Interview 2013-03; Interview 2013-04.

⁵⁷¹ Ye Guocheng, “*Zenyang Rang Yulun Jiandu*.”

⁵⁷² See Zou Daren, “*Woguo Falu Dui Yulun Jiandu de Baohu Queshi Xianxiang Pouxu* [An Analysis of the Phenomenon of China’s Lack of Legal Protection as Regards Popular Opinion Supervision],” *Xinwen Zhishi (Journalism Knowledge)*, (May 2005): 32-33.

⁵⁷³ Interview 2013-04.

⁵⁷⁴ See, Case study 5: Wangsu Science & Technology Co. Ltd., where the out-going chairman was falsely accused of resigning and selling his shares because he had no confidence in the company.

IV. China's Public Whistleblowing System (*jubao*)

For over a decade, internal whistleblowing policies and procedures have formed an expressed and integral part of the remit of audit committees in both the US and the UK.⁵⁷⁵ In contrast, in China, there remains no designated formal corporate whistleblowing system for listed companies. *Jubao* means to inform against an offender to the police or regulatory authority or appointed agency.⁵⁷⁶ This has mainly been, firstly, because of the existence of a public whistleblowing system and, secondly, because the Party-state has its own whistleblowing and disciplinary procedure that proved adequate during a period when most if not all listed companies were directly linked to the Party-state. The whistleblowing system has not yet been formalised but it may be a process that is required.

A. Origins of *Jubao*

In the absence of a legal or regulatory internal corporate whistleblowing system, *jubao* remains the foremost source of information about corporate governance violations for regulators and the press. Generally, in China, it is an important information-gathering tool for the state recognised under law.

China's public whistleblowing system is actually a transplant from Hong Kong. The Shenzhen City Procurate first adopted the system from the Hong Kong Independent Commission against Corruption following a fact-finding mission in Hong Kong in 1988.⁵⁷⁷

⁵⁷⁵ Under section 301 Sarbanes-Oxley Act, implemented on 30 July 2002. There is mixed reception about its effectiveness. Richard E. Moberly, "Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win," *William & Mary Law Review* 49 (2007): 65.

⁵⁷⁶ Similar to the UK's Public Interest Disclosure Act 1998.

⁵⁷⁷ Independent Commission against Corruption Contemporary China borrowed the concept of public complaints from Hong Kong's Independent Commission Against Corruption, which had run a public complaints system since its inception in Hong Kong in 1974. It was only on 8 March 1988 that the first national public complaint centre was established in Shenzhen by Shenzhen People's Procurate, Shenzhen City Economic Crime Public Complaints Centre. As a manifestation of its success, over 4000 such centres in different regions were set up by 2000. During that period, there were 110,504 complaints with 70% supplied by the public. A key difference from the Hong Kong system is that the ICAC forwards the results of investigations to the department of justice where public prosecutors take up the case. Those reports without evidence are sent to an operations review committee, which closes the case but may decide to refer for administrative or disciplinary action. Being administratively opposed to legally biased in resolution of violation of laws, in China, public complaints with

The first public whistleblowing system related solely to economic activity, and specifically reported corrupt officials.⁵⁷⁸ In view of its success, it was rolled out nationally. This has expanded to include privately controlled, listed and unlisted companies and individuals. Increasingly, the utility of public complaints in crime prevention as well as in administrative, civil and criminal law enforcement is recognised by lawmakers, regulators, academics and commentators.

Public whistleblowing is recognised under Chinese law. Article 84 of Criminal Law cites *jubao* as a method of reporting alleged criminal acts or suspicion about someone in that regard.⁵⁷⁹ As with all whistleblowing systems, the great risk of making a public complaint can be the backlash or loss of employment. Apparently, since 1993, no serious backlash has occurred against whistleblowers.⁵⁸⁰ Anyone person or unit that makes a public complaint can do so without concern of exposure as they have a right to anonymity and confidentiality.⁵⁸¹

B. Role of *Jubao* in Corporate Governance: Potential Voice of (Retail) Shareholders

Shareholders, employees, creditors and business counterparts, both listed and unlisted companies, as well as members of the public, have evoked the *jubao* system to report alleged corporate governance.⁵⁸² For corporate governance, *jubao* has two strong advantages for shareholders, especially retail shareholders. Firstly, the process of reporting is straightforward

evidence are not automatically referred to the procurator; instead the relevant administrative or regulatory agency such as the CSRC may elect to decide the matter itself. As demonstrated in this chapter, this falls well within the remit of its authority. Another law that protects public complaints whistleblowers is the Security Administration Punishment Law.

⁵⁷⁸ An example of *jubao* is a clue written on the inside of a cigarette box, which led to key information in a criminal case against former vice chairman of Qinghai County Standard Committee, Han Fucui.

⁵⁷⁹ A work unit (*danwei*) or person has a right and duty to report a criminal act, in fact, or someone suspected of criminal acts to the police, the public security bureau, procuratorate or the courts or *jubao*.

⁵⁸⁰ Yin Chuan, “*Jubao, Rang Zuifan Zhushou* [Public Complaints, Stop the Criminals],” *Gongmin Daokan* [Citizen Tribune], no.3 (2000).

⁵⁸¹ Article 85(3) of Criminal Law.

⁵⁸² See Wang Sanshou, “*100duo chuangyeban shangshigongsi zeng bei jubao* [Over 100 ChiNext Listed Companies Previously Subject of Public-Whistleblowing],” *Financial News*, *sina.com.cn*, (4 November, 2011), url: <http://finance.sina.com.cn/stock/newstock/cyb/20110411/17299669290.shtml>.

and simple. It can be done in writing or online on the website of any relevant regulatory authority or press agency. Secondly, the protection of anonymity is afforded (although not guaranteed) the person making the complaint. The unique point about *jubao* is the access at the grassroots level that is available to ordinary members of the public with protection of anonymity. This contrasts with legal and regulatory processes that do not afford anonymity if a shareholder decides to report or provide evidence against a company insider. Moreover, the regulatory agencies to which a complaint is submitted must investigate it. In enforcement of corporate governance, information about company-level practice remains key for enforcement authorities to monitor, supervise and, where appropriate, punish those that violate corporate governance laws and rules. Many exposés arising due to public complaints on ChiNext appear to be made by employees of companies to the press, the CSRC or the Exchange.⁵⁸³

C. Limitations of *Jubao*

Although there are many references to *jubao* as the initial source of information about corporate governance actions taken by the regulatory authorities, academic studies on the effectiveness of *jubao* remain sparse. The CSRC and exchanges do not publish the number and types of *jubao* received. This perhaps relates to the need for confidentiality in the event that the complaint proves unfounded. Information gleaned so far has been a result of investigative journalism and leaked documents to the press.⁵⁸⁴

In 2005, the chairman of the Chinese People's Political Consultative Conference called for the formulation of a public whistleblowing law (*'jubao fa'*), but to date there has

⁵⁸³ Interview 2013-03; Interview 2013-04.

⁵⁸⁴ For example, it was leaked, along with documents, that 25% of companies listed on ChiNext were subject to public complaint. See “25% *chuangye ban gongshi shangshiqian bei jubao* [25% of ChiNext Companies have Jubao Prior to Listing].”

been no suggesting of one.⁵⁸⁵ The need for such a law may increase with the emergence of family and individual controlled listed companies that may naturally have a fairly opaque decision-making structure. In this scenario, the regulatory authority as well as the media will have to rely more on individual (public) whistleblowers who will require adequate protection.

V. Wither the Market for Control and Private Ordering

This chapter and the previous two have examined the corporate mechanisms internal and external to the company. Two final mechanisms described here are the market for control and private ordering.

A. Market for Control

Plainly, ChiNext has no internal market for control, although ChiNext companies actively participate in the acquisition of unlisted companies outside of the Exchange, and even companies listed on stock exchanges abroad. In 2009, only five surveyed companies acquired a substantial number of or the total issued shares of one or more domestic unlisted companies. In response to successful listing and fundraising on ChiNext, the number of surveyed companies acquiring such interests increased from five to 23 by 2010 and then to 28 by 2011. Except for one, all the acquisition transactions concerned the takeover of non-listed domestic Chinese companies. An exception to the trend of acquiring domestic unlisted companies, Geeya Co. Ltd. acquired a foreign listed company, namely Harvard Instruments Ltd., listed on the UK's AIM. The government encouraged Geeya's takeover of Harvard Instruments by facilitating the transaction through encouraging policies. This suggests that

⁵⁸⁵ “*Jubaofa Huzhi Suchu* [A Longing Desire for a Public Whistle-blowing Law],” Government News, *Renminwang (People's Daily)*, (2005), url: <http://www.people.com.cn/GB/paper83/16191/1430482.htm>..

ChiNext may be a policy market in so far as certain activities are screened. The foreign market for control brings more kudos to ChiNext companies as it demonstrates the ability to comply with international and foreign requirements. Thus, although ChiNext companies are SMEs, they are fast becoming holding companies with complex group structures. The disclosures of directors of their concurrent roles in other companies are a testimony to this.

Evidenced by a lack of takeover activity, there is no active market for control on ChiNext. This stands to reason given that the market was established to achieve a specific policy objectives of the State, namely the financing of China's hi-tech, innovative and high growth SMEs within a consumption-led economy, as discussed earlier in chapters one and two. This suggests that ChiNext as a policy market is unlikely to have any active market for control. Moreover, the government tends to discourage dispersed ownership, which is the ownership structure in which takeovers are most effective.⁵⁸⁶ The IPO Review Panel's rejection of applications from companies that have complicated or multi-tier ownership structures or a history of ownership issues.⁵⁸⁷ Furthermore, an equity market full of aspiring entrepreneurial "owner-managers" also dampens the market for control. Finally past experience of takeovers of controlling shareholdings in privately held companies seem riskier than that of SOEs because the new controlling shareholders may be subjected to bullying tactics by both senior and middle managers remaining in the business, which may include the withholding of key information, for example.⁵⁸⁸

B. Private Ordering: Litigation and the Courts

As briefly discussed in the chapter on regulation, private enforcement in China has four forms: courts, arbitration, mediation and arb-mediation. Under the ChiNext framework,

⁵⁸⁶ Luca Enriques and Paolo Volpin, "Corporate Governance Reforms in Continental Europe," *Journal of Economic Perspectives* 21, no.1 (Winter 2007): 117-40.

⁵⁸⁷ See Sub-section 1. Approval and Rejection of Listing Applications on page 281.

⁵⁸⁸ Liu Junhai, *Legislative and Judicial Controversies*, (2006): 201.

companies must report the existence of any court or arbitration cases. Shenzhen Stock Exchange only reports on the administrative actions and sanctions against companies on their exchanges. This limitation means that such information must be gleaned from annual reports.

Table 15: Percentage of companies with enforcement actions disclosed in annual reports of surveyed companies

| | 2009 | 2010 | 2011 |
|--------------------------|-------------|-------------|-------------|
| | % | % | % |
| Administrative sanctions | 5.00 | 25.00 | 12.50 |
| Litigation | 10.00 | 15.00 | 7.50 |

Source: Author's survey

The occurrence of private enforcement in Company Law matters remains relatively low in China, especially with regard to publicly quoted companies. This is definitely reflected in the fact that in 2009 only 10% of the surveyed companies were parties in litigation. By 2010, it increased by 50% to 15% of the surveyed companies and settled back to 7.5% in 2011.⁵⁸⁹ It was particularly noticeable that none of the litigation disclosed in annual reports relate to company law matters. Instead they range from sale and purchase matters to intellectual property disputes. The findings here correlate with the fact that the courts in China play a more prominent role in legislative interpretation.⁵⁹⁰ Nonetheless, in terms of contractual enforcement of shareholder rights under shareholder agreements there trend is markedly different overall in China as the next chapter suggests.⁵⁹¹

⁵⁸⁹ Author's survey.

⁵⁹⁰ See Section II. Legal Governance Mechanisms and Framework of ChiNext on page 60.

⁵⁹¹ See Sub-Section 5. Shareholder Agreements on page 349.

Closing Remarks

So far, this chapter has illustrated the overall enforcement regime in relation to corporate governance. The CSRC, the Exchange, the media and public whistleblowing together encompass the true corporate governance external regulatory framework, not only for ChiNext but also for other equity boards in China. They have a symbiotic relationship, whether admitted or not. Its routes can be traced back to the Communist era of public criticism.

Four main points can be gleaned from this chapter. Firstly, the external governance landscape in which companies listed on ChiNext exist comprises more than just the regulator and regulated. The immense role of the press in public opinion supervision powers and that of company stakeholders through the use of the public whistleblowing system has been either under-examined or completely ignored, yet they are integral mechanisms of corporate governance. Secondly, the CSRC's proactive regulation at company levels suggests two matters of importance to the institution. One appears to be a pre-occupation in proving that its judgment and expertise in approving listing applications remains correct. The other is that it wishes to be the first to discover any discrepancies between a company's internal governance pre-IPO and post IPO. This intention has become poignant in the context of the rising power of the financial media in revealing scandals before and after IPO, tantamount to indirect criticism of the partiality and expertise of the CSRC. In the past, the CSRC has been criticised on how it implements its decisions and a lack of uniformity. The CSRC not only imposes self-regulation on the stock exchanges it supervises, but also it too must impose self-regulation on itself. As discussed later, the news media plays an important role in providing information not only to investors but also to the regulatory authorities. Thirdly, the Exchange has also adopted a pragmatic approach in regulatory enforcement by identifying issues and then regulating for them. Some scholars argue that corporate governance can only be

effective in the securities market, where the market rather than non-state organisations that will have a bottom-up approach in regulating will make the rules that fill the gaps left by legislation.⁵⁹² But then again, few of these markets have a press that has legal, moral and political authority, as the Chinese press do, to undertake investigative journalism that also assists the regulators. Finally, state institutions dominate the regulatory environment on ChiNext with little or no private ordering occurring, or market for control. The role of intermediaries who present the most likely non-state institutions for enforcement remains limited in regulatory impact. Instead, intermediaries are less likely to be reputable and more likely to be the subject of criticism and accusations of corruption and conflicts of interest by the financial media, or disciplinary action by the Exchange. This certainly does not bode well for proponents of the development of non-state regulation.

At this juncture, it is important to reiterate that the environment in which this enforcement occurs is one dominated by privately controlled listed SMEs and not large listed SOEs. The next chapter pulls to the fore the changes in corporate governance dynamics in shareholder activism, internal governance and regulation wrought by this change.

⁵⁹² Clarke, “The Ecology of Corporate Governance in China,” (29 August, 2008).

Chapter Six – Corporate Governance Practice on ChiNext

The main research question of this thesis is to understand the nature of the corporate governance practice of ChiNext. We have already seen how related corporate governance and, indeed, China's legal system is attached to the nature of its polity, so that using a political science theory to understand the institutional dynamics of corporate governance is not an unnatural development.⁵⁹³ The preceding chapters have examined in detail the officially sanctioned channels: shareholders meeting, boards of directors and supervisors and the legal and regulatory authorities, as well as the market. The case studies in the chapters on ownership and management have indicated that there appear to be other forces rather than law and legal obligations that motivate investment in listed companies controlled by individuals and families, despite the inherent risks.

A key objective in identifying 'informal' institutions of corporate governance is to understand better the risks and constraints arising as well as the limits of law. Formal institutions include state institutions (courts, legislatures and bureaucracies), state-enforced rules (constitutions, laws and regulations) and organisation rules that govern companies, political parties and interest groups.⁵⁹⁴ Weak market institutions result in the increase in the role of 'informal norms' such as trust and obligation being substitutes for weak formal institutions with the effect of reducing agency costs that stem from the operation and performance of the company.⁵⁹⁵ Several studies have found that informal relationships and norms serve as substitutes for market intermediaries in emerging markets; they provide

⁵⁹³ See Xi, *Corporate Governance and Legal Reform in China*, (2009).

⁵⁹⁴ For detailed discussion of organisation rules, see Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* (Cambridge, Mass. ; London: Harvard University Press, 1991). Ellickson finds from case study research of an agricultural region in North California in the US that disputes between familiar people are rarely settled at court; rather, those without prior relationships submit their disputes to formal legal mechanisms. However, his methodology has been criticised as not being scientific enough to prove his conclusions. See Mark Cooney, "Why Is Economic Analysis So Appealing to Law Professors," *Stanford Law Review* 45 (1993 1992): 2215.

⁵⁹⁵ Luo and Chung, "Filling or Abusing the Institutional Void?"

quality and timely information.⁵⁹⁶ Weak market institutions result in there being less incentives for family controlling shareholders to pay mind to the interests of external shareholders.⁵⁹⁷ The family, consequently, has more power to pursue its private interests in the company.

This Chapter is divided into four sections. Section I examines further the Chinese traditions of ‘relationships’ (*guanxi*) and Confucian filial piety (*xiaoshun*) both become important in understanding the dynamics of internal governance and the protection of investors in listed companies. The dynamics of board governance and effectiveness become inevitably influenced by social traditions. Section II proposes that for privately run listed SMEs individual shareholders with board non-executive positions are most effective corporate governance mechanisms and the role of social norms in empowering them. In turn Section III illustrates how this group of shareholders can contribute to board effectiveness and empower independent directors. Finally, Section IV examines the use of covenants and shareholder agreements to control, limit or positively influence the corporate conduct of controlling shareholders.

I. What is the Most Effective Type of Shareholder for ChiNext Listed SMEs?

This section debunks the assumption that institutional shareholders are generally the most important corporate governance mechanism in a listed company, and far more effective than individual shareholders. This entails a discussion of the corporate governance limitations of institutional shareholders in the context of individual and family-controlled listed SMEs.

⁵⁹⁶ For example, Alena Ledeneva, “Blat and Guanxi: Informal Practices in Russia and China,” *Comparative Studies in Society and History* 50, no.1 (2008), doi:10.1017/S0010417508000078.

⁵⁹⁷ Michael N. Young et al., “Corporate Governance in Emerging Economies: A Review of the Principal-Principal Perspective,” *Journal of Management Studies* 45, no.1 (1 January, 2008): 196-220, doi:10.1111/j.1467-6486.2007.00752.x.

A. Limitations of Institutional Shareholders in Privately Controlled Listed SMEs

Based on the results of the study, this thesis proposes that large individual shareholders, specifically those that invest in the company prior to its IPO, are better and more efficient corporate governance mechanisms. Of course, some training and obligations might be required to effectively align their interests with those of the rest of minority shareholders represented by small retail shareholders.

In the context of the surveyed companies, several limitations of institutional shareholders were observed that arguably may apply in other privately held listed SMEs on China's equity markets. Firstly, the results from this research largely indicate that institutional investors are not necessarily a crucial corporate governance mechanism for privately held listed SMEs, as with the surveyed companies in this thesis. The research has demonstrated thus far that institutional investors (excluding venture capitalists) on ChiNext take speculative positions. Corporate governance becomes less of an issue for them in the protection of their interests because they are speculative. This phenomenon is not limited to China, but was identified over 20 years ago when it was found that institutional shareholders undertook a control trade-off in favour of retaining liquidity.⁵⁹⁸ Thus, regulatory framework did not account for the sole reason for the lack of institutional investor engagement in monitoring and decision-making in companies. Secondly, institutional investors appear to have less influence on owner-managers and perhaps this reflects their reluctance to invest pre-IPO. As demonstrated in Chapter Three, there also appears to be some reluctance from institutional investors to engage with private individual and family controlling shareholders, which also presents a potential limit to their effectiveness, at least for individual and family

⁵⁹⁸ See Coffee, "Liquidity versus Control."; see also Bernard S. Black and John C. Jr Coffee, "Hail Britannia: Institutional Investor Behavior under Limited Regulation," *Michigan Law Review* 92 (1994, 1993): 1997. This is not to say that the Chinese experience is similar, but it gives some insight, especially for the argument made in this thesis that comparison of corporate governance issues and remedies may not be helpful as countries go through different stages.

control. It also reflects their relative reluctance to invest substantial amounts of equity in one company, even post IPO. Thirdly, the well-documented limitations posed by disclosure obligations imposed for those holding 5% or more of total voting rights in turn hamper the building of a stake post IPO, also appears to apply on ChiNext. Fourthly, institutional investors that invest in the secondary market remain particularly weary of building a stake once disclosure obligations kick in. They then run the risk of being grouped as ‘insiders’ with all the obligations that arise from that which includes certain restrictions on share dealing. Conclusively, for institutional investors to be effective mechanisms of corporate governance they require a substantial holding in the company in order for their voice to be heard.

B. Proposing Pre-IPO Individual Subscribers as Effective Corporate Governance Mechanisms

Large individual pre-IPO subscribers are a more effective corporate governance mechanism for the protection of minority and shareholders’ rights as a whole in privately controlled small and medium-sized listed companies. A key reason that lends them control factor are the *guanxi* obligations of controlling shareholders to those shareholders that first invested in their company. The importance of *guanxi* stems from the scarcity of funding from financial institutions such as banks for the average private enterprise in China. Privately held companies tend to be funded mainly through familial connections and *guanxi*, so that in privately held companies the effectiveness of the large individual shareholder may be limited in a state-owned or state-private joint venture, where, indeed, their funding proves irrelevant as the state can afford the start-up and to prop up the business activities of the companies, once there is a will.

The first key result of this thesis is that, in the context of ChiNext listed companies, large retail shareholders/individual majority shareholders appear to be more effective

corporate governance mechanisms than institutional shareholders, specifically in the context of listed SMEs, where they present a check and balance on private controlling shareholders. This proposition has credence in the context of how private enterprise raise their funds prior to IPO and the interlinked cultural implications of sources of funding when from private individuals in China.

C. Confucian Filial Piety (*Xiaoshun*) and Corporate Governance

This section presents the Chinese tradition of Confucian filial piety as a mechanism of internal governance within family ownership structures, with the exception being the husband and wife partnership.⁵⁹⁹ Examining the role of Confucianism in the development of Chinese private enterprise has taken hold in the last decade and continues to develop. There is some recognition in Chinese language scholarship of the importance of Confucian thought in enterprise development, particularly the Confucian family system (*rujia jiazu zhidu*), for example, in business management scholarship.⁶⁰⁰ In particular, the literature suggests that filial piety plays a key role in Chinese family enterprises,⁶⁰¹ and generally in business practice in China.⁶⁰²

The effect of Confucian thought in corporate governance manifests in the emphasis on person-to-person relationships. This means that such governance depends on such persons being identifiable. A key limit in trying to utilise Confucian thought to rationalise protection of minority investors is that this pool of investors are mostly anonymous to the controlling

⁵⁹⁹ See Chapter Three for trends in ownership.

⁶⁰⁰ For example, Ni and Chun argue the importance of Confucianism in enterprise. Ni Bo and Chun Yuejun, “*Rujia sixiang shi qiye wenhua jianshe de baogui caifu* [Confucianism is an Invaluable Treasure in the Building of Enterprise Culture],” *Jingren xuebao*, no.2 (2005): 116-18.

⁶⁰¹ For an historical excursion of Chinese family business and the role of culture, see Jamieson, *Chinese Family and Commercial Law*. For a contemporary but non-law (i.e., management) perspective, see Sanjay Goel, Xiaogang He, and Ranjan Karri, “Family Involvement in a Hierarchical Culture: Effect of Dispersion of Family Ownership Control and Family Member Tenure on Firm Performance in Chinese Family Owned Firms,” *Journal of Family Business Strategy* 2, no.4 (December 2011): 199-206, doi:10.1016/j.jfbs.2011.10.003.

⁶⁰² See Li Wenyi and Liu Chundan, “*Kong meng ruxue yu dangdai minying qiye guanli* [Confucianism, Mencianism and Contemporary Private Business Management].”

shareholders. The next section examines how it plays a role in China's enterprise system, so as to potentially have an impact on the corporate governance of listed enterprises.

1. Filial Piety and China's Enterprise System

In terms of China's whole enterprise system, including the public and private, Wu Zhipan, an expert in both company and financial laws in China, cautions that corporate governance in China has to be taken in the context of thousands of years of ancient tradition.⁶⁰³ In particular, he quotes, saying 'cultivate yourself, [then your] family will be regulated, [your] country well governed, [and] the world peaceful' (*xiushen, qijia, zhiguo, ping tianxia*),⁶⁰⁴ which has a profound effect. At national level, the slogan is loosely translated as 'the nation and family being of one' (*jiaguo tonggou*), and then is whittled down to enterprise level to the slogan 'enterprise becomes the family' (*qiye wei jia*). As Lee Yan Phou observed:

The child...if he is taken to task for anything he has done he must never contradict, never seek to explain. The Chinese take no explanations from those subject to them. They deem this method absolutely necessary for the preservation of authority.⁶⁰⁵

Thus, the key link between China's enterprise and Confucian filial piety becomes the fact that every family has a head, whether nominal or *de facto*, and, therefore, the principles of filial piety come into play at both country and enterprise level. Consequently, at national and enterprise level people were expected to behave as in a family.⁶⁰⁶ This perspective has

⁶⁰³ Wu Zhipan, "Zhongguoshi 'Gongsi Zhili' [Chinese-Style Corporate Governance]," in *Gongsizhili Zhuan Lun* = *Studies on Corporate Governance*, eds. Peizhong Gan and Jianbo Lou, Di 1 ban, Jingjifa Luncong (Series of Economic Law) (Beijing Shi: Beijing da xue chu ban she, 2009).

⁶⁰⁴ Qi lu shu she, "*Li Ji*" *Ming Yan* = *Aphorisms From Liji*, Di 1 ban, Ru Jia Ming Dian Zhen Yan Lu (Jinan: Qi lu shu she, 2006).

⁶⁰⁵ See, Yan Phou Lee, *When I Was a Boy in China* (London: George G. Harrap, 1922).

⁶⁰⁶ Interview 2012-7.

received the most attention in the discipline of business management, which proposes the importance of certain aspects of Confucianism in business culture.⁶⁰⁷

2. Implications for Corporate Conduct

The preceding section has focused on the positive force that *guanxi* plays in empowering non-controlling individual shareholders to effectively monitor their personal investments. This section examines the definition of filial piety and its role in China's enterprise system, and discusses the challenges it poses in corporate governance, in particular for board effectiveness, and what mechanisms may work to mitigate its effects.

Corporate law and corporate governance are concerned with facilitating desirable corporate conduct and deterring undesirable corporate conduct. Distinctions between desirable and undesirable conduct may vary from country to country or culture to culture.⁶⁰⁸ In contrast to a conventional analysis of corporate governance practice, this thesis proposes that, for privately controlled listed companies on ChiNext, though Chinese polity plays a role, more pressing challenges to corporate law and rules come in the form of social norms that have the force of law in China, which complicates the corporate governance landscape.

⁶⁰⁷ This seems to be led by regional scholarship in China, with the objective of finding ways to promote regional economic growth through successful business management and performance. For example, Gao Xueshen, "Rujia Sixiang Qiyewenhua Chuangxinzhilu - Laizi Shandong Chenggong Qiye de Qushi [Confucianism and Innovation in Enterprise Culture - Enlightenment from Successful Enterprises in Shandong]," *Huadong Keji [East China Science & Technology]*, no. 12 (2002): 8–9. (Provides a general discussion of the role of Confucianism in successful management.) See also Feng Gao, Huapeng Zhao, and Maoxin Hu, "Qianxi rujiasixiang dui xiandai qiye wenhua de jianshi de qishi [A Brief Analysis of the Inspiration for Confucian Thought in the Construction of a Modern Enterprise Culture]," (*Journal of Shaanxi Vocational & Technical College*) 3, no. 3 (September 2007): 23–26. (Philosophically but briefly examines key concepts in Confucianisms such as "xiao" and acknowledges Western innovations in management but recommends they be adopted but with a Confucian perspective which naturally complements China's norms.)

⁶⁰⁸ For a general discussion see Blair and Stout, "Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law."

a. Counterbalancing ‘Chairperson Control’: a Challenge to Board Effectiveness

China’s corporate governance model, though very much shareholder-orientated in terms of outcome, has a stakeholder feature in terms of who can contribute to the governance of the company by permitting the public whistleblowing system to be part of the process. Yet, in the board, the Confucian concept of hierarchy becomes the rule of engagement.⁶⁰⁹

Strict hierarchy with the chairman of the board at the helm exists. Confucian filial piety plays a key role in board culture in which there appears to be a strict hierarchy with the chairman of the board at the top. This board culture was complimented by 1993 Company Law, which gave the chairman of the board a huge amount of legal power.⁶¹⁰ Most of the companies listed on ChiNext, were first incorporated before 1 January 2006 that is under 1993 Law. The implication thus being that, although the revision of Company Law in 2005 removed the unilateral powers of the chairman, a legacy has been left where all power and influence over the company resided in the chairman. This whether intended or not naturally complements and reinforces Confucian filial piety where the head of the family, work unit (danwei) or country leads without reproach. This control by the chairman can be referred to as ‘chairman control’ in that it exceeds the powers of veto and management of the executive board. This control extends beyond the boardroom with the chairman being able to partake in the organisation at every level with the capacity to liaise, and direct even the most junior employees without reference to senior or middle management.⁶¹¹ This board culture is most noticeable in SOEs.⁶¹² As such, in SOEs, chairperson appointments tend to be as non-executive representatives of the controlling shareholder.

⁶⁰⁹ Ni Bo and Chun Yuejun, “*Rujia sixiang shi qiye wenhua jianshe de baogui caifu* [Confucianism is an Invaluable Treasure in the Building of Enterprise Culture].”

⁶¹⁰ Feinerman, “New Hope for Corporate Governance in China?” (September 2007).

⁶¹¹ See Yan Xuefeng, “*Shangshigongsi Dongshizhang de Quanli Xianjing* [The Power Trap of the Listed Company Chairperson],” *Dongshihui [Directors & Boards]*, no.4 (2009): 43-44.

⁶¹² Zheng Wei, “*Woguo Shangshi Gongsi Dongshihui Moshi Yanjiu* [A Study on China’s Model of the Board of Directors],” *Qiye Keji Yu Fazhan [Enterprise Science and Technology & Development]*, no.1 (2011): 6-8.

This chapter presents the analytical conclusions of the case studies of the last few chapters on the identified corporate governance mechanisms on ChiNext. The multiple case studies undertaken have resulted in four key results for this thesis. Some key traits in Chinese companies that have long been identified by management scholarship as affecting managerial decision can also affect corporate governance where the controlling shareholder also partakes in the day-to-day running of the company. This is an inherent challenge that will continue to undermine the effectiveness of the board regardless of its composition and this can be attributed to the strict hierarchy to be found therein. Confucian filial piety is not only limited to family-controlled companies but can be extended to non-familial private and even public ownership.

This focus on Confucian thought, particularly filial piety, in this thesis contrasts with previous literature that, as a result of the predominance of state-owned listed enterprises, focused on the role of political governance systems. Through these four obligations, a system of governance parallel and in some ways complementary to that set out in Company Law and the regulatory framework arises. Parallel in this sense suggests that a key effect of Confucian thought in governance manifests in the emphasis on person-to-person relationships. This means that such governance depends on people being identifiable and having a filial connection, rather than being anonymous, as is mostly the case with most investors in equity markets, e.g., retail shareholders.

Social norms such as filial piety, personal connections and hidden rules need to be analysed in the context of the corporate governance mechanism because they play an important regulatory role. Social norms have force of law. For ChiNext, this can be directly related to the sources of funding of these privately controlled companies. Social norms are important in promoting continued investment in companies, despite the high risk of bad performance and expropriation. This also indicates that privately controlled listed companies

with several large individual investors who are not institutional investors may have better corporate governance, not because of the laws and rules but because of fear of social sanctions in breaching social norms. This is not to say that there are no breaches of social norms, but what is clear from the literature is that social norms are less likely to be ignored than legal rules. Thus, in some instances social norms as a force of law are more effective than legal and regulatory rules.

b. ‘A Law onto Him/Herself’ (*yigeren shuole suan*)

A pervasive culture in many private non-listed companies, and as a result in some ChiNext companies, remains the culture of one person making the decision or more colloquially, being a law unto himself or herself ignoring established rules (*yigeren shuole suan*).⁶¹³ This is based on the culture that each person is a member of a leader’s group (in other words, the family), which scholars perceive as a pervasive mind-set in China.⁶¹⁴ In practice, in terms of the company as a whole, it translates that the chairman of the board as leader of the group amounts to the head whose leadership decisions must be followed. This also replicates on the board of directors, in that all the directors, whether executive or non-executive (including independent) will be expected to toe the line.⁶¹⁵ They are part of the chairman’s team, despite Company Law carving out a monitoring role for independent directors. Boardroom culture reflects a socialist big family system culture of the boardroom. The leadership style of SOEs manifests in the mantra of the ‘one leader system’.

⁶¹³ Interview 2012-7.

⁶¹⁴ Gao Wuqing, “*Wanshan zhongguoshi guoyou qiye dongshihui zhidu* [The Perfection of Chinese-style Board of Directors in State-owned Enterprises]”: 15.

⁶¹⁵ For an example of problems arising with independent directors due to the dominance of the chairman and or controlling shareholder, see Qian Weiqing, “*Duoguan Qixia Bimian Dudong Cheng Neidong* [More Caution to Prevent Independent Directors from Becoming Inside Directors],” *Dongshihui (Directors & Boards)*, no.8 (2012): 45.

Ultimately, they all belong to the state administrative leadership system (*zhengfu xingzheng lingdao tizhi*), which is where the socialist big family system culture continues in the board room.⁶¹⁶ Importantly, the erudite remains favoured over the professional and this affects the selection and nomination of the constituents of the executive board. The favouring of a broad education compared to professional experience remains crucial to understanding the dynamics of most Chinese boards. For instance, Quqing argues that broad learnedness remains valued over professional qualifications.⁶¹⁷ Indeed, this proposition is arguably reflected in the fact that still legislation at all levels makes no requirements of the qualifications needed for being a director. Nor can you find a perfect match of qualification. The companies that do adopt accountants and lawyers tend to be export-focused companies where the influence of foreign corporate governance systems and international corporate governance systems demand an almost mirror image of integrity.

In this thesis, we refer specifically to the Confucian concept of filial piety (*xiaoshun*). In China's Company Law of 1993, the chairman had a very powerful role that implicitly complemented and reflected Confucian norms in terms of every unit having a hierarchy. Thus, the rigid hierarchy effectively undermines the practical effectiveness of the independent director.

c. 'A Good Hand' (*yibashou*)

A 'good hand' (*yibashou*) has a lot of wide-ranging experience, but may not necessarily be an expert or professional. The phenomenon of the old hand especially arises in relation to founders and entrepreneurs who manage every facet of the company.⁶¹⁸ This is

⁶¹⁶ Gao Wuqing, "Wanshan zhongguoshi guoyou qiye dongshihui zhidu [The Perfection of Chinese-style Board of Directors in State-owned Enterprises]": 16.

⁶¹⁷ Gao Wuqing, "Wanshan zhongguoshi guoyou qiye dongshihui zhidu [The Perfection of Chinese-style Board of Directors in State-owned Enterprises]," *Qiye yanjiu (Business Research)*, no. 11 (2012): 14–17.

⁶¹⁸ Guo Hongye, "Zhongguo Dongshihui Zenme Le? [What Is Wrong with the Chinese Board of Directors?]."

regardless of whether or not they have the requisite skill and expertise for the positions(s) they hold. They are usually the controlling shareholder, the chairman of the executive board or the CEO.⁶¹⁹ They commonly strategically control through controlling information flow,⁶²⁰ and this is the key impact on corporate governance as it means that even the most dedicated shareholding non-executive directors ('SNEDs') and INEDs will be hampered in partaking in decisions. The result of such managerial style for corporate governance has revealed itself in the inability to disclose and transparently discuss problems in the company.⁶²¹ Earlier, it was noted that venture capital investors and other institutional investors remain reluctant to invest in a company where the founder/entrepreneur undertakes multiple roles, and this is a key reason. As one interviewee expressed, 'institutions (investors) will be reluctant to invest unless it is clear that even without any monitoring input on their part they will make a handsome return on IPO; which is almost guaranteed given the pricings system on ChiNext'.⁶²²

D. Relationships (*Guanxi*) and Corporate Governance

One of the effects of the rise in privately held enterprises due to their funding sources and business development initiatives remains the influence of relationship networks, i.e., *guanxi*. Through *guanxi*, most privately controlled enterprise source funding for business activities. Chinese 'relationships' (*guanxi*) acts as a key corporate governance role between large and medium-sized shareholders and the controlling shareholder. In this thesis, and in the context of corporate governance, *guanxi* may be defined as a mechanism by which the

⁶¹⁹ Gi [Ji] Guanglin, "Guanyu Zhongguo Tese Dongshihui Zhidu de Yanjiu [Regarding Research on Chinese-Style of the Board of Directors System]": 40.

⁶²⁰ Yan Xuefeng, "Shangshigongsi Dongshizhang de Quanli Xianjing [The Power Trap of the Listed Company Chairperson]."

⁶²¹ Gi [Ji] Guanglin, "Guanyu Zhongguo Tese Dongshihui Zhidu de Yanjiu [Regarding Research on Chinese-Style of the Board of Directors System]": 39.

⁶²² Interview 2012-12.

actions of insiders may be controlled, limited or deterred, thereby facilitating continued investment and confidence in the company. This section argues that *guanxi*, in context of the surveyed companies, and, indeed, in general for privately controlled SMEs in China, plays an important role in protecting shareholders due to the constraints it imposes on controlling shareholders.

1. Guanxi: Positive or Negative Mechanism?

There is recognition of the role *guanxi* plays in law and governance as reflected by the debate of whether *guanxi* is a positive or negative force in itself. There have been negative connotations to *guanxi*.⁶²³ In a socio-legal analysis, Garrick observes it has been ‘hijacked by opportunists’ to change ‘the rules of the game mid-game’.⁶²⁴ Su, Mitchell and Sirgy take pains to distinguish between good and bad *guanxi*, and explain what they term effective *guanxi* as that which,

...works as a relationship based cultural mechanism that draws on Chinese cultural ethics of cooperation (e.g. mutual assistance) gathers necessary resources for business performance and better enables the survival of firms.⁶²⁵

This thesis concerns itself with effective *guanxi*, which has a positive empowering effect on shareholders *vis a vis* the controlling shareholders. Undoubtedly, any context in which mechanisms that fall outside the realms of formal law and regulations raise questions of the rule of law, and this will be examined toward the end of this chapter.

⁶²³ See Udo C. Braendle, Tanja Gasser, and Juergen Noll, “Corporate Governance in China—Is Economic Growth Potential Hindered by Guanxi?,” *Business & Society Review* (00453609) 110, no.4 (2005): 389-405, doi:10.1111/j.0045-3609.2005.00022.x. (They find that China is deeply rooted in the cultural law of *guanxi* whilst being confronted with new rules and regulations aimed at economic growth. It is a double-edged sword with business-government *guanxi* being the most destructive for the corporate governance system and, therefore, economic growth.)

⁶²⁴ John Garrick, ed., *Law, Wealth and Power in China: Commercial Law Reforms in Context*, Routledge Contemporary China Series (Milton Park, Abingdon, Oxon ; New York: Routledge, 2011): 8.

⁶²⁵ Chenting Su, Ronald K. Mitchell, and M. Joseph Sirgy, “Enabling Guanxi Management in China: A Hierarchical Stakeholder Model of Effective Guanxi,” *Journal of Business Ethics* 71, no.3 (1 March, 2007): 302.

The resignation of many directors in order to cash in on their shares was unlikely to be something that the controlling shareholder could control in the sense that it was more than likely that there existed a tacit agreement that, once floated, will entitle these directors, supervisors and senior managers to cash in on their investments. *Guanxi*, of course, remains a double-edged sword. One reason for the influence of pre-IPO individual subscribers as corporate governance mechanisms is their strong relationship, i.e., *guanxi* with the controlling shareholder and the company.

2. Implications for Corporate Conduct

Guanxi complicates corporate governance because it remains difficult to draw the boundaries of who can be classified as, what is termed in this thesis, a *guanxi insider*. The difference between the regulatory ‘insider’ and a *guanxi insider* lies in the social norms that dictate the relationships of the latter, in addition to whatever framework is implemented. It is proposed that the *guanxi insider* is potentially more powerful and has more information than the insider as defined under corporate governance laws have definitional boundaries that make constituents readily identifiable. They include *de facto* controllers, controlling shareholders, , directors, managers, supervisors and majority shareholders. If insider dealing legislation is included, then the scope of insider extends to spouses and affiliated companies. However, the definitional boundaries of who can be a *guanxi insider* is broader and less traceable or identifiable. Indeed, the opacity of ownership structures on ChiNext highlights the potential issues that may arise for insider dealing detection or lack thereof. More pressing, if *guanxi* forms the basis of an investment, then protection of such investments will also be based on *guanxi* dynamics, arguably to the exclusion of whoever falls outside the *guanxi* web or network.

Consequently, the effectiveness of *guanxi* as a corporate governance mechanism requires that the interest of the Party that has *guanxi* with the controlling shareholder is aligned with the rest of the minority shareholders of the company. As demonstrated by the resigning directors, most of whom held medium-sized holdings, their interests were not aligned. This may be expected since the definition of their interests preceded the existence of those of minority shareholders. The dilution of *guanxi* can only be achieved by making available more formal funding resources for the private sector. However, the negative implication of *guanxi* remains that those minority shareholders will continue to be unrepresented if their interests cannot be aligned with *guanxi*-holding, pre-IPO director-shareholders in ChiNext companies. Thus, a key challenge of how to effectively align the interests of minority shareholders and director-shareholders arises. The next section proposes key ways in which such alignment can be achieved.

This thesis proposes that medium-sized individual shareholders ensure more effective corporate governance in providing a better check and balance of private controlling shareholders than institutional shareholders, at least in the context of ChiNext listed companies. There are several reasons for this. The first is the cultural constraint imposed on private controlling shareholders as a result of obtaining private funding through Chinese relationships, i.e. *guanxi*. The second is the ability of individual shareholders to evoke *guanxi* to effectively monitor the internal governance of the company. The last reason is their attendance of shareholders' meetings and exercise of rights. Of course, there are also cultural limitations to their effectiveness in all three aspects and this will be examined toward the end of this review.

If *guanxi* can be harnessed through large individual shareholders receiving training on corporate governance principles, especially those that aim to promote the protection of shareholders, and particularly minority shareholders, then the risk of the negative potential

and effects of *guanxi* will be reduced. Of course, the problem then arises as to why a large shareholder would want to represent the interests of the minority shareholder. The key here has to be that their interests must be aligned, and they are in practice in so far as the large individual shareholder wishes to see income (dividend) and capital returns on their investment.

II. What Accounts for the Influence of pre-IPO Individual Subscribers cum NEDs?

This thesis proposes that the effectiveness of pre-IPO individual subscribers as corporate governance mechanisms in the surveyed companies arises as a result of their inherent need and willingness to personally monitor their investments, combined with a strong *guanxi*⁶²⁶ with the controlling shareholder, which effectively protects them. In this instance it is proposed here that *guanxi* has positive cultural constraints that act to limit the potential of private controlling shareholders to act in their self-interest or expropriate from the company. To build this argument further, this section defines *guanxi* in generality and, as this thesis perceives, its relationship with corporate governance, as well as demonstrating how it manifests.

A. Effectiveness of pre-IPO Individual Subscribers cum NEDs

Five key traits make pre-IPO individual subscribers cum NEDs, particularly effective in monitoring their investment interests, more involved in decision-making than other types of shareholders, and they are discussed as follows.

⁶²⁶ Both social and economic *guanxi*, as defined later in this part.

1. Readily Identifiable

Large individual shareholders in ChiNext companies are readily identifiable, especially those that hold non-executive directorships because they are relatively small in number. Specific training and development to enhance them as effective monitoring mechanisms is feasible. Moreover, as only a few of them have multiple large investments that may require their presence on numerous boards, it means that they will be able to devote their time and experience.

2. Effective Board Monitoring

It was found that large individual shareholders in ChiNext companies tend to partake in management and monitor the companies in which they invest to varying degrees. Large individual pre-IPO subscribers bring more effective board monitoring, especially in relation to the actions of the chairperson. Large individual pre-IPO subscribers attend executive board meetings and, thus, meetings of executive board change from being a routine. Granted that many pre-IPO subscriber hold executive director or senior manager positions, they also contribute to the monitoring of the controlling shareholder. However, their limitation and conflict in being true monitoring mechanisms arises from their being subject to the power and influence of the controlling shareholder cum CEO on an almost daily basis. Thus, the type of pre-IPO subscriber that will be an effective corporate governance mechanism is the non-executive director who, apart from attendance of board and shareholders' meetings, has no other formal access to the internal governance and decision-making of the company. This importantly lends the ability to evaluate the performance of the executive board and the company from a more detached point of view than executives or senior managers may have. This presents a key element in the potential alignment of their interests with those of the rest of the shareholders in the company.

3. More Involved Shareholder Engagement

As well as engaging as shareholders through their non-executive roles on the board, pre-IPO individual NEDs also engage as shareholders by attending meetings. This occurs despite the fact that they can validly use the executive board as the forum for representing their interests. Importantly, many of them hold enough shares to make shareholder proposals and, therefore, have the potential to ensure that their voices become heard not only on the boards in the company but also, importantly, in the market. Whether or not the proposal results in a resolution being passed becomes academic as the reputational consequences of a would-be challenge to the owner-manager. However, in some companies, attendance was low, perhaps because the resolutions were already approved in principle when the executive board resolved to convene a shareholders' meeting.

4. Stabilising Effect of Large Retail Shareholders Medium to Long-term Shareholding Strategy

SNEDs present a relatively stable group of medium to long-term investors in the company and are, therefore, most likely to have a stabilising effect.⁶²⁷ As many of them have five or more investment years in the listed companies, they have a relatively deep and comprehensive understanding of the investments. Above all, they have demonstrated the tenacity for patience. The extension of this investment time-span is further enhanced by the general rules that pre-IPO subscribers of the company under the Listing Rules cannot trade in the shares within the first 12 months of IPO, and thereafter can only divest up to 25% of their existing holdings in any given year. They are thus not only focused on share price capital gains but on income generation through dividends, which requires the companies to be

⁶²⁷ Interview 2012-12.

successful to have a profit. This interest means that they are more likely to monitor the actual performance of the company rather than the market itself.

As demonstrated in Chapter Three, shareholder agreements and undertakings have been such that some companies have extended the share trading restriction from 12 months to 36 months. More research needs to be done on large retail shareholders who acquire large volumes of shares on the secondary market.

5. Mitigate Effects of Entrenchment of Controlling Individuals and Families

The emergence of owner-managers has corporate governance implications, one being the agency problem of entrenchment. Entrenchment occurs where, despite the inefficiency or lack of qualification of directors or senior managers, they remain in their role on the board or in the company by virtue of their power and influence through shareholding or otherwise.⁶²⁸ The agency problem of entrenchment has not received much attention as an issue for corporate governance in China because it seldom occurs in SOEs, which, to date, have been the main focus of research. SOEs appointments to director and senior managerial roles tend to be in fixed tenure with rotation that also includes succession training starting from supervisory board level. Although they may not have the ability to stop entrenchment of individuals and families who are controlling shareholders, large retail shareholders offer a more efficient check and balance to the pervasive control that Company Law provides. They can promote the employment of professional managers into the company.

As demonstrated in the preceding chapters, undoubtedly the entrenchment of individuals and families in the surveyed companies is clear. This may be seen as one of the consequences of culture entwined with the rise in family ownership. Empirical evidence supports the notion that family-controlled companies are better managed than widely held companies because, as dominant shareholders, they have the power and incentive to both

⁶²⁸ Morck, Wolfenzon, and Yeung, “Corporate Governance, Economic Entrenchment and Growth.”

motivate and discipline management.⁶²⁹ In this paper, shares are widely held where there is more than one majority shareholder (i.e., of 5% or more) thus, no outright control or where ownership is dispersed. Because shareholders are so dispersed, they cannot co-ordinate to share monitoring and control costs, thereby allowing managers to take benefits not shared or take actions to the detriment of shareholders.⁶³⁰ It is thus argued that individual and concentrated owners eliminate the vertical agency problem of managers appropriating shareholders. However, family control fails to protect the interests of shareholders from abuse where the controlling owners are also the managers, as is often the case on ChiNext, and generally in China's SMEs. To date, there have been many reports of the alleged expropriation of minority shareholders.⁶³¹ The details of this are unsubstantiated due to the lack of disclosure. Internal management mechanisms on ChiNext are limited by the fact that controlling families cannot be ousted by replacing the board of directors. They are entrenched by self-representation and/or appointing directors on the board of directors and supervisors. As there is, at present, no market for control on ChiNext, they cannot be challenged by outside investors. There is unlikely to be a market for control any time as ChiNext is the government's policy market focused on financing selected companies as its key economic development objectives.

⁶²⁹ Ibid.

⁶³⁰ Jensen and Meckling, "Theory of the Firm."

⁶³¹ See Zeng Fubin 曾福斌, "Wangsu Keji Tui 550wan Guquan Guli Jihua 网宿科技推 550 万股权激励计划 [Wangsu Keji Pushes Through 5.5million of Shares Option Plan]," *Dongfang Zaobao [Eastern Morning Paper]*, (21 December, 2010), url: <http://www.dfdaily.com/html/136/2010/12/21/550052.shtml>; Ye Tan, "Shui Shi Chuangyeban Duchong? [Who Are the Vermin of ChiNext?]," *Shangjie (Business Review)* (December 2011); Ge Jia, "Chuangyeban Gongsi Shouci Pilu Gagan Jianchi [ChiNext Companies' Announce the First Reductions in Executive Shareholdings]," *Dongfang Zaobao [Eastern Morning Paper]*, (5 November, 2010), url: <http://www.dfdaily.com/html/136/2010/11/5/534137.shtml>.

6. Overcome Limited Market for Control

As stated earlier, one of the most effective mechanisms for the empowerment of shareholders is the market for control, both in concentrated and dispersed ownership structures. One of the key issues in China's listed companies is the limited market for control, and as discussed earlier this state of affairs appears to be supported and actively promoted by the government.⁶³² The highly concentrated ownership means that takeovers through tenders are unlikely as it can be done by private mutual agreement of the controlling shareholder. So far, this is the predominant model of takeovers of listed companies in China. Different types of ownership also display varying attitudes to takeovers. For instance, SOEs tend to transfer control off-market,⁶³³ while family-controlled listed companies rarely transfer control.⁶³⁴ Thus, it may be concluded that with "owner-manager" companies dominating ChiNext, such takeovers unless hostile are highly unlikely on the market.

In line with the other equity boards, the market for control as a corporate governance mechanism on ChiNext remains limited in scope. At present, and as evidenced by a lack of takeover activity, there is no market for control on ChiNext. ChiNext was established to finance SMEs so as to achieve the specific policy objectives of the Party and the state. This suggests that ChiNext as a policy market is unlikely to have any active market for control. Moreover, acquiring a controlling shareholding in privately held companies seem riskier where previously 'owner-managed'⁶³⁵ because the new controlling shareholders may be subjected to bullying tactics by both senior and middle managers who have remained. For instance, they may withhold key operational information.⁶³⁶

⁶³² For an examination of ChiNext see Sub-section A. Market for Control on page 330.

⁶³³ Xi, *Corporate Governance and Legal Reform in China*, 2009.

⁶³⁴ Feng Xunan, Li Xinyu, and Chen Gongmeng, "Jiazu Kongzhi, Zhili Huanjing He Gongsi Jiazhi (On the Family Control, Institutional Environment and Corporate Valuation)," *Journal of Financial Research*, n.d.

⁶³⁵ That is where the controlling shareholder holds the key role of CEO/manager or (executive) chairman.

⁶³⁶ Liu Junhai, *Legislative and Judicial Controversies*, (2006), 201.

B. Pre-IPO Individual SNEDs vs INEDs

In order to highlight the effectiveness of the SNEDs as mechanisms of corporate governance, this section compares and contrasts the roles of SNEDs with those of INEDs based on the key premise that the role of the INED is providing independence, monitoring the board and representing minority interests. It is contended here that SNEDs, particularly individual SNEDs, have the capacity to carry out this role more effectively than INEDs in China's privately held listed SMEs, like the surveyed companies. To this end, it examines their selection and nomination, alignment of interests and monitoring of controlling shareholders.

Firstly, there remains some opacity in the election and nomination of INEDs compared to SNEDs. The nomination and appointment of individual SNEDs is by virtue of their capital contribution to the company. The findings from the survey in the previous chapters indicate a loose link between the level of shareholding and the holding of a directorship by a shareholder. That is, it is not unknown for a shareholder holding a low percentage of voting rights to be a SNED while another with more shares is not. The controlling shareholder arguably has less control on these appointments because they occur in exchange for the financing they provide to the company. Moreover, apart from any shareholder agreement that gives such rights, the controlling shareholder is further constrained by what is referred to as *economic guanxi*. By contrast, by definition, independent directors have made no capital contribution.

Secondly, SNEDs interests are generally better aligned with those of shareholders as a whole, including minority shareholders, than INEDs in so far as they seek a return on their investment. Independent directors' interests are not naturally aligned with shareholders as a whole because they have, by definition, made no capital contribution. Instead, they are selected mostly from academia, with few having any industry recognition or influence that

may act as a counterbalance to the chairman or controlling shareholder. A large proportion are recruited from mainly economic disciplines followed by business administration, accountancy and law. Thus, even the key obligation to represent the interests of minority shareholders reportedly proves difficult for them to carry out in practice. After all, although they may be elected by cumulative voting, their actual selection and nomination for election lays at the door of the board of directors, undoubtedly the chairman, who is the controlling shareholder or represents the controlling shareholder that leads the board in such decisions. The nomination committee does not have the express remit to preside over the selection and nomination of independent directors as this is a matter for the board as a whole. Indeed, problems persist with the role of the independent directors in presenting a check and balance in that they invariably rarely ever disclose an adverse independent opinion, as noted in an interview with Liu Huiqing, the Assistant to the Chief Executive of the Shenzhen Stock Exchange.⁶³⁷ Moreover, SNEDs have readily identifiable interests, namely either income and or capital appreciation, that align them with the average shareholder. Nonetheless, the alignments of individual SNEDs' interests still pose challenges, mostly in the form of RPTs and insider trading. As mentioned in the previous chapter, RPTs are not necessarily illegal, and in many instances contribute to the growth of both listed and unlisted SMEs by encouraging close stable business relationships. The problem here arises where the private rents from RPTs dis-align the interests of SNEDs from the interests of the company and its shareholders.

Thirdly, the results of the research indicate that SNEDs and INEDs equally have a high attendance at meetings. Individual SNEDs attend board meetings with very high attendance levels, which makes it difficult for insiders to overlook their interests. SNEDs, in

⁶³⁷ Tian Haichuan, "*Liu Huiqing: Dulidongshi dui shangshi gonsi fabiao yiyi bilie tigao* [Liu Huiqing: Increasing the Proportion of Independent Directors that Express Dissenting Opinions]," Financial News, *Hexun.com*, (18 December, 2010), url: <http://stock.hexun.com/2010-12-18/126268877.html>.

contrast, have a vested interest in personally monitoring their investments and, therefore, monitor owner-managers or professional managers by attending executive board meetings. It means that decisions reserved to the executive board cannot be taken without their input. The key improvement in terms of internal governance has been that owner-managers cannot arbitrarily decide important matters reserved for the board. It further suggests that, depending on the implications, proposals, policies and decisions of the controlling shareholder will not go unchallenged at first instance on the executive board. Moreover, since the average holdings on private controlling shareholders usually amount to less than half of the total voting rights, they will need the buy-in of other relatively large shareholders at shareholders' meetings. It is not unknown for large shareholders to litigate against the controlling shareholder, but such occurrences tend to be pre-IPO.⁶³⁸

Fourthly, SNEDs tend to have less potential for conflicts of interest with controlling shareholders and CEOs because they are rarely remunerated by companies. The research finds that most SNEDs in the surveyed companies did not receive any remuneration from the company itself, and where they did, it was mostly a nominal sum. Thus, they are not obliged to perform to the bidding of those that dictate the level of remuneration as with independent directors.

III. How Individual SNEDs Contribute to Executive Board Effectiveness?

In line with a process-based analysis of corporate governance, this section presents the overall findings of this thesis and assesses the different mechanisms that contribute to the effectiveness of the executive board in ChiNext listed companies.

⁶³⁸ See Tang Xin, “*Siren Susong Yu Gongsizhili* (Personal Litigation, Corporate Governance and Law Enforcement in Securities),” in *Gongsizhili Zhuanlun (Studies on Corporate Governance)*, eds. Gan Peizhong and Lou Jianbo, Di 1 ban (Beijing: Beijing da xue chu ban she, 2009): 381-419.

A. An Empowered and More Effective Supervisory Board

Earlier, Chapter Four demonstrated how privately held surveyed companies have invented a new category of external supervisor who is neither a shareholder nor an employee of the company, as required under Company Law. However, whether the appointment of external supervisors will benefit shareholders as a whole in corporate governance terms arguably largely depends on the nature of their relationship. In other words, it will depend on whether they are ‘independent’ of the company and its ownership and internal management structure. It has been demonstrated in Chapter Four that external supervisors comprise a mix of those associated with and those independent of internal management.⁶³⁹ This is an area for further research, especially in terms of their role and effectiveness. Moreover, as Company Law only provides for the latter two types of supervisor, and does not preclude such innovation, it will be interesting to see if a shareholder (most likely) decides to challenge the legitimacy of the external supervisor, especially since there does not appear to be any provision under the law, except if the challenge is on the validity of the shareholder resolution appointing the external supervisor.

Firm level innovation has begun to take place in privately held listed companies due to the flexibility in appointing and revising the roles and the occupants of such roles, which SOEs cannot because of the stringent appointment process that is largely dictated by the government policy. A key example of a company-level innovation is the emergence of supervisors on the board of supervisors who are neither employees nor shareholders (or their representatives) as required under China's Company Law. They are less policy focused than SOEs and therefore have room to innovate. Moreover, failure is not an option, otherwise it could lead to personal financial loss, unlike in SOEs where ultimately the state foots the bill of expropriation, mismanagement and corruption.

⁶³⁹ The criteria for independent directors were used as a preliminary basis for assessment.

The main observation here is that the more shareholders represented on the supervisory board, the more influential and more effective it appears in executing its monitoring role. The traditional control of the company according to law is in the shareholders' meeting.

Corporate governance innovation is observable on two levels. The results of this research suggest that, in privately-run and controlled listed companies on ChiNext, corporate governance innovation appears to be driven by the need for monitoring and third-party opinions. In contrast, the innovations observed in the state-owned listed companies appear to be driven more by a public policy focus, which, for example, sees the introduction of minority shareholder representatives on the supervisory board.

This observation can perhaps only be extended in so far as it relates to listed SMEs than with large privately-run and controlled listed companies. The reason for this is that most large privately controlled listed companies, due to their original history as state-owned enterprises, still retain the legacy of SOE culture in which little corporate governance innovation toward efficiency and protection of shareholders has occurred. Having said that, in SOEs some corporate governance innovations for the protection of minority shareholders take place⁶⁴⁰ as a public policy objective, despite decidedly not having profit as the main objective.

Indeed, without a survey of all private listed companies in China, it remains difficult to determine when this innovation of the supervisory board started, which re-empowers the supervisory board's representation of shareholders. This may be largely due to the focus on SOEs, which tend to have representatives from shareholders or within the group of companies on the supervisory board. Moreover, as mentioned earlier in Chapter Four, the

⁶⁴⁰ For example, Siasun has employees who, as minority shareholders, are appointed to its supervisory board.

supervisory boards in SOEs also have a succession planning function as well as a balancing of interests function, which leaves little room for the use of or need for external supervisors.

The increase in privately held listed companies in a regulatory environment that has focused on protecting the state as the controlling shareholder has resulted in the bottom-up innovations in corporate governance to effectively balance interest and power. One reason for firm-level innovation in private listed companies may be to increase efficiency. The larger the number of privately run and controlled listed companies in China, the more innovation on the premise that the private sector is the best for innovating in law, at least economic and business law. China's corporate governance still remains at the evolutionary stage. It is naïve to conclude that transplants will work, as evidenced by the initiatives regarding shareholder protection. It is not clear to what extent regulators and policymakers are aware of this innovation, but it is an innovation that strengthens the independence of the supervisory board, on the proviso that regulators and policy makers do not restrict this.

B. Empowering Independent Directors

Independent directors tend to work very hard in listed SMEs due to the number of transactions and decisions that require their independent opinion. In the literature, there does not appear to be an express recognition that the key way to empower independent directors is through improved and constant engagement with non-controlling (including retail) shareholders.

Individual SNEDs benefit from engaging with controlling shareholders as a result of their *guanxi* and ability to engage and partake in decision-making in the company. As such, they become better placed to empower the independent directors as their representatives. Indeed, independent directors need to be empowered by those they purport to represent. The black letter of the law and regulations cannot achieve this, especially in the face of a powerful and influential controlling shareholder. The law can enable such empowerment by providing

a forum for independent directors to meet with non-controlling shareholders, in the first instance, separate from the controlling shareholder and senior management of the company. A further forum can be provided for them to engage with minority shareholders. This can be in the form of online questions and answers, which is employed by quite a few CEOs during investor road shows.

IV. Self-regulation by Controlling Shareholders

One way of controlling shareholders generally, and specifically controlling shareholders, is through the use of shareholder covenants or undertakings. In general, they provide that the relevant shareholder should pay any fine or sanction, and compensate the company for loss or damage suffered by the company. Some go as far as to require the profit earned to be relinquished to the company. One of the key question remains regarding enforceability and remedies if a breach of covenant arises. With regard to regulation-based covenants, all surveyed companies disclosed what they felt were the most important covenants. All surveyed companies had such covenants with most, if not all, controlling shareholders.

A. Legal, Regulatory and Contractual Undertakings

Undertakings or covenants provide a key mechanism for checking and enhancing the corporate conduct of controlling shareholders on ChiNext, and generally in China's equity markets. Covenants can be legal as provided under Company Law or Securities Law, or regulatory as imposed by the regulators rules and decisions or contractual under the articles of association or other agreement (e.g. a shareholder agreement). Covenants can be further categorised as either mandatory or voluntary. Mandatory ones tend to be legal or regulatory while voluntary are by agreement or even self-imposed on them. Mandatory covenants can be taken as strong indications of the corporate governance risk the regulatory authority perceives

is posed by the controlling shareholder and other shareholders made subject to mandatory covenants. Equally, voluntary covenants become even more potent indicators of future corporate conduct to be expected because they arise from a voluntary recognition by the covenanting shareholder of the potential risk their decision-making poses to the company, especially as private rather than State controlling shareholders. Therefore, they seek to reassure and persuade existing and future investors, the regulatory authorities and other stakeholders that they are aware of certain internal governance risks and are usually willing to bear any financial loss arising from it. Of course, a key question that arises pertains to who can enforce these covenants, and who can seek redress and impose a remedy of disciplinary action. As was seen in Chapter Five, the regulatory authorities have a clear mandate to take action in the event of a violation, but it remains unclear as to who has authority over voluntary covenants. In theory, the CSRC would have authority, especially if the covenant was given in the listing prospectus of the company.

For the purposes of analysis here, this section descriptively categorises covenants into four namely: pre-IPO liability covenants, post-IPO covenants, reputational covenants, and covenants to act in concert. A brief discussion of shareholder agreements completes this section.

1. Pre-IPO Liability Covenants

Another common function of covenants in ChiNext companies is for controlling shareholders to bear any liability arising from administrative sanctions or investigations against the company in matters of potential dispute that occurred prior to IPO. They also typically undertake to compensate the company for any loss or damage incurred as a result of such a matter. A common example is that of tax liability incurred prior to IPO. Thus, for instance, Bestway Ltd. admitted to being subject to tax investigations in 2007 and 2008, prior

to IPO. Consequently, Liu Nan, the controlling shareholder, made a covenant to bear personal liability for any administrative sanctions or investigations and compensate the company for any loss incurred. A similar example but pertaining to a state-held CSME can be found in respect of Lepu Medical Ltd., where the controlling SOE made an undertaking to cover any tax liabilities and compensate the company for any loss.

2. Post IPO Covenants

Covenants under Company Law serve as a formal agreement between the company and shareholders (enforceable by the CSRC). The mandatory covenant not to transfer or deal in the shares of the company in the first 12 to 36 months following IPO applies to pre-IPO subscribers, whether individuals or legal entities with an annual dealing cap of not more than 25% of total holdings in any 12 month period. The length of the dealing cap depend on the percentage holdings with for instance, controlling shareholders not been able to deal in shares in the first 36 months of listing. Shareholders with a holding of 5% or more of the issued share capital of the company have a minimum prohibited period of 12 months. The prohibited dealing period can be voluntarily extended to the whole 36 months. Some surveyed companies also had shareholders with low percentage holdings party to an extended prohibited dealing covenant. Other common and important covenants imposed by the regulators include covenants not to compete with the company and not to steal the company's corporate opportunity, effectively a repetition of provisions under Company Law but which technically become directly enforceable by the CSRC as covenants provided under its listing regime.

In the surveyed companies, the CSRC also imposed covenants that reflect its potential corporate governance issues of individual companies. For instance, on the use of a capital surplus, ownership of proprietary intellectual property, existing RPTs such as rental of office

accommodation by controlling shareholders to the company, and the continuous provision of staff benefits such as accommodation.

3. Reputational Covenants

These are also covenants undertaken by controlling shareholders that effectively lay their reputations on the line. Importantly, these types of covenant are not a direct spin-off from a duty under law nor do they relate to potential liability that occurred pre-IPO. They include covenants against the misuse of company funds.

A noteworthy voluntary covenant was entered into by the controlling shareholder of Daiyu Water Ltd. Wang Dong, the controlling shareholder with 52.77%, covenanted to make up 75% of the difference between the profit forecast of 2009 and the actual result. The remaining 25% was to be covered by the second largest shareholder, Gansu Dacheng Investment Ltd., which holds 7.61%. Unlike other types of covenant, these covenants entail no statutory offence or potential violation of law or rules, nor is there, in any pure sense, any loss or damage caused to the company. Another example of a reputational covenant is the undertaking made by Beilu Bellona Ltd.'s controlling shareholder, Wang Daixue, holding 21.13%, to use the capital surplus for specific projects and to ensure that there were financial safeguards for the company. It is interesting to note that the next three highest holdings in the company were held by venture capitalist investors with relatively high holdings of between 10 and 15%, which meant that if they decided to act in concert they would have been extremely powerful. This covenant appears to have been given in order to infuse confidence in existing and potential investors that the company is not of the packaged variety. As alluded to earlier, ChiNext companies are generally considered with some degree of cynicism,

especially given that the financial press continually waits for evidence of miscreant behaviour. Just looking at the headlines of financial news reports is evidence of this.⁶⁴¹

Such covenants do stir up a certain amount of curiosity as to why they have been made in the first place. That aside, the real issue is how they can be enforced. We already know against whom they will be enforced, but the question remains as to who will be expected to enforce them and using what process. Consequently, as well placed and positive in corporate governance terms as these covenants are, there remains little information regarding enforcement against the giver. Of particular note is that covenants to act in concert tend to be entered into in companies where there are no clear ultimate owners – that is, no shareholder who controls 20% or more of the voting rights, they are widely held.

4. Covenants to Act in Concert

Shareholder agreements form a very important aspect of corporate governance on ChiNext. They can be pervasive wherein groups of individuals agree to act in concert to the effect that together they amount to a single controlling block holder of the company.

Shareholder agreements need not be pervasive however, and can simply relate to specific obligations or circumstances. These types of covenant occur in highly concentrated CSMEs such as Wangsu Co. Ltd., where the ultimate owner agrees to act in concert with another, albeit major shareholder. This suggests that a strategic alliance exists between these shareholders, especially since venture capital and institutional investors make up the top ten investors. Thus, it is a decidedly strategic alliance to contain the controlling shareholding.

5. Shareholder Agreements

Shareholders bear mentioning because they present an important mechanism used by pre-IPO individual subscribers to curtail the risk of investing in a company controlled by an

⁶⁴¹ Ye Tan, “Who Are the Vermin of ChiNext?”

individual or a family. It is also an essential part of controlling blocks that have two or more shareholders acting in concert.

In terms of providing practical restraints, shareholder agreements are all the more important due to the advanced Contract Law litigation process. Indeed, China has a very sophisticated contract law enforcement system. Remedies available for breach of contract are more readily pursuable and cost effective under contract law than bringing an action under Company Law.⁶⁴² Matters included and excluded from the articles of association still remain relevant as articles of association takes precedence in the event of a conflict between the articles and any shareholder agreement.⁶⁴³ Before litigating in the courts, there are various options available, including court-based mediation, arbitration and arb-med (a hybrid). Since enforcement under contract is between the respective parties privy to the contract, the enforcement process is straightforward without recourse to any regulator.⁶⁴⁴

Firstly, ownership structures in companies on ChiNext display relatively simple ownership structures with no strong trend toward the use of pyramidal structures by either individuals, families or those acting in concert. However, opaque ownership and control structures persist in that, where SPV holds controlling shares in a company, not all of the constituents have been disclosed. The importance here is that these SPVs are not financial or investment institutions ordinarily considered as widely held due to the large number of beneficiaries on whose behalf they invest. As was seen in chapter five, the IPO Review Panel plays a key role in ensuring that only privately controlled companies with relatively simple ownership structure are approved for listing on ChiNext. This appears to be a key but unexpressed strategy in keeping opaque ownership structures away.

⁶⁴² Liu Junhai, *Modern Securities Law*, (2011): 36.

⁶⁴³ Shi Rui, “Gudong xieyi yu gongsi zhangcheng falu wenti bijiao,” *Xueli lun (Theory Research)*, no.35 (2012): 156.

⁶⁴⁴ Interview 2012-16. See generally

Closing Remarks

This chapter has demonstrated that there is a need to examine corporate governance practice in listed SMEs more closely, especially in relation to which types of shareholder and combination of directors on executive boards contribute to effective corporate governance. The key conclusion here remains that individual pre-IPO subscribers who take on non-executive directorships (individual SNEDs) tend to be more active in governance than institutional shareholders, after IPO. It was also demonstrated that the Chinese culture of *guanxi* and Confucianism play important roles in promoting corporate conduct for better or worse. In particular, it was demonstrated how Confucian concepts and culture remains a binding and influencing force of hierarchy and behaviour that may undermines legal and regulatory monitoring functions because of the natural subordination of the ‘monitor’ within the hierarchy, with the chairman and controlling shareholder being at the precipice. The second conclusion was that the dynamics of enforcement have changed positively in empowering the Exchange because of the predominance of individual and family-controlled listed companies. A third conclusion was that, due to China’s Company Law being principle based, there are sometimes gaps in regulation that allow for bottom-up innovation as seen in relation to the emergence of external supervisors. Finally, the importance of non-legal and non-regulatory institutions embedded in China’s ancient culture have been highlighted. There are several implications for these findings and the secondary implications were discussed in the preceding chapters.

Chapter Seven – Conclusion

The previous chapters each summarised the findings of this thesis. Thus, this chapter serves three functions. Firstly, it presents the key and secondary contributions this thesis makes to the literature. Secondly, it presents key recommendations resulting from this research. Finally, it concludes the research. It is in this order that the chapter is divided into three parts.

I. Contributions to Literature

The key objective of this research was, through the case study method, to unveil the nature of corporate governance practice on ChiNext, which is largely characterised by no separation of ownership and control. There is extensive research on the nature of corporate governance in listed companies in different countries, which indicates varying levels of concentrated ownership and shareholder protection.⁶⁴⁵ As noted earlier in Chapter One, the studies in China focus on the large listed companies, which also happen to be state-owned in the majority.⁶⁴⁶ They routinely find a separation of ownership and control, which gives rise to both vertical and horizontal agency costs because the controlling shareholder does (can)not directly partake in the management of the company.⁶⁴⁷ Despite the phenomenon of private owner-managers being prevalent on China's stock markets, there remains a gap in the literature, especially in terms of listed SMEs. Addressing this gap, this thesis examined the nature of corporate governance practice and enforcement using ChiNext as a case study. The

⁶⁴⁵ Shleifer and Vishny, "A Survey of Corporate Governance"; Morck, Wolfenzon, and Yeung, "Corporate Governance, Economic Entrenchment and Growth."

⁶⁴⁶ Lu, Zhong, and Kong, "Corporate Governance Assessment on the Top 100 Chinese Listed Companies"; MacNeil, "Adaptation and Convergence in Corporate Governance"; Q. Qiang, "Corporate Governance and State-Owned Shares in China Listed Companies," *Journal of Asian Economics* 14, no.5 (2003): 771-83.

⁶⁴⁷ Xi, *Corporate Governance and Legal Reform in China*, (2009); Wei, *Securities Markets and Corporate Governance*, (2009).

rest of this section presents the key findings that ultimately contribute to creating the corporate governance landscape on ChiNext.

A. Privately Controlled Listed Companies

The thesis adds to the literature relating to corporate governance institutions and mechanisms by specifying the important role that private non-market mechanisms and institutions play in privately controlled listed SMEs. Research has identified legal, regulatory and market-based institutions of corporate governance, which largely reflects the US approach to corporate governance.⁶⁴⁸ The literature on comparative corporate governance also uses this taxonomy in examination of institutions in different countries, including China.⁶⁴⁹ Both schools leave a gap in identifying and examining private non-market mechanisms, such as filial piety and *guanxi*, as the literature is sparse, which limits understanding on the implications of such mechanisms on corporate governance.⁶⁵⁰ This study addressed this gap by examining the role of *guanxi* and its implications for corporate governance practice. Consequently, a few observations arose from the study.

B. Family-controlled Listed Companies

The thesis makes a key contribution to the understanding of the dynamics of corporate governance in family-controlled listed companies. Research on family-controlled listed companies has, until recently, being the sole arena of management studies.⁶⁵¹ Recently, research in corporate governance in family-controlled listed companies has appeared but

⁶⁴⁸ Jensen and Meckling, "Theory of the Firm"; Eisenhardt, "Agency Theory," (1 January, 1989); Williamson, "Why Law, Economics, and Organization."

⁶⁴⁹ Klaus J. Hopt et al., eds., *Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and the U.S* (Oxford: Oxford University Press, 2005); Aguilera et al., "An Organizational Approach to Comparative Corporate Governance"; Guy Liu, "Comparative Corporate Governance: The Experience between China and the UK," *Corporate Governance* 13, no.1 (n.d.), doi:10.1111/j.1467-8683.2005.00397.x.

⁶⁵⁰ Braendle, Gasser, and Noll, "Corporate Governance in China—Is Economic Growth Potential Hindered by Guanxi?"; Ledeneva, "Blat and Guanxi."

⁶⁵¹ M. Bertrand and A. Schoar, "The Role of Family in Family Firms," *The Journal of Economic Perspectives* 20, no.2 (2006): 73-96; Miller et al., "Are Family Firms Really Superior Performers?"; Xian Zhang, Jill Venus, and Yong Wang, "Family Ownership and Business Expansion of Small and Medium-Sized Chinese Family Businesses: The Mediating Role of Financing Preference," *Journal of Family Business Strategy* 3, no.2 (June 2012): 97-105, doi:10.1016/j.jfbs.2012.03.002.

remains sparse.⁶⁵² Regarding China, the literature has focused on financing and control structures.⁶⁵³ This thesis enriches the existing literature by providing case studies on and examining internal governance mechanisms in family-controlled listed companies.

Several insights emanate from this research. A key insight that expands on current literature is the important role that private mechanisms, in this instance filial piety, play in internal governance and the implications for corporate governance practice and enforcement. Filial piety with its own rules and sanctions has the potential to side-step, compete with or exclude through substitution public mechanisms and institutions of corporate governance. This has been found to be the case in terms of the management of companies. The implications for corporate governance in such instances may prove dire because filial piety does not privilege interests that fall beyond filial ties or apply to strangers. Consequently, the interest of non-familial and anonymous investors such as institutions and retail shareholders become secondary interests, which goes against the key policy objective of corporate governance, the protection of shareholders. A secondary insight with family-controlled listed companies, and not necessarily because of filial piety, is that the agency cost of entrenchment arises.⁶⁵⁴ The case studies demonstrated how senior roles such as chairman and CEO are strategically shared among family members, most of them evidently qualified according to

⁶⁵² Ruth V. Aguilera and Rafel Crespi-Cladera, "Firm Family Firms: Current Debates of Corporate Governance in Family Firms," *Journal of Family Business Strategy* 3, no.2 (June 2012): 66-69.; Igor Filatotchev, Yung-Chih Lien, and Jenifer Piesse, "Corporate Governance and Performance in Publicly Listed, Family-Controlled Firms: Evidence from Taiwan," *Asia Pacific Journal of Management* 22, no.3 (1 September, 2005): 257-83.

⁶⁵³ Cheng Shuqiang, "Jiazuqiye Chengchang Yu Kongzhiquan Zhuanyi de Xiangguanxing Fenxi [An Analysis of the Correlation Between the Longevity of Family Enterprise and Transfer of Control]," *China Soft Science*, n.d.; Feng Xunan, Li Xinyu, and Chen Gongmeng, "Jiazu Kongzhi, Zhili Huanjing He Gongsi Jiazhi (On the Family Control, Institutional Environment and Corporate Valuation)"; Xiang Rui, "Jinzita zhongji kongzhiquan, zhidu huanjing yu gongsi xianjin teyou shuiping - laizi zhongguo jiazu shangshi gongsi de jingyan zhengju (Pyramid Ultimate Control, Institutional Environment and the Level of Corporate Cash Holdings: Evidence from the Chinese Familial Listed Companies)," *Shijiazhuang jingjixue xuebao (Journal of the Shijiazhuang University of Economics)* 33, no.5 (October 2010): 67-72; C. Chen, Zengquan Li, and Xijia Su, "Rent Seeking Incentives, Political Connections and Organizational Structure: Empirical Evidence from Listed Family Firms in China," *City University of Hong Kong Working Paper*, (2005), url: http://www.baf.cuhk.edu.hk/research/cig/pdf_download/ChenLiSu.pdf.

⁶⁵⁴ Morck, Wolfenzon, and Yeung, "Corporate Governance, Economic Entrenchment and Growth"; Mehrotra et al., "Adoptive Expectations."

their biographies, some of them not. This reveals a chink in Chinese Company Law, which proscribes who cannot be a director or manager rather than prescribing a threshold for skill and expertise. A final insight regarding family-controlled listed companies in China is that *guanxi* can play a key role in mitigating the effects of filial piety. This is due to the reciprocal nature of *guanxi* where favours and actions are reciprocated, otherwise it results in a loss of face for the family. This proposition leads to the next key contribution of this thesis, namely the role of the individual pre-IPO subscriber.

C. Individual pre-IPO Investor as a Key Corporate Governance Mechanism

The thesis adds to the literature regarding mechanisms that efficiently monitor management and controlling shareholders, by specifying key mechanisms that specifically suit privately controlled listed SMEs. The literature has identified institutional shareholders as the key mechanism for monitoring corporate governance, citing their expertise and resources as key beneficial attributes.⁶⁵⁵ Research on China also attests to these attributes and, in particular, note that retail shareholders are free-riders.⁶⁵⁶ However, there remains a gap in the literature regarding the role of large and medium individual pre-IPO subscribers who also hold non-executive director positions. Crucially, this gap relates in particular to listed SMEs. Addressing this gap, in the preceding chapter, the thesis explored such individuals as an effective corporate governance mechanism, thus making an essential contribution to research on the role of the ownership structure in corporate governance.

This thesis offers a few insights. Firstly, a key insight is that large and medium individual pre-IPO investors are reasonably savvy investors who take a personal interest in monitoring their investments by taking on non-executive board roles, some paid, some unpaid. Importantly, they attend meetings and, therefore, partake in the decision-making process and

⁶⁵⁵ Black and Coffee, “Hail Britannia”; Coffee, “Liquidity versus Control.”

⁶⁵⁶ Xu and Wang, “Ownership Structure in Chinese Stock.”

the monitoring of management, especially owner-managers. Secondly, as providers of early finance providers to the company and long-term investors, they have strong *guanxi* with the controlling shareholder(s), which, in practice, acts as a restraint on undesirable corporate conduct by the controlling shareholder, otherwise social sanctions such as loss of face and loss of reputation come into play. Finally, perhaps most importantly, their interests in getting a return on their investment align them with other non-controlling shareholders in the company. Their function in monitoring the company and the protection of shareholders will depend on ensuring they are corporate governance savvy and their interests remain aligned with shareholders.

D. Enforcement Mechanisms with Chinese Characteristics

The thesis adds to the literature regarding the governance of equity markets, specifically corporate governance enforcement, by identifying the key roles played by China's press and the public whistleblowing system. The research has thus far focused on the legal and regulatory enforcement institutions laid down under Company Law and Securities Law.

1. China's Press

There has also been acknowledgement of the financial press as watchdog and its role in corporate governance.⁶⁵⁷ Research on the role of the press in China focuses either with regard to the legal system,⁶⁵⁸ public opinion supervision⁶⁵⁹ or its impact on the securities

⁶⁵⁷ Bushee et al., "The Role of the Business Press as an Information Intermediary"; Alexander Dyck, Natalya Volchkova, and Luigi Zingales, "The Corporate Governance Role of the Media: Evidence from Russia," *The Journal of Finance* 63, no.3 (June 1, 2008): 1093-1135, doi:10.2307/25094468; Dyck and Zingales, *The Corporate Governance Role of the Media*.

⁶⁵⁸ Liebman, "Watchdog or Demagogue?"; Qi Lei and Liu Li, "Xinwen yulunjiandu de falu wenti [The Legal Problems of Public Opinion Supervision by the Media]," *Xinwen aihaozhe [Journalism Enthusiast]*, no.4 (2011): 86-87.

⁶⁵⁹ Zhao and Sun, "Public Opinion Supervision: Possibilities and Limits of the Media in Constraining Local Officials"; Chen Han and Luo Meng, "Yulunjiandu de Zhineng He Jibenyanze Yanjiu - Yulunjiandu Yu Xinwen

market.⁶⁶⁰ Thus, a gap exists in terms of the role of the press in the enforcement of corporate governance. Addressing this gap, this study examined how the press's is the watchdog and how it supports the CSRC and the Exchange in carrying out corporate governance enforcement.

2. China's Public Whistleblowing System

In terms of enforcement mechanisms, the study adds to the literature on public whistleblowing, specifically in the securities market. Research has largely focused on the whistleblowing systems set up by financial regulatory authorities.⁶⁶¹ There remains a gap in the literature regarding the role of public whistleblowing systems that apply to all facets of life. Addressing this gap, the role and effectiveness of China's public whistleblowing system was assessed.

II. Recommendations for Policy and Practice

A. Specific to China

In addition to the main points made in the preceding sections, corporate governance policy and practice can be further enhanced in China in three ways. One is for the external corporate governance whistleblowing mechanism to have its own standalone law that states clearly the rights and obligations as well as gives protection to whistleblowers such as confidentiality and anonymity, and in particular employee whistleblowers. Another

Qinquan [The Fundamental Doctrine and Role of Public Opinion Supervision - Violations by the Press and Public Opinion Supervision], *Dazhong Wenyi* [Literature and Art for the Masses], no.7 (2011): 140-41; Y. Lin, *A History of the Press & Public Opinion in China*, 1937.

⁶⁶⁰ Zheng Zhigang, Ding Dong, and Wang Changyun, "Meiti de fumian baodao, jingliren shengye yu qiye yeji gaishan - laizi woguo shangshi gongsi (Negative Media Coverage, Management Reputation and Firm Performance Improvement: Evidence from China's Listed Firms)," *Jinrong yanjiu* (Journal of Financial Research), no.12 (2011).

⁶⁶¹ Moberly, "Unfulfilled Expectations"; Alexander Dyck, Adair Morse, and Luigi Zingales, "Who Blows the Whistle on Corporate Fraud?" *Journal of Finance* 65, no.6 (December 2010): 2213-53; Elletta Sangrey Callahan, Terry Morehead Dworkin, and David Lewis, "Whistleblowing: Australian, U.K., and U.S. Approaches to Disclosure in the Public Interest," *Virginia Journal of International Law* 44 (2004, 2003): 879.

recommendation is to have a requirement for a registered public board secretary qualification to ensure that members of the board of directors and supervisors, respectively, have a qualified and knowledgeable first point of contact for corporate governance issues before reverting to external advice. As mentioned earlier in the thesis, there appears to be a growing trend for recruited board secretaries on ChiNext to have a clear requirement for this as some companies employ candidates with EMBA's. The curriculum of EMBA's pragmatically ensures that professionals have a mix of management, finance and law content, such as chartered secretary exams in the UK and Hong Kong.

A final recommendation is that online voting should ideally be provided for under Company Law. The survey earlier in the thesis testifies to the convenience by the increased voting of (mostly minority) shareholders who would otherwise have not been able to attend.

B. Specific to Growth Enterprise Markets

The observations made during the case studies of the companies listed on ChiNext can also be expanded into general observations relevant to emerging economies that decide to establish a growth enterprise market, similar to that discussed. Of course, the usual caveats of complementarity and culture apply, but nonetheless, there are some general lessons to be learnt from China's experience, as follows.

Firstly, corporate governance policy and practice for SMEs will naturally differ in some respects from that of large listed companies because of the high prevalence of owner-managers. Secondly, high-risk and hi-tech SMEs require more industry-specific disclosure requirements that promote information symmetry and undermine issues such as insider trading. Thirdly, distinctions must be made as to whether corporate governance rules promote long-term or short-term shareholder maximisation. The distinction remains especially crucial for growth enterprise markets where businesses are immature, high risk and high growth. For instance, quarterly reporting requirements in growth enterprise markets may adversely affect

corporate governance. SMEs are listed on growth enterprise markets for the purpose of giving them funding to achieve long-term sustainable growth; however, quarterly reporting promotes even entrepreneur-founders to take a short-term profit maximisation view. After all, the published financial statements and business review of companies, i.e., records of their performance do have an impact on companies in terms of investor confidence and share price. At worst, anxiety at adverse market conditions may mean that even entrepreneur-founders will seek quick ways of gaining a return on their investment. Finally, the listing rule requirement of quarterly reporting particularly undermines any intention for long-term shareholder value as an objective of a growth enterprise market.

C. Implications for Methodology

The use of a multi-disciplinary approach of examining empirical evidence to identify trends and case studies to obtain company-level and company-specific information leads to richer information about practice. These are then enhanced by interviews.

D. Limitations of Research

The limitation for this particular case study is the inability to undertake certain types of surveys within the ‘public’⁶⁶² arena in China without permission from the relevant authority. With the exception of Tenev and Stoyan, whose research was sponsored by the World Bank, scholars of corporate law and governance in China have largely employed documentary text analysis and interviews, as employed in this thesis.⁶⁶³ Thus, although respondent-based survey results remain desirable, they do not reduce the relevance or legitimacy of a library-based study. Even if the respondents had replied, they may have cautiously done so in accordance with already publicly available information to avoid

⁶⁶² The ‘public’, which is expressly under a regulatory authority such as a registered company or listed company, as opposed to the ‘private’ such a consumer who is just a member of the public.

⁶⁶³ For examples, see Clarke, “The Ecology of Corporate Governance in China.” See also Benjamin L. Liebman and Curtis J. Milhaupt, “Reputational Sanctions in China’s Securities Market,” *Columbia Law Review* 108, no.4 (1 May, 2008): 929-83, doi:10.2307/40041782. Cf. Peerenboom and Cambridge Books Online, *China’s Long March Toward Rule of Law*.

ambiguity. Nonetheless, the lack of access through surveys by questionnaires sheds light on why most research on Chinese corporate governance rarely takes place at firm level but rather examines Company Law and corporate governance issues and enforcement at a macro level.

III. Implications for Further Research

Corporate governance on growth enterprise markets is important within the current economic climate to ensure that laws and rules promote long-term investment and sustainability, which, in turn, will enhance shareholder protection, especially ensuring that owner-managers do not revert to venture capital tactics once the initial post-IPO limits on trading have been lifted.

A key issue for further research would be the suitability of adopting a “comply or explain” regime for periodic reporting on ChiNext as a way of effectively explaining corporate governance variances in companies listed in same equity markets. As mentioned, earlier a typical example for comply or explain would be the use of cumulative voting in accordance with the Code.

Conclusion

China appears to be in an evolutionary stage of both business and modern enterprise, specifically moving from the public to the private. There are many implications in terms of law and governance. China’s capital market, not fully developed, means that the law becomes caught up in the development of the market and results in frictions caused by regulation in anticipation of the market. As demonstrated by the resignations of directors and officers from ChiNext companies, anticipatory legislation does not always work in new circumstances, such as where the majority of listed companies on a market are privately controlled.

Their highly speculative nature on ChiNext may be a result of the present social and economic atmosphere in China, with everyone trying to capitalise on present opportunities

because the future is unknown. Promoting long-term investment strategies leads to more interest in the company by shareholders and are the first stage for empowerment of shareholders at all levels to engage in the decision-making of the company. It also leads to better stability in the company and in the market. However, the problem is how to encourage institutional investors and retail investors to take part.

Appendices

Appendix 1 – List of Surveyed Companies with Industry and Type of Controlling Shareholder¹

| Ticker | | Date listed on ChiNext | Industry ² | Type ³ of Controlling Shareholder |
|--------|---|------------------------|-----------------------|--|
| 300001 | Qingdao TGOOD Electric Co Ltd | 30 October 2009 | Machinery | I |
| 300002 | Beijing Ultrapower Software Co Ltd | 30 October 2009 | IT | A |
| 300003 | Lepu Medical Technology Beijing Co Ltd | 30 October 2009 | Machinery | SOE/F ⁴ |
| 300004 | Nanfeng Ventilator Co Ltd | 30 October 2009 | Machinery | F |
| 300005 | Beijing Toread Outdoor Products Co Ltd | 30 October 2009 | Wholesale and Retail | F |
| 300006 | Chongqing Lummy Pharmaceutical Co Ltd | 30 October 2009 | Pharmaceuticals | F |
| 300007 | Henan Hanwei Electronics Co. Ltd. | 30 October 2009 | Machinery | F |
| 300008 | Shanghai Bestway Marine Engineering Design Co. Ltd. | 30 October 2009 | Social services | I |
| 300009 | Anhui Anke Biotechnology (Group) Co. Ltd. | 30 October 2009 | IT | F |
| 300010 | Beijing Lanxum Technology Co. Ltd. | 30 October 2009 | IT | I |
| 300011 | Beijing Dinghan Technology Co. Ltd. | 30 October 2009 | Machinery | I |
| 300012 | Centre Testing International Shenzhen Co. Ltd. | 30 October 2009 | Social services | F |
| 300013 | Jiangsu Xinning Modern Logistics Co. Ltd. | 30 October 2009 | Transportation | A |
| 300014 | Eve Energy Co. Ltd. | 30 October 2009 | Electronics | F |
| 300015 | Aier Eye Hospital Group Co. Ltd. | 30 October 2009 | Social services | I |

| | | | | |
|--------|---|------------------|----------------------|--------------------|
| 300016 | Beijing Beilu Pharmaceutical Co. Ltd. | 30 October 2009 | Pharmaceuticals | SOE/I ⁴ |
| 300017 | Wangsu Science & Technology Co. Ltd. | 30 October 2009 | IT | F |
| 300018 | Wuhan Zhongyuan Huadian Science & Technology Co. Ltd. | 30 October 2009 | Machinery | A |
| 300019 | Chengdu Guibao Science & Technology Co. Ltd. | 30 October 2009 | Petrochemicals | W |
| 300020 | Enjoyor Co. Ltd. | 30 October 2009 | Wholesale and Retail | F |
| 300021 | GANSU DAYU Water-saving Group Co. Ltd. | 30 October 2009 | Machinery | I |
| 300022 | Gifore Agricultural Machinery Chain Co. Ltd. | 30 October 2009 | Wholesale and Retail | F |
| 300023 | Bode Energy Equipment Co. Ltd. | 30 October 2009 | Machinery | F |
| 300024 | Siasun Robot & Automation Co. Ltd. | 30 October 2009 | Machinery | SOE |
| 300025 | Hangzhou Huaxing Chuangye Communication Technology Co. Ltd. | 30 October 2009 | IT | I |
| 300026 | Tianjin Chase Sun Pharmaceutical Co. Ltd. | 30 October 2009 | Pharmaceuticals | A |
| 300027 | Huayi Brothers Media Corp. | 30 October 2009 | Media | F |
| 300028 | Chengdu Geeya Technology Co. Ltd. | 30 October 2009 | IT | I |
| 300029 | Jiangsu Huasheng Tian Long Photoelectric Equipment Co. Ltd. | 25 December 2009 | Machinery | F |
| 300030 | Guangzhou Improve Medical Instruments Co. Ltd. | 25 December 2009 | Machinery | SOE/I ⁶ |
| 300031 | Wuxi Boton Belt Co. Ltd. | | Petrochemicals | I |
| 300032 | Jinlong Machinery & Electronic Co. Ltd. | 25 December 2009 | Electronics | F |
| 300033 | Hithink Flush Information Network Co. Ltd. | 25 December 2009 | IT | I |
| 300034 | Beijing Cisri-Gaona Materials & Technology Co. Ltd. | 25 December 2009 | Metals & Non-metals | SOE |
| 300035 | Hunan Zhongke Electric Co. Ltd. | 25 December 2009 | Machinery | F |
| 300036 | Beijing SuperMap Software Co. Ltd. | 25 December 2009 | IT | SOE/I ⁶ |
| 300037 | Shenzhen Capchem Technology Co. Ltd. | 8 January 2009 | Petrochemicals | A |

| | | | | |
|--------|---|----------------|-----------------|--------------------|
| 300038 | Beijing Meteno Communications Technology Co. Ltd. | 8 January 2009 | IT | F |
| 300039 | Shanghai Kaibao Pharmaceutical Co. Ltd. | 8 January 2009 | Pharmaceuticals | I |
| 300040 | Harbin Jiuzhou Electric Co. Ltd. | 8 January 2009 | Machinery | SOE/F ⁶ |

Notes:

1. List of first 40 companies listed on ChiNext according to Shenzhen Stock Exchange as of 20 April 2011.
2. Categorisation by industry according to Shenzhen Stock Exchange as of 20 April 2011.
3. Types of controlling shareholder: F – Family; I – Individuals; A – Affiliated (i.e., two or more acting in concert); SOE/F or I – State-private ventures; and SOE – State only. Holdings are analysed per surveyed companies' disclosures in each company's annual report as of 31 December 2009. At the start of the research in October 2010, there were 135 companies listed on ChiNext (on 26 October 2009), with the aforementioned population representing almost 30% of the listed companies.
4. State-private with either Individuals or Families.

Appendix 2 – List of Main Interview Questions Categorised by Type of Interviewee

This Appendix presents a selection of the closed and open ended questions inquired of interviewees, which form part of the basis of this thesis. Interviewees included retail shareholders, regulators, directors of companies, academics, business and finance professionals including intermediaries and journalists. These interviews were all semi-structured and lasted on average between 45 and 60 minutes, but with overall shorter interviewing times with retail shareholders.

For clarity, interview questions are categorised under three sections. Section I presents a mix of the closed and open-ended questions were asked of retail shareholders in the following order. Section II lists a selection of questions posed to regulators, directors/officers of companies, academics, journalists and business and finance professionals. Finally, Section III lists additional questions posed to journalists. Other question not included, are those specific to the knowledge of interviewees or naturally arising from the interview which help increase the depth of understanding.

I. Retail Shareholders

1. Do you have investment in companies listed on ChiNext?
2. Do you invest in other markets?
3. Why do/don't you invest in ChiNext?
4. What influences you when you invest in ChiNext?
5. Do you attend shareholder meetings? How often?
6. Do you vote online?
7. Do you trust the largest shareholder of the company?

8. Does it matter to you whether the largest shareholder is a private person or entity rather than the State? If so, why?

II. Regulators, Academics and Professionals

1. What are the key achievements of corporate governance in China today?
2. What are the key challenges of corporate governance in China today?
3. What role do professionals play in corporate governance?
4. What are the key achievements of ChiNext?
5. What are the corporate governance achievements of the regulators of ChiNext?
6. What are the key challenges of enforcement of corporate governance on ChiNext?
7. How do you see corporate governance in China developing in future?

Closed questions included:

8. Do you think there are any general implications in the rise of family-owned listed enterprises? (ownership being judged at 20% or more of total voting shares)
9. Do you think corporate governance in China has improved?
10. Do you think non-executive directors are effective in the governance of the company?
11. Do you think Chinese culture plays an important role in business and compliance with law?
12. Is there a difference in legal and regulatory enforcement against state and private controlling shareholders?
13. Do you think the media has a role as a watchdog of corporate conduct? Do you think this role is linked to and/or justified to its public opinion supervisory role (*yulun jiandu*)?

In addition to the main questions above, additional open and closed questions were asked specific to the profession of the interviewee, examples of which are given below.

Academics and Directors/Officers

1. What was the reason behind the setup of ChiNext?
2. What do you think is the key problem companies, (directors, officers) in complying with corporate governance law and regulation?
3. What (corporate governance) issues do you think private ownership poses compared to state ownership?
4. What aspects of Chinese culture do you think are prevalent in business in China?
5. How are directors nominated and appointed to ChiNext boards?
6. Do you think the duty of loyalty is appropriate to China?

Finance and Business Professionals

1. What do you think of financial disclosure in listed companies in China, particularly on ChiNext?
2. What is needed to enhance financial disclosure?
3. Do you think auditors/supervisory board are an effective corporate governance in China today?
4. What do you perceive are the implications for corporate governance of the rise in family ownership of listed companies?
5. Do you think enforcement affects investments? Why?
6. How do institutional investors typically monitor their investments?
7. What do you think affects the (lack of) recruitment of professionals in ChiNext companies?

III. Journalists

1. Do the media have a role in corporate governance?

2. On what basis of authority do the media have a role, if any, in corporate governance?
3. How does the media carry out its role in corporate governance?
4. Does the media have a formal/informal relationships regarding corporate governance enforcement with the CSRC and the Shenzhen stock exchange?
5. What do you perceive to be the challenges in corporate governance enforcement on ChiNext?
6. Is public opinion supervision on ChiNext a duty of the press?
7. Do you think the new delisting regime will be a successful deterrent of undesirable corporate conduct?

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