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The Structure of Ownership and Corporate Governance

The Case of Chinese Listed Companies

A Thesis Submitted for the Degree of Doctor of Philosophy

by

Zhaohong Xu

School of Law

Brunel University

February 2007

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Abstract

Modern companies have made a great contribution to the development of the economy. However, the company is not a perfect organization – modern companies, particularly listed companies, suffer from agency problems, in the form of conflicts of interest between management and shareholders, majority shareholders and minority shareholders, and shareholders and other stakeholders.[1] These agency problems form the core subject matter of the corporate governance debates that have attracted the attention of governments, international organizations, and scholars in the fields of economics, law, politics, management and other areas.

The type of agency problem that arises is determined by the structure of share ownership. Where the structure of share ownership is concentrated, the agency problem takes the form of a conflict of interest between majority shareholders and minority shareholders, whereas where the structure of share ownership is dispersed the agency problem takes the form of a conflict between management and shareholders. The appropriate model of corporate governance follows from this. The structure of share ownership is concentrated in some countries or regions of the world and dispersed in others, depending on the economic, political, legal, historical and cultural circumstances. There is no single perfect model of corporate governance, but different models appropriate to different countries or regions, in the light of the structure of share ownership.

The case of Chinese listed companies will be examined to illustrate the argument, and in particular to contrast it with the "law matters" and the "politics matters" theories. The major problem of corporate governance in Chinese listed companies is the agency problem characteristic of concentrated ownership, of a conflict between the majority shareholder and minority shareholders. The problem in China is compounded by the fact that the majority shareholder is in most cases the state. Although the structure of ownership is affected by many factors, such as the economy, politics, law, culture and history, today the main determinant of the development of the economy will be the change of the structure of share ownership from concentrated share ownership by the state to relatively dispersed ownership.

[1] The thesis is building on the assumption that the company is run for the best interest of shareholders rather than stakeholders

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Abbreviations and Acronyms

AMC	Asset Management Company
BSAM	Bureau of State Assets Management
CalPERS	California Public Employees' Retirement System
CCP	Chinese Communist Party
CEO	Chief Executive Officer
CNAO	China National Audit Office
CSRC	China Securities Regulatory Commission
EU	European Union
GDP	Gross Domestic Product
IPO	Initial Public Offering
LLC	Limited Liability Companies
MRCS	Management Responsibility Contract System
NSOE	Non State-Own Enterprise
PBOC	People's Bank of China
PLC	Publicly Listed Companies
PRC	People's Republic of China
ROE	Return on Equity
ROS	Return on Sale
SCER	State Commission of Economic Restructuring
SCSC	State Council Securities Commission

SEC	Securities and Exchange Commission (United States)
SETC	State Economic and Trade Commission
SOCB	State-Owned Commercial Bank
SOE	State-Own Enterprise
SPC	State Planning Commission
TVE	Township and Village Enterprise
WTO	World Trade Organization

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Introduction

Corporate governance is one of the hottest topics in the fields of economics, jurisprudence, politics, management etc. all over the world. Scholars have put forward their arguments on corporate governance from various angles, although there is still no common agreement in relation to the definition of corporate governance.

Adolph Berle and Gardiner Means argued comprehensively that separation of ownership from control leads to conflict of interest mainly between shareholders and managers due to dispersed share ownership in large companies in America in their classic book "The Modern Corporation and Private Property" in 1932. Since then the literature by scholars on corporate governance constantly appears in favor of Berle and Means's argument on the principal-agent (shareholders and managers) relationship, for example Baumol (1959), Jensen and Mechling (1976), and Grossman and Hart (1980)etc..[2]

However, from the 1970s onwards, the more and more results of empirical studies by scholars on corporate governance are at odds with the argument by Adolph Berle and Gardiner Means, for instance, Eisenberg (1976), Demsetz(1983), Shleifer and Vishny(1986), Edwards and Fischer (1994), Franks and Mayer(1994), Prowse

[2] E.g. see Baumol,William, 1959, Business Behavior, Value and Growth, MacMillan, New York, N.Y.; Marris, Robin, 1964, The Economic Theory of Managerial Capitalism, Free Press, Glencoe, Ill; Penrose, Edith, 1959, The Theory of the Growth of the Firm, Basil Blackwell, Oxford, U.K.; Williamson, Oliver, 1964, The Economies of Discretionary Behavior: Managerial Objectives in a Theory of the Firm, Prentice Hall, Englewood Cliffs, N.J.; Galbraith, John Kenneth, 1967,The New Industrial State, Houghton-Mifflin, Boston, Mass.; Jensen, Michael, and William Mechling, 1976, 'Theory of the Firm: Managerial Behavior, agency Costs, and Ownership Structure', Journal of Financial Economics 3, pp 305-360.; Grossman, Sanford, and Oliver Hart, 1980, 'Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation', Bell Journal of Economics 11, pp 42-64.

(1992), La Porta et al.(1998), Claessens et al (2000)etc.[3] That is, in reality the concentration of ownership is universal and big shareholders control companies (e.g. in large companies, in particular publicly traded companies) all over the world except for the United States and the United Kingdom etc.[4] by share ownership in the hands of families, banks, or the state, and through the use of pyramid structures, deviations from one-share-one vote rules, cross-holdings, and the appointment of managers and directors who are related to the controlling shareholders. Conflict of interests in the concentration of ownership mainly occurs between the majority shareholders and minority shareholders besides the traditional conflict of interest between management and shareholders that could be controlled by majority shareholders.

What is the relationship between share ownership and corporate governance? What determines the relationship or how do dispersed and concentrated ownership come into existence? What model of corporate governance should be learned across the countries? The thesis will answer the above questions in detail systematically for the first time (referring to the below diagram 1).

The thesis argues that the company as a legal personality is the outcome of

[3] E. g. Eisenberg, Melvin, 1976, The Structure of the Corporation : A Legal Analysis, Little, Brown and Co., Boston, Mass.; Demsetz, Harold, 1983, 'The Structure of Ownership and the Theory of the Firm', Journal of Law and Economics 26, pp 375-390.; Shleifer, Andrei, and Robert Vishny, 1986, 'Large Shareholders and Corporate Control', Journal of Political Economy 94, pp 461-488.; Holderness, Clifford, and Dennis Sheehan, 1988, 'The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis', Journal of Financial Economics 20, pp 317-346.; Edwards Jeremy, and Klaus Fisher, 1994, Banks, Finance and Investment in West Germany since 1970, Cambridge University Press, Cambridge, U.K.; Franks, Julian, and Colin Mayer, 1994, 'The Ownership and Control of German Corporations', Unpublished manuscript, London Business School; Prowse, Stephen, 1992, 'The Structure of Corporate ownership in Japan', Journal of Finance 47, pp 1121-1140; La Porta, Rafael, Florencio Lopez-de Silanes, Andrei Shleifer, and Robert Vishny, 1998, 'Law and Finance', Journal of Political Economy 106, pp 1113-1150; Stijn Claessens, Simeon Djankov, Larry H.P.Lang, 2000, 'The Separation of Ownership and Control in East Asian Corporations', Journal of Financial Economics58, pp 81-112.

[4] Most scholars think that the U.S and the U.K. belong to the structure of dispersed share ownership in the world. But some scholars think the U.S., the U.K., Canada, Australia, and New Zealand etc are the structure of dispersed share ownership in the world. e.g. See Neil Fligstein and Jennifer Choo, 2005, 'Law and Corporate Governance', Working Paper; Peter Gourevitch, with Richard Carney, and Michael Hawes, 2003, 'Testing Political Explanations of Corporate Governance Patterns', Working Paper, (February).

"survival of fittest" and has a lot of advantages compared to other enterprise forms in the long history but there are many weaknesses at the same time regarding the company per se as a legal personality. In particular, with the development of technology, progress of society and fierce competition in market, when companies become larger and larger, companies require much more funding beyond their ability in order to meet the expansion of marketing, production, and distributions etc. by debt or by equity. If the company selects external finance from debt, the structure of ownership remains the same as before, and generally speaking, the structure of ownership is concentrated under these circumstances. When companies, especially publicly traded companies get outside finance by equity, it means the change of the structure of ownership in companies will have to take place. It is the structure of ownership that leads to agency problems resulting in agency costs that is the core issue of corporate governance all over the world in place of separation of ownership from control by Berle and Means. That is, the structure of share ownership determines the model of corporate governance directly all over the world.

When companies need much funding by equity, the change of the structure of ownership in companies will have to develop in the two directions: dispersion and concentration. Once the change of structure of ownership develops towards dispersion, the agency problem in corporate governance is mainly that conflict of interest happens between dispersed shareholders and management, which is consistent with the argument of separation of ownership from control by Berle and Means because of information asymmetry, free-rider problem, cost, skill etc for dispersed shareholders.

Management will take advantage of its position to tunnel companies in the interest of managers instead of the company or dispersed shareholders. When the change of the structure of ownership grows towards concentration, the agency problem in corporate governance is mainly that conflict of interest rises between majority shareholders and minority shareholders besides the traditional conflict of interest between shareholders and managers because companies or management is controlled by majority shareholders. Majority shareholders will transfer assets to their or their relatives' other companies by related party transactions or other ways at the expense of the minority's interests. Hence the actual structure of ownership instead of the "law matters" by La Porta et al. and the "politics matters" by Mark J.Roe etc., determines the model of corporate governance which should be improved to a certain varying extent.

Although political decision-making, or protection of investors by law will have a certain effect on structure of ownership or corporate governance, the function of politics or law is very limited and the influence by politics or law on corporate governance should not be emphasized excessively. The thesis argues that the structure of share ownership will be affected by many elements such as economy, politics, law, culture and history, but determined by economic factors ultimately. Thus it draws a conclusion: there is no best model of corporate governance in the world, only a model of corporate governance that adapts to a particular country or region.

In order to support the argument that the structure of ownership determines the model of corporate governance in the world, the thesis takes the case of Chinese listed companies as example to explain and show the reason of the above. The thesis argues

that the structure of concentrated ownership of listed companies in China has been influenced by history, culture, law, politics and economy etc. which leads to agency problems and conflicts of interest between controlling shareholders and minority shareholders, shareholders and managers; but the major conflict of interest between the state as controlling shareholder and the public as minority shareholders, because the state as controlling shareholder controls the listed companies and always pursues its goals in place of profit maximization at the cost of the interests of minority shareholders, which results in the poor quality of listed companies and the poor corporate governance in China. Thus the concentrated share ownership of listed companies controlled by the state through share ownership in China directly determines the quality of corporate governance of listed companies.

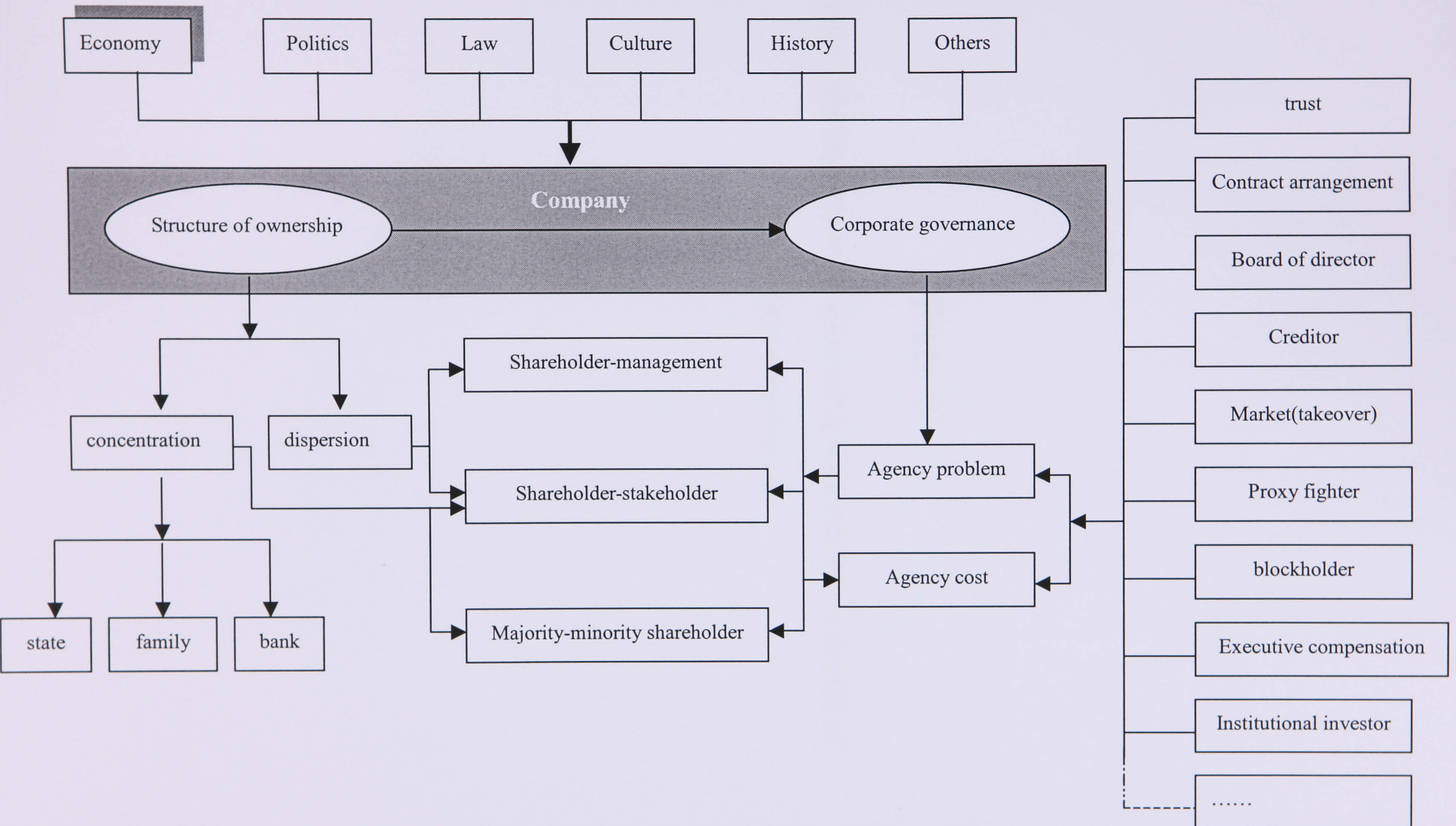
The thesis suggests that only if the reform of the structure of concentrated ownership in China is successful, will the improvement of corporate governance of listed companies be possible. In order to improve corporate governance, the shares owned by the state must be privatized reasonably and properly in accordance with worldwide experience and given environments. Maybe the institutional investor is one of the ways to improve the quality of corporate governance, which has been proved a good experience in the improvement of corporate governance in some Western countries.

In brief, based on the scholarly literature, mainly conducting library-based research in the UK and China, and analyzing by means of comparative study economically, culturally, historically, politically and legally, the thesis puts forward

the following argument for the first time: the structure of ownership everywhere determines the model of corporate governance, which is the contribution made to academic understanding.

The thesis is organized as follows. Chapter 1 describes the characters of companies, the result of survival of fittest, and the advantages and disadvantages of companies, in particular agency problems. Chapter 2 presents the core issue of corporate governance, and the conflicts of interest in the structure of dispersed share ownership and in the structure of concentrated share ownership. Chapter 3 discusses the relationship between the structure of share ownership and corporate governance. Chapter 4 challenges the "law matters" and the "politics matters". Chapter 5 outlines how the structure of share ownership comes into being. Chapter 6 explains how the structure of concentrated ownership is formed in history in China. Chapter 7 shows that the culture has great effect on ownership in China. Chapter 8 emphasizes the influence of politics on the structure of concentrated ownership in China. Chapter 9 explores the relationship between the law, ownership and corporate governance in China. Chapter 10 expounds disadvantages of the structure of concentrated ownership in China. Chapter 11 suggests that the reform of ownership is a precondition for the improvement of corporate governance in China. Chapter 12 draws conclusions.

Diagram1: The Relationship between Structure of Ownership and Corporate Governance



Part 1

Theory: the structure of ownership determines a model of corporate governance

Introduction

In this part, I will elucidate briefly the advantages and disadvantages of companies in their long history. Compared with other forms of enterprises, companies could adapt easily themselves to changing environments owing to elaborate and efficient internal mechanisms while their shortcomings lead to the practical problems of corporate governance.

As for corporate governance, scholars in varying disciplines have different comments on it of which "law matters" and "politics matters" are very famous. I argue that the issue of corporate governance derives from the structure of share ownership: the structure of share ownership determines the model of corporate governance in the world. In other words, the major problem of corporate governance in the structure of dispersed share ownership is conflict of interest between shareholders and management, while the major problem of corporate governance in the structure of concentrated share ownership is conflict of interest between majority shareholders and minority shareholders.

The core issue of corporate governance is agency problems that originate from relationships between management and shareholders, majority shareholders and minority shareholders, and shareholders and stakeholders. As we know, there is no company without shareholders who can take part in the activities of the company by means of share ownership in accordance with its laws and charters; in other words, there is no company without shares which make up the structure of share ownership

which is affected by many elements such as economy, law, politics, history, culture etc. but by economy ultimately.

Although not all shareholders are interested in the operation of companies due to cost, skill, information asymmetry etc., we could say all shareholders are concerned with their assets or interests which have a close relationship with the operation of companies, which results in different agency problems in different structures of share ownership. Therefore I come to a conclusion that the structure of share ownership determines directly a model of corporate governance in the world for the first time.

Here I emphasize that I am concerned with only the corporate form in general, not the detail of substantive law of any jurisdiction. Sometimes I will make particular reference to the company law of particular countries for illustrative purposes.

Chapter 1. The nature of company[5]

1.1 Evolution of the corporate form according to market pressures

Modern companies in Western societies are creatures of a market economy. The sole tradership is the simplest and earliest form of business organization.[6] The Commenda and the Societas as the two earliest business organizations are similar to the modern partnership.[7] But with the development of society and technology, the existing business organizations of the day could not keep the pace with the requirement for the growth of economy and society, for example, the construction of railways needed huge amounts of money in the late 19th century, and neither sole tradership nor the partnership could satisfy the conditions. The company was created to adapt to the demands of the society. The emergence and development of the corporation is not only significant but also reasonable in practice, which is the result of evolution of the means of productivity.

Darwin's theory of evolution and natural selection in the natural sciences is well known, and there also exists competition among organizational forms for survival. We can say that firms that survive in competitive markets are supposed to have optimal

[5] The terms 'company' and 'corporation' are used interchangeably in the thesis, however 'firm' in particular when citing articles in economics, 'firm' is often used to represent any business including a partnership and a company. But 'company' in the thesis means mainly 'large companies' (including 'public companies' or 'listed companies') since chapter two onward.
[6] See John H Farrar and Brenda Hannigan, 1998, Farrar's Company Law, London: Butterworths, 4th ed., p 15.
[7] See John H Farrar and Brenda Hannigan, 1998, Farrar's Company Law, London: Butterworths, 4th ed., p 16. (citing Holdsworth, op cit, at195 ff).

governance structures. Firms that could not adapt their governance structures to the changing business environment supposedly have to challenge extinction via bankruptcy, dissolution or takeover, resulting in a natural selection of efficient organizational forms.[8] In other words, only those firms that could adapt themselves to competition could survive in the market. That is, from the perspective of cost, the form of organization that survives in a transaction is the one whose cost is less than the profitability.[9] According to organization theory, adaptation is the central problem of economic organization. Friedrich Hayek stressed the adaptation of autonomous economic actors who adjust spontaneously to changes in the market, mainly as signaled by changes in relative prices. The marvel of the market is present in "how little the individual participants need to know to be able to take the right action".[10] By contrast, Chester Barnard emphasized coordinated adaptation among economic actors working through deep knowledge and the use of administration. In his view, the marvel of hierarchy is that coordinated adaptation is accomplished not spontaneously, but in a "conscious, deliberate, purposeful" way.[11] In fact the problem of economic organization is properly assumed not as market or hierarchies, but rather as the problem of combining market and hierarchies.[12] Only firms that should be active rather passive in the market could survive in the fierce competition. Therefore, Arrow

[8] See Stacey Kole and Kenneth Lehn, 1997, 'Deregulation, the Evolution of Corporate Governance Structure, and Survival', The Emerging New Economics of the Firm, Vol. 87, No. 2, p 421.
[9] See Eugene F.Fama, and Michael C.Jensen, 1983,'Agency Problems and Residual Claims', Journal of Law & Economics, Vol.XXVI.
[10] See Chester Barnard, 1938, The Functions of the Executive, Cambridge: Harvard University Press.
[11] See Chester Barnard, 1938, The Functions of the Executive, Cambridge: Harvard University Press.
[12] See Oliver E. Williamson,2002, 'The Theory of the Firm as Governance Structure: From Choice to Contract', Journal of Economics Perspectives, Vol.16, Number 3, p 175.

argued it would not be completely right to regard the firm as a black box[13] that changes inputs into outputs according to the laws of technology. Instead, firms must be described in relation to other modes of governance, all of which have internal structure, which structure "must arise for some reason".[14] In other words, the structure emerges to reduce transaction costs by contract/ private ordering/ governance approach.[15] Thus Coase argued that firms rose because there were "transaction costs" involved in entering markets, negotiating for goods and services, and enforcing contracts. Coase continued that if the cost of carrying out a transaction in the firm was less than the cost of carrying out the same transaction within the market, firms would internalize the transaction in order to lower costs.[16] In this scenario, firms rise and develop precisely when the market is less efficient than firms.[17] As March and Simon pointed out, organizational structure was created by attempts to decrease the effects of these constraints, such as cognition and information.[18] In other words, enterprises must deal with transaction costs actively by their internal mechanism in intense competition in order to survive in the market.

The corporation has been able to adapt itself to the society and market in its long history because it constantly and purposefully adjusts itself through its organization to adapt to changes in market and society. Companies are the result of institutional

[13] ' black box' put forward by the neoclassical theory which predicts how the firm's production plan varies with input and output prices, but says nothing about how this production plan comes about. See Oliver Hart, 1995,' Corporate Governance: Some Theory and Implications', The Economic Journal, Vol.105, No. 430, p 678.
[14] Kenneth Arrow, 1999, '"Forward" in Firms, Markets and Hierarchies: The Transaction Cost Economics Perspective', G Carroll and D. Teece, eds. New York University Press, p vii.
[15] Oliver E. Williamson, 2002, 'The Theory of the Firm as Governance Structure: From Choice to Contract', Journal of Economies Perspectives, Vol.16, Number 3, , p 178.
[16] See Coase R, 1937, ' The Nature of Firm', Economica 4, pp 386-405.
[17] See Neil Fligstein and Robert Freeland, 1995, 'Theoretical and Comparative Perspectives on Corporate Organization', Annu. Rev. Sociol,. 21, p 24.
[18] See Simon H, 1957, Administrative Behavior, New York: Macmilan; March J, Simon H, 1958, Organizations, New York: Wiley.

competition because they have efficient organizations. In other words, companies are not passive but active in the market. The company as an entity and an organization has a lot of advantages compared to other enterprise forms, for example, its ability to raise substantial amounts of capital from outside easily; limited liability (non-exclusive now) which attracts investors; a relatively perfected management system and elaborate structure; flexibility, namely the company form can be used to suit all kinds of firms, from the smallest, one-person business to the largest, multi-national undertaking;[19] freedom of establishment; etc. which are beneficial to the development and competition of companies in the market. But the above improve constantly in the process of development of companies in the market. In a word, the characteristics of companies and their structure and internal organization resulting from their historical development show the adaptability of companies to the changing environment. Therefore, the modern company, which adapts easily and naturally to the changing environments through its internal elaborate mechanism, is the result of "survival of fittest".

1.2. Nexus of contracts model

What is a company? Coase argues that the corporation is certainly a species of firm—a group of people organized to raise funds and operate a profitable business.[20] In economics the current dominant model of the corporation, the nexus of contracts

[19] See Paul L. Davies, 2003, Gower and Davies' Principles of Modern Company Law, Sweet & Maxwell, 7th ed., p 3.

[20] See Ronald H. Coase, 1937,'The Nature of firm', 4 Economia, pp 386-405.

model that is based on an economic analysis of the firm, emphasizes this profit aspect of the firm. Bainbridge describes the corporation as follows:

> "The firm (is) not as a single entity, but is an aggregate of various inputs acting together with the common goal of producing goods or services. Employees provide labor. Creditors provide debt capital. Shareholders provide equity capital, bear the risk of losses, and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is simply a legal fiction representing the complex set of contractual relationships between these inputs. In other words, the firm is not an individual thing, but rather a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up firm."[21]

In light of the above concept, corporate law is only a provider of standard contract terms with which the contracting parties comply.[22] Sometimes the economic analysis of the nexus of contracts concerning corporation does not take into account all of law's separate objective such as fairness and justice. Or economic analysis of the nexus of contracts stresses an emphasis on the function of economy rather than social responsibility. The thesis will analyze the drawbacks of the nexus of contract next chapter.

Law is concerned not only with economic efficiency, but with things we term retribution, personal responsibility, fairness, and a just society etc. Law should regulate not only individual human being's economic aim or demand but also the goal of society as a whole. Its structure is not and cannot be restricted to maximizing

[21] See Stephen Bainbridge, 1997, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law scholarship', 82 Cornell L. Rev. 856, p 8.
[22] See Benedict Sheeshy, 2004, 'The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law', Depaul Business & Commercial Law Journal, Vol. 2:463, p 465.

wealth transactions.[23] In particular, law should not only discuss how to organize and protect those rich persons but also care about social welfare.[24] Law should regulate not only rights and obligations but also the responsibility (result) which the company causes. As for corporate law, it performs two general functions at least: first, it sets up the structure of the corporate form as well as procedure requirements to strengthen this structure; and second, it attempts to solve conflicts of interest among corporate shareholders and stakeholders.[25] So it is not strange sometimes that the scholars in law and economics have a different understanding regarding companies and corporate governance etc. in the world.

1.3. The main features of the company— limited liability and personality

In Europe, the evolution of the corporation can be traced to the commercial societies of the Middle Ages with the characteristic of the state concession.[26] The early company regulations or laws regulated shareholders strictly and put emphasis on the protection of society and outsider against the company, for instance, by way of the creditor's right to petition for the liquidation of the firm if minimum capital requirements were not met. Until well into the nineteenth century, the allocation of

[23] See Benedict Sheeshy, 2004, 'The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law', Depaul Business & Commercial Law Journal, Vol. 2:463, pp 482-483.
[24] See Robert Dworkin, 1980, 'Is Wealth a Value? 9 J. of Legal Studies 191.
[25] See Reiner Karaakman et al, 2004, The Anatomy of Corporate Law: A Comparative and Functional Approach, Oxford: Oxford University Press, p22.
[26] See Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West, 'The Evolution of Corporate Law, A Cross-Country Comparison', The University of Pennsylvania Journal of International Economic Law, Vol. 23, Issue 4, pp 791-871.

control rights among the shareholders of the corporation was decided by state. At the early stage, companies as independent legal entities could not engaged in operation without state's permission in many aspects, such as selling their shares.[27] With the development of the company, the above legal provisions limit agency problems, but at the same time greatly restrict the ability of the company to respond to a quickly changing environment. For instance, in 1720, the parliament of the United Kingdom had to pass the Bubble Act which attempted to restrict, and to restore rigid legislative control, through the use of the corporate form, in response to the speculative bubble associated with the South Sea Company that did great harm to market and society then. But one of its negative effects was to dwindle the competition to which chartered corporations were exposed.[28]

Companies are the result of the development of society and are improved gradually, as stated above. Historically there have been many different types of companies, or companies could be categorized into variant forms. Modern companies regulated by company law have the five core structural characteristics as follows: "(1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital."[29] However, there are other different forms of business enterprises that adapt to different situations and that are short of one or more of these characteristics in the

[27] See Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West, 'The Evolution of Corporate Law , A Cross-Country Comparison', The University of Pennsylvania Journal of International Economic Law , Vol. 23, Issue 4, pp 791-871.

[28] See Michael J. Whincop, 2001, An Economic and Jurisprudential Genealogy of Corporate Law, Aldershot(UK): Ashgate Publishing Limited, p 1.

[29] Reinier Kraakmain, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hidekkanda and Edwardrock, 2004 , The Anatomy of Corporate Law, Oxford: Oxford University Press, p 5.

history of the development of organizations. Even the company may lack one or two characteristics at early stage compared to modern corporations. For instance, the joint stock company with tradable shares as one of its characteristics was not legal for business activities in England until 1844 and limited liability was not stipulated in law until 1855.[30] Of course, there ever existed only a handful of specially chartered companies that coalesced all five of these characteristics before the beginning of the nineteenth century in the history and that were outcomes of particular period and history.

As an economic entity, a company will engage in activities stipulated by law and charter through a nexus of contracts, which requires the company to be recognized as an independent entity. The first and most important contribution of corporate law, as of other forms of organizational law, create a legal personality of a company that is distinct from the various individuals, such as investor, suppliers or customers of the firm.[31] The core element of legal personality is that company is able to own assets, participate in all kinds of activities independently and take responsibility for its consequence, which are distinct from its investors, such as the company's shareholders. The company can sue and be sued in its own name, and can make profits and losses that are its own. Thus the individual shareholders of the corporation cannot withdraw their share of company assets at will but can sell off their shares according to laws and the articles of association or shareholders' contract and the company is free not only to use and sell its assets but to pledge or lien its assets as

[30] Phillip Blumberg, 1988, The Law of Corporate Group: Substantive Law, Boston/Toronto: Little Brown & Co., pp.9-20.
[31] ibid, p 7.

security to creditors whose claim on the company's assets is prior to the claims of the personal creditors of the company's shareholders. In a word, legal personality strengthens the stability and creditworthiness of the company in order that the company can take part in all kinds of activities stipulated by the law.

Historically, limited liability has not always been associated with the birth and development of the corporate form. Unlimited shareholder liability as the governing rule for corporate debts was an important institution in some corporate jurisdictions for a long time.[32] For example, England was the first country to adopt free registration in 1844,[33] but only after several court decisions, which recognized contractually granted limited liability. The Act for Limiting the Liability of Members of Certain Joint Stock Companies was passed on 14th August 1855, in which limited liability was firstly provided in England. French legislators firstly accepted limited liability in Code de Commerce in 1807.[34] Limited liability was specified by law in Germany in 1861.[35] Limited liability means the creditors of the corporation are limited to making claims against the assets of the company itself rather than the personal assets of the company's shareholders. The major advantages of limited liability are not only to encourage investment as the member's risk is minimized, but also to facilitate a public share market, since without limited liability shares would be

[32] See Paul L. Davies, 1997, Gower and Davies' Principles of Modern Company Law (6th ed.,) pp 40-46.
[33] See Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West, 'The Evolution of Corporate Law, A Cross-Country Comparison', The University of Pennsylvania Journal of International Economic Law, Vol. 23, Issue 4, pp 791-871.(citing Joint Stock Companies Act 7and 8 Vict., ch. 110 and 111(1844) (Engl.)).
[34] See Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West, 'The Evolution of Corporate Law , A Cross-Country Comparison', The University of Pennsylvania Journal of International Economic Law , Vol. 23, Issue 4, pp 791-871.(citing Art.33 Code de Commerce(C.com.), adopted by Law No.2804, November 1807,Bull. Des Lois No.164 (1808),161-299 (France)).
[35] See Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West, 'The Evolution of Corporate Law, A Cross-Country Comparison', The University of Pennsylvania Journal of International Economic Law, Vol. 23, Issue 4, pp 791-871.(citing Allgemeines Deutsches Handelsgesetzbuch(ADHGB), od 1861 reprint in BGBL.Norddtsch. Bd, Nr. 32.379,Append.C Part 3, at 445 (Germany)).

worth less to a wealthy shareholder due to the debt of companies. That is, the wealthy shareholder would be more likely to be sued in a liquidation than a poor one, so the value of shares would depend on the wealth of individual holder,[36] which is unfair to some of shareholders who are wealthier. The relation between legal personality and limited liability is that legal personality permits the business to possess assets, and thus acts as a kind of floating lien giving priority to business creditors over the individual creditors of investors and managers, and limited liability keeps the assets of shareholders' individuals exclusively for their personal creditors.[37] As a consequence, it strikes a balance between the creditor of company and the individual creditor of investors.

One of basic characteristics of the business corporation that differentiates the corporation from the partnership and from various other standard-form legal entities is fully transferable shares.[38] Shares must be transferred in compliance with the law and articles of association. Transferability of shares benefits not only shareholders who can construct and maintain diversified investment portfolios but also the corporation itself because it can go on conducting business without interruption as the identity of its shareholders changes. In particular, the transferability of shares could promote the development of a stock market, and where a modern capital market developed it could accelerate the change of structure of ownership in companies.

With the growth of the corporation and the change of the structure of share

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[36] See John Lowry and Alan Dignam, 2003, Company Law (Second Edition), London: Lexis Nexis Butterworths, Reed Elevier (UK) Ltd, p 48.
[37] See Reinier Kraakmain, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hidekkanda and Edwardrock, 2004, The Anatomy of Corporate Law, Oxford: Oxford University Press, p 9.
[38] ibid, at 10.

ownership, the professional management developed gradually. Delegated management with a board structure is an attribute of nearly all large companies with numerous fractional shareholders, which result in the centralization of management in place of the centralization of shareholders. It was said that the potential problems of the separation of ownership and control were ascertained in the eighteenth century in An Inquiry into the Nation and Causes of the Wealth of Nations by Smith.[39] Centralized management under a board structure result in separating management from ownership, as a consequence of a shift from ownership to control of firm[40] and the emergence of professional managers and directors within the corporation has represented a new "managerial revolution" within the corporate governance system.[41] "Separation allows firm to combine managers with talent but without much capital (at least initially) with investors who have capital but neither the time nor the skills to manage."[42] But management can in effect use the company as a device for enhancing their own utility. The manager's own self-interest may prevail and lead them to use the company's resources for other purposes such as increasing their remuneration and perquisites, or working with less diligence, or retaining profits within the company to finance growth and expansion designed to enhance their own prestige, which is called an adverse selection and a moral hazard problem in economics and leads to the agency problem in corporate governance that the thesis will discuss more below.

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[39] See Jean Tirole, 2001, 'Corporate Governance', Econometria, Vol.69, No.1 .at 1. (citing Smith.A (1776), 'An Inquiry into the Nation and Caused of the Wealth of Nations', New York: Modern Library, 1937).
[40] C S Beed 1 Journal of Economic Studies (1966) at 29.
[41] Cf: Burnham, 1962, The managerial Revolution, Indian University Press, and Nichols, 1969, Ownership, Control and Ideology, London: Allen & Unwin,.
[42] See Mark.J.Roe, 'The Inevitable Instability of American Corporate governance' Discussion Paper No.493, 09/2004. Harvard Law School, Cambridge, MA 02138.

Most people who managed the company at the early stage of company development were owners of the company before the twentieth century, which bears some resemblance to partners in partnership today. Shareholders were not only management but also owners of company. Investor ownership means investor has right to participate in control of corporation and receives the corporation's residual earnings or profits, which are typically proportional to the amount of capital contributed to the corporation. At that time, there was no agency problem in the company, or at least the conflict of interests was not extensive if there was. Thus earlier corporate statutes did not pay much attention to the governance structure of the firm. All laws initially stipulated that the company would be managed by directors or by trustees who were shareholders of the firm. From the beginning of the twentieth century, the law prescribes companies as entities or legal personalities that own its assets and are quite distinct from shareholders who own shares in companies but are not the owners of assets in the company.

In a word, the emergence and development of the company are reasonable in the market around the world due to its adaptability to the changing environment, while the characteristics of companies show that companies are independent entities in the market and are at an advantage in comparison with other forms of enterprises.

1.4. Companies and property

The concept of ownership is a very complex, powerful and controversial idea.[43] Ownership has been conceptualized in a number of ways in economics. In the accepted economic theories the ground of ownership is commonly conceived to be "the productive labor of owner."[44] Or ownership can be approached in terms of "who owns organizational resources,"[45] "who possesses organizational property,"[46] or "who owns the means of production."[47] In law it emphasizes justice, and explains and gives moral force to a host of rights and duties as well as serving to legitimate the allocation of wealth and privilege. Thus to own something means owner enjoys a variable bundle of rights, liberties, powers, and liabilities against all others in relation to some tangible or intangible thing. The content of ownership mainly includes: (1) The right to possess; (2) the right to use; (3) the right to the capital; (4) the right to manage; and (5) the right to security; and (6) the right to the income.[48] The above rights, liberties, and powers associated with property could be separated from each other, combined together or someone else authorized for use by the owner for the purpose of obtaining optimal results in accordance with law.[49] Historically in

[43] See Harris, 1996, Property and Justice, Clarendon Oxford, p 3; Penner, 1997, The idea of Property in Law, Clarendon, Oxford, at 1; Honore, 1961, Ownership in Guest (ed.), Oxford Essays in Jurisprudence, O.U.P., Oxford, p 107.

[44] See Thoristein Veblen, 1898, 'The Beginnings of Ownership', The American Journal of Sociology, Vol. 4, No. 3, Nov., at 352.

[45] See Lipsey, Peter O. Steiner, Douglas D. Purvis, and Paul N. Courant, 1990, Economics, New York: Harper & Row.

[46] See Barry Bozeman, 1987, All Organizations Are Public and Private Organizational Theories, San Francisco: Joseey-Bass.

[47] See Thomas Sowell, 1985, Marxism, New York: William Morrow and Company.

[48] See John Christman, 1994, ' Distributive Justice and the Complex Structure of Ownership', Philosphy and Public Affaire, Vol. 23, No.3, p 227; A.M.A.Honore, 1961, 'Ownership' in Oxford Essays in Jurisprudence, ed. A. Guest (Oxfor: Clarendon,), pp 107-47; Lawrence Becker, 1977, Property Rights: Philosophic Foundations (Boston: Routledge and Kegan Paul); Andrew Reeve, 1986, Property (Atlantic Highlands, N.J.: Humanities Press,); Jeremy Waldron, 1988, The Right to Private Property (Oxford: Oxford Univ. Press); and Stephen Munzer, 1990, A Theory of Property (Cambridge: Cambridge Univ. Press,).

[49] See John Christman, 1994, 'Distributive Justice and the Complex Structure of Ownership', Philosophy and Public Affairs, Vol.23, No.3 (Summer,), p 226.

company law, ownership as the foundation for the establishment of company was ever the principal explanation and justification for the central role of shareholders in corporate affairs.[50] As owner, shareholders had right to control and supervise the management of the company and to the exclusive result of the company's activities in the past.[51] However, in England it was *Salomon's case* in 1896 and in America it was *Santa Clara County v. Southern Pacific Railroad* in 1886 that established the company's identity as a legal personality in the common law,[52] that is, the company as an independent legal artificial personality having a its status is distinct from its shareholders in law and being owner of its assets instead of shareholders, who make a contribution to the company in return for shares in the company. Since then shareholders have rights and liabilities in proportion to their share in company but are not owners of asset in the company. By the beginning of the 20th century the idea that shareholders had no direct interest in the company's assets had become well established in the common law system. Thus the company itself as an entity is the owner of its asset and the shareholders of the company enjoy corresponding rights stipulated by law or articles and memorandum of association in civil law systems and in common law systems. As the owner of assets, a company can independently engage in all kinds of business activities by laws, regulations, memorandums and articles and take responsibility in society. The law no longer conceives of shareholder rights as a

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[50]See Dallas, 1995, 'Working Toward a New Paradigm' in Mitchell (ed.), Progressive Corporate Law, West View, Colorado, p 37; Hill, 1998, 'Changes in the Role of the Shareholder' in Grantham and Rickett (eds.), Corporate Personality in the 20the century, Hart, Oxford, Chapter 10.

[51] See Ross Grantham, 1998, 'The Doctrinal Basis of the Rights of Company Shareholders', Cambridge Law Journal, 57(3),(November) p 554.

[52] See Ross Grantham, 1998, 'The Doctrinal Basis of the Rights of Company Shareholders', Cambridge Law Journal, 57(3), (November) p560 (footnote36, citing (1897) A.C.22.)

consequence of their status as owners of the company but as owners of a shareholding (share) in the company. Shareholders are owners of share in the company while the company is owner of its assets, which may be contributed by shareholders who are residual claimants, entitled to derive benefits from a company only after all other claims have been satisfied. That is why the thesis should use shareholding structure (or structure of share ownership) instead of ownership structure in strict law[53] when owners of shares are referred to collectively concerning companies. As Fama and Jensen pointed out, "Our concern in this section is with the organizational forms characterized by separation of decision management from residual risk bearing—what the literature on open corporations calls, somewhat imprecisely, separation of ownership and control".[54] In sum, ownership structure in economics is in a sense different from ownership structure in law. But in this thesis, ownership, share ownership, and shareholding ownership have the same meaning regarding companies, unless stated otherwise.

1.5. The room for the improvement of companies

The corporate form is considered as another milestone for industrialization, which is

[53] Generally speaking, economists or scholars in economics in books, articles or other media like to use ownership structure related to company: e.g.Jensen, Michael, and William Mechling, 1976,'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', Journal of Financial Economics 3, No, 4 (October). J.R. Davies.el. at, 2005, 'Ownership Structure, Managerial behavior and corporate value', Journal of Corporate Finance 11, pp 645-660; Jian Chen, 2001, ' Ownership Structure as Corporate Governance Mechanism: Evidence from Chinese Listed Companies' , Economics of Planning 34: 53-72,; James S. Ang. et.al, 2000, ' Agency Cost and Ownership Structure', the Journal of Finance. Vol. LV, No.1,(February) pp 81-106; Rafael La Porta.et. al, 1999 'Corporate Ownership Around the World', the Journal of Finance. Vol. LV, No.2, (April), pp 471-517. They should use the shareholding instead of ownership related to company in strict law.

[54] Eugene F. Fama and Michael C. Jensen, 1983,'Separation of ownership and control', Journal of Law and Economics, Vol. XXVI,(June), p 9

the result of viable market economies, and ultimately economic prosperity.[55] The corporation as a wonderful flexible legal institution has existed for 200 years of industrialization and modernization largely due to its capacity to acclimatize constantly to changing conditions.[56] As stated above, companies as entities and organizations have many advantages that have improved (or evolved from other systems) constantly in the long history compared with other enterprise forms to adapt themselves easily to fierce competition in the market. Simply speaking in terms of economics, any enterprise that carries out the transaction or activity has to bear costs in the market on account of informational asymmetry, supervision etc., namely transaction costs. As for companies, as mentioned before, companies are active in the market due to the structure of orderly and elaborate internal organization which could reduce transaction costs greatly compared with other forms of enterprises. Therefore the company could take the advantage of competition in the market.

However, there are many problems with companies which are identifies by scholars and practitioners, which are difficult to deal with, such as evading limited liability (e.g. stripping the assets of companies in order to pay a dividend to shareholders that leaves nothing to creditors), managerial discretion, related-party transactions by big shareholders, when the market is imperfect (in fact there is no perfect market in reality). In particular, there is agency problem or agent cost which is one of hottest topics in the disciplines of economics, law, management and others. In a

[55] See Ronald I. Mckinnon , 1973 Money and Capital in Economic Development, Washington D.C.: Brooking Institution.
[56] See Mary O'Sullivan, 'The Innovative Enterprise and Corporate Governance', 24 Cambridge Journal of Economics 393(2000) on the Importance of Innovative Capacity of Companies.

word, the corporation system still needs to be improved in order to adapt to the environment of globalization of the economy due to its current drawbacks.

1.6. Conclusion

Economic activity in modern societies is dominated by firms that have internal organization, possess assets, conclude contracts, and assume liabilities as entities that are legally different from their owners and managers, completely taking place of individuals as dominant position in economy in the past.[57] The company as a legal personality owns its assets and can take part in all kinds of activities in society by laws, regulations, memorandum and article of association. Compared to other enterprises, the mechanism of company can adapt more easily to changing environment and it is the result of "survival of fittest." If the invention of the steam engine started the industrial revolution, then the invention of companies, in particular the invention of the joint-stock company was definitely even more significant and symbolized a new and more important revolution: the system of the joint-stock company, especially raising funding from the public, not only stimulated the industrial revolution and innovation of knowledge and technology, but also lay the foundation for the development of the modern economy and the progress of civilization as we know it today.[58] Companies have both pros and cons. But theirs disadvantages that

[57] See Henry Hansmann, Reinier Kraahman, and Richard Squire, 'Law and the Rise of the Firm', Law Working Paper No. 57/2006, January 2006.www.ecgi.org/wp.
[58] See Dr. Cyril Lin, 2001, 'Private Vices in Public Places: challenges in Corporate Governance Development in China', Working Paper, (April), OECD Development Centre.

are very difficult to tackle will give rise to the problem of corporate governance in the real world.

Chapter 2. The Core Issue of Corporate Governance

2.1. The agency problem[59]

2.1.1. The drawback of the company system

The 1840s indicate the beginning of a great wave of organizational change that has developed into the modern corporation from traditional one.[60] With the development of the economy, the structure of share ownership has changed greatly in companies. In particular, the separation of ownership and control leads to a change in the organization of enterprise almost as important as that which happened in the industrial revolution.[61] The evolution of the modern corporation in the 20th century has undergone multidivisional organization, the conglomerate and the multinational corporation that have made a great contribution to economic integration and economic globalization. The standard for organizing commercial transactions is supposed to be

[59] Agency theory that is in relation to the dissertation will be stressed and described below. However, there are many theories regarding corporate governance development: (1) Transaction cost economics. It views the firm itself as a governance structure. The choice of an appropriate governance structure can help align the interests of directors and shareholders. (2) Stakeholder. The theory takes account of a wider group of constituents rather than focusing on shareholders. Where there is an emphasis on stakeholders (employee, creditor, supplier and consumer .etc.) then the governance structure of the company may provide for some direct representation of the stakeholder groups. (3) Stewardship. It thinks directors are regarded as the stewards of the company's assets and will be predisposed to act in the best interest of the shareholders. (4) Class hegemony. The theory supposes directors view themselves as an elite at the top of the company and will recruit / promote to new director appointments taking into account how well new appointments might fit into that elite. (5) Managerial hegemony. It thinks management of a company, with its knowledge of day-to day operation, may effectively dominate the directors and hence weaken the influence of the directors. See Christine A. Mallin, 2004, 'Corporate Governance', Oxford University Press, Chapter 2, p 10.

[60] Chandler, A.D., 1977 , The Visible Hand: The Managerial Revolution in American Business, Cambridge, Mass.: Belknap Press.

[61] Gardiner C. Means, 1931, 'The Separation of Ownership and Control in American Industry', The Quarterly Journal of Economics, Vol. 46, No.1, (Dec.), p 96.

the strictly instrumental one of reduction of cost, namely lower transaction costs. In fact, however, the efficacy of internal organization relies on whether sound principles of internal organizational design function very well. In other words, the details of internal organization will have strong effect on the improvement of the operation,[62] as analyzed in Chapter one. The corporation is first and foremost an efficiency instrument that develops fastest and has become the most popular due to the efficient structure of internal organization as compared with the partnership, sole tradership or proprietorship, or other enterprises currently. However, as stated in chapter one, the organizational structure of the corporation as an entity instead of the shareholder as the owner of corporation in the past, is not perfect as expected and designed because corporations maybe seek to monopolize markets, management sometimes pursue their own goals to the detriment of system goals, and shareholder activities lead to the cost of a shareholder's shirking (e.g. big shareholder). As a result, presumably the poorer performance of the firm is shared by all shareholders in proportion to the number of shares of stock they own due to drawbacks of the company system itself. The greater is the quantity of shares, the greater the degree to which benefits and costs are assumed by the same shareholder.[63] Shareholders are not owners of the assets of company, however, the ultimate result will be borne by shareholders in proportion to their shares in companies.

Traditionally in legal theory, shareholder democracy has been used as

[62] Oliver E. Williamson, 1981, 'The Modern Corporation: Origins, Evolution, Attributes', Journal of Economic Literature, VOL. XIX,(December), p 1547.
[63] See Harold Demsetz and Kenneth Lehn, 1985, 'The Structure of Corporate Ownership: Causes and Consequences', The Journal of Political Economy, Vol. 93, No. 6,(Dec.), p1156.

mechanism to ensure that shareholders can monitor corporate management in the company. That is, shareholders are given the right to appoint and dismiss the directors and approve the basic issues of corporate affairs through voting attached to their shares. However, due to the structure of share ownership, in reality in the absence of incentive, skills and knowledge and on account of asymmetry of information, cost problems and free rider problems, individual shareholders are passive with respect to monitoring management performance. Particularly when shareholders become dispersed in publicly traded companies because of separation of ownership and control, management will have substantial discretion over how to allocate the company's assets necessary for day-to-day performance, which makes it possible for managers to divert company assets for their own interests. They may collect private benefits by means of an adverse selection and a moral hazard, such as building empires, enjoying perks.[64] This is the so-called agency problem. Or that is the agency relationship between a "principal" (investors, outsiders) and an "agent" (managers, insiders).[65]

2.1.2. The reason for the agency problem: shareholding structure

The agency problem is actually a vital part of the so-called contractual view of the firm, developed by Coase,[66] Jensen and Meckling.[67] "The essence of the agency

[64] Jean Tirole, 2001, ' Corporate Governance', Econometrica, Vol. 69, No.1 (January), p 1-2.
[65] Jean Tirole ibid, p 1.
[66] See Coase, Ronald, 1937, 'The nature of the firm', Economica 4, pp386-405.
[67] See Jensen, Michael, and William Mechling, 1976, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', Journal of Financial Economics 3, No, 4, (October), pp 305-360.

problem is the separation of management and finance,— or in more standard terminology— of ownership and control,"[68] which traces back at least to Berle and Means and was ascertained by Berle and Means in their creative work.[69] In their 1932 classic, Berle and Means call attention to the fact that widely held corporations is prevalent in the United States, where ownership of capital is dispersed among small shareholders, managers have already controlled corporations.[70] Since then the issue of corporate governance has dealt with the agency problem between managers who exert control over corporation and shareholders that bear residual claims over the corporation assets. However, since the 1970s more and more studies on the agency problem have begun to question corporate governance that is only based on the assumption of the separation of ownership and control in modern public companies with diffuse ownership. For example, studies of other rich countries reveal more significant concentration of ownership, in Germany by Edwards and Fischer,[71] Franks and Mayer,[72] and Gorton and Schmid,[73] in Japan by Prowse,[74] Berglof and Perotti,[75] in Italy by Barca,[76] and in seven OECD countries by European Corporate Governance Network.[77] In addition, ownership is also highly concentrated in

[68] Anderi Shleifer and Robert W. Vishey, 1997, ' A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No.2, (June), p 740.
[69] See Adolph Berle and Gardiner Means, 1932, The Modern Corporation and Private Property, Chicago: Commerce Clearing House.
[70] See Rafael La Porta.et. al., 1999, 'Corporate Ownership Around the World', The Journal of Finance. Vol. LV, No.2, (April) , p 471.
[71] Edwards, Jeremy, and Klaus Fischer, 1994, Banks, Finance and Investment in West Germany since 1970, Cambridge University Press, Cambridge, U.K.
[72] Franks, Julian, and Colin Mayer, 1994, The Ownership and Control of German Corporations, Unpublished Manuscript, London Business School.
[73] Gorton, Gary, and Frank Schmid, 1996, Universal Banking and the Performance of German Firm, Working Paper 5453, National Bureau of Economic Research, Cambridge, Mass.
[74] Prowse, Stephen, 1992, 'The Structure of Corporate Ownership in Japan', Journal of Finance 47, pp1121-1140,
[75] Berglof, ERIC, AND Enrico Perotti, 1994, 'The Governance Structure of the Japanese Financial Keiretsu', Journal of Financial Economics 36 , pp259-284.
[76] Barca, Fabrizio, 1995, On Corporate Governance in Italy: Issues, Facts, and Agency, Unpublished Manuscript, Bank of Italy, Rome.
[77] European Corporate Governance Network, 1997, The Separation of Ownership and Control: A Survey of 7

developing economies,[78] La Porta et al. point out, and the above research shows that these shareholders in large corporations are active in corporate governance and take responsibility for companies in many countries in contrast to the Berle and Means idea that managers are not accountable.[79]

As a result of the research above, they suggest the agency issue of corporate governance has arisen not only in the United States and the U.K. with the structure of diffuse shareholding of publicly quoted company, but also in other countries in the world with the structure of concentrated shareholding of publicly quoted companies where controlling shareholders suppress minority rights or exploit minority interests. Therefore the agency relationship (problem) includes not only the relationship between managers and shareholders but also the relationship between controlling shareholders and minority shareholders, and between shareholder and stakeholders etc. The Berle and Means corporation is not common over the countries; in reality there are many corporations controlled by majority shareholders (e.g. family, state, bank, pyramid) in other countries in the world except for the U.S. and the U.K etc. Thus the fundamental agency problem across the countries is the conflict between minority shareholders and controlling shareholders having nearly full control over the managers rather than between dispersed shareholders and managers put forward by Berle and Means in 1932.[80] In fact, as Alfred Chandler points out, the largest British

European Countries Preliminary Report of the European Commission, Volumes 1-4, European Corporate Governance Network, Brussels.

[78] La Porta Refael, Florencio Lopez-de-Silanes, Andrai Shleifer, and Robert Vishny, 1998, Law and Finance, Journal of Political Economy 106, pp1113-1155.

[79] Rafael La Porta.et. al , 1999, 'Corporate Ownership Around the World', The Journal of Finance, Vol. Liv. No.2, p 472.

[80] See Rafael La Porta, Florencio Lopez-de-Silances, Andrei Shleifer, Robert Vishny, 2000, 'Investor Protection and Corporate Governance', Journal of Financial Economics 58, p15.

firms were family-dominated and family influence and control lasted as late as the Second World War, the structure of concentrated ownership structure in British's large firm was closer to that of continental family firms than to American structure after the Second World War, with family owners controlling many, or most big firms.[81] Thus scholars point out, the Berle and Means picture of dispersed ownership being separated from a professional management could not depict an accurate picture of the U.K. The family in the U.K. kept controlling companies through board and exploited minority shareholders, which gave rise to conflict between controlling shareholder and minority shareholders.[82] This means the change of the structure of share ownership took place towards diffusion of ownership since as early as mid-twentieth century in the UK. However, concentrated ownership remained after the Second World War at least.

The thesis argues, from the viewpoint of world as general patterns across the countries, the agency problem results from the substantial change of structure of share ownership instead of Berle-Means's argument (separation of ownership from control). Or in other words, the different structures of share ownership lead to different agency problems. Although Berle and Meams have found the significance of separation of ownership from control, in essence, it is the structure of share ownership that has caused the separation of ownership from control and leads to agency problems

[81] See Mark J.Roe, 2003, Political Determinants of Corporate Governance: Political Context, Corporate Impact, Oxford University Press Inc. New York, pp 99-101.(citing Alfred D.Chandler, Jr, Scale and Scope: The Dynamics and Industrial Capitalism 240 (1990), See also Alfred D. Chandler, Jr. and Herman Daems, 'Introduction', in Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise1, 6 (ed, by Alfred D. Chandler, Jr and Herman Daems, 1980) ('Until World War II, the British economy was for the most part an example of family capitalism').

[82] See Julian Franks, Colin Mayer, and Stefano Rossi, 2002, 'The Origination and Evolution of Ownership and Control', Working Paper, 15 (December). (note: with regard to the working paper, there are different versions, e.g. 2003)

between management and dispersed shareholders in America before the 1930s. Only the development of the economy and the change of the structure of share ownership towards the dispersion provided the possibility of the production of professional management and the separation of ownership from control in America. The production of professional management would not on its own result in the agency problem without the change of structure of share ownership toward the dispersion, and the consequence of the agency problem by professional management is not so serious that it attracts the attention of society, because shareholders or large shareholders can control the conduct of professional management completely. Today management as profession is very popular throughout the world and the separation of ownership from control arises across the countries to varying extents, but the phenomenon that conflict of interest happens between management and shareholders in other countries is not described so seriously as by Berle and Means. For example, the separation of ownership and management is very popular in most Central and East European firms. Shareholders, who cannot afford to depend on other institutions and arrangements devised to monitor and discipline managerial performance, have both the capacity and impetus to execute their rights.[83] The agency problem occurs between management and shareholders in most of countries, but except in the US and in the UK, it is not main conflict of interest in corporate governance.

The thesis argues that it is not the separation of ownership from control but the structure of ownership that causes the agency problems in corporate governance as a

[83] See Roman Frydman, Cheryl Gray, Marek Hessel, Andrzej Rapaczynski, 1997, 'Private Ownership and Corporate Performance: Some Lessons from Transition Economics', Working Paper, (June).

general pattern across countries. As a rule, the change in the structure of share ownership around the world develops in two directions: diffused ownership and concentrated ownership. The reason is that the growth of the firms needs funds of which the firms themselves are short, the firms must get external capital by equity or by debt in an intensely competitive market to expand their production, marketing and distribution etc. Otherwise the firms will fail and disappear by bankruptcy or takeover etc. in the market. Of course, whether the firm uses equity or debt depends on specific environments just like the internal capital and external capital that is more efficient and on which there are different viewpoints by scholars. The first argument by Williamson and Alchian etc. that the internal capital market is more efficient because funds are used appropriately by informed providers of capital. A second view, by Modgliani and Miller etc, holds that internal and external capital markets will result in the same resource allocation. A third view holds that internal capital markets are less efficient than external capital markets because the bureaucratic decision-making of corporate executives replaces the profit-based decision-making of investors.[84] Generally speaking, when the firm selects debt rather than equity in capital market as its tool for expansion, the structure of share ownership will be affected little except for the structure of concentrated share ownership by banks that are both owners of equity and creditors in companies in some circumstances, and the structure of share ownership in companies by debt is always concentrated across countries, and the agency problem takes place between controlling shareholders and small shareholders,

[84] See Patrick Bolton and David S.Scharfstein, 1998, 'Corporate Finance, the Theory of the Firm, and Organizations', the Journal of Economic Perspectives, Vol.12, No.4, (Autumn,), p 106.

for example South Korea. If the company gets external finance by equity, the change of structure of share ownership will develop towards dispersion or relatively lower concentration and agency problems occur mainly between shareholders and management (structure of dispersed ownership), between majority shareholders and minority shareholders (structure of concentrated ownership). Without question, the change of structure of share ownership under the circumstances will take the form of equity through the securities markets, and the result (dispersion or concentration) will depend on other elements in essence. However, it is determined by economy mainly and ultimately which will be discussed in chapter five. As regards the relationship between the structure of ownership and corporate governance, I will discuss it in the detail in chapter three.

Whether the structure of share ownership in a company is of dispersion or concentration is directly and prima facie dependent on the following facts at least: (1) cost. If it is much cheaper for companies to get external finance from debt rather than equity, the company will try its best to do it, and the structure of share ownership in a company is usually concentrated under the circumstance. For example, state-owned companies can get debt more easily from banks with a lower interest rate instead of getting equity from outside finance. Otherwise companies will get equity from outside finance and the structure of share ownership will be dispersed. (2) Issue of dilution. If a large shareholder in a given company does not want its shareholding to be diluted and control to be reduced, (of course, it is also extra costly due to the discounts sometimes given to new outside shareholder), a company will have to get money from

creditors instead of going public. The structure of share ownership in the company is easily concentrated. (3) Constraint on condition by the law. Some countries restrict investment in companies by financial institutions by law or regulation. For example, in the U.S. and in China, the law prohibits banks from investing directly in the equity market. However, any law that restricts investment of any entity in companies must adapt itself to the development of economy in order to serve the economy.

As for shareholders in companies, the transferability of share will affect the structure of share ownership, which will be stated in next chapter. However, in fact, the structure of share ownership in a given country is affected deeply by politics, culture, history, economy and other facts etc that will be discussed in chapter five.

As I stated above, the structure of ownership is very important. However, why has the model of Berle-Means corporations affected countries around the world in such a far-reaching way since it was put forward? Because, on the one hand, some of the experience in the model of Berle-Means corporation may be worth learning; on the other hand, America has gradually become the biggest and the most powerful economic, military, and political country in the world since the First World War. Any theory that is suitable for American is likely to have a great influence on other countries in the world, even if it is not really suitable for them. Actually the model of the Berle-Means corporations only fitted America when it was put forward by Berle and Means. The theory did not fit the U.K until maybe the 1970s. Today the model of the Berle-Means corporations mainly applies to the U.S. and the U.K. but it has

affected other countries in the world indeed. In a word, the theory advanced by Berle and Means is limited now. As some scholars put as follow.

> "The Berle and Means (1932) perspective is to identify the firm with a single individual, the CEO, and a single productive asset. But firms are actually organizations with many different kinds of employees; with internal capital and labor markets; with formal management structures and decision-making procedures; and with a wide variety of rules governing the allocation of inputs, capital, and the hiring and promotion of employees. To develop a better understanding of the conflict between the firm's management and its investors, this perspective must be broadened to introduce the Coasian themes of internal organization and interaction among managers inside the firm."[85]

In a word, the theory by Berle and Means is significant indeed but needs developing.

2.2. Agency cost

2.2.1. Concept of agency cost

As Oliver Hart pointed out, corporate governance issues arise in an organization whenever two conditions are met. First there is an agency problem, or conflict of interest, occurring between owners, managers, workers or consumers in the

[85] See Patrick Bolton and David S.Scharfstein, 1998, 'Corporate Finance, the Theory of the Firm, and Organizations', the Journal of Economic Perspectives, Vol.12, No.4, (Autumn,), p 101.

organization. Second, transaction costs are such that this agency problem can not be solved through a contract.[86]

Jensen and Meckling define an agency relationship as a contract under which agent provides some service for principals and agent is delegated some decision-making authority. If both parties to the relationship maximize themselves, there is enough reason to believe that the agent will not always act in the best interests of the principal.[87] Thus agency problem will arise, which will lead to agency costs that will be generated by the divergence between agent' interests and that of principal. Agency cost is the core of the agency problem in economics because the more efficient it is, the less cost it is if the agency problem could be solved. Or the aim pertaining to the agency problem is to minimize the agency cost in companies. What is agency cost? The cost of monitoring agent is called agency cost. According to the interpretation of Jensen and Meckling, agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, Agency cost also includes the value of output lost because the costs of full enforcement of contracts exceed the benefits. Thus agency cost includes: "(1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, (3) the residual loss. Of course, if there are enough 100 percent owner-managers available to own and run all the firm in an industry (competitive or not) the agency costs in that industry will be zero."[88]

[86] See Oliver Hart, 1995, 'Corporate Governance: Some Theory and Implications', The Economic Journal, Vol.105, No. 430,(May), p 678.

[87] See Michael C. Jensen and William H. Meckling, 1976, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', Journal of Financial Economics 3, No, 4, (October), pp 305-360.

[88] see Jensen, Michael, and William Mechling, 1976, 'Theory of the Firm: Managerial Behavior, Agency Costs,

In countries with the structure of dispersed ownership, managers with discretion can expropriate dispersed shareholders in different ways, such as the consumption of perquisites, entrenching themselves and staying on in the job even if they are no longer competent or qualified to run the firm, which are agency problems and lead to agency cost because dispersed shareholders are not likely to spend cost policing the performance of the management in a corporation.[89] In countries with the structure of concentrated ownership, although there exists a conflict of interest between management and shareholders, large shareholders have incentives to monitor management and take excessive risk in order to get returns on investment. However, there may be costs of large investors as well, for example, one cost is that large shareholders may bear excessive risk due to inadequate diversification. Some scholars[90] support the argument that large shareholders better monitor management and thereby improve firm valuation while other studies have however contradicted this general finding.[91] This relationship, while subject to interpretation, suggests that on the one hand, big shareholders may monitor managers and reduce agency costs in companies with more concentrated ownership; on the other hand there big shareholders in the companies with concentrated ownership can do harm to market valuation.[92] That is, theoretically and logically large shareholders only represent their

and Ownership Structure', Journal of Financial Economics 3, No, 4 ,(October), pp 305-360.

[89] See Andrei Shleifer and Robert W.Vishny, 1986,'Large Shareholders and Corporate Control', the Journal of Political Economy, Vol. 94, No.3, Part 1(Jun.,), p 461.

[90] Studies on the United States (e.g.Levy, 1983, Lease et al., 1984, DeAngelo and DeAngelo, 1985, Shleifer and Vishny, 1986, McConnell and Servaes, 1990) find a positive relation between ownership concentration and corporate valuation.

[91] E.g. Demsetz, H. and K.Lehn. 1985, 'The Structure of Corporate Ownership: Causes and Consequences', Journal of Political Economy 93, pp 1155-77; Morck et al, 1988, 'Management Ownership and Market Valuation: An Empirical Analysis', Journal of Financial Economics 20, pp 293-315.

[92] See Stijn Claessens et al., 2000, 'Expropriation of Minority Shareholders: Evidence From East Asia', SSRN Elec. Library, Working Paper No. 202, 390.

own interests and may expropriate other shareholders or other stakeholders, or large shareholders might try to treat themselves preferentially at the expense of other shareholders or other stakeholders, which are agency problems and lead to agency cost in concentrated ownership countries. Some scholars find that the largest shareholder in listed companies does obtain private benefits at the expense of minority shareholders.[93] In other words, expropriation or other wrong actions by big shareholder will be of major conflict of interest in the structure of concentrate ownership. The research has showed the disadvantages of expropriation by majority shareholders as follows at least:

> (1) "Expropriation by large investors can be detrimental to efficiency through adverse effects on the incentives of managers and employees, who might reduce their firm-specific human capital investments when they are closely monitored by financier without enough return or may be easily dismissed with the consequent loss of rents. (2) When the targets of expropriation by large investors are other investors, the adverse incentive effect of such expropriation is the decline of external finance".[94]

Thus based on the analysis above, agency cost is the core issue due to the agency problem in corporate governance both in the structure of dispersed share ownership and in the structure of concentrated share ownership.

[93] See e.g.Edwards, J., and Weichenrieder, 1999, 'Ownership, Concentration and Share Valuation: Evidence from Germany', Working Paper 193, CESifo, p 33; Bebchuk, L., 1999, 'A Rent-Protection Theory of Corporate Ownership and Control,' Working Paper No.260, Harvard University. In addition, evidence of such private benefits control obtained by large shareholders at the expense of minority shareholders has been provided for the USA by Barclay and Holderness (1989), for Sweden by BergstrÖm and Rydqvist(1990), and for Italy by Zingales (1994).

[94] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p 760.

2.2.2. Methods of solving the agency cost

How to solve the agency problem or make agency cost as little as possible owing to the structure of share ownership which leads to agency problems between dispersed shareholders and management as well as relationship between majority shareholders and minority shareholders in companies is worldwide issue which makes trouble for scholars, lawyers, government officials, businessmen etc. In theory, the reduction of agency costs will result in the improvement of firm performance, better corporate governance and overall economic growth. A great body of empirical evidence has supported the theoretical prediction.[95] The main methods to settle the agency problem and minimize agency cost suggested by scholars are as follows.

2.2.2.1. Contractual arrangements[96]

New economic theorists view the firm as a legal fiction that serves as a nexus of contracts among all participants of production, and primarily between shareholders and managers. They argue the best way to solve the agency problem is to structure the contractual relation (including compensation incentives) between the principal and agent to provide appropriate incentives for the agent to make choices that will maximize the principal's welfare, given that uncertainty and imperfect monitoring

[95] E.g, see Black B., H. Jang, and W. Kim, 2003, 'Does Corporate Governance Affect Firm Value?', Working Paper 327, Standford Law School; Klapper Leora. F. and Lnessa Lova, , 2003 , 'Corporate Governance, Investor Protection, and Performance in Emerging Market', Journal of Corporate Finance 195, pp 1-26.

[96] On this topic, see, e. g. Hart, Oliver, 1995, Firms, Contracts, and Financial, Oxford University Press, London; Hart, Oliver, and Bengt Holmstrom, 1987, The Theory of Contract, in T. Bewley, Ed.: Advances in Economic Theory, University Press, Cambridge, U.K. pp 294-351; Tirole, Jean, 1994,'Incomplete Contracts: Where Do We Stand?' manuscript, IDEI, Toulouse, France.

exist.

The contractual view could be dated back to as early as Coase's publication in 1937,[97] which was further developed and applied to public companies by Alchian and Demsetz in 1972[98] and Jensen and Meckling.[99] For example, Jensen and Meckling thought the level of agency costs counted, among other things, upon how statutory and common law and human innovation to design contracts between principal and agent. Both the law and the sophistication of contracts in relation to the modern corporation were the outcomes of an historical process in which there were strong motivations for individuals to reduce agency costs as much as possible.[100] In brief, they argue that agency costs can be tackled by the contracts between managers and shareholders because of the contractarian assumption that participants are "economic men", self-interested with the desire to maximize their investment welfare and to reduce transactional costs and tackle the agency problem by a set of contracts.

Although some agency problems can be settled by contract and contract is in theory the result of agreement by parties at will, resting on the existence of private property and strong enforcement mechanisms, in practice contract could not express sufficiently the will of the principal due to the existence of shortcomings, such as information asymmetry about the operation in the company, bargaining status, fraud,

[97] See Coase R. H., 1937, 'The Nature of the Firm', Economica 4. In the article, he points out that transactions in market are costly and argued that firms consisting of a nexus of contract exist to minimize these transactional costs.
[98] See Alchian A.A. and Demsetz H., 1972, 'Production, Information Costs and Economic Organization', American Economic Rev. 62.
[99] See Jensen M.C. and W.H. Mechkling, 1976,'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', J. of Fina. Econ. 3.
[100] See ibid .

unforeseen circumstance, and ambiguous language.[101] This is the problem of incomplete contracts. The difficulty with incomplete contracts is that they make parties take advantage of ambiguities in the contract to their own advantage. In fact, parties to a contract are unable to foresee what will happen or not in the future. That is, it is impossible for parties to predict and plan for future contingencies, and correspondingly practically impossible for parties to conclude a contract which comprehensively provides for rights and obligations in the many varied situations which might happen.[102] Thus the contract that defines the parties' rights and entitlement in every future contingency is impossible to achieve. Meanwhile situations in which one party (the agent) has the ability to unilaterally affect the interest of the other party (the principal) are likely to be ubiquitous. In these situations, the former has power over the latter. In addition, the scope of the contract is limited, and the function of contract is restrictive in disciplining the action of agent, and in particular, contracts may be incomplete because of the inadequacy of legal system and processes— what the literature describes as problems of verifiability in the courts, for example, generally speaking, the role of courts in the United States is more extensive than anywhere else in the world, but the so-called business judgment rule always make the courts keep silent in the affairs of companies in America.[103] So some scholars argue that the corporation is a nexus of power relationships regulated only

[101] See Bradley M., C.A.Schipani, A. K.Sundaram, and J.P. Walsh, 1999, 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads' , 62 law & Contempt. Prob.9, pp 38-40.
[102] See Paddy Ireland, 2003, 'Property and Contract in Contemporary Corporate Theory', 'Legal Study', p 476. (citing O Hart, Firms, Contracts and Financial Structure (Oxford: Oxford University Press), 1995, pp 23-28).
[103] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p 741.

partially by the law rather than a nexus of contracts.[104] Sometimes courts are unable or unwilling to invest the resources necessary to ascertain the facts pertaining to complicated contacts because judges are maybe subject to political pressure or corruption in many cases. This shows the disadvantages of contracts and limitation of their enforcement.

2.2.2.2 Board of directors

Traditionally the conflict of interest always takes place between managers and shareholders, which is regarded as the agency problem. Control of agency problems in the decision process is crucial when the decision makers who initiate and implement important decisions are not the major shareholders and therefore do not assume a major result of the wealth effects of their decisions.[105] General speaking, on the part of organizations (companies, enterprises etc), the decision process has four steps:

> "(1) initiation— generation of proposals for resource utilization and structuring of contract; (2) ratification— choice of the decision initiatives to be implemented; (3) implementation— execution of ratified decisions; and (4) monitoring— measurement of the performance of decision agents and implementation of rewards."[106]

If decision management (the initiation and implementation of decisions typically are allocated to the same agents) is separated from decision control (including the ratification and monitoring of decisions) due to the separation of ownership and

[104] See Amir N. Licht, 2004, ' The Maximands of Corporate Governance: A Theory of Values and Cognitive Style', Delaware Journal of Corporate Law, Vol. 29, p717.
[105] Eugene F. Fama and Michael C. Jensen, 1983, 'Separation of ownership and control', Journal of Law and Economics, Vol. XXVI, (June), pp 2-5.
[106] See ibid, Eugene F. Fama and Michael C. Jensen, p 4.

control, the agency problems will be controlled or agency cost will be reduced in a sense.

Therefore, based on the above ideal, a lot of scholars think the board of director could take responsibility for the reduction of agency cost on behalf of company and for shareholders ultimately. Today in practice most corporate charters require that shareholders elect a board of directors, whose mission is to select the CEO, monitor management, and vote on important decisions. Thus board of directors would have a fiduciary duty to company to monitor the managers in order to reduce the agency cost. For example, a large number of CEOs of under-performing or marginal corporations have been dismissed in the United States in the 1990s. Companies involved include General Motors, Compaq Computer Corporation, General Electric, American express, Apple Computing Company and many others.[107]

But the CEOs actually have a considerable influence over the choice of directors and directors generally only have a very limited financial stake in the corporation. In other words, traditionally the board of director is limited to the reduction of agency cost because the board of directors, mainly dominated by executives, or insider director, does not have sufficient incentives or independence to perform the supervisory function over managers. Therefore most regulatory efforts have focused on the issue of independence of the board and the composition of boards should consist of a majority of independent directors with nominating, compensation and audit committees, at least the reason for independent directors is a majority of

[107] See Robert W.Hamilton , 1999, The Law of Corporations, Law Press House (China), p 343.

independent directors who have no material relationship with the listed company or have no relationship or circumstances that are likely to affect the director's judgment.[108] But independent director may have no special skill, knowledge or information about the companies. Theoretical work and laboratory experiments show that the boards with a majority of trustworthy but uninformed "watchdogs" may lessen conflicts of interest.[109] In addition, such boards are also likely to be not good at making strategic decisions on operation for short of industry or firm-specific knowledge.[110] It should be noted here that most companies in the U.S. have had a majority of nominally independent directors since the 1970s without any legal compulsion. However, there is no evidence that these directors have improved the performance of corporation.[111] Hence what the independent directors do to mitigate the agency problem is limited, although independent directors are very prevalent across the world. In a word, a few empirical studies carried out mainly in the US seem to indicate that the results are blended. Some evidences prove that there is positive relationship between presence of independent directors and overall performance of the firm[112] while other studies found no such relationship at all.[113]

[108] See § 302A(2) NYSE Listed Company Manual and § A.3.1UK Combined Code.
[109] See Gillette, Ann B., Thomas H.Noe, and Michael J.Rebello, 2003, 'Corporate Board Composition, Protocols, and Voting Behavior: Experimental Evidence', 57 Journal of Finance, p 1997.
[110] See Gerard Hertig, 2005,'On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture', Law Working Paper No. 25/2005,(March), www.ecgi.org/wp.
[111] See Reiner Karaakman et al, 2004, The Anatomy of Corporate Law: A Comparative and Functional Approach, Oxford University Press, p 39.(Citing Benjamin E. Hermalin and Michael S. Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance', 20 Journal of Financial Management 101(1991); Sanjai Bhagat and Bernard Black, 'The Uncertain Relationship Between Board Composition and Firm. Performance', 54 Business Lawyer 921 (1999)).
[112] See Gillette Ann B., Thomas H. Noe, and Michael J. Rebello, 2003, 'Corporate Board Composition, Protocols, and Voting Behavior: Experimental Evidence', Journal of Finance 58(5).
[113] See e.g. Bhagat Sanjai and Bernard S. Black, 1999, 'The Uncertain Relationship between Board Composition and Firm Performance', The Business Lawyer 54.

2.2.2.3. Blockholders[114]

Logically if legal protection of small shareholder has not enough capacity to supervise the management, then perhaps shareholders can have to become large and strong in order to get more effective control rights against management. In practice small shareholders have little incentive to monitor management due to cost while owing to having large share in company, and blockholders will have motivations to monitor management and they have the impetus to collect information and have enough voting control to constrain management in some cases or perhaps even to force out the management through a proxy fight or takeover.[115] In other words, Blockholders who are characterized by majority or holding at least 5% of a firm's outstanding shares, are considered to have incentives to supervise a firm's operations, lessening agency costs and improving firm value.[116] But they are believed to have access to private, value-relative information via their roles as monitors of firms' operation and to have possibility of collusion with management to expropriate the minority. For example, the large shareholder might persuade management to divert profit to himself by selling or buying goods between company and the large shareholder, or the large shareholder would agree to leave management alone, in exchange for having his

[114] On this topic in detail, see, e.g. Franks, Julian, and Colin Mayer, 1994,'The Ownership and Control of German Corporations', manuscript, London Business School; Shleifer, Andrei, and Robert Vishny, 1986(b) ,'Large Shareholders and Corporate Control', Journal of Politcal Economic 94, , pp 461-488; Kang, Jun-Koo, and Anil Shivdasani, 1995, ' Firm Performance, Corporate Governance, and Top Executive Turnover in Japan', Journal of Financial Economics 38, pp 29-58.

[115] See Shleifer, Andrei, and Robert Vishny, 1986(b) 'Large Shareholders and Corporate Control', Journal of Political Economic 94, pp 461-488.

[116] See Frank Heflin and Kenneth W. Shaw, 2000, 'Blackholder Ownership and Market Liquidity', The Journal of Financial and Quantitative Analysis, Vol. 35, No. 4, (Dec.), p 632; Barclay, M., and C. Holderness, 1991, 'Negotiated Block trades and Corporate Control', Journal of Finance, 46, , p 861-878; McConnell, J, J., and H. Servaes, 1990, ' Additional Evidence on Equity Ownership and Corporate Value', Journal of Financial Economics, 25, pp 595-613; Morck, R; A. Shleifer; and R. Vishny, 1988,'Management Ownership and Market Valuation: An Empirical Analysis', Journal of Financial Economics,20, pp 293-315.

shares repurchased at a premium (this practice is known as greenmail in the United States).

Most of the time large shareholders action is channeled through the board of directors. Large shareholders are in principle able to appoint board members representing their interests in accordance with the principle of one-share and one-voting, although in theory the board of directors acts on behalf of the company. When the large shareholders have majority control of the board, they can hire (or fire) management at the cost of the company. Large shareholders can also exercise power for the interests of themselves by blocking ratification of unfavorable decisions, or possibly by initiating decisions at expense of minority shareholders.[117]

It is generally accepted that large shareholders tend to use their control rights to both monitor management and to divert resources disproportionately to themselves. Thus large shareholders will likely make contribution positively in countries where "self-dealing" by large shareholders is tightly regulated, while in countries where it is not, large shareholders are often regarded as the source of the corporate governance problem rather than the solution to it.[118] In brief, there is a shortage of loyalty. Blockholders have to extract a return on their cost through self-dealing or insider trading at the expense of diversification and liquidity,[119] which will cause the conflict of interest between large shareholders and minority shareholder. As a consequence, a

[117] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control', Working Paper. No.02/2002(ECGI Working Paper Series in Finance), 30 (September), p78.
[118] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control', Working Paper. No.02/2002(ECGI Working Paper Series in Finance), 30 (September) pp 110-111.
[119] See Willian W.Bratton and Joseph A.McCahery, ' Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference', Working Paper. 007,2000.http://papers.ssrn.com/paper.taf?abstract0_id=205455.

new agency problem will occur and agency cost will increase in companies.

2.2.2.4. Creditors[120]

Debt is regarded to decrease agency costs through lessening free cash flow and restricting managerial discretion.[121] The governance role of debt comes from the threat of bankruptcy and due diligence monitoring by creditors. Thus Jensen and Meckling argue that managers have to eschew leverage in order to mitigate the risk of corporate bankruptcy and the consequent transfer of control to bondholders.[122] Significant creditors, such as banks, are also large and potentially active investors. Like the large shareholders, they have large investments in the firm, and want to have the returns on their investments greatly. The effectiveness of large creditors, like the effectiveness of large shareholders, reckons on the legal environment. In Germany and Japan, the powers of the banks vis-a-vis companies are very significant in corporate governance, such as playing a dominant role in lending and monitoring the operation of company.[123] Of course, not all of the creditors have an incentive to monitor the firm, if debt is diffusely held then no individual lender may have sufficient incentive to spend the private costs in monitoring. Only banks that can hold a substantial piece of a firm's debt have incentives to monitor firms by pooling the

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[120] On this topic, see ,e. g. Smith, Clifford, and Jerold Warner, 1979 ,'On Financial Contracting: An Analysis of Bond Covenants', Journal of Financial, pp 117-1611; Diamond, Douglas, 1984, 'Financial Interneterdiation and delegated monitoring', Review of Economic Studies 51, pp 393-414; Gorton, Gary, and Frank Schmid, 1996, 'Universal Bank and the Performance of German Firms' , Working Paper 5453, National Bureau of Economic Research , Cambridge, MA.

[121] See Jensen, M., 1986, 'Agency Costs of Free Cash Flow, Corporate Finance and Takeovers', American Economic Review, 76, pp 323-29.

[122] See Jensen, Michael C. and William H.Meckling, 1976,'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', Journal of Financial Economics 3, pp 305-360.

[123] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2,(June), p 757.

resources of many depositors and lending to many firms. In addition, the bank could get private information by loan, which enables the bank to supervise management and check the fulfillment of the correct investment choices. Banks also carries out a monitoring role by enforcing debt covenants periodically.[124] In summary, classical corporate finance theories argue that high leverage lessens managerial agency costs and improves the quality of corporate governance.[125] However, much debt not only enlarges the risk of bankruptcy but also causes conflicts between shareholders and debtholders.[126]

If a company takes on debt, it will restrict how inefficient management can be, at least if management must repay its debt indeed. Hence debt can act as a bonding or commitment device to management. But compare an entirely debt-financed firm with an all-equity firms that are otherwise identical. While voting equity retains the control rights all the time, debt has control rights only on some occasions, namely creditors could take measures typically only when the borrower defaults on the scheduled repayment,[127] or debtors are on the verge of bankruptcy. So roe governing agency problem except for a few countries that the creditors play is very limited.

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124 See Kose John, and Simi Kedia, 2003,'Design of Corporate Governance: Role of Ownership Structure, Takeovers, and Bank Debt', Working Paper, (April).

125 See, e. g. Jensen, Michael C. and Willian H.Meckling, 1976, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', Journal of Financial Economics3 (4), pp 305-360; Harris, Milton and Artur Raviv, 1991, 'The Theory of Capital Structure', Journal of Finance 46(1), pp 297-355.

126 See Bruce Seifert, Halit Gonenc, Jim Wright, 2005, 'The International Evidence on Performance and Equity Ownership by Insiders, Blockholders, and Institutions', J.of Multi. Fin.Manag. 15, pp 171-191.

127 See Mike Burkart, Denis Gromb, and Fausto Panunzi, 1997, 'Large Shareholders, Monitoring, and the Value of the Fim', The Quarterly Journal of Economics, Vol. 112, No. 3, Aug., at 715.

2.2.2.5. Market (takeover)[128]

The theory of the market for corporate control was initially established by Manne[129] and developed by Easterbrook and Fischel.[130] The theory argued that the takeover, in particular hostile takeover served as a major constraining force on managerial discretion and inefficiency. They thought the market for corporate control ran in two ways. On the one hand, companies with inefficient management would attract and then be taken over by a bidder and accordingly efficient managements would take the place of inefficient ones. On the other hand, the main function claimed for the market for corporate control as an external disciplining device was effective because the target's management feared takeover so that they could try to improve their corporate performance instead of diverting company such as self-dealing, fraud and cheat.[131] The theory is based on the assumption that the share market valuation of companies with inefficient management will be lower than that of well-managed counterparts and therefore attract predators. The effectiveness of the market for corporate control rests on the proposition of the efficient market hypothesis. That is, a hostile takeover is in principle a much more powerful mechanism for disciplining management since it allows someone who identifies an underperforming company to obtain a large reward. In reality, hostile bids may be less profitable than the above argument would indicate. First, there is a free-rider problem. Small shareholders who do not believe that their

[128] On this topic, see, e.g. Manne, Henry, 1965, 'Merges and the market for corporate control', Journal of Political Economy 75, p 110-126; Jensen, Michael, 'Takeovers: 1988, Their Causes and Consequences', Journal of Economic Perspectives 2, pp 21-48; Easterbrook, Frank and Daniel Fishchel, 1991, The Economic Structure of Corporate Law, Harvard University Press, Cambridge, Mass.

[129] See Manne H. G, 1965, 'Mergers and the Market for Corporate Control', 73 J. Pol. Econ., p 113.

[130] See Easgterbrook F. H. and D. R. Fishel, 1981, 'The Proper Role of a Target's Management in Responding to A Tender Offer', 94 Har. L. Rev., pp 1169-1171.

[131] See Manne H. G, 1965, 'Mergers and the Market for Corporate Control', 73 J. Pol. Econ., pp 113-114.

decisions are to affect the success of the bid have no an incentive to tender to the raider. Second, the raider may face competition from others, including other bidders and minority shareholders as well as incumbent management.[132]

It seems the hostile takeover is one of the most radical and spectacular mechanisms for disciplining and replacing managers. This mechanism is highly disruptive and costly. Even in the U.S. and the U.K, it is relatively rarely used.[133]

2.2.2.6. Proxy fights

A proxy fight is one of ways governing performance of management. It is where a dissident shareholder is not satisfied with the performance of management, and he puts up a slate of candidates to stand against management's slate, and attempts to ask other shareholders to support his candidates. Out of question, proxy fights can offer a degree of managerial disciplining and improve shareholders value. But the proxy fight is very rare and may not be very effective tool because first, and the most important, there is a significant free-rider problem. That is, the dissident has to assume the cost of launching the proxy fight— this may include everything from the cost of finding out the names and addresses of the shareholders and mailing out the ballots, to the cost of persuading other shareholders of the support and the advantages of the dissident slate. However, the benefits from improved management will be distributed to all shareholders in the form of a higher share price in proportion to shares. Thus

[132] See Oliver Hart, 1995, 'Corporate Governance: Some Theory and Implications,' The Economic Journal, Vol.105, No. 430, (May), pp 684-685.
[133] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control,' Working Paper No.02/2002(ECGI Working Paper Series in Finance), 30 (September), p 24.

most of shareholders are not interested in launching a proxy fight that is socially valuable but uneconomical for them. Second, in practice most of shareholders have no incentive to a proxy fight launched by a strange shareholder. A reasonable rule of thumb for a small shareholder may be to vote for incumbent management on the grounds that "the devil you know is better that the devil you don't". Namely they would rather support incumbent management than a stranger. Finally, management could take an advantage of using company funds to promote management's slate of directors under company law and charter. This further would help the incumbent management against the dissident.[134]

2.2.2.7. Executive compensation

Another way of improving shareholders' protection and monitoring and controlling CEO actions is to devise the CEO's rewards so as to associate his interests with those of shareholders. This is what executive compensation is supposed to achieve. Most compensation packages in publicly traded firms are made up of a basic salary component, a bonus in relation to short run performance, and a stock participation plan. The package also includes various other benefits, such as pension rights and severance pay. In theory, for management to have an adequate shareholding in a company is beneficial to the improvement of corporate governance because they are shareholders of companies. In other words, management will get return on shares or future shares if companies earn profit. According to practice, institutional investors

[134] See Oliver Hart, 1995, 'Corporate Governance: Some Theory and Implications', The Economic Journal, Vol.105, No. 430, (May), pp 682-683.

prefer executive directors to be shareholders and option-holders in their companies. It is a depressing experience for institutional shareholders to see boards where virtually directors have no shares at all.[135]

Although stock options may improve CEOs' incentive to raise share value, CEOs could make use of them to enrich themselves and expropriate shareholders by manipulating stock prices due to their positions in the companies, for example, Enron, Global Crossing, WorldCom and others.[136]

Executive stock options as major executive compensation have become an increasingly popular and controversial in the past decade. The options are inefficient and lead to more trouble if they are not based on some relative performance measure such as the excess stock performance relative to an industry or market index. If there are not any proper measures taken to regulate stock options and discipline management, they will create new incentive problems by inducing CEOs to manipulate earnings or "cook" the books in order to support stock prices. Furthermore, they will give rise to many problems when the CEO borrows from the firm to "purchase" his or her stock options, such as emphasis on the price of stock rather than rather the quality of company, short-term interest in place of long-term interest.[137] In a word, the serious problem with this approach is that it will create enormous opportunities for self-dealing on CEOs and it can not completely solve the agency problem, but still sometimes increase the seriousness of the agency problem.

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[135] See D.D. Prentice and P.R.J.Holland, 1993, Contemporary Issues in Corporate Governance, Clarendon Press ,Oxford Allen & Overy, p 110.

[136] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control', Working Paper No.02/2002(ECGI Working Paper Series in Finance), 30 (September), pp 45-47.

[137] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control', Working Paper No.02/2002(ECGI Working Paper Series in Finance), 30 (September),p 109.

2.2.2.8. Institutional investors

Shareholders as the residual risk bearers have powers to supervise management through the general meeting in order to ensure that the management acts in the best interest of the company, and ultimately the shareholders, and the company is run for shareholder's purposes. However, shareholders, who usually lack the special ability, time, incentives, in addition, involving cost and skills, and free-rider problem, may exit by selling out their shares, rather than using voice through the shareholder general meeting, especially in the structure of dispersed share ownership. It thus has been widely perceived that shareholders are passive concerning the agency problem.

But the change of situation has taken place greatly since the late 1980s onward. The recent growth of institutional shareholding in publicly traded companies has led to increasing debate on the role of institutional investors in corporate governance. It has been argued that the widely dispersed structure of share ownership in the US and UK publicly traded companies has been replaced by a relatively concentrated structure of share ownership in the hands of institutional investor, and therefore the role of shareholders in corporate governance has accordingly switched from passivity to activism. The typical forms of activism are shareholder proposals by institutional investors. As Bernard Black pointed out, shareholder activism has been recognized as a helpful new way for solving the problems of dispersed holdings and a lack of major shareholders.[138] The experience shows in the UK and the US that it is helpful for

[138] See Bernard Black, 1992, 'Agents Watching Agents: The Promise of Institutional Investor Voice', UCLA Law

institutional investors to reduce the agency problem in corporate governance.

In corporate affairs, institutional investors could take measures of how to strengthen corporate governance structures and improve the effectiveness of corporate boards including the following in practice: disuniting the functions of chairman and chief executive officer and designating non-executive chairmen in all companies above a certain size; choosing independent external directors; taking advantage of cumulative voting for board election; opening the proxy process to allow greater communication among shareholders; making use of confidential voting at board meetings; enlarging the role of board committees that are independent of executive directors; uncovering the amount and rationale of managerial compensation; challenging anti-defense measures that are designed to protect incumbent managers at the cost of shareholders.[139] But there are problems and limitations of institutional investors' participation in corporate governance, such as short-termism, that is, institutional investors may put emphasis on short-term earning instead of long-time earning in order to satisfy their clients with high return on the investments, and will have no time or make no effort to improve the corporate governance. As we know, some institutional investors have a business relationship with firms in which they invest. For example, investment banks provide services for a firm, commercial banks provide loans to firm as clients, and insurance companies may provide firms with underwriting services. For these institutional investors, who are not only investors but also clients of firms in which they invest, part of their revenue counts on economic

Review39, pp 811-892.

[139] See Dimitri Vittas: Institutional Investors and Securities Markets: Which Comes First? Development Research Group. The World Bank (Paper presented at the ABCD LAC Conference, June 28-30,1998) at 15.

exchanges with the firm. On the one hand, institutional investors as shareholders have to protect their investment by exercising certain rights; on the other hand, institutional investors as creditor or debtor will have to establish a close relationship with the firm. The dual nature of these activities may cause a conflict of interest between status such as both shareholders and cooperators (creditor or debtor).[140] In a word, these problems and limitations decrease the effectiveness of institutional investors in corporate governance.

2.2.2.9. Trust

2.2.2.9.1. The conception and importance of trust

Trust is very important in our society because it helps us to make information easy, lessens the complexity of signals, and shields us from the ambiguity and uncertainties of many situations. Scholars put emphasis on the importance of trust to our society from the different perspective. For example, political scientists have considered social trust as essential for the work of democratic political institutions,[141] economists for the working of a market economy,[142] and sociologists have regarded trust as essential foundation for the implementation of agency in intricate societies.[143] Trust as social

[140] See Heard, J.E. and Sherman, H.D. 1987. Conflicts of Interest in the Proxy Voting System. Washington ,DC: Investor Responsibility Research Center.
[141] See Almond, G, and Verba, S., The Civic Culture: Political Attitudes and Democracy in Five Nations, Princeton University Press, Princeton.
[142] See Raiser, M., 'Trust in Transition', 1998, Paper Given at the Conference on Post Communist Transformations and the Social Sciences: Cross Disciplinary Approaches. Berlin, October.
[143] See Seligman, A.R., The problem of Trust, 1997, Princeton University Press, Princeton; Simmel, G. The Sociology of Georg Simmel (translated and edited by K.H.Wolff), Free Press,1950, New York; Sztompka, P., Trust: A Sociological Theory, 1999, Cambridge University Press, Cambridge.

capital[144] must be sufficiently widespread within a given society in order to present positive effect not only at relational level but also at the economic level because trust can improve the quality of interpersonal relationship and make the market mechanism more efficient. As we know that market will fail in the absence of trust in the economy[145] because most transactions are in relations to an element of trust, such as contracts between merchants in our society.[146] In other words, trust as social capital could produce socially and economically efficient outcomes and avoid inefficient non-cooperative traps such as that in the prisoner's dilemma. As Geraity Parry puts it, mutual trust benefits polyarchy and public contestation while extreme distrust lead to hegemony. The reasons are as follows: firstly people will trust one another in polyarchy by mutual communication. Secondly, people are to associate together in the achievement of those objectives by trust that they cannot gain by their own individual action. Thirdly, a feeling of trust stops political disputes from changing into severe animosity.[147] In a word, trust can simplify the complexity of a situation and enhance the likelihood of cooperation[148] in order to achieve the goal socially and economically.

However, many researchers recognize that the study of trust faces many

[144] Social capital in terms of trust is often assumed to be accumulated via social participation activities, where 'consumption' and 'investment' in relational goods tend to coincide. E.g. Paldam and Svendsen identify social capital with 'the density of trust within a group' (See Paldam M, and Svendsen GT, 'Missing Social Capital and The Transition in Eastern Europe', J Inst Innovation. Dev Transition 2002; 5, at 21-34); Putnam et al think that ' social capital refers to features of social organization, such as trust, norms, and network than can improve the efficiency of society'.(See Putnam R. Bowling alone. New York: Simon and Schuster; 2000)

[145] See Angelo Antoci ,Marcello Galeotti, Paolo Russu and Luca Zarri, 2006,'Gemeralized Trust and Sustainable Coexistence Between Socially Responsible Firms and Nonprofit Organizations', Chaos, Solitons and Fractals 29, pp793-802.

[146] See Arrow, K., 1972, Gifts and Exchanges, Philos. Public Aff. 1, pp 343-362.

[147] See Geraint Parry, 1976, 'Trust, Distrust and Consensus', British Journal of Political Science, Vol. 6, No.2 (Apr.,), at 129-142.

[148] See Misztal, B.A. 1996, Trust in Modern Societies, Cambridge: Polity Press,.

difficulties such as problems of definition, confusion of the levels of analysis, and ambiguity in conceptualizations of the factors responsible for trust production.[149] The majority of researchers writing about trust pay their attention primarily to how one may set about creating and fostering trust in the context of various recent changes, and they tend to emphasize the notions of vulnerability, uncertainty, and risk when their they define trust.[150] For example, trust is "the mutual confidence that no party to an exchange will exploit another's vulnerability";[151] "to trust others is to accept the risks associated with the type and depth of the interdependence inherent in a given relationship."[152]

In our society, when we trust a person or organization, it means there is a rise in probability of our taking risks with them. Trust has been defined as "confidence in a person or thing because of the qualities one perceives."[153] In the literature, the definition has been taken a step further to include the person's behavioral intentions as "willingness of a party to be vulnerable to the actions of another party based on the expectations the other one will perform particular actions important to the trustor, irrespective of the ability to monitor or control the other party."[154] Thus, trust is distinct from confidence and reliance, which also have a close relationship with the estimated prediction of risk and outcomes, and rely more on the perceived intentions

[149] See Kramer, R., and T. Tyler (eds.) , 1996, Trust in Organizations: Frontiers of Theory and Research, Thousand Oaks, CA:Sage.
[150] See Barbara A. Misztal , 2001, 'Normality and Trust in Goffman's Theory of Interaction Order', Sociological Theory, Vol.19, No.3. (Nov.,), pp 312-324.
[151] See Sabel, C.F. 1993, 'Studied Trust: Building New Forms of Cooperation in a Volatile Economy.' Human Relations 46, pp 1133-70.
[152] See Shepard, B.H., and D.M.Sherman, 1998, 'The Grammars of Trust and General Implications', Academy of Management Review 23, pp 422-38.
[153] See New Webster's Dictionary, Lexicon Publications, Danbury, CT,1993.
[154] See R.C.Mayer, J.H.Davis and F.D Schoorman, 1995, 'An Interview Model of Organizational Trust', Academy of Management Review 30(3), pp 709-734.

and motivations of the trusted party than on results and outcomes, which means "trust" with more risk and more unexpected results than reliance and confidence.[155] Therefore trust is not necessary when you can calculate how others will act accurately or you can monitor and control the other's behavior.[156]

In a word, trust is a concept with many meanings, but most concepts of personal trust share three common elements. First, the theories suppose the relationship between trustor and trustee is interdependent. Second is the assumption that trust provides an approach to deal with risk or uncertainty in an exchange relationship. The third common assumption on trust is a belief or an expectation that no one should not take advantage of vulnerability which results from the acceptance of risk by the other party in the relationship.[157]

2.2.2.9.2. Trust and agent problem

Zucker thought there were three ways to create trust: process-based, institution-based, and characteristic-based. Process-based trust is produced through social exchange between organizations and individuals. Institution-based trust is produced through a third party. Characteristic-based trust is produced through a sense of share commonality with the other party. This could derive from similar values, backgrounds,

[155] See R.William Ide III and Douglas H.Yarn, 2003, 'Public Independent Fact-Finding: A Trust-Generating Institution for an Age of Corporate Illegitimacy and Public Mistrust', Vanderbilt Law Review, Vol.56, p 1113.(citing See Trudy Govier, Social Trust and Human Communities 6 (1997) (comparing trust in intimate relationships with trust in the context of social roles); Adam Seligman, The Problem of Trust 14-30 (1997)(distinguishing trust from confidence and understanding trust as role fulfillment); Lawrence C.Becker, Trust as Noncognitive Security About Motives, 107 EHHICS 43, 54 (1996)(using the government as an example of trust depending on intentions and motivations).

[156] See Denise M.Rousseau et al., 1998, 'Not So Different After All: A Cross-Discipline View of Trust, 23 Acad. Mgml. Rev., p 395.

[157] See Christel Lane and Reinhard Bachmann, 1998, Trust Within and Between Organizations: Conceptual Issues and Empirical Applications, Oxford University Press.

ethnicity and experiences.[158] Here I only take the characteristic-based trust as an example and look at characteristic-based trust and explore how to share values between the management and shareholders, or between majority shareholders and minority shareholders. Trust is very important for organization[159] because trust could create socially efficient results and evade inefficient non-cooperative traps.[160] Trust without doubt could help managers obtain more effectively[161] because manager will make use of cooperation with shareholder to improve the performance instead of opportunistic behavior if managers could share the same or similar values with shareholders in a company. Each person or organization owns or projects a given set of values[162] by which entities could judge and choose among alternative modes of behavior.[163] With regard to value in trust, the same value (100%) between different entities is impossible in real life, in particular in a unit or organization. Value congruence is enough instead. Value congruence has been identified as value similarity and value compatibility that could support common causes or avoid clashes over issues important to the participant. Value congruence has a positive effective on trust while value conflict has a negative effective on trust.[164] In a company, in

[158] See L.GZucker, 1986, Production of Trust: Institutional Sources of Economic Structure 1840-1920, Research in Organization Behavior 8, pp 53-111.
[159] See Donaldson, T, 2001, 'The Ethical Wealth of Nations', Journal of Business Ethics, Vol. 31, pp 25-36; Lewicki, R., McAllister, D., & Bies, R, 1998, 'Trust and Distrust: New Relationships and Realities', Academy of Management Review, 23(8), pp 438-458.
[160] See Putnam, R. 1993, Making Democracy Work: Civic Traditions in Modern Italy, Princeton, NJ: Princeton University Press; Fukuyama ,F., 1995, Trust; New York: Free Press,; Porta et al, 1997 ,'Trust in Large Organizations', American Economic Review Papers and Proceedings 87(2), , pp 333-38.
[161] See Atwater, L. 1988, 'The Relative Importance of Situational and Individual Variables in Predicting Leader Behavior', Group and Organization Studies, 13, pp 290-310; Bazerman, M., 1994, Judgment in Managerial Decision Making, New York: Wiley.
[162] See Joseph A. Cazier, Benjamin B.M.Shao and Robert D.St.Louis, 2006, 'E-Business Differentiation Through Value-Based Trust', Information & Management 43,pp 718-727.
[163] See D.Elizur, A. Sagie, 1999, 'Facets of Personal Values: A Structural Analysis of Life and Work Values', Applies Psychology 48(1), pp 73-87.
[164] See Joseph A. Cazier, Benjamin B.M.Shao and Robert D.St.Louis, 2006, 'E-Business Differentiation Through Value-Based Trust', Information & Management 43, pp 718-727.

particular public companies, as describe above, if managers share the similar values with shareholders for the sake of the company, managers will perform the obligations that are sometimes beyond the regulation of laws and contracts, such as duty of care, loyalty and fiduciary. It is known that the common law recognizes specific relationships as inherently fiduciary,[165] such as relationships between attorney and client, principal and agent, and senior corporate managers and shareholder,[166] but laws on the regulation of these relationships are very ambiguous and contentious sometimes, which needs trust to regulate them. Therefore trust can reduce the agent problem and agent cost to a certain degree if management and shareholder, or majority shareholders and minority shareholder share similar values and put trust in each other.

The thesis argues trust derives from the past experience, reputation, communication and co-operation. Generally speaking, if people have not interacted with each other and no other trust information is available, there is no trust at all. That is, trust may not be spontaneous, instinctive or natural, but based on some information at least. Economists argue that trust should be more vital for ensuring co-operation between strangers or people who meet each other rarely than people who often encounter in a given place. It suggests that trust is most important to cooperate between people in large organizations, where members encounter each other only

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[165] Some scholars think trust is equal to fiduciary duty, e.g. See Nathan Heyde, 2004-2005, ' Can You Keep A Secret? The "Similar Relationship of Trust and Confidence" in Misappropriation Theory: U.S. V. Kim', Whittier Law Review, Vol. 26, pp 678(a similar relationship of trust and confidence must be the functional equivalent of fiduciary duty) ; See Chestman, 947 F. 2d , at 566 (fiduciary duty or similar relationship of trust and confidence); See Chiarella, 445 U.S. p 228 (fiduciary or other similar relationship of trust and confidence)

[166] See U.S. v. Chestman, 947F. 2d 551, 568(2d Cir. 1991)

infrequently because they have a rare chance to co-operate in joint production.[167] For example, in public companies where management and shareholders interact infrequently, on the one hand, management who are in charge of operation are familiar with business; on the other hand, shareholders who have almost no chance to know what has happened to the company except through mandatory disclosure, annual or extraordinary meetings and whose interests are need protecting. Therefore there needs to be a bridge between management and shareholders, or majority shareholders and minority shareholders: trust through which lots of conflicts of interests between them will be reduced or solved.

As we know, the regulatory function of the law is limited concerning its ability to create trust because the costs of enforcement are too great to monitor every interaction and too much regulation could not shape trustworthiness.[168] Trust among managers and shareholders or between majority shareholders and minority shareholders is necessary for corporate efficiency that has been mentioned. However, asymmetrical information provides ample opportunity for managers or majority shareholders to abuse trust. For example, most shareholders must place their trust in corporate management because they do not have the resources to determine whether or not the executives of a publicly held corporation are acting in a way to maximize shareholder value or reporting financial statement accurately.

Conventional legal and economic analysis is based on assumption that the

[167] See Rafael La Porta; Florencio Lopez-de-Silanes; Andrei Shelifer; Robert W. Vishny, 1997, 'Trust in Large Organization', The American Economic Review, Vol. 87, No. 2, p 333.
[168] See R.William Ide III and Douglas H.Yarn, 2003, 'Public Independent Fact-Finding: A Trust-Generating Institution for an Age of Corporate Illegitimacy and Public Mistrust', Vanderbilt Law Review, Vol.56, p 1121.

corporation is best considered as a "nexus of contracts", a collection of explicit and implicit agreements voluntarily reached among the rationally entities who join in the corporate enterprise. However, this viewpoint disregards the value of trust to the corporation as well as incompleteness of most contracts.[169] That is, corporate participants often cooperate with each other because of internal ones instead of because of external constraints, such as trust in place of law and contract in cooperation.[170] As we know, in making contribution to the corporation, individuals who participate in the corporation often expose themselves to great risk of loss from other participants' failure or misbehavior, in particular management and majority shareholders. How to deal with the relationship between management and shareholders, or majority shareholders and minority shareholders? Will it be settled by law, or by contract or by other means? Of course, markets, law and contract work better when the situation is transparent and opportunistic behavior can be detected and punished, which can reduce agency costs but such efforts usually can't eliminate all opportunities for an agent to shirk or steal, especially making mistakes in operation or making use of position for the sake of himself, which goes beyond the regulation of laws and contracts. That is to say, maybe what the managers or majority shareholders do does not violate laws and contracts but does harm to the company and shareholders. Especially asymmetrical information between management and dispersed shareholders, or majority shareholders and minority shareholders occurs often. Trust can work better in such situation. Thus creating and maintaining trust in a corporation

[169] See Williamson , O., 1985, The Economic Institutions of Capitalism, New York: Free Pres.
[170] See Margaret M. Blair &Lynn A. Stout, 2000-2001, 'Trust, Trustworthiness, and The Behavioral Foundations of Corporation Law', University of Pennsylvania Law Review, Vol. 149, p 1725.

is very important because the trust could reduce the inefficiencies and the need to expense resources on constant monitoring on management. Therefore, a scholar thinks "trust is the glue that holds organizations together. More powerful than contracts or authority, trust enables partner companies— or groups within a company— to achieve results that exceed the sum of the parts."[171]

With regard to law and contract, although I am not suggesting that legal rules, explicit contracts and market sanctions are unimportant in governing agency costs, there are shortcomings as follows. Firstly, no matter how carefully the legislature drafts laws and parties to a contract negotiate or reach agreement, it is impossible to predict what will happen exactly and control opportunities. That is to say, it is impossible for laws or contract to develop a plan of action that takes into account all possible contingencies. Second, it is too expensive to enforce the law or contract if management breaks it. Thirdly, as far as the development of trust to the importance of company is concerned, the use of binding law or contract can not help the creation of trust but actually harm the development of trust.[172] Therefore, some literature pointed out that certain measures imposed to increase trust may unintentionally harm trust. For example, in the organization literature, Sitkin and Bies suggested that legalistic remedies to enlarge trust could have a negative effect;[173] and Malhotra and Murnighan have shown that contracts can have a detrimental effect on interpersonal

[171] See Jordan D Lewis, 1999, Trusted Partners: How Companies Build Mutual Trust and Win Together; Trust Within and Between Organizations, Christel Lane & Reinhard Bachmann Eds., 1998. (www.Amazon.com)
[172] Malhotra, D., & Murnighan, J.K. 2002, 'The Effects of Formal and Informal Contract on Interpersonal Trust', Administrative Science Quarterly, 47, pp 535-559.
[173] See Sitkin, S.B., & Bies, R.J. 1993, 'The Legalistic Organization: Definitions, Dimensions and Dilemmas', Organization Science, 4, pp 345-351.

trust.[174] That is, trust must come from trustor and trustee internally instead of externally. Here I by no means deny the importance of law and contracts.

2.2.2.9.3. Disadvantages of trust

As Putnam puts it, trust is a custom shaped during a centuries-long history of "horizontal networks of association" between people, including both commercial and civic activities.[175] It shows trust comes into being over a long period of time in a certain environment which is affected by comprehensive elements; secondly, trust in others is created more easily in horizontal relationships than in vertical relationships; thirdly, without sufficient information, there will be no trust at all. That is to say, due to asymmetrical information, the function of trust is very limited. With regard to the relationship between management and shareholders, it is very difficult for shareholders to trust in management in company due to asymmetrical information on some occasions.

Although good social norms, conventions, institutions, law, morality, contract etc could help generate trust among people in our society, the production and the realization of trust are very complex process which stems from the inmost activity of soul and which is the outcome of trustworthiness for a long time by others. In other words, trust is very difficult to check and accompanies a great of risk that may lead to catastrophes to people in a certain circumstance. That is why the stories such as Enron,

[174] See Malhotra, D., & Murnighan, J.K, 2002, ' The Effects of Contracts on Interpersonal Trust', Administrative Science Quarterly, 47, pp 534-559.
[175] See Putnam, Robert, 1993, Making Democracy Work: Civic Traditions in Modern Italy, Princeton, NJ: Princeton University Press.

Worldcom happened in the USA where law, contract, institution, review mechanism, judicial review etc are very advanced in the world but trust is gone sometimes. That is the fatal shortcoming of trust that seems to have nothing to do with agent problem and agent cost in some situations. The above stories show the relationship between management and shareholders is in need of trust which could reduce agent problem and agent cost if they treat each other honestly on the one hand; however, on the other hand, trust is very breakable because management will not fulfill the obligation of trust at any time when law and contract do not prescribe it, although what management do will damage their reputation.

2.2.2.9.4. Conclusion

Trust based on conscience, vulnerability and risk-taking is the result of progress and civilization of society. Trust is functionally necessary for the continuance of harmonious social relationships. Therefore trust is very significant in our society, including the relationship between the management and shareholders, or majority shareholders and minority shareholders in a company where trust can reduce the agent problem and agent cost which go beyond the regulation of laws and contracts sometimes. In a word, trust can play a great role in a company where laws, charters and contract are lacunary. However, the level of trust is quite varying between different persons, different groups, different regions, different countries and different societies, of which some people or organization will take advantage, for example managers will abuse the trust of shareholders in a company. In a sense, the function of

trust is limited in the regulation of relationship between management and shareholders, or between majority shareholders and minority shareholders.

To sum up, the above ways of solving the agency problem which mostly stem from the countries with the structure of dispersed share ownership but also popularly are used in the counties with the structure of concentrated share ownership in order to minimize the agency cost in corporate governance may be useful under some circumstances. Unfortunately, many of the mechanisms mentioned above to reduce the agency problem generate their own problems or the results are not as good as expected. For example, an increase in managerial ownership strengthens managerial alignment with those of shareholders while it simultaneously decreases the effectiveness of takeovers in monitoring and regulating management.[176] It seems that there is no better way of solving the agency problem so far. How to tackle the corporate governance problem is a worldwide problem. The thesis argues that the first step is to develop economy and solve the issue of the structure of share ownership according to the practical situation in a given country or region. The thesis will discuss it below.

2.3. The concept of corporate governance

Why has corporate governance become such a prominent topic in the past two

[176] See Kose John, and Simi Kedia, 2003, 'Design of Corporate Governance: Role of Ownership Structure, Takeovers, and Bank Debt', Working Paper, (April).

decades or so and not before? The reasons are as follows: (1) the world-wide wave of privatization in the past two decades, (2) reform of pension fund and growth of private savings, (3) the takeover wave in the 1980s, (4) deregulation and integration of capital markets, (5) the 1998 East Asia crisis, and (6) a series of recent U.S. scandals.[177] Since modern companies are the main typical economic organization across countries, the common problem in companies will affect the development of economy and stability of society. Therefore it is not excessive however much the importance of corporate governance is emphasized.

As a matter of fact, the corporate governance issues are the same old as companies themselves since their birth.[178] The term "corporate governance" derives from "an analogy between the government of cities, nations or states and governance of corporations".[179] Today there is no universal conception of corporate governance in the world. The concept of corporate governance has been lively debated by scholars in law, law and economics, management, sociology, and political economy from different angles respectively in the past two or more decades but there is no common agreement on it. It is not surprising that scholars, countries or regions, and organizations have different conceptions of corporate governance from varying disciplines according to their understanding on corporate governance, in addition to

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[177] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control', Working Paper No.02/2002(ECGI Working Paper Series in Finance), 30 (September), p 10.

[178] John Lowry and Alan Dignam, 2003, Company Law (Second Edition), London: Lexis Nexis Butterworths, Reed Elevier (UK) Ltd., p345.

[179] See Marco Becht, Patrick Bolton, and Ailas Röell, 2002, 'Corporate Governance and Control', Working Paper No.02/2002(ECGI Working Paper Series in Finance), 30 (September),p 6. According to authors' footnote 5, the analogy between corporate and political voting was explicit in early corporate charters and writings dating back to the revolutionary origins of the American corporation and first railway corporations in Germany (Dunlavy 1998).The precise term "corporate governance" itself seems to have been used first by Richard Eell (1960, p.108), to denote "the structure and functioning of the corporate polity".

different practices in countries or regions, and organizations. That is, there is variation in systems of corporate governance across societies and most of this difference reflects national political, social, and cultural trajectories etc.

It is said that the earliest debate on "corporate governance" originated with the U.S. In America this debate on "corporate governance" started at least as early as 1932 when Berl and Means published the classic book, The Modern Corporation and Private Property.[180] In 1971 Mace further put emphasis on the importance of this debate in his book, Directors: Myth and Reality.[181] However, the discussion "corporate governance" really became heated in 1982 with the publication by The American Law Institute (ALI) of their Principles of Corporate Governance and Structure: Restatement and Recommendations. The result of the discussion led to a stream of publications on the topic of corporate governance in America, which gradually influenced the other countries or regions in the world. Since then, the publication and debate on corporate governance have been going without stop. In UK one of the most famous reports is the Cadbury Report that was published in 1992 and inspired the whole debate on corporate governance and affected the development of many corporate governance codes globally.[182]

As mentioned above, different scholars in different disciplines, even in the same field, have a different opinion on the concept of corporate governance. The following

[180] See Hopt, 1994, 'Preface' in Baums, Buxbaum &Hopt (eds), Institutional Investors and Corporate Governance, I, Berlin, New York: Walter de Gruyter & Co.
[181] Mace, 1971, Directors: Myth and Reality, Boston, MA: Harvard Business School Press.
[182] The European Corporate Governance Institute (ECGI) keeps track of corporate governance codes around the world. There are more than 100 countries, regions and international organizations promulgating codes of corporate governance. A comprehensive list of these documents and the text can be found at http://www.ecgi.de/codes/a_codes.htm.

conceptions of corporate governance are typical and referable, for example,

"Corporate governance is the framework that defines the division of power in the corporation. This division of power in turn determines the division of wealth created by the corporation. Oftentimes, the regulation of power in the corporation— either of managers or controlling shareholders— is subsumed under the rubric of 'accountability."[183]

"Corporate governance can be defined as the set of mechanisms that translate signals from product markets and input markets into firm behavior. This definition focuses on two elements, the signals generated outside the firm and the control structures inside the firm to execute decisions based on these signals."[184]

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. That is, because straight-out expropriation is a frequent manifestation of the agency problem that financiers need to address, the people who sink the capital need to be assured that they get back the return on this capital. The corporate governance mechanism provides this assurance."[185] Or say, "corporate governance deals with the agency problem: the separation of management and finance. The fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment."[186]

Gillan and Starks define corporate governance as "the system of laws, rules, and factors that control operations in a company."[187]

The Cadbury Report defines corporate governance as "the system or process by which companies are directed and controlled."[188]

The OECD (2004) recognized corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. The OECD (2004) describes that "corporate governance

[183] See Amir N. Licht, 2004, ' The Maximands of Corporate Governance: A Theory of Values and Cognitive Style', Delaware Journal of Corporate Law, Vol. 29, p 680.
[184] See Eriik BerglÖf and Ernst-Ludwig von Thadden, 1999, 'The Changing Corporate Governance Paradigm: Implications for Tansition and Developing Countries', Working Paper, (June).
[185] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), pp 737-742.
[186] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, June, p773.
[187] See Gillan, S.L., Starks, L.T., 1998, 'A Survey of Shareholders Activism: Motivation and Empirical Evidence', Contemporary Finance Digest 2 (3), pp 10-34.
[188] See Committee on the Financial Aspects of Corporate Governance Report, Gee & Co., para. 2.5., 1992, at 15.

> involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."[189]

These endlessly varying definitions that reflect different expectations on what corporate governance should be supposed to do, however, may be divided with respect to one fundamental criterion: the identity of the interests the corporation is supposed to serve: societal objectives such as equity, fairness, freedom, and citizen responsibilities, or narrowly economic efficiency.[190]

The thesis argues corporate governance refers to the mechanisms and processes by which corporations are governed with minimized agency costs. On the one hand, in the structure of dispersed ownership in countries, power over the enterprise is concentrated in the hands of senior managers, who have large discretion in enterprise decision-making. From a practical standpoint, the task of corporate governance mechanisms is to monitor whether managerial discretion is controlled within reasonable bounds.[191] On the other hand, big shareholders using their position exploit minority shareholders in the structure of concentrated ownership in other countries or regions, and how to discipline the action of majority shareholders is big problem. The institutional arrangements on corporate elections and the role and fiduciary duties of

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[189] See Organization for Economic Co-operation and Development, 'OECD Principles of Corporate Governance', 2004.

[190] See John W.Cilffi, 2000, 'State of the Art: A Review Essay on Comparative Corporate Governance: The State of the Art and Emerging Research', The American Journal of Comparative Law, Vol.48, pp 507-508.

[191] See David Charny, 1998,'The German Corporate Governance System', Colum. Bus. L. Rev. No.1:145,No., p 148.

the board have been the key themes in the corporate governance literature from its inception. Now the dilemma is how to balance the limits on managerial discretion for the protection of the interests of shareholders, and constraints on the exploitation by majority shareholders of minority shareholders protection in corporate governance. In a word, the corporate governance problem can be described as an "agency problem" in a sense.

The different understanding of corporate governance by scholars may be the same as the story happened many years ago. That is, the debate on whether management should run the corporation solely in the interests of shareholders or whether it should take account of other constituencies is almost as old as the first writings on corporate governance between Berle (1931) and Dodd (1932). Berle held the view that "corporate powers are in trust for shareholders and nobody else."[192] But Dodd argued that "[business] is private property only in the qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers even if the proprietary rights of its owners are thereby curtailed."[193] The above debate on corporate governance will continue forever too.

The various views on corporate governance can be related to different cultural contexts, intellectual backgrounds and interests of scholars because scholars in different fields come from different academic disciplines and backgrounds. As Shann Turnbull points out, these disciplines such as micro-economics, organizational

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192 See Adolf A.Berle, Jr., 1931, 'Corporate Powers as Powers in Trust', 44 Harv. L. Rev., p 1049.
193 See E.Merrick Dodd, Jr., 1932, 'For Whom Are Corporate Managers Trustees?', 45 Harv. L. Rev., p 1162.

economics, organizational theory, information theory, law, accounting finance, management, psychology, sociology and politics, may consider corporate governance in a different approach, just like "the apocryphal group of blind people trying to identify an elephant through touch by each describing quite different parts of the animal."[194]

This thesis argues that the content of the modern corporate governance debate at least includes three aspects as follows: (1) the conflict between shareholders and managements, (2) the conflict between majority or controlling shareholders and minority or non-controlling shareholders, (3) the conflict between shareholders and stakeholders.[195] Based on the above relationships, there are substantial costs that derive from the clash of the interests between different agents. Corporate governance is the result of the relationships and interactions between these agents. An optimal corporate governance structure is the one that would minimize agent costs deriving from these agency problems.[196]

No matter what definition of corporate governance it is and however the corporate governance develops, because corporate governance varies widely across countries and across firms, but better corporate governance could help firms improve the possibility of performance and easily raise funding from the public on better terms,[197] the thesis argues the aim of corporate governance is to balance the interests

[194] See Shann Turnbull, 1997, 'Corporate Governance: Its Scope, Concern and Theories', Corporate Governance, Vol.5, No.4, (October) ,p 180.
[195] The paper only discuss relationship between management and shareholders, and between controlling shareholders and minority shareholders.
[196] See Stilpon Nestor and John K.Thompson, 'Corporate Governance Patterns in OECD Economies: Is Convergence Under Way? http://www.oecd.org/dataoecd/7/10/1931460.pdf (visiting date: 3,20 2007)
[197] See Craig Dodge, G Andrew Karolyi and René M. Stulz, 2004 ,'Why Do Countries Matter So Much For Corporate Governance?', Finance Working Paper N, (September), www.ecgi.org/wp.

between parties concerned in companies in order to promote the development of companies, even the progress of society and growth of economy. So good corporate governance has far-reaching significance at least as follows:

(1) "It helps to ensure that an adequate and appropriate system of controls within a company and hence assets may be safeguarded;
(2) It also prevents any single individual having too powerful an influence;
(3) It is concerned with the relationship between a company's management, the board of directors, shareholders, and other stakeholders;
(4) It aims to ensure that the company is managed in the best interests of the shareholders and the other stakeholders;
(5) It tries to encourage both transparency and accountability which investors are increasingly looking for in both corporate management and corporate performance." [198]

In a word, corporate governance is an arrangement or mechanism that strikes the right balance of power and interests between managers, blockholders, dispersed investors and all the other stakeholders in order to solve the agency problem and mitigate the agency cost as much as possible. Therefore good corporate governance is separation of the functions with clearly-defined accountability, responsibilities and checks-and-balances among them.

2.4. The classification of corporate governance around the world

[198] See Christine A. Mallin, 2004, Corporate Governance, Oxford: Oxford University Press, p 4.

2.4.1. Outsider and insider systems

Corporate governance around the world can be classified into different categories, for example, the outsider and insider systems put forward by Franks and Mayer.[199] Franks and Mayer argue that the United Kingdom and United States have "outsider systems" of corporate control with large share markets, dispersed ownership, and active markets in corporate control. The distinguishing characters of the outsider model are (1) the structure of dispersed equity ownership with institutional investors; (2) shareholders interests superior to stakeholders in the company law; (3) the protection of minority investors emphasized in securities law and regulation; and (4) relatively strong emphasis on requirements for disclosure.[200] In contrast, a majority of Continental European capital markets have "insider systems" with relatively small numbers of quoted companies, the structure of concentrated share ownership, and comparatively a small number of takeover activities,[201] and less protection of minority. Japan has an insider system too.

The problem with these differences is that there are no "systems" that are different to such an extent as to explain the various factual phenomena. Although they are different, there are also some of the same characters between them. The differences are in reality in degree only. On the one hand, there are still much difference even if they are regarded the same system. The systems classified as insider,

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199 See Franks, J. and Mayer, C., 'Corporate Control: A Synthesis of the International Evidence'. IFA Working Paper 165-92, 1992, London Business School.

200 See Stilpon Nestor and John K.Thompson, 'Corporate Governance Patterns in OECD Economies: Is Convergence Under Way? ? http://www.oecd.org/dataoecd/7/10/1931460.pdf (visiting date: 3,20 2007)

201 See Julian Franks and Colin Mayer, 2001, 'Ownership and Control of German Corporations', The Review of Financial Studies, Vol. 14, No.4, (Winter), pp 943-944.

for example, are too divergent to be considered as one category. Each of the continental European systems has to a different extent some elements of as outsider system besides the features of "insider systems". From a legal point of view, some are very similar to the English system, but are at the same time quite distinctive in the growth of financial markets. On the other hand, the Netherlands, Sweden and Switzerland, three countries are considered to be much 'closed' systems, namely a relatively large number of domestic listed companies and a relatively advanced stock market capitalization, although they are regarded as "insider systems". In a word, it seems unreasonable according to the categories above. For instance, comparing Germany and Japan, both regarded as a typical insider system is also rather problematic. Both might have some similar mechanisms of corporate control, such as bank playing an important role in corporate governance, but their dissimilarities are ever greater.[202]

2.4.2. Market— oriented and bank— oriented systems

Another classification is market-oriented and bank-oriented systems.[203] The former are the UK and USA, and the latter are mainly Germany and Japan. The systems are categorized differently by following criteria: the size of banking systems and stock markets, the degree of external finance that results from bank and market sources and

[202] See Karel Lannoo, 1999, 'A European Perspective on Corporate Governance', Journal of Common Market Studies, Vol. 37,No.2.,(June), pp272-273.
[203] See Edwards,J., and Fischer,K., 1996, 'Bank, Finance and Investment in Germany', Cambridge, Cambridge University Press.

the amount of corporate equity owned by banks including the role in corporate governance played by banks. Bank-oriented systems are considered to have large banking systems, high levels of bank finance, concentrated shareholding and large equity holding by banks, while market-oriented systems are mainly thought to have high levels of takeover activities, a huge amount of information disclosure, dispersed shareholding and big equity market. Therefore there are certain differences between countries with "market-oriented and bank-oriented systems", or emphasis on the degree of division between investor and firm, "arms-length and close relationship systems".[204]

In fact, the distinction between bank-orient and market-oriented systems proved to be fragile. For example, Japan not only has a large banking system but also has a well-capitalized equity market. While bank lending to corporations has been high in Japan in comparison to the UK and USA, but such situation is different in Germany. It seems Japan is the mixture by this criterion. Bank holdings of corporate equity are modest in most countries. While banks are thought to have been actively involved in corporate activity and, in particular, bank often taking part in reorganizations of companies in Japan, they have not in Germany,[205] which means Germany is different from Japan in some aspects although they are the same category by this criterion.

[204] See Colin Mayer, Oren Sussman, 2001, 'The Assessment: Finance, Law, and Growth', Oxford Review of Economic Policy, Vol.17, Iss. 4, (Winter), p 457.
[205] See Colin Mayer, Oren Sussman, 2001, 'The Assessment: Finance, Law, and Growth' , Oxford Review of Economic Policy, Vol.17, Iss. 4, (Winter) , p 457.

2.4.3. Dispersion and concentration systems

The thesis argues that the above classifications are not ideal because they could not represent the universal phenomena of corporate governance in the world but they are not persuasive. The research has shown that the United States and the United Kingdom has the structure of broadly dispersed ownership by diversified shareholders, but large shareholdings in some forms are the norm in the rest of the world, including most of Europe (e.g. Italy, Finland, and Sweden), as well as Latin America, East Asia, and Africa, corporations typically having controlling shareholders. In sum, the structure of heavily concentrated ownership and a predominance of controlling shareholders are very common around the world.[206]

As a matter of fact, the structure of concentrated share ownership is universal across the countries except for the US and the UK mainly. For example, some scholars investigate the separation of ownership and control in 2,980 publicly traded companies in nine East Asian countries (including some regions, Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand). They find that more than two-thirds of firms are controlled by a single shareholder. Combination of management and ownership control is frequent, and the top management of about 60% of firms that are highly concentrated is in relation to the family of the controlling shareholder.[207] In nine East Asian countries (or regions),

[206] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), pp754-755.
[207] See Stijn Claessens, Simeon Djankov, and Larry H.P. Lang, 2000, 'The separation of ownership and control in East Asian Corporations' Journal of Financial Economics 58, p 82.

the concentration of control rights in the hands of largest blockholders is very high. Thai and Indonesian companies have the highest concentration at 35.25% and 33.68%, respectively, followed by Malaysian and Hong Kong companies at 28.32% and 28.08%, respectively. The least concentration of control rights is proved in Japan, Korea, and Taiwan (10.33%, 17.78%, and 18.96%, respectively).[208] Companies in Philippines and Singapore are controlled apparently by the state.[209]

In Western European countries (Austria, Belgium, Finland, Franc, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, and the UK), scholars analyze the ultimate ownership control of 5,232 corporations from1996 to the end of 1999. They find that typically firms are widely held (36.93%) or family control (44.29%). That is, widely held firms comprise 63.08% of UK firms and 62.32% of Irish firms; in continental Europe the highest percentages of widely held firms are all in Scandinavia but are substantially lower (Sweden 39.18%, Norway 36.77%, Finland 28.68%). The lowest percentages of widely held firms are in Germany (10.37%), Austria (11.11%), and Italy (12.98%). The picture for family control is reversed. The lowest percentages are in the UK (23.68%) and Ireland (24.63%); in continental Europe, the lowest percentages are in Norway (38.55%), Sweden (46.94%), Switzerland (48.13%) and Finland (48.84%). In every other Western European country, family controlled firms are concentrated.[210] Therefore, the structure of share ownership in most of western countries is concentrated.

[208] See Stijn Claessens, Simeon Djankov, and Larry H.P. Lang, 2000, 'The separation of ownership and control in East Asian Corporations' Journal of Financial Economics 58, p 99.
[209] See Stijn Claessens, Simeon Djankov, and Larry H.P. Lang, 2000, 'The separation of ownership and control in East Asian Corporations' Journal of Financial Economics 58 , p 101.
[210] See Mara Faccio, and Larry H.P.Lang, 2002, 'The ultimate Ownership of Western European Corporations', Journal of Financial Economics 65, p 378.

Based on investigation by scholars above, the thesis argues the shareholding structure composed of shares is the foundation for corporation, because incorporation, contribution and establishment of organization are dealt with by shareholders who constitute the general meeting. Since the agency problems derive from the change of the structure of share ownership and the agency problem is prevalent in corporate governance of publicly traded company around the world, the thesis allows for two types of corporate governance system of the publicly traded company around the world according to the degree of the structure of share ownership in companies: dispersed and concentrated systems. The former is characterized by dispersed shareholders and mainly conflict of interest between shareholders and management as agency problem. The latter is characterized by controlling shareholders and major conflict of interest between majority and minority shareholders as agency problem. For example, the family firm has different corporate governance problems. Although there may be conflicts between big shareholders and hired managers in the family firm, these problems are probably of minor importance compared with conflict of interest between big shareholder and minority shareholders, as owners (big shareholders) are generally believed to have capacity to control the operations of their firm.[211]

The concentration is sub-grouped into: (1) family concentrated systems according to family concentrated shareholding structure, e.g. southeastern Asian countries and regions; (2) bank concentrated systems according to bank

[211] See Eriik BerglÖf and Ernst-Ludwig von Thadden, 1999, 'The Changing Corporate Governance Paradigm: Implications for Tansition and Developing Countries', Working Paper, (June).

concentrated shareholding structure, e.g. Germany and Japan; (3) state concentrated systems according to state concentrated shareholding structure, e.g. China, Russia.[212]

The thesis argues that the classification of corporate governance based on the structure of share ownership is very significant and the pattern is very universal across the countries because whether in the structure of dispersed ownership or in the structure of concentrated ownership, the agency problem, the core issue of corporate governance emanates from the substantial change of structure of share ownership in the world.

2.5.Conclusion

The aim of corporate governance is to solve the agency problem and minimize the agency cost that is the core of corporate governance, while agency problems derive from the structure of share ownership that is consisted of shares I will discus in the next chapter. That is, the difference of the structure of share ownership leads to the different agency problem. The major agency problem in the structure of dispersed share ownership is the conflict of interest between management and dispersed shareholders while the major agency problem in the structure of concentrated share ownership is the conflict of interest between majority shareholders and minority shareholders. So the thesis argues study on the structure of share ownership is the first

[212] See Olga Kuznetsova, and Andrei Kuznetsov, 1999, 'The State as a Shareholder: Responsibilities and Objectives', Europe-Asian Studies, Vol. 51, Vol. 51, No.3 (May), p 437. For example, in Russia the state retain a contrlling stake of shares in 30% of all industrial firms, with total output accounting for 20-25% of GDP. In addition, in large firm and firms in key industries the state guaranteed itself the controlling power of a majority shareholder through the so-called golden share.

step in order to strike the balance on allocation of power and distribution of interest between parties related to companies and to improve corporate governance.

Chapter 3. Relationship between the structure of share ownership and corporate governance

3.1. The nature of the share

The share is a unit in the share capital of a company and represents the right and liability of shareholders to the company. The share itself as a special commodity is nominal and intangible in form while rights attached to a share are a matter of substance. In other words, the share in the form of paper or electronic certification is insignificant in a sense but the rights of its representative are significant. Therefore, here the nature of the share is shown by means of the rights (ownership rights of the share) attached to the share in the company measured by a sum of money that is contributed to the company. With regard to a share in the company, Farwell J in *Borland in Borland's Trustees v Steel Brothers & Co Ltd* ([1901] 1 Ch 279) defined a share as follow, "A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second. A share is an interest measured by a sum of money and made up of various rights." Therefore, in practice ownership rights of shares will fall under four main heads: (1) attendance at meetings and voting, (2) dividends, (3) return of capital on a winding up, (4) others, e.g. bringing derivative suits on behalf of company.

As we know, the company's assets consist initially of money, goods, or intellectual

property etc. supplied by shareholders in exchange for shares in the company issued to them. That is, the contribution which is made by shareholders to the company is independently of shareholders after contributing but belongs to the company's assets which, the shareholder can not get back originally, however, shareholders can get a share from the company in exchange for their contribution to the company. Although the shares will be transferred constantly from old shareholders to new ones in accordance with law and charters, particularly in publicly traded companies, shareholders owning shares can take part in all kinds of activities of the company and the profit is distributed to the shareholders by way of dividends or others on the shares from time to time declared by the company under laws and charters. A share in company is a form of property for shareholders and its position is at the heart of company law. There is no company without share in a sense.

However, it seems corporate shareholders are ever more passive and functionless to some extent compared to partners in partnership in some countries or regions since the early 20th century. Thus different scholars have different opinions on the nature of a share. Some think the nature of a share is of a right of membership of a legal association, or of ownership.[213] Some scholars think shares come to suggest debt-like features because shareholders increasingly rely on regular dividends offered by corporate managers in proportion to shares as sources of steady income streams in place of as speculative financial instruments whose returns change greatly

[213] See Mei Shen Shi, 2001, System of Modern Corporate Governance, China Legal System Press House (China), pp 181-188. "Ownership" in this part (feature of share) is referred to property rights and is different from "ownership rights of share" or "ownership structure" in the thesis.

dramatically with the ups and downs of a business.[214] Others emphasize the contractual qualities of the shares. For example, Pennington asserts that shares constitute simply arrays of contractual and statutory rights that the shareholder has against the company.[215] Most of scholars share the view that shares have characters of both property and a proprietorial interest in the company.[216] In addition, despite the general acceptance of the "ownership" assumption, the legal nature of the share and shareholding appear to be uncertain, for instance, it seems very difficult to distinguish shareholders from debenture holders. As L.C.B.Gower says, the share does not readily fit into any "normal legal category".[217] As a result, shareholders found themselves being unfavorably regarded in some quarters as "absentee owners", owners of claims to "unearned or free income", and even compared to corporate bondholders.[218]

What is the nature of the share? First of all, let us briefly go back in the history of modern company law and the development of creditors. Modern company law originated from joint stock company law that was regarded as an appendage of partnership law.[219]

Modern loan, as a relationship between credit and debt, has a strong relationship with usury, the loan of money for high interest in ancient times. Usury was always

[214] See Jonathan B.Baskin, 1988, 'The Development of Corporate Financial Markets in Britain and the United States, 1600---1914: Overcoming Asymmetric Information', 62 Business History Review, pp 232-236.
[215] See Robert Pennington, 1990, Company Law, London: Butterworths, 6th ed, pp 56-144.
[216] See Paddy Ireland, 1999, 'Company Law and the Myth of Shareholder Ownership', The Modern Law Review, Vol.62, p 46.
[217] See Paul Davies, 1997, Gower's Principles of Modern Company Law, London: Sweet & Maxwell, 6th ed, pp 299-321.
[218] See Paddy Ireland, 2003, 'Property and Contract in Contemporary Corporate Theory', 'Legal Study' p 481. (citing Thorstein Veblen, 'The Theory of Business Enterprise (New York: Scribner's, 1904) and 'Absentee Ownership and Business Enterprise in Recent Times' (New York: Huebsch, 1923); See also FS Wood, 'The Status of Management Stockholders' (1928) 38 Yale LJ 57; J Frank 'Book Review' (1933) 43 Yale LJ 898.)
[219] See Paddy Ireland, 1999, 'Company Law and the Myth of Shareholder Ownership', The Modern Law Review, Vol.62, p 38.

frowned upon in Greek and Roman times, when Roman law permitted usury as long as the interested charged was not excessive, and was completely prohibited in the Middle Ages. Over time, as trade expanded overseas, merchants were in need of a huge amount of money to enlarge the quantity of trade. Therefore the function of money gradually expanded to include "loan" as well as "investment" and the status of the provider of money correspondingly changed from "lender" into "partner" who would like to take the risk of 'investment' instead of accepting the fixed "interest".[220] That is, an investor of money whose return was neither guaranteed nor fixed in advance but depended on the result of the venture was deemed a risk-taking partner, while the money lender transferred ownership of his money to the borrower and took a fixed and guaranteed return. Thus, "lenders" who received interest were different from "partners" who received a share of profit. Both received the return on the capital, however, they have been quite distinctive in legal status since ancient times.

In fact today, generally speaking shareholders as owners of shares are distinguished from creditors[221] of debt as follows. First, with regard to the form of investment, shareholders can contribute to the company by means of money, in kind, intellectual property while creditors only invest money in the company, relatively speaking. Second, concerning the return on investment, shareholders will depend on the success of the company while creditor will enjoy a fixed return that is agreed by company. Third, shareholders can take part in certain activities of the company such

[220] See Paddy Ireland, 1999, 'Company Law and the Myth of Shareholder Ownership', The Modern Law Review, Vol.62, 1999,pp 34-35.
[221] Here creditors mean who invest money in companies excluding other kinds of creditors such supplies, consumer as creditors of companies.

as monitoring and voting according to its charters in proportion to the shareholding in principle while creditors should not (there is an exception in some states in the USA). Fourth, shareholders can claim the residual profit, but creditor can not. Fifth, creditors of the company can get a return on their investment before shareholders do. In a word, creditor's rights can be against the company, but the creditor has only limited control over the company' affairs. Generally speaking, such controls by creditor arise contractually from loan agreement until default, breach of contract or on the verge of bankruptcy of companies. While shareholders can take part in all kinds of activities of company from the beginning to the end in accordance with laws and articles, in particular by voting rights which are critical and lead to the objective of pursuit of parties who are in relation to the company in the course of operation, such as institutional investor, big shareholder, takeover bidder.

What relationship is there between ownership (referring to the rights of assets) and the rights attached to a share? The right of ownership of the share is derived from the right of ownership but is distinctive from the latter. As analyzed above, once shareholders make a contribution to the company and the contribution is the company's asset, but shareholders get their share from the company in return. As stated in Chapter one, ownership is composed of many rights, such as "the right to possess, the right to use, the right to manage, the right to the income of the thing, the right to the capital, the right to security, the rights or incidents of transmissibility and absence of the term, the duty to prevent harm, liability to execution, and the incident

of residuarity. They make eleven leading incidents."[222] Compared with ownership, ownership rights of share are limited. So the rights attached to shares are different from ownership.

In a word, shares with their own characters are the result of the development of a commercial society, shareholders are quite different from creditor of company and ownership rights of shares are independent rights that originate from ownership but determine the destiny of company.

3.2. The relationship between the structure of ownership and corporate governance

The company as an entity or mechanism consists of shares, organization structure and information etc, but shares belongs to one kind of property rights that form the foundation for the operation of the company. That is, property rights are fundamental: investors will not invest if they expect to be unable to keep the fruits of their investment. In a sense, there is no company without shares. A share is a thing (or chose) in action. That is, a share that does not have a physical existence of its own is a form of property, and the shareholders who are quite distinct from the creditors are granted certain rights,[223] which are analyzed above. As we know, property rights play no role at all in the world of Robinson Crusoe. Property rights are an instrument of a society and their significance records the status of man and enables man to realize

[222] See Alison Clarke and Paul Kohler, 2005, 'Property Law: Commentary and Materials', Cambridge University Press, p 194.
[223] See Ewan MacIntyre, 2005, Business Law, Person Education limited, Second Edition, p 536.

expectation by their exchange value, which is recognized in the laws, customs, and mores of a society.[224] That is, property rights do not refer to relations between men and things but, rather, to relations between human beings that arise from the existence of things and pertain to their use. In other words, the property rights demonstrate the relationship between men and represent man's status in the society. In fact Roman law, Common Law, Marx and Engels, and current legal and economic studies basically agree with argument that property rights controlled or scarce resources used by man in the community show his economic and social status.[225] In other words, property is associated with rights or social status that becomes focus by the mankind during the process of exchange, while the exercise of right has something to do with costs or at the expense of interest. Thus Coase suggested that transactions that are typically conducted within the firm are not governed by the price mechanism but by a power relationship.[226] According to the views of Grossman and Hart[227] and Hart and Moore,[228] authority or power is different from the price mechanism because it involves the exercise of rights that are not contractible, the so-called residual rights of control. The power derives from the ownership of physical assets and assets of other forms. There is no right or power without ownership or other assets in companies, although directors or management can make decisions and operate companies through

224 See Harold Demsetz, 1967, 'Toward A Theory of Property Rights', The American Economic Review, Vol. 57, No.2, Papers and Proceedings of the Seventy-ninth Annual Meeting of the American Economic Association (May,), pp 347-359.
225 See Eirik G.Furubotn and Svetozar Pejovich, 1972, 'Property Rights and Economic Theory: A Survey of Recent Literature', Journal of Economic Literature, Vol.10, No.4. (Dec.,), p 1139.
226 See Coase, Ronald, 1937, 'The Nature of the Firm', Economica, IV, pp 386-405.
227 See Grossman, Sanford, and Oliver Hart, 1986,'The Costs and the Benefits of Ownership: A Theory of Vertical and Lateral Integration', Journal of Political Economy, XCIV, pp 691-719.
228 Hart, Oliver, and John Moore, 1990, 'Property Rights and the Nature of the Firm', Journal of Political Economy, XCVIII, pp 1119-1158.

the delegation of their powers. The decision rights refer to the use of assets, of resources, in fact they are property.[229] It is known that the shareholders' general meeting is power organ but directors or management exercise day-to-day power or rights through the delegation. Therefore it should be noted that the attenuation of the stockholder's property rights in the firm and the "rule of management" result from the costs to the shareholders of detecting and policing managerial decisions and of enforcing wealth maximizing behavior rather than from legal restraints on private property rights.[230] In reality, if the attenuation of stockholders' rights comes from the fact that the costs of detecting, policing and enforcing appropriate managerial behavior exceeds the expected benefits, they will give it up. In other words, shareholders always think of the balance between cost and profit at least and it will be better for them that profit outweighs cost when monitoring companies. In a word, the share as the part of property rights institutions is the principal source of diversity among national corporate governance systems while the structure of ownership is made up of shares.

Shares that shareholders own in companies are of interests that belong to shareholders themselves exclusively. The structure of share ownership is made up of the share which shareholders own in companies. In theory, since shareholders have interest in companies owing to their shares, every shareholder should be concerned about the development of companies or the situation of companies in detail. The

[229] See Eric Brousseau and Jean-Michel Glachant, 2002, The Economics of Contracts: Theories and Applications, Cambridge University Press, p 256.
[230] See Larenr,R, 1966, 'The 200 largest Non-Financed Corporations', Amer. Econ. Rev., (Sept.) 56, pp 777-87; Samuelson, P. 1966, Economics. 7th Edition. New York: McGraw Hill.

reason is very simple that every shareholder hopes he will get a certain expected return on the contribution by him to the company. Therefore, shareholders should take part in activities and play a positive role in companies by voting rights,[231] especially supervising the management or controlling shareholders to maximize the company's value for the sake of the shareholders themselves ultimately.

However, in practice because the quantity of shares which every shareholder owns differs greatly in companies, the activity that every shareholder takes part in varies to the extent that some shareholders never care about companies due to the Wall Street Rule. As described above, the structure of share ownership is classified into dispersion and concentration across countries. In the structure of dispersed share ownership in countries, small and medium shareholders never mind what happens to companies because of cost, skill and free-rider problem etc. Especially when the costs of control exceed the benefit, shareholders tend not to take action. In contrast, big shareholders in particular care about the companies in a structure of concentrated share ownership in other countries. Hence, the conflict of interest shows differently in the structure of dispersed and concentrated share ownership due to the shareholder playing a different role in "governance".

> " "Governance" is issues of structure, control and process. "Structure" is about the forms through which decisions are made and "control" as about the power to make those decisions via such structures, while "process" refers to the implementation of structure and control."[232]

[231] There are exceptions from the one-share-one vote-principle in some countries, for example, in western Europeans countries, there are multiple-vote shares or no-vote share issued.
[232] See Nick von Tunzelmann, 2003, 'Historical Convolution of Governance and Technology in the Industrial Revolutions', Structural Change and Economic Dynamics14, p 366.

Based on the concept of "governance", the thesis argues that how to deal with the relationship between "structure", "control" and "process" is very important because "structure" is selected by shareholders in theory. But "control" is manipulated by the management or majority shareholders in practice, while "process" is the logic result of "control". Once the change of structure of ownership develops towards dispersion, the company is controlled mainly by management and the agency problem in corporate governance is mainly that conflict of interests happens between dispersed shareholders and management, which is consistent with the argument that is separation of ownership from control by Berle and Means because of information asymmetry, free-rider problem, cost, skill etc for dispersed shareholders. Management will take advantage of his position to "tunnel" companies in interest of himself instead of companies or dispersed shareholders. While when the change of structure of ownership grows towards concentration, the company is controlled by majority shareholders and the agency problem in corporate governance is mainly that conflicts of interests arise between majority shareholders and minority shareholders because managements are selected or controlled by majority shareholders. Majority shareholders will transfer assets to his or his relative's other companies by related party transactions or other ways at the expense of minority's interests.

Today it is known that the aim of corporate governance is to balance the conflict of interest between entities related to companies. That is, conflicts of interest happen between shareholders and management, majority and minority shareholders, shareholders and stakeholders. In countries with a structure of dispersed share

ownership, the aim of corporate governance is mainly to solve the agency problem that is the conflict of interest between dispersed shareholders and management. While in countries with a structure of concentrated share ownership, the aim of corporate governance is mainly to solve agency problem that is the conflict of interest between the majority shareholders and minority shareholders. Although there is a conflict of interest between manager and shareholders in the structure of concentrated ownership, if the shareholding is concentrated, the shareholders, in particular big shareholders or majority shareholders, will receive reliable information about the company's performance. Big shareholders have broad powers to remove managers. Managers may then feel constrained to pursue strategies that are in the shareholders' best interests in the structure of concentrated share ownership.

Therefore the thesis draws the following conclusion on the relationship between the structure of share ownership and corporate governance: whatever is the structure of share ownership across the countries in the world, there is the corresponding model of corporate governance in reality. Namely, the structure of share ownership determines the model of corporate governance in the world.

3.3. The implication of model

Models serving as an example to be imitated or compared have an important part to play in understanding, whether trying to understand oneself, organization, system one's community, our society, our planet or even the universe itself. Generally, models

are miniature or simplified representations of structures, systems, mechanism or processes. They will help people understand about how things may work and what they will take place probably, and offer a platform from which it is possible for people to gain deeper understanding and make better predictions, projections and suggestions about how things may function in the future. Models compete each other like plants and animals on the earth, some models will be abandoned and a new model emerges and grows, which rely on whether models meet the need of nature or society. Where those competing models have a strong effect on our life, national policy and as a result, on society, and even on the planet as a whole, the role that the model plays will be beyond the academy, even to the most remote corners of the earth.[233] So research on the model of corporate governance is very significant.

Because there are differences in the economy, politics, law, culture, history etc. across different countries, there is not the same structure of share ownership and corporate governance in the world. But there will be some similarities in some aspects or some characteristics of the structure of share ownership or corporate governance, from which are worth learning or using for reference for other countries or regions, or from which we will find some similar problems to be dealt with for some countries or regions in the future. This is why I should carry out the classification of the structure of share ownership and study the model of corporate governance.

3.4. The share ownership structure determines the model of

[233] See Benedict Sheeshy, 2004, 'The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law', Depaul Business & Commercial Law Journal, Vol. 2:463, pp 487-492.

corporate governance

The study of corporate governance and the structure of ownership should be open to scholars from many disciplines; scholars in financial and economics research don't have a patent over it. It is said Karl Marx first studies comprehensively who controls the use of capital and how this control affects the creation and distribution of wealth in society.[234] Today there is a growing consensus among academics and practitioners that both the design and the ownership patterns of financial securities have a significant impact on the creation of value in large corporations. Economists and legal scholars have conducted research for the effect that large shareholders have on firm behavior.[235] As described above, agency problems occur due to substantial change of structure of share ownership in firm on account of the development of economy and society. Since the agency problem derived from the substantial change of structure of share ownership which resulted in issues of corporate governance in the modern corporation around the world, the crucial issue of corporate governance is to tackle the agency problem and minimize agency costs in order to balance the power and interest of the parties in relation to companies, and then the relationship between the structure of ownership and corporate governance should be worth studying deeply in detail for reference in the future.

In terms of shareholders of companies, as stated above, there are different kinds

[234] David L. Kang and Aage B. Sørensen, 1999, 'Ownership Organization and Firm Performance', Annu, Rew, Social, 25, p 122.
[235] For example, Economists: Shleifer and Vishny (1986), Smith (1996), Burkart, Gromb, and Panunzi (1997) and Maug (1998); Legal scholar: Black (1992).

of conflict of interest among participants in companies: (1) majority and minority shareholders; (2) shareholders and management; (3) shareholders and stakeholders etc. The task of corporate governance as a mechanism is to balance the conflict of interest among participants in companies in order to make the operation and organization of companies orderly, proper and efficient and promote the competition of companies in market.

Although company laws specify the power distribution among the general meeting, the board of directors, the board of supervisors or other departments either in common law system countries or in civil law system countries or in any other country in the world, different structures of share ownership in publicly traded companies have different decision-making styles in practice. Or say, the process of decision-making is controlled by different participants due to the structure of share ownership in companies that results in agency problems. That is, when the structure of share ownership is diffuse, theoretically, the shareholders have the power to select the members of the board and to vote upon certain key issues facing the company through the use of their voting rights, but in practice the fragmentation of ownership has proven to be a serious impediment to the actual exercise of such control and when shares in companies are owned by thousands of individuals who are not interested in decision-making or whose share is not big enough to have any effect on decision-making, the process of decision-making is controlled by management. The distinguishing feature of publicly traded companies in countries with a dispersed structure of share ownership is that it has a large number of small owners, which

creates two issues. First, the shareholders, even though they typically have (ultimate) residual control rights in the form of votes, could not exercise this control on a day-to-day basis due to too small and numerous dispersed shareholders. The dispersed shareholders have to delegate day-to-day control to a board of directors who in turn delegates it to management. In the words of Berle and Means, there is a separation of ownership and control. The second, related issue is that dispersed shareholders have little or no incentive to monitor management because monitoring is a public good that easily results in the free-ride problem. That is, if one shareholder's monitoring leads to improved company performance, all shareholders will enjoy benefit in proportion to shares. Therefore every shareholder hopes other shareholders monitor management and wait for the good result. In addition, monitoring management require expensive cost. If all shareholders think in same way above and the unfortunate outcome is that the monitoring will not happen at all.[236] For example, dispersed shareholders have no incentive to monitor management in the U.S.A. and the U.K.

Meanwhile when the structure of share ownership is concentrated, majority shares are owned by banks, families or by states, and the process of decision-making is controlled by the majority shareholders or sometimes a smaller proportional shareholding is sufficient for control by the biggest shareholder where holdings are more widely dispersed and therefore a different criterion should be used for each company, for instance, Germany, Italy and China respectively.

Differences in the structure of share ownership account for differences in the

[236] See Oliver Hart, 1995, 'Corporate Governance: Some Theory and Implications', The Economic Journal, Vol.105, No. 430, (May), p 681.

agency problem, which are described above. For example, in countries with a dispersed structure of share ownership of publicly traded companies, the major agency relationship is between management and shareholders. Corporate managers tend to engage in earnings at the expense of the interests of dispersed shareholders. While in countries with a concentrated structure of share ownership of publicly traded companies in countries, the major agency relationship is between majority shareholders and minority shareholders, majority or controlling shareholders tend to exploit the private benefits of control at the expense of minority shareholders. As famous professor John C. Coffee pointed out, in particular, dispersed ownership systems of governance are prone to creating financial and accounting scandals in the United States, while the characteristic scandal in concentrated ownership economics is the appropriated action.[237] In recent years, corporate scandals have occurred in different structure of share ownership and their contents and types are quite different between a structure of dispersed share ownership and a structure of concentrated share ownership. For example, the United States General Accounting Office has declared that over 10% of all listed companies in the United States announce at least one financial statement restatement between 1997 and 2002.[238] A more recent, fuller study in 2003 by Huron Consulting Group shows the following results: in 1990, there were 33 earnings restatements; 1995, there were fifty; then the rate truly accelerated to 216 in 1999; to 233 in 2000; to 270 in 2001; and the in 2002 , the number peak at

[237] See John C. Coffee, 2005, 'A Theory of Corporate Scandals: Why the U.S. and Europe Differ', The Center for Law and Economic Studies. 435 West 116th St. New York, NY 10027-7201, working paper No. 274, (March).
[238] See U.S. General Accounting Office, 2002, 'Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges', Pub.No.03-138, (October) P 4.

330 (ten times the 1990 level). On this basis, roughly one in eight listed companies restated over this period. The study by Huron Consulting shows that the number of restatements fell to 323 in 2003 and then rose again to 414 in 2004.[239] Why did the fraud occur in the U.S. that had something to do with financial statement? It is well known that the mechanism of managerial incentives is relatively perfect, of which the scale of compensation is very big. In 2004, CEO compensation as a multiple of average employee compensation was estimated to be 531:1 in the U.S., but only 16:1 in France, 11:1 in Germany, 10:1 in Japan, and 21:1 in nearby Canada. Even Great Britain, with the most closely similar system of corporate governance to the U.S., had only a 25:1 ratio.[240] Even though the scale of compensation for management is so large, the scandal always happens in the US. Because there is no incentive for shareholders to monitor management in the structure of dispersed share ownership and stock options are widely used as compensation for CEOs plus possessing asymmetric information, corporate managers use manipulative techniques to maximize stock price over the short-run in order to exercise their options and bail out at the expense of the interests of the company and shareholders. So it is not strange that cases such as Enron and WorldCom occurred in the U.S. By contrast, generally speaking, financial statement restatements are rare or less frequent in the concentrated structure of share ownership. Corporate managers in those countries have both less discretion to engage in opportunistic earnings management and less motivation to

[239] See John C. Coffee, 2005, 'A Theory of Corporate Scandals: Why the U.S. and Europe Differ', The Center for Law and Economic Studies. 435 West 116th St. New York, NY 10027-7201, working paper No. 274, (March).
[240] See Gretchen Morgenson, 2004, 'Explaining (or Not) Why the Boss Is Paid So Much', N.Y. Times, Jan. 25, § 3, P 1.

create an earnings spike. Controlling shareholders always get benefits through related party transactions. For example, controlling shareholders can compel the company to sell its output to, or buy its raw materials from, a corporation that they independently own for their interest only in China.

As Coase pointed out, science and scientist must cope with their models by the evidence instead of the reverse.[241] Thus the thesis will further analyze the relationship between the structure of share ownership and the corporate governance based on the evidence in details as follows.

3.4.1. In the United State: the structure of dispersed share ownership— shareholder & management model of corporate governance

As described above, the structure of share ownership in the USA and the UK is dispersed. In this model, there are continuous external controls and threats to replace non-performing executives, and preventive and post-activities monitoring measures are performed by different institutions. Here the thesis takes the USA as an example. In America, as for the phases of corporate governance evolution, they are as follows:

> "(1) until 1933: bank centered financial capitalism; (2) 1933-early 1950s: Berle crisis-period capitalism, brought about by anti-Wall Street populism developed during the first decades of the century and precipitated by the Great Crisis, with the Glass-Steagall Act (though banks played a lasting

241 See Benedict Sheeshy, 2004, 'The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law', Depaul Business & Commercial Law Journal, Vol. 2:463, p 498.

> role until the end of the period), the Securities Exchange Act and wide Federal intervention; (3) early 1950s-mid 1970s: strong manager capitalism, characterized by a growing lack of monitoring mechanisms; (4) mid 1970s-late 1980s: market and court capitalism, marked, since *Miller v. Miller*, by more intense court monitoring, new SEC disclosure rules and a growing number of takeovers; (5) late 1980s onward: active investor capitalism, brought about by negative perceptions of the effect (on managers' incentive structures) of market and court monitoring and the softening that ensued in that monitoring."[242]

As we know the corporate governance was ever affected by law and politics in America in the past. But the characteristic is that the structure of share ownership is still dispersed, and conflicts of interest remain mainly between management and shareholders in corporate governance.

With the change of economy and development in society, the pursuit of value by companies is changeable. In North American from the 1930s until the 1970s, the model for the corporation was the communitarian model in which the corporation had to take some social responsibilities besides the emphasis on the importance of shareholders. This model derived from the outcome of the Berle and Means debate "Whom should the corporation serve?" which was one result of the economic collapse and Great Depression of the 1930s. But since the 1980s, the circumstance has changed greatly, that is, the model for the corporation moved from the communitarian to the contractarian model that was proposed by Neo-classical economists. The contractarian's concentration on only wealth generation has been most directly propounded by the Chicago School. This model stresses "shareholder primacy" and

[242] See Fabrizio Barca, 1998, 'Some views on U.S. Corporate Governance', Columbia Business Law Review, Vol.,N.o1:1,pp 20-21.

places the interests of the shareholders above all stakeholders.[243]

Although many changes have taken place in America, the character of the dispersed structure of share ownership in publicly traded companies remains the same as in 1932. As we know,

> "Berle and Means conducted a survey between 1929 and 1930 of the 200 largest non- financial corporations from various sectors of industry. They found that 44 per cent of these companies by number and 58 per cent by wealth, were subject to management control. Further, 21 per cent by number and 22 per cent by wealth were found to be controlled by a legal device. This meant that the aggregate of non-ownership control of large companies was 65 per cent by number and 80 per cent by total wealth. Control was therefore located with the controllers of the company who were described as the 'new princes' of industry, for this revolution had changed the company into one that was management controlled."[244]

In the seminal book "The Modern Corporation and Private Property" by Berle and Means in 1932, they made three feature contributions to this preeminence: First, they proved that share ownership was typically widely dispersed with a large number of small shareholders in large American companies. Second, it was impossible for dispersed shareholders to control the corporation any more. Third, they argued that management controlled corporations and divert profit maximization for themselves. Many companies were completely controlled by management because the number of shareholders was so dispersed that management could make decision in disregard of

[243] See Benedict Sheeshy, 2004, 'The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law', Depaul Business & Commercial Law Journal, Vol. 2:463, pp 494-501.
[244] Saleen Sheikh & Willian Rees, 1995, Corporate Governance & Corporate Control, London: Cavendish, pp 39-40.

shareholders' interests.[245]

More than seventy years have passed. What is the contemporary relationship between the structure of share ownership and corporate governance in American? Some scholars have given the answer as follows. Based on a sample of 4,639 firms that is broadly representative of approximately 5 million small, non-farm, non-financial businesses operating in the United States as of year-end 1992, which had been surveyed by the Federal Reserve Board's National Survey of Small Business Finances (NSSBF), Ang et al utilized a sample of 1,708 small corporations from the FRB/NSSBF database above. They analyzed the equity agency costs for corporations under different ownership and management structure based on the zero agency-cost firm put forward by Jensen and Meckling's (1976). They argue shareholders incur agency costs resulting from management's shirking and perquisite consumption when management owns less than 100 percent of the firm's equity. They confirm the result as follows: (1) If the firm is owned solely by a single owner-manager, the agency cost is zero, as shown by Jensen and Meckling (1976);[246] (2) if firms are controlled by the primary owner, the agency cost is inversely related to the share ownership of the primary owner. Therefore, the profit of primary owner will increase with the rise of shareholding when firm makes profits because the primary owner has incentive to monitor firm as large blockholders at publicly traded corporations; (3) if a single

[245] Saleen Sheikh & Willian Rees, 1995, Corporate Governance & Corporate Control, London: Cavendish, p 40.
[246] Ang et.al argued because of limitations imposed by personal wealth constraints, exchange regulations on the minimum numbers of shareholders, and other considerations, no publicly traded firm is entirely owned by management. Thus, Jensen and Meckling's zero agency cost base case cannot be found among the usual sample of publicly traded firms for which information is readily available. The absence of information about sole owner-manager firms explains why agency costs are often inferred but not directly measured in the empirical financial literature. See James S.Ang, Rebel A. Cole, and James Wuh Lin, 2000, 'Agency Costs and Ownership Structure', The Journal of Finance, Vol. LV, No. 1, (February), pp 81-82.

family controls more than 50 percent of the firm's equity, agency costs are lower. In a small, closely held corporation where a single family controls the firm, the controlling family also performs the monitoring role that large blockholders carry out in publicly traded corporations; (4) if firms hire a number of non-manager shareholders, agency costs should increase. As the number of shareholders increases, the free-rider problem reduces the incentives for limited-liability shareholders to monitor. With less monitoring, agency costs increase.[247] Although Ang et al use data on small businesses to examine how agency costs vary with a firm's ownership structure, the results found by them will apply to publicly traded corporations or other type of corporations in the U.S. due to the separation of ownership and control. That is, when management owns less than 100 percent of the firm's equity because of the change in structure of share ownership and the free-rider problem, shareholders incur agency costs resulting from management's shirking and perquisite consumption in all kinds of corporations where agency costs vary to some extent in the structure of dispersed share ownership.

In brief, the results of agency cost in corporate governance due to the different structure of share ownership are as follows: agency costs are higher when firm is managed by an outsider; agency costs was quite different inversely with the manager's ownership share; agency costs extend with the number of non-manager shareholders; and to a lesser extent, external monitoring by banks creates a positive externality and leads to the reduction of agency costs,[248] because of the change in the

[247] See James S.Ang, Rebel A. Cole, and James Wuh Lin, 2000, 'Agency Costs and Ownership Structure', The Journal of Finance, Vol. LV, No. 1,(February), pp 81-84.
[248] See James S.Ang, Rebel A. Cole, and James Wuh Lin, 2000, 'Agency Costs and Ownership Structure', The Journal of Finance, Vol. LV, No. 1, (February), p104.

structure of share ownership toward dispersion which leads to free-rider problems and non-incentive to monitoring.

As Peter Drucker pointed out, this "dispersed model" of the corporation faces significant challenges for the legal and financial system, let alone society as a whole. The "dispersed model" with its higher concentration of power and corollary lower level of participation exponentially multiplies the risks of managerial abuse of power from perspective of either financial malfeasance or the political arena.[249] In America, the board can at least initiate, or ratify all major corporate decisions under a central and well-settled principle of U.S. corporate law. Shareholders can change the course of the corporation only by substituting the board with new board rather than initiate any decisions.[250] The above principle and provision in law facilitate the managerial abuse of power. For example, in Delaware, the most important corporate jurisdiction in American, according to the Delaware General Company Law § 141(a), "[t]he business and affair of every [corporation] shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." But shareholders' substantive powers "are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution."[251] Apart from the election of directors and the amendment of the bylaws, all these decisions need approval by the board. However, Delaware law provides that

[249] See Benedict Sheeshy, 2004, 'The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law', Depaul Business & Commercial Law Journal, Vol. 2:463, p 512.
[250] See Lucian Arye Bebchuk, 2003, 'Empowering Shareholders', Working Paper, (March),.(citing Robert Charles Clark, Corporate Law (1986), Ch1&3;and infra section II.A).
[251] See Stephen M.Bainbridge, 2002, 'Director v. Shareholder Primacy in the Convergence Debate', 16 Transnat'l Law 45, p 48.

outside the election at the end of directors' terms, shareholders can remove only for cause,[252] which is an absolute rule that directors could be removed only by cause at common law.[253] In other words, the lion's share of powers in the U.S. is in the hands of the board and management. Thus it is not surprising that management can take advantage of tunneling companies because directors who have been influenced by management are vested with primary control rights over key decisions in America. In theory, shareholders can remove the board of directors for cause, which is the fundamental power that corporate statutes provide for[254] and that courts strongly protect.[255] The power of shareholders to cause the replacement will have a forceful effect on management and generally induce it to follow shareholders' preferences. In practice, it is very difficult for shareholders to remove a member of the board of directors due to the structure of dispersed share ownership. Individual shareholders, even if collectively they form a majority, have no interest in doing it owing to cost, free-rider problem, and information asymmetry etc. It seems that it is natural for management to abuse its power without limitation in America.

No matter it is at Berle and Mean's times or today, the structure of share ownership is still dispersed in the United Stats, which has often been identified as the cause of shareholders' weak power in the U.S.A. Although the number of institutional investors is increasing in America, the main contradiction remains the conflict of interest between the dispersed shareholders and management in corporate governance

[252] See Delware General Company Law § 141(k).
[253] See Campbell v.Loew's Inc., 134A.2d 852(Del.Ch.1957).
[254] See, e.g. Delaware General Corporations Law, Sections 211-212.
[255] See.e.g. Blasius Industries v.Atlas Corp., 564 A.2D 651 (Del. Ch. 1988).

because the cases of Enron and WorldCom etc. show the above argument. In other words, in the US, many corporate boards are actually controlled by powerful management, and highly dispersed ownership leads to serious opportunistic behavior of managers. Therefore in the structure of dispersed share ownership in the world, how to settle the relationship between dispersed shareholders and management in corporate governance is the key question.

3.3.2. In Germany: the structure of bank-concentrated share ownership— majority shareholder (bank) & minority shareholders model of corporate governance

The extent to which the structure of share ownership in Japan and Germany is bank-concentrated is remarkably. Banks are thought to have a great effect on corporate governance in non-financial corporations.[256] In this model, there is more cross-holding and external monitoring by banks and other financial institutions; more bank-centered debt financing; and less reliance on external governance mechanisms. The major advantage is that strategic investors' interventions become close and direct control mechanisms in order to reduce the risk of incompetence and malfeasance by management; and the main disadvantages are that an internalized governance structure will be less responsive to external change, and the company will take on

[256] e.g. Kang, J. and Shivdaasani, A . 1995, 'Firm Performance, Corporate Governance, and Top Executive Turnover in Japan', Journal of Financial Economics 38, pp 29-58; Kaplan, S. N. and Minton, B.A. 1994, 'Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers', Journal of Financial Economics36, pp 225-58; Morck, R., and Nakamura, M. 1999, 'Banks and Corporate Control in Japan', Journal of Finance 54, p 319-39.

more risk if it borrows too much from banks. In addition, the bank and the company have to undertake market risk together due to the close ownership and borrowing relationship between the bank and the company, which is very likely to cause a financial crisis when many companies are in financial distress.

In the structure of bank-concentrated share ownership, banks play an important role in corporate governance, such as appointing their staff to the boards of firms and affecting corporate strategy. Banks as creditors and shareholders may have considerable voice in corporate governance without significantly associating their interests with those of other shareholders, and can do harm to share value for public shareholders. [257] Therefore, scholars have different views regarding banks in corporate governance. For example, Wenger and Kaserer argue that German banks pursue objectives that benefit themselves rather than provide adequate monitoring of German companies for outside shareholders.[258] However, Gruntfest,[259] Gorton and Schmid[260] argue that German banks can positively influence the operations of German companies. Some Japanese scholars[261] argue that banks as important monitors help to reduce agency costs. But Weinstein and Yafeh argue that client firms of main banks do not perform better than other Japanese firms in the improvement of

[257] See Randall Morck, Masao Nakamura, and Anil Shivdasni, 2000 ,'Bank, Ownership Structure, and Firm Value in Japan', The Journal of Business, Vol. 73, No.4 (Oct.,), p 539.
[258] See Wenger,E., Kaserer,C., 1998, The German System of Corporate Governance---A Model That Should not Be Inintiated.In: Black, S.W., Moersh(Eds.), Competition and Convergence in Financial Markets. Elsevier, Amsterdam, pp 41-78.
[259] See Grundfest, J., 1990, 'Subordination of American Capital', Journal of Financial Economics 27, pp 89-114.
[260] See Gorton, G, Schmid, F.A., 2000, 'Universal Banking and the Performance of German Firms', Journal of Financial Economics 58, pp 29-80.
[261] E.g. Aoki, M., 1990, 'Toward an Economic Model of the Japanese Firm. Journal of Economic Literature 28, pp 1-27; Prowse,S., 1992, 'The Structure of Corporate Ownership in Japan', Journal of Finance48, pp 1121-1140; Shear, P., 1989, 'The Main Bank System of Corporate Monitoring and Control in Japan', Journal of Economic Behavior and Organization 11, pp399-422.

corporate governance.[262] The following example of Germany shows the importance of the banks' role in corporate governance in the structure of bank-concentrated share ownership.

In contrast to the U.S. system, German corporate governance is generally characterized by greater reliance on large inside investors and financial institutions in raising capital in the corporate sector in place of by reliance on capital markets and outside investors. That is, equity capital is less important than debt capital in Germany. Banks and insurance companies play an important role as shareholders in German listed companies with the structure of highly concentrated share ownership.[263] In Germany, higher control rights of the largest shareholder decrease the market value of a firm's equity, which implies that the largest shareholder in a listed company with highly concentrated ownership does acquire private benefits of control at the cost of minority shareholders. The evidence demonstrates that most types of large shareholders with these beneficial effects of increased ownership have a negative effect on minority shareholders. That is, minority shareholders investing in companies with high ownership concentration thereby expose themselves to the likelihood of exploitation by large shareholders.[264]

According to a study of 171 large German corporations, there is one shareholder possessing more than 25 percent of the company's equity in 85 percent of the largest

[262] See Weinstein, D., Yafeh, Y., 1998, 'On The Cost of a Bank-centered Financial System: Evidence From the Changing Maim Bank Relations in Japan', Journal of Finance 53, pp 635-672.
[263] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., p 509.(citing Ekkehart Boehmer, 2001, 'Country Reports: Germany , in Corporate Governance and Economic Performance pp 96-103 (K.Gugler ed.,)).
[264] See Jeremy S.S. Edwards and Alfons J. Weichenrieder, 1999, 'Ownership Concentration and Share Valuation: Evidence From Germany' Working Paper No.193 (CESifo Working Paper Series),(July).

quoted companies, of which 57 percent have a single shareholder owning more than 50 percent of the equity,[265] which means the structure of ownership in Germany is highly concentrated. These figures are for all listed firms during the period from 1985 to 1997.[266] In addition, large blockholders control 77 percent of the median firm's voting rights for officially traded shares, corresponding to 47 percent of gross market capitalization. These consequences have resulted in the conclusion that the German stock market, in contrast to other developed economies, is controlled by relatively few large shareholders.[267] A large number of listed companies are part of enterprise groups (combined companies) with only a minority of their shares listed. Blockholders are mostly other business enterprises, wealthy families, or banks.[268] Given the high concentration of share ownership in Germany, blockholders are often banks that are in a position as both shareholders and creditors to exert substantial influence on management. Banks, industrial firms, holding companies, and insurance companies account for over 30 percent of the market value of all firms listed in Germany's official markets. The top five banks and the top three insurance companies, which are closely related through direct ownership and voting control, jointly control

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[265] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., pp509-510 (citing Julian Franks & Colin Mayer, 2001, ' ownership and Control of German Corporations', 14 The Rev. of Fin. Studies 943, 947; Julian Franks & Colin Mayer, 1997,'Corporate Ownership and Control in the U.K., Germany, and France', in Studies in International Corporate Finance and Governance Systems 281-296(D.H.Chew ED.,).

[266] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., p 510 (citing Ekkehart Boehmer, 2000 ,'Business Groups, Bank Control, and Large Shareholders: An Analysis of German Takeovers', 9 J.Fin. Intermed. 117).

[267] See Tanja Santucci, 2002,'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., p 510(citing Ekkehart Boehmer, 2000 ,' Who Controls Germany? An Exploratory Analysis (University of Georgia, Working Paper No. 20,)

[268] See Harald Baum, 2005, 'Change of Governance in Historic Perspective: The German Experience', Law Working Paper No. 28/2005, March. www.ecgi.org/wp.(citing R.H.Schmidt, 2004, 'Corporate Governance in Germany: An Economic Perspective in :Krahnen/Schmidt(ed), The German Financial System(Oxford), p 394).

over 14 percent of all listed firms.[269] In a word, as stated above, 85% of the largest quoted companies have a single shareholder owning more than 25% of voting shares in Germany. Corporate ownership is characterized by the structure of strikingly highly concentrated ownership in the form of complex webs of holdings and pyramids of intercorporate holdings primarily in the hands of families and other companies. Bank influence and control are expansive where the structure of shareholdings is widely dispersed.[270] That is, bank ownership is not important in the large proportion of highly concentrated firms, but is significant in the minority of widely held companies with no single shareholder having in excess of 25% by proxy votes, voting rights restrictions, and board representation.[271] In other words, banks may not be largest shareholders in the companies in Germany, however, banks as shareholders and creditors play a great role in corporate governance indeed.

In Germany, banks exert influence on listed companies in the following ways: (1) Banks as shareholders can appoint representatives on the supervisory board. The supervisory board is a powerful organ of the company under German law. The function of the supervisory board representatives is to represent the shareholders' voice at annual general meetings, and protect shareholders' interest from violation by management. The number of board seats filled by bank representatives and the number of votes controlled by banks in proportion to the shares directly owned by the

[269] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., p 510 (citing Ekkehart Boehmer, 2000, 'Who Controls Germany? An Exploratory Analysis (University of Georgia, Working Paper No. 20,)

[270] See Julian Franks and Colin Mayer, 2001, 'Ownership and Control of German Corporations', the Review of Financial Studies, Winter, Vol.14, No. 4, p 944.

[271] See Julian Franks and Colin Mayer, 2001, 'Ownership and Control of German Corporations', the Review of Financial Studies, (Winter), Vol.14, No. 4, p 974.

banks show thus an important measure of bank influence on corporate governance in Germany. The German "bank-based" system of corporate finance is often regarded as having made an important contribution to the historically successful performance of the German economy. One of the contributions of bank-based corporate finance that arises from the role of banks is supervision over corporate management. In short, due to their unique position as equity holders, German companies are controlled substantially by banks and financial institutions.[272] (2) As creditors. Banks are able to have a profound effect on corporations as creditors by providing loans to companies and through their other businesses and financing relations with clients. As both creditors and shareholders, banks may enjoy information advantages compared to other shareholders as a result of their financing arrangement with the borrowing companies. In addition, banks may have an additional advantage in this regard over other financial intermediaries or other shareholders. That is, information about a company's payments and receipts is generally not available to external suppliers of finance or other creditors and shareholders, but banks are able to control companies by observing strictly the deposits and withdrawals of firms that open accounts with them.[273] (3) By proxy votes. One of the other forms to influence of banks on corporate governance is the proxy vote by which small shareholders delegate banks to administer their stock portfolios and supervise management, even if the banks shares make up a small proportion of shares in the company.[274] The structure of the German

[272] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., pp 511-513.
[273] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., pp513-517.
[274] See Tanja Santucci, .2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance

proxy voting system gives banks significant influence over the composition of company boards, and thus allows banks to exercise substantial control over the equity voting rights of the corporation. But today the proxy role is under change in Germany, and corporations have recently acquired the power to designate third parties in place of banks to serve as shareholder representatives, which can reduce the proxy role of depository institutions.[275] Thus, maybe the role of banks in proxy voting will decline in the future. To summarize, as a result of the unique position banks play as both shareholders and creditors, banks (as shareholders and creditors) are able to gain information unavailable to ordinary shareholders and are in a position to have a substantial effect on German companies,[276] while information asymmetries might exacerbate conflicts between bank and other shareholder interests or other stakeholders. As Mark J. Roe argued,

> "German firm could be analyzed by abstracting it into three parts: management, labor and capital. Managers who face the possibility that an independent board may scrutinize them might perform better than those who do not face an independent board, but for the board to be able to get good information about the firm from managers, which will occur conflict of interest between them. Capital might insist on this scrutiny, or managers might from time to time ask for it or firms with this scrutiny might tend to prosper and those without it to contract. Normally the board would be the vehicle for this scrutiny.— Internal rent-seeking between capital and labor could be in play; capital might want to keep labor in the dark so that labor is less effective in internal rent-seeking."[277]

Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., p 518.(citing Ekkehart Boehmer, 2001, 'Country Reports: Germany , in Corporate Governance and Economic Performance at 109-10 (K.Gugler ed.,)).

[275] See Reinier Karrkman et.al. 2004, The Anatomy of Corporate Law: A Comparative and Functional Approach, Oxford University Press, p 43. (Henary Hansmann and Renier Kraakman 'The Basic Governance Structure)

[276] See Tanja Santucci, 2002, 'Extending Fare Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies', Colum.Bus.L.Rev.No.2:499, Vol., p 518.

[277] See Mark J.Roe, 1998, 'German Codetermination and German Securities Markets', Colum. Bus. L. Rev. No. 1:167, Vol., p 172-173.

Therefore conflicts of interest between management and shareholders may occur because the supervisory board relies on the managerial board for information, supervisory board meetings are infrequent, information flow to the supervisory board is poor and the function of a board composed of shareholders and employees is limited, although there exist conflicts between shareholders and employees. But banks as shareholders and creditors have a unique position as analyzed above, and banks can exert substantial control over German companies, and, together with poor legal protection of minority stockholders,[278] the agency problems of corporate governance in Germany consist not only of conflict of interest between shareholders and management but also conflict of interest between majority shareholders (banks) and minority (common shareholders) in the structure of concentrated share ownership. In other words, most German corporations are controlled by a family, a controlling majority shareholder (including banks), or at least a number of large shareholders.[279] For this reason, German corporate law has concentrated more on the regulation of these relationships between controlling and minority shareholders than on the regulation of conflicts between shareholders and managers. Thus a specialized area of German corporation law (Konzernrecht) regulates, inter alia, the conflicts of interest that may take place in connection with transactions between a corporation and its controlling shareholders.[280]

[278] See Rafael La Porta et al., 1997, 'Legal Determinants of External Finance', 52 J. Fin. 1131..

[279] See Theodor Baums and Kenneth E. Scott, 200, 'Taking Shareholder Protection Seriously?: Corporate Governance in the United States and Germany', Working Paper No.272, www.ecgi.or/wp.(citing M.Becht/E.Boehmer 'Ownership and Voting Power in Germany,' in F.Barca & M.Becht (eds.), The Control of Corporate Europe, 128-153).

[280] See Theodor Baums and Kenneth E. Scott, 'Taking Shareholder Protection Seriously?: Corporate Governance in the United States and Germany', Working Paper No.272, www.ecgi.or/wp.

Although reform on corporate governance has been fulfilled recently, much has changed which seems to be more or less closely connected to corporate governance in Germany. The investor protection has improved considerably. The big banks are partially withdrawing from their traditional role in the governance of other corporations. However, a transition towards a more modern capital market-based outsider system has not yet taken place. At least so far, no fundamental change has taken place. That is, the main characteristics of the traditional German system on corporate governance as a whole are still as before.[281]

In a word, in the structure of bank concentrated share ownership across the countries, banks are both shareholders and creditors and they will take advantages of information or other convenient means to benefit themselves at the expense of other shareholders and other stakeholders. Thus there is no doubt that the main conflict of interest arises between banks as majority shareholders and minority shareholders in corporate governance.

3.3.3. In Korea: the structure of family-concentrated share ownership— majority shareholder (family) & minority shareholders model of corporate governance

Family-based corporations are very common for the majority of Asian developing economies. In such corporations big shareholders are also the managers in most cases

[281] See Andreas Hackethal, Reinhard H. Schmidt and Marcel Tyrell, 2005, 'Banks and German Corporate Governance: On The Way To a Capital Market-Based System?', Corporate Governance, Vo.13, No.3, (May), pp 397-409.

and family groups control the company completely (including the decision to hire and fire management and in many cases the selection of members of board of directors). Under such circumstances there is an asymmetry of information between minority shareholders and the controlling shareholders. This will usually result in both an adverse selection and a moral hazard problem.[282] With the emergence of these problems in family-based corporations, agency costs will rise as the share of outside shareholders increases and scatters. That is, the dominant conflict of interest occurs between the family-owner (majority shareholders) and minority shareholders in the structure of family concentrated share ownership.

In South Korea, large conglomerate groups, known as chaebol groups, developed after the Second World War. The Korean government offered these groups low-cost loans and other incentives to establish corporations in order to compete globally. The founding family members of most chaebol groups have managed and controlled these large conglomerates.[283] By the 1980s, the top 10 chaebol accounted for more than 20 percent of national income.[284] Research demonstrates that the largest 10 families in South Korea control about one-third of the corporate sector.[285] In 1997 family members possessed 8.5% of the total shares in the 30 largest chaebol, and group affiliates owned an additional 35% of the total shares within the group; within the five largest chaebol, family members' holdings in 1997 were 8.6% of the total shares

[282] See Haider A.Khan, 1999, 'Corporate Governance of Family-Based Businesses in Asia: Which Road to Take?', Paper prepared for the 2th anniversary symposium of ADBI, Tokyo (Dec.10),.
[283] See Terry L.Campbell,II and Phyllis Y.Keys, 2002, 'Corporate Governance in South Korean: The Chaebol Experience', Journal of Corporate Finance, Vol.8, Issue 4, (October), pp 373-391.
[284] See Marcus Noland, 2005, 'South Korean's Experience with International Capital Flows', Working Paper, Number WP 05-4, (June).
[285] See Stijn Claessens, Simeon Djankov, and Larry H.P.Lang, 2000, 'The separation of Ownership and Control in East Asian Corporations', Journal of Financial Economics 58, pp 81-112.

within the group and affiliates owned an additional 37%.[286] In a word, family control of companies in South Korea is strong.

The word chaebol, in fact, comes from the same two Chinese characters found in Zaibatsu, the word that depicts the pre-war Japanese business groups: Chae, meaning wealth or finance, and bol meaning lineage, faction or clique, with a strong connotation of exclusivity.[287] However a Korean chaebol is owned, controlled and managed by the family.[288] The term chaebol is commonly used to refer to conglomerates consisting of many related companies, including a number of companies listed on the stock exchange, which are engaged in a board range of industrial and service businesses. Most chaebol have highly centralized, autocratic management by the founder and his immediate family members. Since (until recently) the establishment of holding companies is prohibited, each chaebol group is controlled by the founder and his family through an intricate web of cross-company shareholdings and the relationship between companies is strengthened by intra-group loans and guarantees.[289] That is, the assets and management of a Korean conglomerate are controlled by family members and they heavily influence the operations and strategy of chaebol firms.[290] In South Korea, as mentioned above, one

[286] See Bernard S.Black, Coudert Brothers, and Shin & Kin, 2001, 'Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness', 26 Journal of Corporation Law, pp 551-552. (citing Yoan-Doo Cho, 1999, 'Corporate Governance in Korean: Issues and Options, p 6. (report to the Asian Development Bank)).

[287] SeeEuysung Kim, 2005, 'The Impact of Family Ownership and Capital Structures on Productivity Performance of Korean Manufacturing Firms: Corporate Governance and the "Chaebol Problem", J. Japanese Int. Economics, (March), www.elsevier.com/locate/jjie.

[288] See Ungki Lim, Chang-Soo Kim, 2005, 'Determinants of Ownership Structure: An Empirical Study of the Korean Conglomerates', Pacific-Basin Finance of Journal 13, p 2.

[289] See Bernard S.Black, Coudert Brothers, and Shin & Kin, 2001, 'Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness', 26 Journal of Corporation Law, p 551.

[290] E.g.Hattori, H., 1989, 'Japanese Zaibatsu and Korean Chaebols. In: Chung.K.H., Lee. H.C.(Eds.), Korean Managerial Dynamics. Praeger, New York, ,pp 79-95; Kong, B., 1995, A Study on the Ownership Structure of Korean Chaebol, Economic Studies42, pp 307-330; Lim, U., 2000, 'The Ownership Structure and Family Control in Korean Conglomerates', International Finance Review1, pp 397-310.

of the most important hidden liabilities within chaebols is the cross-guarantees for bank loans between chaebol affiliates, which will constitute a chain of risk once one affiliate or more are in financial trouble. All decisions within the group are made by a small group of family-related individuals in an informal way, including publicly quoted companies.[291]

With regard to a chaebol's ownership structure, the "chaebol problem" stemed from the fact that the interlocking-ownership structure between members led to the family control among chaebol subsidiaries, despite their low direct ownership stake, being virtually incontestable, and hence made it easy for chaebols to pass absolute corporate control within their own family from generation to generation, and small shareholders are easily exploited.[292] Because the characteristic structure of share ownership in companies in South Korea is family control, which results in management controlled or selected by the family, there is no doubt that conflicts of interest arise between the controlling shareholders (family owner) and smaller shareholders in corporate governance. Thus some scholars from South Korea make the point, "In order to avoid this type of market failure, it is quite crucial for Korea to take steps to correct opaque accounting as well as interest conflicts between minorities and controlling shareholders." [293] In a word, the excess of family blockholder's control rights over cash flow rights in typical firms gives rise to large

[291] See Stilpon Nestor and John K.Thompson, 'Corporate Governance Patterns in OECD Economies: Is Convergence Under Way? Working paper, http://www.oecd.org/dataoecd/7/10/1931460.pdf (visiting date:3.20,2007)
[292] SeeEuysung Kim, 2005, 'The Impact of Family Ownership and Capital Structures on Productivity Performance of Korean Manufacturing Firms: Corporate Governance and the "Chaebol Problem", J. Japanese Int. Economics, (March). www.elsevier.com/locate/jjie.
[293] See Ick Jin, TacHong Jin, and JeongHo Hahm, 2005, 'Path-dependency and Transition Strategy of Korean Financial System', The Journal of the Korean Economy, Vol. 6, No.1(Spring), p22.

agency costs, because the diversified business structure allows controlling chaebol families to expropriate other shareholders easily.[294]

Because companies are under family control shareholders, the company is often characterized not only by concentration of ownership but also by the presence of a CEO, Board Chairman or Vice Chairman who is also a controlling shareholder of the company. That is, the production, distribution, personnel, operation and decision on strategy of companies are controlled by majority shareholders. In addition, ownership of these firms is also characterized by the separation of voting rights from cash flow rights where control rights (or voting rights) of the largest shareholders often exceed the corresponding cash flow rights, which is helpful for the largest shareholders to control companies. It is clear that high voting rights may incur serious agency problems, and are often associated with pyramid ownership structures, and crossholding. Such cases are associated with an over-reliance on debt in order to continue controlling the company, because large shareholders are unwilling to dilute their ownership.[295]

In a word, in the structure of family concentrated share ownership, the selection or employment of management or other issues in companies is decided by family (controlling shareholders) under principle of one share on vote in company law, in particular under the circumstance of share without voting rights, companies only offer service for the family (controlling shareholders) in a sense. Conflicts of interest

[294] See Euysung Kim, 2005, 'The Impact of Family Ownership and Capital Structures on Productivity Performance of Korean Manufacturing Firms: Corporate Governance and the "Chaebol Problem"', J. Japanese Int. Economies,(March), www.elsevier.com/locate/jjie.

[295] See Nigel Driffield, Vidya Mahambare, and Sarmistha Pal, 2005, 'How Ownership Structure Affects Capital Structure and Firm Performance? Recent Evidence From East Asia', Working Paper, (May).

always take place between family (controlling shareholders) and minority shareholders in corporate governance. Minority shareholders will suffer from exploitation by controlling shareholders.[296]

3.3.4. In China: the structure of state-concentrated share ownership— majority shareholder (state) & minority shareholders model of corporate governance

Ownership of listed companies in transition economies tends to be highly concentrated. In Central and Eastern Europe, blockholders control on average between 40 and 50 percent of voting stock.[297] In China, there are more than 60 percent of non-tradable shares (today the reform is under way since on 29 April 2005) that are owned by the state directly or indirectly in listed companies.

Alternatively, there is a typical phenomenon of so-called insider control in corporate governance in transitional economies, where insiders, managers and /or employees, gain substantial control rights during the process of corporatization.[298] Therefore, the main issue of corporate governance in the transitional economy is how to design a device to deal with insider control problems, or this centralization of ownership and decentralization of control rights gives rise to a peculiar conflict

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[296] See Ok-Rial Song, 2002-2003, 'The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol', Law & Pol' y Int'l Bus. Vol. 34, pp 202-203.

[297] See BerglÖf, Erik, and Anete Pajuste, 2003, 'Emerging Owners, Eclipsing Markets?' in Peter Cornelius and Bruce Kogut, eds., Corporate Governance and Capital Flows in Global Economy. Oxford: Oxford University Press.

[298] See Aoki Masahiko, 1995, 'Controlling Insider Control: Issues of Corporate Governance in Transition Economies' in Aoki Masahiko and Hyung-Ki Kim(ed),

between the owners, or rather the state official who acts as owner, and managers and other state official as managers.[299] However, the situation is different from as described above in corporate governance in listed companies in China because more than 60% non-tradable shares are owned by the state. In practice, management is controlled by the state and managers of state-owned enterprises are typically responsible to political decision-makers instead of shareholders, and while the discretion of politicians is restricted by the limitations on political institutions as a monitoring system in a developing democracy, generally speaking managerial discretion is easy to control.[300] In other words, with the development of the market, the procedures for selecting new managers are increasingly sensitive to firm performance. Managers can be fired when firms are not performing well, and there is a significant turnover in managers within state-owned firms. The actual conflict of interest mainly takes place between the majority shareholder (the state) and minority shareholders (dispersed shareholders), which is a major agency problem in corporate governance in listed companies in China. How to tackle the agency problem in corporate governance has become a controversial topic in China.

According to the law and finance theory, a powerful State with a responsive legal system will make use of advantages to divert the flow of society's resources toward its goal and this power will hinder the development of a free, competitive financial system.[301] In the structure of state concentrated share ownership across the countries,

299 See J.Kornai, 1990, The Road to A Free Economy---Shifting from a Socialist System: the Example of Hungary, New York, W. W. Norton & Company.
300 See John Vickers and George Yarrow, 1991, 'Economic Perspective on Privatization', The Journal of Economic Perspectives, Vol. 5, No.2. (Spring,), pp 111-132.
301 SeeBeck, Thorsten, Asli Demirguc-Kunt and Ross Levine, 2003, 'Law, Endowment, and Finance', Journal of

because the state accounts for most of the shares in companies, the state will take its advantages of serving its social aim at the expense of companies or other shareholders, especially national policy in place of law under some circumstances. That is, sometimes the state as the biggest shareholder in listed companies pursues its political goals at the cost of other shareholders rather than pursuing profit maximization or efficiency, which should be usually given priority in a market economy. So the main conflicts of interest that arises in corporate governance is between the state as controlling shareholder and the public as minority shareholders. (This will be discussed in Part two below)

3.5. Conclusion

We must remember that in fact as a rule every shareholder (or say, everyone in the world) cares about his or her own asset or interests (or property rights) rather than companies only in different way. Because the issue of property rights concerns mainly whether or not ownership rights are assigned to individuals and ownership rights implies that if a person makes an investment in the company, as the investor he will be able to reap the profit of the investment. So investors will not invest if they do not have ownership rights over the returns on their investment in the company. Investors will not make an investment or they will exit from the company even if they have a property right, if the profits are subject to seizure by others. Concretely speaking, in

Financial Economics 70-2, , pp 137-81.

dispersed ownership countries, dispersed shareholders may use the "Wall Street Rule" to secure his or her asset or interests in companies when they have no choice and they have no incentive to supervise the management because of cost, time and skill etc. While in concentrated ownership countries, controlling shareholders will select or control management for their interests at the cost of minority. On the part of companies, cost is a determinant of whether they select debt or equity as external finance if they meet the requirements by law, which may lead to a change to a different structure of share ownership, namely dispersion and concentration. In terms of countries, the development or status of the economy fundamentally determines the structure of share ownership that must adapt to the level of economy.

Because these differences in costs, interests and economies can lead to different structures of share ownership, agency problems in corporate governance are varied. Where there is a structure of share ownership in the world, there will be a corresponding model of corporate governance across countries. That is the secret of the connection between the structure of share ownership and corporate governance. That is, corporate governance is determined by the structure of share ownership, and therefore ultimately by the economy (either macro-economy or micro-economy).

In sum, share ownership structure is an instrument to solve the trade-off between control and initiative because it determines the shareholders' incentives to monitor. Where there is a dispersed ownership structure, shareholders have no incentives to interfere in management because of free-rider problem, costs and skill etc., which will result in management's discretion and the agency problem will arise between the

management and shareholders. While where there is a concentrated ownership structure, majority shareholders have incentives to control and monitor management in order to promote their own interests, but this may be at the expense of other shareholders (minority shareholders), and the agency problem will mainly occur between majority and minority shareholders.

Chapter 4. Is it true that "law matters" (La Porta et al.) and "politics matters" (Mark. J. Roe etc.)?

The scholarship has discussed corporate governance over time and debated about what determines it. So far there are two influential points of view: one is the "law matters" theory by La Porta et al; other is the "politics matters" theory by Mark.J. Roe etc. This thesis argues that law and politics have a close relationship with the historical development of the company. They have had a great effect on the corporate governance in modern times but we should not emphasize excessively the importance of law and politics to corporate governance because they could not solve the major agency problems of corporate governance as a universal pattern across countries. Maybe law or politics plays a great role in corporate governance in a given country or region at particular time.

4.1. The "law matters" theory

Laws have a close relationship with corporate governance indeed. As we know, from the perspective of economics, in the process of the commercial activity by entities, conventions, practices and constrains of the market— "laws of game"— have such a profound impact on the belief, values, and normative understandings which influence the economic and social behavior of entities, or say, the "rules of the games" embody,

infuse, and propagate values which influence the behavior of individuals within institutions.[302] Since laws or rule of game will affect behavior of individuals, economy and society, let alone formal laws. As we know, law is very important for the economic and market development. In a sense the existence of a legal system that protects contract and property rights is a precondition for the economic development because, without the legal system, the legal interests of individuals would not be safeguarded and as a result there would be no transaction and no one would be interested in investment. Or, if they occurred, the cost of doing them would be too high.[303] Thus, in the absence of such a legal order, the development of markets will stop and economic growth will halt.[304] But we should not overstate the function of law in corporate governance. From the perspective of the development of long history, in particular for the current young market, it is legal change follows and serves the economic development, rather than the other way around.[305]

4.1.1. The brief content of "law matters"

It is very significant to improve the legal environment so as to reduce the conflict of interest between management and dispersed shareholders in the structure of dispersed share ownership, and between the controlling and minority shareholders and to make

[302] See John W.Cilffi, 2000,'State of the Art: A Review Essay on Comparative Corporate Governance: The State of the Art and Emerging Research', The American Journal of Comparative Law, Vol.48, p517.
[303] See North, D. 1990, 'Institutions, Institutional Change and Economic Performance', Cambridge, UK: Cambridge University Press.
[304] See Zhiwu Chen, 2003, 'Capital Markets and Legal Development: The China Case', China Economic Reveiw14, p452.
[305] See Zhiwu Chen, 2003, 'Capital Markets and Legal Development: The China Case', China Economic Reveiw14, p452.

expropriation of a minority more difficult in the structure of concentrated share ownership. But some scholars argue that the law determines corporate governance. In fact the "law and development" movement that legal engineering intended to facilitate socio-economic development in countries occurred in the 1960s, which by 1975, had been declared a failure at all.[306] The ideal that "law matters"— reinvigorated in large part by Rafael La Porta et al. (hereafter "LLSV" or "La Portal et al.") advocated only legal reforms that were expected to offer adequate legal protection to investors in the 1990s in order to improve corporate governance.[307] They argue that deep capital markets cannot be developed and corporate governance could not be improved unless shareholder-friendly fundamental legal reforms are adopted as a precondition.

To understand better the importance of legal protection of investors in advanced countries or regions, in particular protection for minority shareholders, Rafael La Porta et al. use a sample that covers 49 countries from Europe, North and South America, Africa, Asia, and Australia. There are no countries or regions with a character of socialist or "transition" economies in the sample. A country is selected for inclusion if, on the basis of the WorldScope sample of 15,900 firms from 33 countries and the Moody's International sample of 15,100 non-U.S. firms from 92 countries, that country has at least five domestic non-financial publicly traded firms with no government ownership in 1993.[308] The above countries are classified traditionally

[306] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p 251.(citing Kevin E.Davis & Michael J.Trebilcock, 2001, Legal Reforms and Development, 22 Third World Q.21).
[307] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p251.
[308] See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 1998, 'Law and Finance', Journal of Political Economy, Vol.106, No.6, p1117.

into civil law and common law according to the following criteria.

> "(1) historical background and development of the legal system, (2) theories and hierarchies of sources of law, (3) the working methodology of jurists within the legal systems, (4) the characteristics of legal concepts employed by the system, (5) the legal institutions of the system, and (6) the divisions of law employed within a system."[309]

Based on the above standard, civil law families are further classified into French-civil-law countries, German-civil-law countries and Scandinavian-civil-law countries. The authors analyze laws pertaining to investor protection, and specifically in company and bankruptcy/ reorganization law. LLSV mainly analyze the importance of law to corporate governance by six indicators for minority shareholders protection. These six indicators are: proxy by mail allowed, shares not blocked before meeting, cumulative voting, oppressed minority, preemptive right to new issues, and percentage of share capital to call an extraordinary shareholder meeting. There are four indicators for creditor protection. They are no automatic stay on secured assets, secured creditors first paid, restrictions for going into reorganization, management does not stay in reorganization. With regard to each indicator, if a country or region protects minority shareholders (or creditors) according to their measures, it gets a score of 1 and a score of 0 otherwise. These measures are supplemented by more or less generally accepted indices of "rule of law" and quality of accounting standards. After making

[309] See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 1998, 'Law and Finance', Journal of Political Economy, Vol.106, No.6, p 1118.(citing Glendon, Mary Ann; Gordon, Michael W.; and Osakwe, Christopher, 1994, ' Comparative Legal Traditions: Text, Materials and Cases on the Civil and Common Law Traditions, with Special References to French, German and English', St.Paul, Minn.: West, p 4-5).

comparisons by their designed criteria, they conclude: Common-law countries generally have the strongest, and French-civil-law countries the weakest, legal protections of investors, with German- and Scandinavian-civil-law countries in the middle.[310] They conclude that common law systems do produce superior economic growth. They put emphasis on the importance of the laws that protect minority shareholders, that is, common law countries provide legal protection more extensively and enforce law more effectively. They argue that it is the reason that the content of legal rules of different countries demonstrated these corporate governance puzzles.[311] In addition, they analyze law enforcement and ownership that have a close relationship with legal protection of investors in the paper.

Before or after that, La Porta et al emphasize repeatedly the importance of law to corporate governance rather than other things in provocative series of papers. For example, Anderi Shleifer and Robert W. Vishny point out, "much of the difference in corporate governance systems around the world stems from the differences in the nature of legal obligations that managers have to the financers, as well as in the differences in how courts interpret and enforce these obligations."[312] They lay an emphasis on the importance of law to corporate governance and argue that legal protection of investor rights is one essential element of corporate governance. Thus they draw the conclusion: "corporate governance systems of the United States, Germany, and Japan have more in common than is typically thought, namely a

[310] See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 1998, 'Law and Finance', Journal of Political Economy, Vol.106, No.6, p 1116.
[311] See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 1998, 'Law and Finance', Journal of Political Economy, Vol.106, No.6, pp 1114-1115.
[312] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p 750.

combination of large investors and a legal system that protects investor rights. Corporate governance systems elsewhere are less effective because they lack the necessary legal protection."[313]

4.1.2. Shortcomings of "law matters"

Although law is very important to corporate governance, especially after a market reaches certain mature stage, the argument by La Porta et al is doubtful. First of all, the design of the anti-director index regarding investor protection is not effective or reliable. For example, Belgium is the only country that received a score of zero in the 1998 version of "Law and Finance" by La Porta et al. But Belgium should have a score of four rather than zero.[314] The first right in the anti-director index is whether shareholders can send their proxy by mail rather than show up in person or send an authorized representative to the general meeting. There is a score of one if shareholders can mail their proxy vote to the firm under the company law or commercial code, and zero otherwise.[315] LLSV grants Belgium a score of zero. In fact, the Companies Code in Belgium unequivocally specifies that a shareholder can vote in person or by proxy. The Companies Code does not explicitly stipulate that shareholders can mail their proxy to firm, but there is no doubt that they can. Accordingly, as regards proxy by mail allowed, the score for Belgium should get a

[313] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p770.
[314] See Sofie Cools, 2004, 'The Real Difference in Corporate Law Between The United States and Continental Europe: Distribution of Powers', Discussion Paper No. 490, 09/2004.
[315] See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, , 1998, 'Law and Finance', Journal of Political Economy, Vol.106, No.6, pp 1122-1127.

score of one instead of zero.[316] With regard to cumulative voting or proportional representation, it is true that the Belgian Companies Code does not explicitly specify cumulative voting and proportional representation. As a matter of fact, case law and doctrine imply that the charters can validly specify cumulative voting and proportional representation. Such a provision may be in conformity with any provision of the Companies Code. Hence, Belgium should get score of one in place of zero in this aspect.[317] Apparently the indictors for statistical analysis by La Porta et al have a lot of shortcomings. As scholars point out, while the quantitative analysis of law has seemed superficially much attractive in legal issues and has created interesting results, such analysis has at least the following limitations. Firstly, the result of the indicator designed by La Porta et al is unfair. Coding legal provisions as binary variables while giving each indicator equal weight assume that counting the number of indicators indicates better legal protection. In fact, each indicator plays a different role, has different functions and weighs differently in the law. That is, that the above study by LLSV gives each indicator the same value in each country in their sample on an equal-weight basis is unreliable. Adding more indicators may distort the picture rather than help assess differences in the quality of law. Secondly, the criteria of indicators may be biased against some jurisdictions, because conventions, practices or implicit legal constraints may have the same effect as a large number of explicit rules. In other words, there are no explicit stipulations on "anti-director" provisions in

[316] See Sofie Cools, 2004, 'The Real Difference in Corporate Law Between The United States and Continental Europe: Distribution of Powers', Discussion Paper No. 490, 09/2004.
[317] See Sofie Cools, 2004, 'The Real Difference in Corporate Law Between The United States and Continental Europe: Distribution of Powers', Discussion Paper No. 490, 09/2004.

some countries, but in practice the court recognizes the legality of it and the outcome of enforcement is desirable, for instance, in the case of Belgium above. Thirdly, some of the indicators used by LLSV do not necessarily indicate greater the protection of minority shareholders. Some scholars point out that a closer analysis of the indicators that have been used in previous studies reveals that their function may be more ambiguous than has been assumed (e.g. preemptive rights, as one of the indicators in their anti-director index, may benefit existing block-holders in place of minority shareholders, because they force the company to return to existing financiers rather than reach out to new investors, as a consequence, giving rise to a more dispersed ownership structure over time).[318] Fourthly, could the six indicators for protection of minority shareholders, plus other four points for creditor protection, represent the law of the country as a whole? In other words, the ten indicators can not really be used to judge which country's law is much better than others regarding the protection of investors or corporate governance. Therefore the result by La Porta et al may not be true. That is, they draw the conclusion that the Common law systems are much better than the Civil law systems with regard to investor protection and corporate governance as determined by law, which is not right.

Second, the practical impact of formal law is difficult to measure from a reading of law in the books. Other facts, such as local practices, customs, culture, functional substitutes and business norms, may improve, create, lessen or even remove the actual

[318] see Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West , 'The Evolution of Corporate Law , A Cross-Country Comparison. The University of Pennsylvania Journal of International Economic Law', Vol. 23, Issue 4, pp 791-971.

impact of formal laws.[319]

According to the logic of La Porta et al., if minority shareholders are given more legal protection, the economy or finance will develop efficiently and fast. That is, countries in Common law systems financially developed faster at the turn of the 20th century because investor protection was much better than that of any other place in the world, but the situation is contradictory. Some scholars point out: "More generally, by most indicators, the main countries of Continental Europe were more developed financially in 1913 than the United States. In fact, in contrast to the findings of La Porta et al. (1997) for the 1990s, we find that countries with Common Law Systems were not more financially developed in 1913."[320] In Italy, the structure of ownership was more concentrated in the1980s than in the 1940s. Family controlled groups and pyramids were more common in the 1980s than in the 1930s. Does this mean that laws concerning the protection of investors were better in the past than they are now? These findings do not agree with the view of La Porta et al that the stock market development and ownership concentration are invariably related with investor protection.[321]

Of course, sometimes the above analysis by LLSV is reasonable in a sense, namely legality may play a role in the actual working of corporate governance systems. Well-functioning legal systems not only protect outside investors and this in turn should enhance firms' ability to raise external funding easily and cheaply, but

[319] See Nei Fligstein and Jennifer Choo, 2005, 'Institute of Industrial Relations', Working Paper.
[320] See Raghuram G.Rajan and Luigi Zingales, 2003, 'The Great Reversals: The Politics of Financial Development in the 20th Century', 69 J.Fin.Econ.5.
[321] See Alexander Aganin, and Paolo Volpin, 2003, 'History of Corporate Ownership in Italy', Finance Working Paper,(March).http:// ssrn.com/abstract=391180.

also restricts expropriation by insiders that should result in less price protection for outsider investors.[322] For example, mass privatization that caused the securities market to crash happened overnight in the Czech Republic, at least in part due to the absence of investor protection.[323] But the analysis is not universal, for example, four Scandinavian nations protect minority stockholders well by law, but why are their corporate governances not as good as that of America? Many of the same nations by measurement have good corporate law as well as good contract law or other laws of high quality. For example, all the Scandinavian nations, Germany, and several other continental European countries have the same enforcement of contract as the United States does.[324] But it seems that the quality of corporate governance is quite different in these nations, and the above theory can not explain the reason from the perspective of legal protection. In addition, shareholder rights are stronger in countries belonging to the English-speaking cultural region. However, the qualities of laws in these countries are not better than others in protecting creditors. This casts doubt on the claims of superiority of the law in common law countries for protecting investors[325] because creditors are investors too. As Professor Coffee points out, the principal weakness of the "law matters" thesis is its narrow focus on the rights of minority

[322] See Luzi Hail and Christian Leuz, 2005, 'International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter? Working Paper, (December). (Forthcoming in Journal of Accounting Research June 2006)

[323] See John C.Coffee, 2001-2002, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', The Yale Law Journal, Vol.111,2, p 23.

[324] See Mark J.Roe, 2003, Political Determinants of Corporate Governance: Political Context, Corporate Impact, Oxford University Press Inc. New York, p192 (citing Gerald P.O'Driscoll, Kim R. Holmes, and Melanie Kirkpatrick, 2001 Index of Economic Freedom 18 (2001) (Denmark, Finland, Germany, Norway, Sweden, and the United States protect private property and contract strongly and have largely efficient legal systems) The index, a crude one, purports to measure both property rights and 'the ability of individuals and business to enforce contracts'. Id. at 57. Cf. Ross Levine, 1999, 'Law, Finance, and Economic Growth', 8 J.Fin. Intermediation 8, 14-15, 20).

[325] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p232.

shareholders and on enforceable legal rights in theory and on paper rather than in practice, just considering the distinction between common law and civil law.[326] In reality, within common-law systems, the differences between common-law systems are sometimes greater than those between civil-law systems and common-law systems in certain key respects. For example, corporate-insolvency law illustrates the point in England and the USA. Despite their common legal origin, corporate-insolvency law in the two countries is quite different. For instance in England the court emphasizes the terms of debt contracts, while in the USA the courts have to put emphasis on the contractual rights of lenders, particularly as regards liquidation rights of secured creditors. In the area of corporate governance, there are many different too. For example, levels of anti-shareholder devices in the USA are higher than in the UK, such as poison-pills, state legislation, and a variety of corporate board entrenchment devices being widely applied in the USA but not in the UK. With regard to hostile takeover, the UK and U.S. are greatly different in their respective reliance on standards and decision-making strategies for solving the management— shareholder agency problems. It seems more flexible and more protective of managers in the USA.[327] Therefore some scholars point out, it is unreasonable because financial systems are too changeable to be explained by fixed legal origins, for example the structure of financial systems at the beginning of the 20th century was quite distinct

[326] See John C. Coffee, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control.' Columbia Law School, The Center for Law and Economic Studies, 435 Wesr 116th St. New York, NY10027-7201, Working Paper No.182/2001.
[327] See Reinier Karrkman et. al. 2004, The Anatomy of Corporate Law: A Comparative and Functional Approach, Oxford University Press, pp 163-173.

from that at the end of the 20th century.[328]

LLSV have emphasized the importance of the legal conditions (backdrop): dispersed ownership is possible in their view only when the legal system provides adequate protection for minority shareholders. Yet modern history seemingly supplies two counterexamples.[329] The U.S and U.K. law did not yet comprehensively adopt the standards of minority protection that LLSV contemplate as the precondition for dispersed ownership before the change of structure of share ownership had taken place in the direction of dispersion. For example, the structure of ownership began the development of dispersion from the 1890s in America. In other words, before the Securities Act of 1933 and the Securities Exchange Act of 1934 were promulgated, the structure of dispersed share ownership had taken place in the U.S. Even in the U.K., the structure of ownership started dispersion from the 1940s to the 1970s when the protection of minority was weak. For instance, in the UK, there was a landmark case of unsuccessful litigation by an injured investor in 1843 that refused to offer minority investor protection in *the Foss v. Harbottle* case. *Foss v. Harbottle* (1843), seriously restricted minority shareholder rights for the next hundred years. The judge made two important rulings: the company as the proper plaintiff in an action of an alleged wrong to a company itself, instead of the minority shareholder, and, where a transaction can be made binding by a majority of the shareholders, then an individual shareholder can not bring an action against the company.[330] As Lord Justice Hoffman

[328] See Colin Mayer, Oren Sussman, 2001, 'The Assessment: Finance, Law, and Growth', Oxford Review of Economic Policy, Vol.17, Iss. 4, (Winter), p 457.
[329] See John C.Coffee, 2001-2002, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', The Yale Law Journal, Vol.111,2, p 24.
[330] See Julian Franks, Colin Mayer, and Stefano Rossi, 2002, 'The Origination and Evolution of Ownership and

has noted, this case had repercussions for minority investor protection for over a century: "A statutory remedy was provided for the first time in 1948 but this proved relatively ineffectual. It was not until 1980 that Parliament forged the sword which is now section 459 of the Company Act 1985 and which enables the unfairly treated minority shareholder to slay the dragon."[331] According to the logic of La Porta et al., the U.K. should have had the structure of highly concentrated ownership like most European countries until investor protection was offered. But on the contrary, the dispersion of ownership began to develop rapidly in the first half of the twentieth-century through issuance of shares to local investors on provincial exchanges in the UK.[332]

As we know most European countries have codification in law in contrast to precedent (case law) in Common Law Systems. But many lawyers have been critical of the classification of countries by legal origins. They find the distinction between common law and civil law particularly superficial. In fact there is some overlap in the sources of law or form of legislation between common law and civil law. For example, a considerable degree of codification has been enacted in common law countries (for instance, many of the rules protecting investors under US law are described in the Uniform Commercial Code and creditor protection is in part defined by the Bankruptcy Code of 1978) and powerful bodies of case law are recognized practically

Control', Working Paper, 15 (December).

331 See Julian Franks, Colin Mayer, and Stefano Rossi, 2002, 'The Origination and Evolution of Ownership and Control', Working Paper, 15 (December). (cited in the foreword to Robin Hollington's Minority Shareholders' Rights, 1999, Sweet and Maxwell, London).

332 See Julian Franks, Colin Mayer, and Stefano Rossi, 2002, 'The Origination and Evolution of Ownership and Control', Working Paper, 15 (December).

in civil law countries.[333] Since investor protection by law will improve corporate governance greatly, why have countries with a civil law system not transformed governmental policy into law because laws emanate more easily from the centre rather evolving through judicial decisions in those countries where the government systems is more centralized? The problem is not just simple.

Law is very important to the development and improvement of corporate governance in the world, but law is very limited. Because law only resolves part of the agency problem, or say, law only reduces some of the agency cost and obvious examples are rules and procedures that enhance disclosure by the agent or facilitate enforcement actions brought by principals against dishonest or negligent agents, but many agency problems can not be resolved by the law. For example, in America managerial agency costs are sum of managers' thievery (unjustifiably high salaries, self-dealing transactions, insider trading, etc) and their mismanagement (over-investment; under-investment; negligent action, etc) in the structure of dispersed ownership, the business judgment rule in law only regulates the former in America but has nothing to do with latter. That is, unless the management has a conflict of interest or acts fraudulently, the business judgment rule does nothing in America because judges prevent directors and managers from legal inquiry. In the case of controlling shareholders in the structure of concentrated ownership, similar legal doctrines (the one share-one voting right, or one share without voting right) prevent the controlling shareholder from a lawsuit for a non-conflicted mistake. Because the controlling

333 See Eriik Berglöf and Ernst-Ludwig von Thadden, 1999, 'The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries', Working Paper, (June).

shareholder possesses a majority share in the company, it internalizes much of the cost of any mistake, as a result every shareholder will bear the cost in proportion to his share. Law may reduce stealing, but can not solve problems, such as non-conflicted dissipation and mismanagement.[334] In a word, law can not control all agency problems or reduce agency cost from poor decision in the world.

Commentators came to share the view that it is not enough to simply write investor rights into the law.[335] In reality laws stipulate the protection of investors to the varying degrees in countries. For instance, when investors finance firms, they will get protection through the enforcement of regulations and laws. Some of these rights include disclosure, audit and accounting rules. Protected shareholder rights include receiving dividends on pro-rata terms, suing for directors or the majority shareholders for suspected expropriation, etc. Protecting creditor rights include repossessing collateral, protecting their seniority in bankruptcy and reorganization procedure.[336] However, only adequate protection rights in law will not definitely improve corporate governance. For instance, several countries formerly under communist regimes carried out legal reforms during the 1990s in order to enhance investor protection. With few exceptions, these reforms results varied from disappointing to ruinous.[337] It was thought that since law is a determinant of corporate governance, countries with a

[334] See Mark J.Roe, 2003, Political Determinants of Corporate Governance: Political Context, Corporate Impact, Oxford University Press Inc. New York, pp 171-173.
[335] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p 230.
[336] See Rafael La Porta, Florencio Lopez-de-Silances, Andrei Shleifer, Robert Vishny, 2000, 'Investor Protection and Corporate Governance', Journal of Financial Economics 58, p7.
[337] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p 230.(citing Bernard Black, Reinier Kraahman, & Anna Tarassova, 2000, 'Russian Privatization and corporate Governance: What Went Wrong?' 52 Stan.L.Rev. 1739; Edward Glaeser, Simon Johnson, & Andrei Shleifer, 2001, ' Coase versus the Coasians' 116Q. J.Econ. 853).

transitional economy should imitate the law of advanced economies, like the rules of common-law legal systems in order to develop their economies. But the outcome in transitional countries is contrary to the theory of La Porta et al. Some researchers have warned that attempts to "transplant" law in this fashion must not usually be successful if the legal rules so adopted are not consistent with local customs and traditions.[338] The example shows the law is limited, only shareholder protection in law may not be adequate to facilitate the sustainable economic development, although law is very important, especially in transition economies.[339]

One must remember that shifts in the system of corporate governance and the structure of share ownership should precede and not follow shifts in legal rules.[340] The development of the economy, strong markets, and a good model of corporate governance do create a demand for strong legal rules. In practice, the federal securities law passed in the 1930s in the U.S., the Company Act amendments adopted in the late 1940s in the U.K., the Stock Exchange Law of 1896 enacted in Germany, the Company Law of 1993 passed in China were a response to this demand, not vice versa. But we can not say that law is a precondition to their development because many laws have been passed in both developing countries and transition countries, but corporate governance is the same as before: China is a good case. Today the law system in the book in China is relatively complete. Generally speaking, laws or

[338] See Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 2000, 'Economic Development, Legality, and The Transplant Effect', SSRN Elec. Library, Working Paper No.183,269.
[339] See Erik Berglöf & Ernst-Ludwig won Thadden, 1999, 'The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries' in Annual World Bank Conference on Development Economics 135.
[340] See John C. Coffee, 2001, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control.' Columbia Law School, The Center for Law and Economic Studies, 435 Wesr 116th St. New York, NY10027-7201, Working Paper No.182/2001.

regulations enacted in developed countries can be found in China except for some in unusual fields, and apart from a lack of detail. However, corporate governance is not good as we would expect. In addition, according to the logic of "law matters" by La Porta et al., in countries with weak protection for minority shareholders, both the demand and supply of new share will be low. Individuals will be reluctant to purchase shares for fear of being exploited by the manager or controlling shareholders. However, in China, individuals or other entities are eager to purchase new shares at the stage of IPOs. Even in the second market, the turnover velocity for China's listed firms is 500%, much higher ever than that NASDAQ with the well-known trading patterns of technology stocks in recent years,[341] including purchasing shares in the first and second markets in 2007. At least the theory of "law matters" is not suitable for China indeed.

In addition, in the paper "A Survey of Corporate Governance", the authors point out, "Corporate governance deals with the agency problem: the separation of management and finance. The fundamental question of corporate governance is how to assure financiers that they will get a return on their financial investment."[342] "Financiers" above include not only shareholders but also creditors of investment in companies without doubt. On the one hand, they place emphasis on the importance of law (in particular company law) to corporate governance. On the other hand, they fail to take account of an important distinction in the law, because they treat shareholders

[341] See Franklin Allen, Jun Qian, and Maijun Qian , 2002, 'Law, Finance, and Economic Growth in China', Working Paper, The Wharton Financail Institutions Center, (December).
[342] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', the Journal of Finance, Vol. LII, No. 2, June, p 773.

and creditors of investment as financiers who are identical in the eyes of an economist (e.g. "the initial investors have no special ability to help the firm once they have parted with their money"[343]). This implies that there is no difference between shareholders and creditors of investment in company and it seems company law should not exist any more, and investment law or enterprise law could replace it. As a matter of fact, shareholders and creditors are quite different in company laws in every country where shares and shareholders are one of the central topics in company laws while creditors are protected by other laws or contracts.

4.1.3. Conclusion

I accept that a good legal environment will benefit the development of the economy and promote the improvement of corporate governance. But I can not agree with the "law matters" theory by La Porta et al. based on the above analysis. As North pointed out, the adoption of the U.S. Constitution by South American countries did not result in democracy.[344] Following the collapse of socialist system in late 1980s, countries in Central and Eastern Europe and the former Soviet Union reestablished their legal systems drawing heavily on the European and the United States models.[345] But what about corporate governance in these countries? At least the "law matters" theory by La Porta et al. is not universal across all countries.

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343 See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', the Journal of Finance, Vol. LII, No. 2, (June), p 748.

344 See North, Douglass C, 1991, 'Institutions' J.Econ. Perspectives 5, (Winter), pp 97-112.

345 See Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 2000, 'Economic Development, Legality, and The Transplant Effect', SSRN Elec. Library, Working Paper No.183, 269.

4.2. The "politics matters" theory[346]

Politics is taken to be a process by which a group of people with differing interests reach an accommodation. The view originates ultimately from Aristotle, who said politics are the processes by which order is maintained in a polis (for Aristotle, the Greek city-state) which is an aggregate of the people, and the concept will apply to organizations or unit, such as a department, a company or members of a sports club as to a city or a nation state. Finally, the accommodations which are created, changed or ended by politics will ultimately count on dispositions of power.[347] In a word, politics is a process by which a group of people or a state makes the policy or law for the people, which is the result of compromise between the different interest groups.

4.2.1. Summary of "politics matters"

Politics affect all aspects of life in our society indeed, including the structure of ownership and corporate governance. However, some scholars think most systems of governance arise out of struggles over the rights and roles of capitalists and workers in democratic and authoritarian societies, in other words, that the corporate

[346] The view that corporate governance is determined by politics is supported by some scholars, eg.Marco Pagano & Paolo F. Vovpin, 2000, 'The Political Economy of Corporate Governance', CSEF Working Paper No 29; Raghuram G.Rajan and Luigi Zingales, 2003, 'The Great Reversals: The Politics of Financial Development in the 20th Century', 69 J.Fin.Econ.5; Mark J.Roe, 2003, Political Determinants of Corporate Governance: Political Context, Corporate Impact, Oxford University Press Inc. New York.
[347] See Peter Chechland and Jim Scholes, 1990, Soft Systems Methodology in Action, John Wiley and Sons Ltd, p 50.

governance is determined by politics. Recently the research has shown that, historically, political pressures are the same important as economic ones in the evolution of corporate governance systems, for example, Professor Roe argues that politics rather than economic efficiency created American corporate law, at the federal level. Professor Roe further provides a detailed account of how the American political system systematically discouraged large investors. That is, with politicians' effort in the history of American, banks, insurance companies, mutual funds, and pension funds were all prevented from becoming influential in corporate affairs, or at least the above institutions did not have big enough shareholding to interfere in the affairs of companies due to the role played by politicians in history. The hostile political response to the 1980s takeovers can be considered as another good example of the influence of politics on companies.[348]

Politics, without question, is very important to corporate governance. In a sense, politics can influence a firm in many ways, for example politics and its policy have a close relationship with the following cases: how firm raises capital, who has the capital to invest, how managers or employees treat themselves and one another, and how authority is allocated inside the firm etc.[349] Professor Roe analyzes the relationship between politics and corporate governance based on data by graphs and tables in detail in his famous book "Political Determinants of Corporate Governance: Political Context, Corporate Impact", and lays the emphasis on the effect of politics

[348] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p 771 (citing Grundfest, Joseph, 1990, 'Subordination of American Capital', Journal of Financial Economics 27, pp 89-114; Jensen, Michael, 1993, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems', Journal of Finance 48, pp 831-880.).
[349] See Mark J.Roe, 2003, Political Determinants of Corporate Governance: Political Context, Corporate Impact, Oxford University Press Inc. New York, p 1.

on corporate governance in some developed countries, for example, lifetime employment to many employees in Japan, and particularly labor codetermination in boardroom in Germany, which have a great effect on the corporate governance of those countries. At present, for example, the German law of codetermination is contained in several different statutes. Under sections 76-117 of the German Stock Corporation Act, German public corporations have a two-tier board structure but limited liability companies usually have a single board. The managing board is responsible for day-to day operations. By contrast, the supervisory board is, inter alia, responsible for appointing and supervising the managing board. The corporation's shareholders generally elect at least half of the members of the supervisory board. According to the Coal and Steel Codetermination Act of 1951, which was supplemented by the Supplementary Act to the Coal and Steel Codetermination Act in 1956, and the Codetermination Act of 1976, companies that employ more than 2000 workers have to form a supervisory board with half members selected by workers. Under the Industrial Constitution Act of 1952, the companies employ more than 500 workers and have to form the supervisory board with one third of members selected by employees.[350] In sum, the codetermination influenced by politics in Germany is understood to contribute to the goals of protecting workers, such as standing against their employers' abuse of power, fostering working conditions, stopping the abuse of market power, and safeguarding the integrity of the political process.[351] Thus some

[350] See Jens C. Dammann, 2003, 'The Future of Codetermination After Centros: Will German Corporate Law Move Closer to the U.S. Model?', Fordham J. Corp. & Fin. L. Vol. VIII, pp 619-621.
[351] See Jens C. Dammann, 2003, 'The Future of Codetermination After Centros: Will German Corporate Law Move Closer to the U.S. Model?', Fordham J. Corp. & Fin. L. Vol. VIII, p 670.

scholars always take Germany as an example to show the influence of politics on corporate governance, because they always think that codetermination is the result of politics.

After research for comparisons, Professor Roe remarks in his book: there is a powerful political pre-condition to ownership separating from control, to the rise of the structure of dispersed ownership, and to the eventual disappearance of block and family ownership in the United States, namely the absence in the U.S. of a strong social democracy. In other words, the structure of dispersed ownership in America is attributable in part to powerful politics. Professor Roe continues, where the social democracy is strong, there is concentrated ownership, otherwise dispersed ownership.[352] That is, whether ownership is concentrated or dispersed is the result of politics in broad sense. It means politics determine corporate governance.

To sum up the features of the politics thesis: First, the political process as being determined by coalitions between different interest groups. In the agency view of the firm, managers are employed to act in the interests of shareholders. But in order to defend their interest respective, workers and managers as a group have to stand together against shareholders to protect private benefits and high wages from shareholders and others. For example, managers have private benefits of control that they wish to protect from shareholder intervention. They seek to limit shareholder rights and to avoid takeovers that could result in managerial dismissals and the loss of private benefits of control. However managers are always controlled or monitored by

[352] See Mark J.Roe, 2003, Political Determinants of Corporate Governance: Political Context, Corporate Impact, Oxford University Press Inc. New York, pp 6-7.

shareholders. They therefore have to require the support of workers in minimizing investor protection and making troubles against takeovers, and in return they must offer workers higher wages and continue employment. It is private benefits of control that bring the interests of managers in line with those of workers, and the coalition between managers and workers is against the interest of shareholders. Second, laws and regulations are an outcome of the bargaining and coalition formation between different interest groups.[353]

4.2.2 The drawback of "politics matters"

Is the above viewpoint of politics true? The answer is "No", or the viewpoint is unreliable at least. As we know, although Germany and Japan in history were influenced deeply by politics, the trouble is, the argument that the political process serves the powerful interests in the economy rather than maximizing social welfare applies to Germany and Japan as well. Politics serve and are subject to economy. Both countries have created their systems of powerful banks at the end of 19th century, during a period of rapid economic growth, and with strong support from the state.[354] In both countries, policies of the United States tried to ruin the powerful financial

[353] Some scholars have similar viewpoint .e .g. see Colin Mayer, Oren Sussman, 2001, 'The Assessment: Finance, Law, and Growth' , Oxford Review of Economic Policy, Vol.17, Iss. 4, (Winter), p457; also see Mark J.Roe, 2003, 'Political Determinants of Corporate Governance: Political Context, Corporate Impact', Oxford University Press Inc. New York, pp29-46; also see Marco Pagano and Paolo Volpin, 2005,'The Political Economy of Corporate Governance', American Economic Review, (September), Working Paper, No.29).

[354] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p 771 (citing Gerschenkron, Alexander, 1962, 'Economic Backwardness in Historical Perspective', Harvard University Press, Cambridge MA).

institutions during the occupation after World War II [355] and in both countries it failed to set up new institutions as planned.[356] As Professor Coffee points out, "the U.S. and European experiences in the late 19th century suggest that the first step is the separation of the market from politics. When, as in late 19th century France, the government administers the market, the market suffers."[357] The means that politics indeed have a great effect on the market, the structure of ownership, and corporate governance etc. in a given country, but its function is as a limitation instead of a determinant. However, even if the theory by Mark J. Roe is right for a particular country or region, as Professor Coffee points out, the Roe social-democrat thesis does not explain the origins of concentrated ownership in any other country, and certainly does not fit the situations in Asia or much of the Third World.[358] In addition, although employee participation in the supervisory organ is also mandated (with qualification) in Austria, Denmark, Germany, Luxembourg, the Netherlands, and Sweden,[359] it should be emphasized that employees as members of the supervisory board do not have formal decision-making power.[360] That is, the employee as members of the supervisory board can take part in the activities of supervision over management, but

[355] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2, (June), p 771(citing Adler, Hans, 1949, ' The Post-War Reorganization of The German Banking System', Quarterly Journal of Ecnomics 63, pp 322-341).
[356] See Anderi Shleifer and Robert W. Vishny, 1997, 'A Survey of Corporate Governance', The Journal of Finance, Vol. LII, No. 2,(June), p 771.
[357] See John C. Coffee, 2001, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control.' Columbia Law School, The Center for Law and Economic Studies, 435 Wesr 116th St. New York, NY10027-7201, Working Paper No.182/2001.
[358] See John C.Coffee, 2001-2002, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', The Yale Law Journal, Vol.111,2, p74.
[359] See Luca Enriques, 2003, 'Silence Is Golden: The European Company Statute as a Catalyst for Company Law Arbitrage (ECGI Law Working Paper No. 07/2003) (citing Weil, 2002, Gotshal & Manges LLP, Comparative Study of Corporate Governance Codes Relevant to the European Union And Its Member States, Final Report & Annexes I-III, AT 44).
[360] See Amir N. Licht, 2003, 'The Maximands of Corporate Governance: A Theory of Values and Cognitive Style' Law Working Paper N. (November). www.ecgi.org/wp.

have no power to determine or influence directly the management of the company in those countries, so the function or influence of employees is limited. In other words, the coalition or alliance between managers and employees that is assumed in theory is impossible in practice.

According to the theory of "politics matters", under appropriate political condition there is a foundation for an alliance between managers and employees that could stand against shareholders. It suggests that politics have a very close relationship with corporate governance because social democratic policies potentially could aggravate agency costs by promoting an identity of interest between managers and employees. In other words large public companies in social democracies are essentially forced to behave like growth-maximizing firms from which managers and employees can get much more benefit than shareholders, who will receive a small dividend.[361] However, the empirical study by scholars is contrary to the theory of "politics matters". Some scholars have studied dividend pay-outs made by British public companies between 1949 and 2002 so as to discover possible relationships between politics and corporate governance. Surprisingly, the results contradict the proposition that politics affects corporate governance. If politics "mattered" then dividend pay-out should have been higher when Britain had a right-wing government and lower when the government was on the left-wing of the political spectrum. The study indicated that there was no meaningful statistical relationship between the politics and dividend distribution in

[361] See Dennis C.Mueller, 2005, 'The Economics and Politics of Corporate Governance in the European Union', Law Working Paper No.37/2005, (May). www.ecgi.or/wp.

British public companies during that time.[362] Why dividends? Because dividend policy can act as a "bonding" mechanism for managers to attempt to maximize share value for the company, ultimately in the interest of shareholders. In accordance with Michael Jensen's free cash flow theory, in essence, managers take the opportunities to use cash from the operations of a company in the interest of themselves rather than shareholders. One way to prevent management from diverting corporate funds is to set a high, fixed pay out ratio.[363] This could be achieved through a high debt-equity ratio, or a mechanism like dividends. In addition, dividend policy in the company can be considered as an important "signaling" function to the outside.[364] When the dividend decreases in a company, this will be interpreted by the market as a powerful signal of bad news about the operation of company, and the failure to meet an anticipated dividend level can activate alternative corporate governance mechanisms that try to improve financial distress or solve corresponding problems.[365] In other words, poor performance or financial distress will attract the attention of shareholders and competitors in the market. According to the "signaling hypothesis" by Grinblatt, Masulis, and Titman, they argue as follows.

> "Accounting principles require that stock dividend distributions be accompanies by a reduction in retained earnings in the balance sheet. In the presence of information asymmetry, i.e., when managers (insiders) know more about the future prospects of the firm than investors (outsiders)

[362] See Steven A.Bank, Brian R. Cheffins and Marc Goergen, 2004, 'Dividends and Politics', Law Working Paper N. 24/2004, (December) .www.ecgi.org/wp.
[363] See Michael Jensen, 1986, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers', The American Economic Review, 76:2, (May), pp 323-329.
[364] See Merton Miller & Franco Modigliani, 1961, 'Dividend Policy, Growth and the Valuation of Shares', 34 J.Fin. 411.
[365] See Steven A.Bank, Brian R. Cheffins and Marc Goergen, 2004, 'Dividends and Politics', Law Working Paper N. 24/2004, (December).www.ecgi.org/wp.

> do, managers of high-quality firms can use stock dividend distribution to convey favorable information to the investors. These managers can afford to signal because they do not expect the reduction in the balance of retained earnings to constrain future cash dividend payments. On the other hand, managers who anticipate poor future earnings will find it costly to mimic the signal of a high-quality firm. An empirical implication is that stock prices, on average, react positively to stock dividend announcements, ceteris paribus."[366]

Therefore, if politics could determine corporate governance, the distribution of dividend in companies would be a good example of the influence of politics on corporate governance. However, the result is on the contrary. In other words, based on analysis above, "politics matters" does not fit other countries in the world except for Germany. In both the United States and the United Kingdom, politics appears to have played only a little small role in the rise of dispersed ownership, and the structure of concentrated ownership had been established in Germany and France by the late nineteenth century [367] before the earliest appearance of a social-democratic government in either country. But there is no proof that dispersed structure ownership and its corresponding corporate governance is determined by politics. On the contrary, as Cambridge Professor Brian Cheffins has found that the structure of dispersed ownership in the United Kingdom actually had taken place during a period in which British Labor governments were pursuing social-democratic policies.[368] Under the Roe theory, such a political environment should have created the structure of

[366] See,Grinbatt, M., Masulis, R., & Timan,S., 1982, 'The Valuation Effect of Stock Splits and Stock Dividends', Journal of Financial Economics 13, pp 461-490.
[367] See John C.Coffee, 2001-2002, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', The Yale Law Journal, Vol.111,2, p73.
[368] See John C.Coffee, 2001-2002, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', The Yale Law Journal, Vol.111,2, pp 73-73.(citing Brian R.Cheffins, 2000, 'Putting Britain on the Roe Map: The Emergency of the Berle-Means Corporation in the United Kingdom', SSRN Elec.Library, Working Paper No.218, 655).

concentrated share ownership, but it did not.[369]

In addition, if politics could determine corporate governance, when Vodafone in the UK launched a hostile bid for Mannesman in Germany in 1999, politics would have played a pivotal role but politics seemed to have no influence. In response to pressure from SPD party leaders, Chancellor Schröder made his address "Hostile takeovers destroy an enterprise's culture. They harm the target, but also, in the medium-term, the predator itself." However, his comments ultimately played no role in the transaction. In the end Vodafone succeeded in its bid for Mannesman by the ultimate decision of the shareholders of Mannesman in place of politics.[370] As a matter of fact, from the perspective of history, the effect of politics on corporate governance always falls behind accidents, such as "Bubble Act" in the UK in 1720 after the event of South Sea Company, Securities Act of 1932 and Securities Exchange Act of 1934 after Great Depression in 1929, many laws and regulations enacted in Asian countries after Asia crisis in 1998 and Sarbanes-Oxley Act of 2002 after the financial scandals in the USA, this shows the limitations of politics as a determinant of corporate governance.

4.2.3. Conclusion

Although the government needs to create the essential ingredients of a system of

[369] See John C.Coffee, 2001-2002, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', The Yale Law Journal, Vol.111,2, p 74.

[370] See Curitis J. Milhaupt , "Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals",(Jeffrey N.Gordon, 2003, 'Convergence on Shareholder Capital: An Internationalist Perspective), Columbia University Press, pp 241-242.

corporate governance through by political intervention, it will be failure if it is against the rule of the economic development, for example, in China and the former socialist countries. Therefore the thesis argues that politics is only an influence on corporate governance instead of determining corporate governance.

4.3. Conclusion

If there is some set of political and legal institutions that produce corporate governance structures that might in the long run prove more efficient than other institutions in the world, then politicians and legislators should concurrently adopt this set of best institution on earth by legislation to improve their countries' economic growth. On the contrary, there exist no best political and legal institutions that produce corporate governance that can be followed by other countries. Although both politics and law can have a great effect on corporate governance, for example, the Securities Act of 1933 and the Exchange Act of 1934, and the Sarbanes Act of 2002 demonstrate that law and politics have important influences on corporate governance, their effect on corporate governance is limited. There is no proof that dispersed share ownership in the U.S.A. and the U.K. or concentrated share ownership in Japan and Germany or in other countries is historically determined by law or politics. To the contrary, today the former socialist countries' experience shows that corporate governance has not been improved a bit, although law and politics has been reformed greatly in accordance with some western models. At the same time, in East Asia, corporate

governance remains as before although law or politics has been adjusted a lot after the financial crisis. Many countries in Europe are trying to develop towards a dispersed structure of ownership in their systems of corporate governance through the enactment of laws on the protection of minority shareholders, but corporate governance changes little despise the passage of many laws over the years. If there is multi-party political system in Western countries, there is a conflict of interest between them, which affects the improvement of corporate governance. However, in China there is only one party in power all the time and the corporate governance remains as before. Or say, the improvement of corporate governance is only a small. Why? How to explain the above phenomena? In fact, the reason is very simple. The structure of share ownership in companies in those countries remains as before. (Both in Russia and in the Czech Republic, mass-privatization through the sale or distribution of privatization vouchers to the citizenry inevitably created a highly dispersed ownership structure according to the style of the West, but only for a transitory period. Over time, concentrated ownership re-emerged[371]). It is no surprising that corporate governance remained as before.

[371] See John C.Coffee, 1999, 'Privatization and Corporate Governance: The Lessons from Securities Market Failure', Journal of Corporate Law, Vol.25, Iss. 1, (Fall).

Chapter 5. How does the structure of share ownership come into being?

Why do societies fail to adopt the organization or system of more economically successful ones? The answer to the question seems to be very simple: because the organization or system in societies is affected by many elements and one organization or system which is suitable for one country or region may not be fit for any other country or region. As the endowment theory puts it, in the past differences in endowments created the initial formation of property rights and the initial systems for the definition, defense and interpretation of property rights, and these have had long-lasting and different effect on property rights and private contracting today.[372] So it is normal that there exist different structures of share ownership which determine and lead to varying models of corporate governance analyzed above across countries. The structures of share ownership in publicly traded companies in different countries have been affected by the economy, politics, ideology, history, law and culture etc. But the economy lays the foundation for the structure of share ownership in publicly traded companies. That is, the economy plays a pivotal role in the change of the structure of share ownership in publicly traded companies.

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[372] See Ross Levin, 2003, 'Law, Endowments, and Property Rights', Working Paper,. http://www.econ.brown.edu/fac/Ross_Levine/Publication/Forthcoming/Forth_JEP_RL_Law%20Endowments%20Property%20Rights.pdf (3.21.2007)

5.1. Law and politics have effect on the structure of share ownership

Law and politics are very important to the formation of the structure of share ownership in a given country indeed. One scholar asserts that corporate ownership in a country therefore not only depends on the corporate law and on the legal regime but ultimately on the acceptance of entrenched private ownership politically. This scholar further thinks that the structure of corporate ownership and governance, as well as the development of the financial system, are regarded as very much integrated parts of a country's political history.[373]

Most societal rules and laws are products of political processes that reflect the relative power of various organized social groups that directly or indirectly affect the structure of share ownership. Generally speaking, incumbent groups work to yield benefits for themselves and impose costs and restrictions on their challengers or opponents. Thus the legal systems that evolved prove the accommodation of these struggles and have had a profound influence on the national structures of corporate governance.[374] For example, politics played an important role in the construction of the common law system in Great Britain and the civil law system in France. In England the common law system stemmed from the victory of private landholders over the king and nobility. The law attempted to stop arbitrary seizure of land by sovereign. In France, Napoleon established a civil law system exactly because he

[373] See Peter Högfeldt, 2004 ,'The History and Politics of Corporate Ownership in Sweden', Working Paper (ECGI), (July).
[374] See Neil Fligstein and Jennifer Choo, 2005, 'Law and Corporate Governance', Working Paper.

prevented judges from restoring feudal privileges at their discretion after the French Revolution.[375] Therefore, the structure of share ownership in the two countries is quite different due to the influence of politics. Today the former is the dispersed share ownership and the later concentrated share ownership in most of public traded companies.

Recent studies show that in highly ethnically diverse economies, the group that comes to power tends to carry out policies that (a) deprive the ethnic losers of as many resources as possible, (b) restrain the rights of other group, and (c) inhibit the growth of industries or sectors that menace the ruling group.[376] When this view is applied to the structure of share ownership, politicians will create a structure of share ownership that fits in with their interests by policy and by the passage of laws. For example in accordance with laws and the principle of one-share— one-vote, policies made in companies have a close relationship with the structure of share ownership and policy makers will be responsible for striking the best balance between the different groups in the company.

In a word, the structure of share ownership is affected by politics through policy and law. For instance, if capital for investments can be supplied primarily through borrowing from banks or by the infusion of private capital at a lower interest rate or cheaper than obtaining capital through share issues, companies have no immediate need to go through the strictures of equity offers and place a larger fraction of shares

[375] See Mahoney PG, 'The Common Law and Economic Growth', J. Legal Study 30, 503-25.
[376] See Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine, 2003, 'Law, Endowment, and Finance', Journal of Financial Economics 70-2, pp 137-81.(citing Alesina, A., Baqir, R., Easterly, W., 1999, 'Public Goods and Ethic Divisions', Quarterly Journal of Economics 114, pp 1243-1284; Easterly, W. Levine, R., 1997, 'Africa's Growth Tragedy: Policies and Ethnic Divisions', Quarterly Journal of Economics 112, pp 1203-1250.)

in a wider group of investors and dilute the private benefits of control in the process. Also larger shareholders can use dual-class shares to separate votes from capital contribution in order to maintain control after issues of equity in some European countries. Or a company with concentrated share ownership can get exemption from tax or tax preferential treatment by policy or law, for example, a chaebol can get loan at a lower rate of interest from banks, and preferential treatment of tax in accordance with policy and law in South Korea. These provisions of law and policy strengthen the structure of concentrated share ownership in South Korea.[377]

As mentioned above, in a sense, the law is the outcome of politics. Generally speaking, law has an effect on the structure of share ownership through the following ways at least: (1) prohibiting some institutions, companies or other entities from holding shares or restricting the number of shares they hold; (2) whether there is protection for minority investors or not; (3) whether there is one–share— one –voting or not. The following sections show that laws and politics in some countries have a close relationship with the structure of share ownership.

5.1.1. The United States

In the United States, one of the reasons why dispersed ownership became established historically is the combined function of law and policy at the turn of the 20th century. Today banks, mutual funds, and pension funds are either prevented entering from the

[377] See 'Korean, South The Origins and Development of Chaebol' Sources: The Library of Congress Country Studies; CIA World Factbook. http://www.photius.com/countries/korea_south/economy/korea_south_economy_the_origins_and_deve~204.html

securities business and from owning stock or are significantly restricted in their portfolios and cannot easily develop their portfolios to big blocks under the control of laws and by the influence of politicians. Moreover, some financial institutions, such as mutual funds and pension funds, face legal and structural problems that restrict them from appointing the member of board of directors. The general result under these legal restrictions is that the structure of dispersed ownership has been created and a shift of power from shareholders to managers has resulted.[378] If the banks and insurers had been large and capable of owning stock, the structure of ownership in America would not have been the same as it is today. In the wake of the Great Depression, the US Congress passed several pieces of legislation designed to facilitate the development of financial markets and promote the structure of dispersed share ownership further: the 1933 Glass-Steagal Act prevented commercial banks from underwriting, holding and dealing in corporate securities; the 1933 Securities Act mandated disclosure in the securities markets; and the 1934 Securities Exchange Act established and empowered the Security and Exchange Commission, which benefits the protection of minority shareholders and promotes the development of the structure of dispersed share ownership further.

As a historical matter, government intervention in corporation traces back to the 1890s with the case of Standard Oil and the prevention of "trusts" from holding and controlling shares in a number of different corporations by the imposition of regulations. For instance, not only Standard Oil, but also other corporations such as

[378] See Mark J.Roe, 1994, Strong Managers, Weak Owners: The Political Roots of American Corporate Governance, Princeton: Princeton University Press.

American Tobacco and DuPont, were prevented from merging with others to become giant businesses by the Sherman Antitrust Act of 1890.[379] Generally speaking, before the Great Depression and World War II, the influence of the state and federal government on the modern corporation was primarily through taxes, tariffs, and regulatory legislation.[380] In brief, the politics and law have always played a certain role in the change of the structure of ownership in American history.

5.1.2. Sweden

The structure of heavily concentrated ownership has been profoundly affected by politics and law in Sweden. The largest listed firms are controlled by a few families and banks due to the persistent political influence of the Social Democratic Party since the Great Reversal in 1932. Firms have been dependent on the debt market in place of the primary equity markets, and in consequence the structure of concentrated ownership has been kept since then. The policies concentrated on the very largest firms but systematically disregarded the need to create new entrepreneurial firms. The consequence is that there are an unusually large proportion of very old and very large firms with well-defined owners in control in an ageing economy. For example, 31 of the 50 largest listed firms in 2000 were founded before 1914, only 8 in the post-war period and none after 1970.[381]

379 See Alexandre Padilla and Andrei Kreptul, 2004, 'Government Regulation, Unintended Consequences, and the Rise of Omnipotent Management', Working Paper.
380 See Alfred D. Chandler, Jr., 1977, The Visible Hand: The Managerial Revolution in American Business, The Belknap Press of Harvard University Press, Cambridge, Massachusetts and London, England, p 494.
381 See Peter Högfeldt, 2004,'The History and Politics of Corporate Ownership in Sweden', Working Paper

Influenced by politics, banks and large listed firms have kept a close good relationship which has had profound and lasting effects on corporate financing and ownership in Sweden over the last 100 years. The two pivotal reforms of bank ownership in 1911 and 1934 both had the strong support of the Social Democrats. Banks could directly own shares and operate as investment banks under The Banking Act of 1911. After the crisis in the early 20s last century, the banks owned a significant number of shares in the major listed firms and became the controlling owner. After the financial crisis in the 30s last century when banks owned very large portfolio of listed stocks and de facto controlled the largest, listed firms, and then the Swedish 1934(light) version of Glass-Steagall banned them from directly holding equity, but a few years later they were permitted to transfer their assets to holding companies if the shares were distributed to the bank's shareholders.[382] One of the reasons why the structure of share ownership is concentrated are affected profoundly by politics: the use of dual-class shares and pyramiding with tax-exemption, which gets the support of politicians who help separation of internal funding from external funding that causes an enhanced (political) pecking order of corporate financing. As a result, the corporate control is strengthened and the structure of ownership is concentrated by the political support for the separation of control from ownership and for non-equity financing benefit established firms and in effect it associates the interests of the incumbent political power with incumbent capital (in particular the leading banks), while it was very difficult for new firms to develop by equity

(ECGI), (July).

382 See Peter Högfeldt, 2004, 'The History and Politics of Corporate Ownership in Sweden', Working Paper (ECGI), (July).

financing under the disfavored environment for egalitarian reasons.[383] In a word, policies by politics stimulate and support the development of firms with concentrated ownership.

5.1.3. Italy

The structure of share ownership is the result of the joint effect by both politics and law in Italy in a sense. The important regulatory intervention was that the Bank Law of 1936 banned universal banks due to the Great Depression. Banks could not own equity stakes in non-financial firms. Commercial banks could only engage in short term lending. Since the Great Depression, the state had to intervene in the economy and took part in the economy as the owner of profit-oriented firms. As a consequence, the character of the structure of ownership is concentrated in Italy and groups of companies are controlled and managed by a family via a complex chain of holding companies. Over the century, there were important political strategy and decisions that influenced the stock market and regulatory environment. The stock market all the time has been controlled by family-controlled pyramidal groups and state-controlled conglomerates.[384] Therefore the structure of concentrated share ownership is affected deeply by politics in Italy.

[383] See Peter Högfeldt, 2004, 'The History and Politics of Corporate Ownership in Sweden', Working Paper (ECGI), (July).
[384] See Alexander Aganin, and Paolo Volpin, 2003, 'History of Corporate Ownership in Italy', Finance Working Paper N, (March), http://ssrn.com/abstract=391180.

5.1.4. Japan

In Japan, the history of the structure of share ownership shows that zaibasu and keiretsu are one of outcomes of political rent-seekers. Prior to World War II, wealthy Japanese families exercised control of large corporations through pyramidal groups, called zaibatsu. After World War II, the American occupation force tried to supplant zaibatsu with a widely held corporate sector similar to that of United States but this eventually failed by the end of the 1960s. A bout of takeovers and greenmail ensued. To defend their position, Japanese top executives placed numerous small blocks of stock with each other's firm, shaping dense networks of small inter-corporate blocks that summed to majority blocks in each firm. These networks, called keiretsu, that emerged during the 1950s and developed more fully in the 1960s, halted hostile takeovers completely and the current pattern of corporate ownership was essentially in place. Both zaibatsu and keiretsu were influenced by politics. Such influence was often instrumental in securing lasting advantages over the competition, as when the early zaibatsu families grew as giant firms by obtaining tax farming concessions, mines and government contracts. In the postwar period, keiretsu banks and firms also benefited disproportionately from regulatory favoritism and overt subsidies from government. In addition, there were lots of laws relating to the structure of share ownership influenced by politics. For example, the Anti-Monopoly Law of 1947 was actually an anti-pyramid law, but subsequently this law was frequently amended in

response to corporate lobbying.[385]

5.1.5. The United Kingdom

In the United Kingdom in 1945, when the Labor Party won the general election and came to power, it began to implement the policy of nationalization in the electoral document titled "Let us face the future". Nationalization was carried out in many areas where it accounted for 20 percent of the economy, such as public water, gas, electricity, transportation, coal mine, and Bank of England. As a result of this nationalization, ownership of many companies and enterprises was changed into state ownership, namely concentrated ownership by state.[386] In the traditional socialist view, nationalization is one of the methods— by no means the only one— by which the means of production and distribution are separated from private ownership and put under the control of the community as a whole. Nationalization will serve, according to the socialist program, to get rid of the private acquisition of the surplus value yielded in that particular enterprise or industry and the surplus should be controlled by and distributed to the entire community.[387] Nationalization is supposed to make a substantial contribution to the socialist objective of achieving a more egalitarian distribution of income, offer the advantages of large-scale production, better co-ordination, and integration. However, when Margaret Thatcher won the general

[385] See Randall Morck and Masao Nakamura, 2003, 'Been there, Done That: The History of Corporate Ownership in Japan', Finance Working Paper N, (July), www.ecgi.org/wp.
[386] See Mary E.Murphy, 1952, 'Nationalization of British Industry', The Canadian Journal of Economics and Political Science, Vol.18, No.2 (May), pp 146-162.
[387] See Adolf Sturmthal, 1953, 'Nationalization and Workers' Control in Britain and France', The Journal of Political Economy, Vol. 61, No. (Feb.,), pp 43-79.

election in 1979, she carried out the privatization of nationalized enterprises in coal, iron and steel, gas, electricity, water supply, railways, trucking, airlines and telecommunications. That is, state ownership of companies or enterprises was changed into private ownership.[388] In fact the long-term economic problems of the British economy stem from a history of policy errors that go back at least to the 1920s.[389] That is, the reform of the structure of ownership is a requirement for the development of the economy. However, the above reform of the economy was carried by the Labor Party or the Conservative Party, which changed the structure of share ownership greatly in some of companies, under the influence of politics in Britain.

In a word, the structure of share ownership is indeed affected by politics and law, but it is not easily and directly modified by politics and law except in some special circumstances (e.g. wartime, revolution, nationalization, and privatization) because the right of share ownership is a vested right and a private property right which should be controlled by its owner in accordance with its requirement and the development of the economy in a given country or region and not by politicians and legislators who only give guidelines for the current structure of share ownership or may directly influence the future structure of share ownership. In fact, the effect of politics and law on the structure of share ownership ultimately has to be subject to and adapt to the change and growth of economy.

[388] See Simon Jenkins, 1996, Accountable to None: The Tory Nationalization of Britain, London, Penguin books Ltd,. p 23.
[389]See Thayer Watkins, "Privatization in the United Kingdom Under the Thatcher Government",2007,1 http://www.sjsu.edu/faculty/watkins/privUK.htm

5.2. Culture and the Structure of Share Ownership

5.2.1 Concept

"Culture" is very vague and ambiguous concept and is recognized as "one of the two or three most complicated words in the English language."[390] Sociologists and anthropologists regard the organization of society to be an expression of its culture—an important integrated part of which is cultural beliefs.[391] Various social science disciplines define culture for their purposes. The preeminent anthropologist Clifford Geertz states that culture "denotes a historically transmitted pattern of meaning embodied in symbols, a system of inherited conceptions expressed in symbolic forms by means of which men communicate, perpetuate, and develop their knowledge about and attitudes toward life."[392] In the formal jargon of economists, culture can be translated as the social norm and the individual beliefs that maintain Nash equilibria[393] as focal points in repeated social mutual or reciprocal action.[394] Some

[390] See Philip M.Nichols, 1997, 'The Viability of Transplanted Law: Kazakhstani Reception of a Transplanted Foreign Investment Code', 18 U.Pa. J. Int'L Econ.L. 1235, pp1242-43. (citing Raymond Willliams, 1976,'Keywords: A Vocabulary of Culture and Society' 76).

[391] See Greif, A., 1994, 'Cultural beliefs and the organization of society: A historical and theoretical reflection on collectivist and individualist societies', Journal of Political Economy 102, p 915.

[392] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 157.(citing Clifford Geertz, 1973, 'The Interpretation of Cultures: Selected Essays', 89).

[393] See http://en.wikipedia.org/wiki/Nash_equilibrium. In game theory, the **Nash equilibrium** (named after John Forbes Nash, who proposed it) is a kind of solution concept of a game involving two or more players, where no player has anything to gain by changing only his or her own strategy unilaterally. If each player has chosen a strategy and no player can benefit by changing his or her strategy while the other players keep theirs unchanged, then the current set of strategy choices and the corresponding payoffs constitute a Nash equilibrium

[394] See e.g.Greif, A, 1994, 'Cultural beliefs and the organization of society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies', Journal of Political Economy,n.5, Vol.102, (October); Myerson R.B. 1991,'Game Theory: Analysis of Conflict', Cambridge, MA: Harvard University Press; Schwartz, A. , 1981, 'The Economic Theory of Social Institutions', Cambridge, MA: Cambridge University Press, (January).

scholars define culture as follows: "Culture refers to the complex of meanings, symbols, and assumptions about what is good or bad, legitimate or illegitimate that underlines the prevailing practices and norms in a society."[395] In other words, culture is defined as a system of beliefs that shape and affect the action of individuals or other entities within a society.

A radical view is that culture has a direct effect on individual behavior through values and preferences.[396] Action that culture operates to motivate and justify is compatible with its values which have a great impact on organizational policies and on the values of individual decision-makers.[397] When values are used to characterize cultures, what is sought are the socially shared values among a group of people or in a society. These are abstract ideas that will be expressed about what is good, right, and desirable in society or other bounded cultural group.[398] Cultural values are the bases for the specific norms that let people know what is right or reasonable in various situations.[399] Different groups of people or ethnics have varying cultural value (standard) in a country or region after a long history of evolution. After research, the scholar Schwartz grouped the nations of the world into clusters that share similar

[395] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p233.(citing Pierre Bourdieu, 1972, Outline of a Theory of Practice ;Hazel R. Markus & Shinobu Kitayama, 1994, A Collative Fear of the Collective: Implications for Selves and Theories of Selves, 20 Personality & Social Psychol. Bull. 568).

[396] See e.g. Akerlof, G and R.Kranton, 2000, 'Economics and Identity', Quarterly Journal of Economics, August; Rabin M. 1993, 'Incorporating Fairness into Game Theory and Economics', American Economic Review, 83, pp 1281-1302.

[397] See Amir N.Licht, Chanan Goldschmidt, Shalom H.Schwartz, 2005, 'Culture, Law and Corporate Governance', International Review of Law and Economics 25, p 233.(citing Robin M.Williams, 1970, American Society: A Sociological Interpretation (3rd ed.,)).

[398] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 157.(citing Shalom H. Schwartz & Maria Ros, 1995, ' Values in the West: A Theoretical and Empirical Challenge to the Individualism-Collectivism Cultural Dimension', World Psychol. 91, 93).

[399] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 168.

cultural traits: West European, Anglo, East European, Islamic, East Asian and Latin American. Countries belonging to the same cluster share conceptually similar cultural value or belief dimensions.[400] In other words, some countries may have similar cultural background, history, values and beliefs, while some countries (or societies) may have varying cultures which lead to divergences in many aspects, and may even result in conflicts between people.

5.2.2. The effect of culture on the structure of share ownership

Cultures develop, change and adapt in response to the change of economy, but they generally do so slowly.[401] Meanwhile the culture has a great effect on the economy, politics, and the law etc. Theorists, policy-makers, and practitioners share the intuition that corporate governance is the reflection of national culture.[402] In other words, culture influences the corporate governance. Cultural values thus rise as the "mother of all path dependencies" in corporate governance systems and national culture had shaped the initial conditions which influence company, its organization, structure of ownership and corporate governance etc. when companies and financial markets first appeared.[403] There are two major implications of path dependence. First, with

[400] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 177.

[401] See René M. Stulz and Rohan Williamson, 2001, 'Culture, Openness, and Finance' Working Paper 8222, (April).

[402] See,eg.Lucian Arye Bebchuk & Market J.Roe, 1990, A Theory of Path Dependence in Corporate Governance and Ownership, 52 Stan. L Rev. 127, 168; OECD Ad Hoc Task Force on Corporate Governance, OECD Principles of Corporate Governance, Document SG/CG(99)53(1999); CalPERS, Global Corporate Governance Principles(1999).

[403] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 200.

hindsight, cultural values form part of the heritage of certain interpersonal relations and institutions, which influence the selection of particular corporate structures and legal rules out of a large menu. Second, from a forward-looking viewpoint, cultural values are deeply ingrained in people's minds and in social institutions, which will have profound effect on corporate governance in the future. A corporate governance system that is consistent with social preferences in other areas (most importantly, legal areas) is more likely to run efficiently in a particular society. However, such compatibility may increase the persistence of certain features and impede reforms[404] in the future. Therefore culture could affect companies through its values. That is, culture will affect not only the structure of share ownership but also corporate governance.

In east Asia (China, Japan and Korea), the Confucian ideal of social structure that is built on the "Five Relationships" is a prime example (Formulated by classical Chinese philosophers, this concept states that there should be affection between father and son, righteousness between ruler and minister, attention to their separate functions between husband and wife, proper order between old and young, and faithfulness between friends). Based on the above ideal of rigid hierarchy and harmony in the society, this is why the structure of concentrated share ownership, which is affected by culture, has developed in those countries, particularly in big companies, which are always based on blood kinship with an important element of Confucianism in China (mainly in Hong Kong and Taiwan today, but Mainland in the past which I will

[404] See Amir N. Licht, '2001, The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, pp 186-187.

discuss in Chapter 8), Japan, and South Korea. For instance, the standard story of Japanese corporate governance tells of managers imbued with Confucian cultural values of harmony and consensus, which helps lessen self-interest and opportunism. The Japanese people allegedly prefer to endure rather than to resort to combative litigations and these cultural values also expedite the working of the keiretsu— the hallmark of Japanese corporate structure.[405] In Korea, Confucianism saturates all the aspects of Korean society[406] and the structure of ownership is often based on extended family (clan) kinship. Both the Japanese keiretsu and the Korean chaebol exhibit extensive cross-holdings among corporations that engage in a variety of industrial and financial activities to coordinate their relationships toward harmony in the society. In China, the structure of share ownership is mainly concentrated in the hands of the state, which represents all the people in theory at least, in conformity with Confucian cultural values of harmony and consensus and modern collective spirit. In contrast, "autonomy" is primarily emphasized in the thoughts and feelings of the individual in Western countries.[407] But cultural values in Western European countries attribute greater importance to egalitarianism and harmony, so in most of European countries, the concentrated structure of share ownership occurs in many companies, which represents most of people's interest and reflects the expectation of harmony. However, cultural value in English-speaking countries (especially American samples) is characterized by hierarchy and mastery, and the incidence of structure of dispersed

[405] See Curtis J.Milhaupt, 1996, 'A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law', 37 Harv. Int'L LJ. 3, pp 6-7.

[406] See Craig Ehrlich and Dae-Seob Kang, 2000, 'U.S. Style Corporate Governance in Korea's Largest Companies', UCLA Pac. Basin L. J. Vol.18: 1,p 22

[407] See Amir N. Licht, 2004, 'The Maximands of Corporate Governance: A Theory of Values and Cognitive Style', Delaware Journal of Corporate Law, Vol. 29, p 677.

share ownership in these countries very high, which stresses the interest of individuals and the distinction between individuals. In other words, the cultural differences between the United States and Western Europe are consistent with the different positions of these countries in regard to the maximands of corporate governance. Cultural values in Western European countries emphasize the more social responsibility. In contrast, the cultural values of the United States emphasize the autonomy of the individual person. For example, with regard to accountability, the Western European accountability will feature multiple constituencies as accountees, while the American accountability will seek to define power hierarchies among constituencies.[408] Most U.S. scholars agree that the maximization of shareholder wealth is by far most important goal of U.S. corporation law,[409] for example, Milton Friedman argues that "this norm (a managerial belief in shareholder-wealth maximization), widespread in American business circles, surely affects what managers think about their task,"[410] while German corporate law continues to specify that the interests of other stakeholders are very important,[411] in particular, German corporate law is designed to "serve the interests of employees as well as those of shareholders"[412] because of different culture in the two countries. In Germany, with

[408] See Amir N. Licht, 2004, ' The Maximands of Corporate Governance: A Theory of Values and Cognitive Style', Delaware Journal of Corporate Law, Vol. 29, pp737-738.
[409] See, e. g., Stephen M. Bainbridge, 1993, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green', 50 Wash. & Lee L.Rev. 1423, pp1423-25; Bernard Black & Reinier Kraakman, 1996, 'A Self-Enforcing Model of Corporate Law', 109 Harv. L. Rev. pp1911-1921; D. Gordon Smith, 1998, 'The Shareholder Primacy Norm' ,23 J.Corp. L. pp277-278.
[410] See Milton Friedman, 1970, 'The Social Responsibility of Business Is to Increase its Profits', Y.N. Times Mag. 13 (Sept.), p 32.
[411] See, e.g., Michael Bradley et al., 1999, 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads', 62 Law & Contemp. Probs. 9. 52.; Lawrence A. Cunningham, 1999, 'Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance', 84 Cornell L. Rev. 1133, 1157.
[412] See Thomas Lee Hazen, 1987,' Corporate Director's Accountability: The Race to the Bottom-The Second Lap', 66N.C.L.Rev. 171, 176n.35.

respect to the principle of democracy, it is suggested that this principle should not be limited to the field of politics. Corporate power is also in need of democratic legitimacy. It is necessary for the providers of capital and labor to be offered equal treatment in order to protect the interests of workers against adverse decisions by their employers of corporation.[413] Therefore the structure of share ownership of listed companies in America is more dispersed, while the structure of share ownership of listed companies in most west European countries is more concentrated, which has a close relationship with culture or cultural values.

Of course, as analyzed above, culture has an effect on corporate governance too. In the European Union (EU), it was cultural differences that resulted in the failure to adopt the Draft Fifth Directive on Company Law.[414] In order to unify company law across the EU, the Draft Directive has experienced many revisions and changes in response to bitter conflicts of interest between member states due to the difference in culture. In May 1997, an expert panel came to the conclusion that significant differences between national cultures prevented the likelihood of consolidation as originally intended. Consequently, it said, there could be no single ideal system without further details.[415] The Fifth Directive case offers a vivid lesson for policy makers about the potential obstacles cultural differences give rise to in the attempt to

[413] See Jens C. Dammann, 2003, 'The Future of Codetermination After Centros: Will German Corporate Law Move Closer to the U.S. Model?', Fordham J. Corp. & Fin. L. Vol. VIII, p 655.(citing Drucksache des Bundestages[BT-Drs.] VI/334,18-20.).
[414] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 157. (citing Amended Proposal for a Fifth Council Directive Based on Art.54 of the EEC Treaty in an European Company and Financial Law[European Commounity Law: Text Collection](Klaus J. Hopt & Eddy Wymeersch eds.,1994).
[415] See Amir N. Licht, 2001,'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 157.(citing Corporate Governance Update, 5 Corp. Governance: Int'L Rev, 256 (1997)).

converge corporate governance systems. In other words, the role played by culture in corporate governance should not be ignored. It especially suggests the requirement for a cross-cultural theory to inform corporate governance reforms. Even if this was the case in some countries, it is necessary to acquaint with the role of culture in corporate governance, perhaps even a fortiori.[416]

Some scholars argue that differences in culture (mainly religion and language) can explain differences in investor protection through studying the data of 49 countries: "Shareholders rights are better protected in Protestant countries with common law legal origins than in such countries with civil law origins. Creditor rights are strongest in countries where the main religion is Protestant regardless of legal origin. Within civil law countries, the protection of creditor right is weaker in Catholic countries. Spanish-speaking Catholic countries have weaker enforcement of rights."[417] The above research shows the culture has a close relationship with corporate governance.

As Landes makes the point, "Max Weber was right. If we learn anything from the history of economic development, it is that culture makes almost all of the difference."[418] In a seminal paper on the role of culture as a determinant of institutions, Greif compares Maghribi traders of the eleventh century and Genoese traders of the twelfth century and concludes that "Differences in the societal organization of the two trading societies can be consistently accounted for as reflecting diverse cultural beliefs." He states that his "findings suggest the theoretical

[416] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, p 158.
[417] See René M. Stulz and Rohan Williamson, 2001,'Culture, Openness, and Finance' Working Paper 8222, (April).
[418] See Landes, D., 'Culture makes almost all the difference, in Culture Matters', L.E.Harrison and S.P.Huntington, eds., Basic Books, New York, NY.

and historical importance of culture in determining societal organizations, in leading to path dependence of institutional frameworks, and in forestalling successful intersociety adoption of institutions."[419] The extant academic literature admits the importance of cultural differences in the development of corporate governance, company law and securities regulation regimes.[420] The OECD, the IMF and the World Bank also think that cultural differences are very important to the development of corporate governance in some instruments.[421] Thus, cultural differences preclude the implementation of a single corporate governance model and warrant country-specific adaptations. Therefore the varying cultures across countries lead to different kinds of corporate governance to a certain extent in our society. That is why the largest American pension fund CalPERS, in the wake of a strategic decision to increase its foreign portfolio investment, found it necessary to develop different policies on foreign corporate governance due to cultural differences. In other words, it recognizes that the legal, economic and cultural traditions that are unique to each market have an effect on the modern corporation and the corporate governance structures and principles that are appropriate for different markets.[422]

In a word, different cultural beliefs derive from divergent cultural heritages and political and social histories in different countries or regions in the world, and hence

[419] See Greif, A., 1994, 'Cultural beliefs and the organization of society: A historical and theoretical reflection on collectivist and individualist societies', Journal of Political Economy 102, p 914.
[420] For example, James A.Fanto, 1996,'The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance', 17NW.J.INT'L L.& BUS. 119; Lucian Arye Bebchuk & Mark J. Roe, 1999, ' A Theory of Path Dependence in Corporate Governance and Ownership, 52 Stan.L.Rev. 127; Marcel Kahan & Michael Klausner, 1996, 'Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, 74 WASH.U.L.Q.347.
[421] See. E.g. Principle of Corporate Governance (2004); Memorandum of Understanding between OECD and the World Band; the World Bank's Corporate Governance web-page.
[422] See Amir N. Licht, 2001, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems', Delaware Journal of Corporate Law, Vol. 26, pp 150-154.

diverse cultural beliefs result in a distinct trajectory of organizational development. Namely divergent cultural values must affect deeply the origin and development of institutions. Meanwhile "the effect of organizations is a function of their impact on the rule of the game and the cultural beliefs of society within which this game is embedded."[423] It demonstrates culture and institutions interact with each other. Thus, the structure of share ownership and corporate governance are affected greatly by the culture in a given country or region.

5.3. History and structure of share ownership

History always leaves us something that may be meaningful or not, which will affect us more or less. But sometimes the effect is great. Some scholars have argued that distant histories and traditions give rise to pronounced differences in civic, social and economic behavior between Northern and Southern Italy and that these different endowments of "social capital" in turn can explain the economic backwardness of Southern Italy.[424] Both law and endowment theories stress the importance of how initial conditions influence institutions today, but there are crucial differences. The law and finance theory focuses on the legal tradition brought by colonizers. Namely, the emphasis on the colonizer is the most important key to the institutions of the colony. By contrast, the endowment theory focuses on how the colony's own

[423] See Greif, A., 1994, 'Cultural beliefs and the organization of society: A historical and theoretical reflection on collectivist and individualist societies', Journal of Political Economy 102, p 944.
[424] See Guido Tabellini, 2005, 'Culture and Institutions: Economic Development in the Regions of European', Working Paper.

endowments shaped the building of long-lasting institutions. The emphasis on the initial historical conditions of the colony itself is most important key to the institutions of the colony.[425] Although the two theories stress different issues, both of them lay emphasis on the importance of history and its a great effect on institutions today.

As stated above, a widespread interpretation is that history has a strong effect on current economic performance by "institutions".[426] The idea that history influences the current development and progress of society through institutions is beyond question. "Institutions not only are a fundamental determinant of the incentives of private individuals to innovate and invest but also remain in place for long periods of time, and thus they are a natural candidate to explain the legacy of history."[427] Social scientists have discussed whether the prevailing conditions, when the former European settlers arrived, resulted in the adoption of specific institutions that then had long-term effects on economic growth; or whether some institutions brought by colonizers had influenced society in new territories. For example, the historical accident that has had a profound effect on ownership structure and corporate governance is the transplantation of similar institutions in some countries or regions in the past. That is, many institutions, such as property rights, ownership structure, and legal system, are similar to or model on those of its colonizers. Because of

[425] See Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine, 2003, 'Law, Endowment, and Finance', Journal of Financial Economics 70-2, pp 137-81.
[426] "institution" is often used as a catch-all concept that means different things to different people. In a narrow interpretation, institutions can be thought of as the formal rules of game that shape individual incentives and constrains. In a broader interpretation, institutions also include systems of beliefs or social norms that sustain specific equilibria.(See Guido Tabellini, 2005,'Culture and Institutions: Economic Development in the Regions of European', Working Paper,(June)).
[427] See Guido Tabellini, 2005,'Culture and Institutions: Economic Development in the Regions of European', Working Paper, (June).

colonialization, many societies were forced to take similar systems to those of their respective conquerors, and those systems or institutions have lasted for a long time even till today. Some scholars argue that other early conditions such as settler mortality and the proportion of indigenous populations at the time of colonization (i.e., endowments) are powerful explanatory variables of financial development. For example, countries or regions that inherited the British Common law tradition got a legal tradition that attempts to stress private property rights and support financial development to a much greater degree than countries or regions that inherited the French Civil law tradition.[428] The idea is that exogenous conditions sometimes determined certain formal institutions, such as legal regimes or specific voting and property-rights systems that then had a long-time effect on the subsequent paths of institutional and economic development these countries followed, even including life style, belief and enforcement of the law. For instance, "the legitimacy of a legal system was affected by the conditions under which it was transplanted and this legitimacy had a big effect on the subsequent efficacy of the legal system."[429] In fact, research based on current economic indicators has demonstrated that there is a strong relationship between certain initial institutions and today's development levels, suggesting that institutions might have a lasting effect over time.[430] The empirical results demonstrate that stock market development and private property rights protection in the colony are affected by both the legal system brought by the

[428] See Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine, 2003, 'Law, Endowment, and Finance', Journal of Financial Economics 70-2, pp 137-81.
[429] See Berkowitz D, Pistor K, Richard J, 2003, 'Economic development, legality, and the transplant effect', European Econ.Rev. 47, pp 165-95.
[430] Aldo Musacchio, 'Law, Politics, and Finance: Creditor Rights, Contract Enforcement, and the Rise and Decline of Bond Markets in Brazil, 1850-2002', Working Paper.

colonizers and the initial endowment in the colonies.[431] In other words, history has a close relationship with institutions today.

History has a persistent effect on the structure of share ownership. As some scholars put it, once structures were set up long ago, they can last for a long time even if they would not be built today. Keeping them may be efficient in a basic economic sense because the cost of destruction and reconstruction may much more than the value of the new improved model.[432] Development and reform in a given country in the world must build on current economy, politics, law and culture etc., but the imprint of history will be left impressively on them. Economy is the foundation, interest group always try their best to support their vested interests through political policy, law, culture etc as tools. For example, the legal rules in favor of the structure of concentrated or dispersed corporate ownership affect corporate shareholders and stakeholders, and these players might be influential interest groups like majority shareholders or powerful managers. The power of controlling shareholders and of professional managers count on their strength, right or power that derives from the existing pattern of ownership structures.[433] Once the legal rules at earlier times are chosen or maintained, they will be connected with the existing structure of share ownership. Thus it is no surprise that the imprint of the history of the economy, politics, law and culture at earlier time has a persisting effect on the existing structure of share ownership.

[431] See Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine, 2003, 'Law, Endowment, and Finance', Journal of Financial Economics 70-2, pp 137-81.
[432] Jeffery N.Gordon and Mark J. Roe, 2004, Convergence and Persistence in Corporate Governance, Cambridge University Press, p 11.
[433] See Lucian Arye Bebchuk and Mark J.Roe, 1999-2000, 'A Theory of Path Dependence in Corporate Ownership and Governance', 52 Stan. L. Rev. p 158.

Historically parliamentary power was weaker in France and Germany, and the government intervened in economic activity greatly, for example, at the time of Napoleon and Bismarck.[434] Thus the state had a great effect on the structure of share ownership through intervention in theses two countries and the structures of share ownership has been concentrated since then. The difference is that in the former control is by the state itself and in the latter control is by family-owners and banks.

A state develops based on its history, or say, the development of a state has a close relationship with its history. A country's pattern of ownership structures at any point in time depends partly on the pattern it had earlier. Consequently, "when countries had different ownership structures at earlier points in time— because of their circumstances at the time, or even because of historical accidents— these differences might persist at later points in time even if their economies have otherwise become quite similar."[435] It shows the history of countries has great effect on the structure of ownership.

No matter how the structure of share ownership changes in a given country, its economy, politics, law and culture at earlier times have an effect on the current structure of share ownership, more or less. For example, the state accounts for more than 60% of share ownership in listed companies in China now, because China was always centrally planned-economy system, and more than 90% of assets were controlled by state-owned enterprises in terms of economy. On the part of politics, the

[434] See Rafael La Porta, Florencio Lopez-de-Silances, Andrei Shleifer, Robert Vishny, 2000, 'Investor Protection and Corporate Governance', Journal of Financial Economics 58, p12.
[435] See Lucian Arye Bebchuk and Mark J.Roe, 1999-2000, 'A Theory of Path Dependence in Corporate Ownership and Governance', 52 Stan. L. Rev. p 129.

Communist Party reinforces the stability of society and the reform of the structure of share ownership should be possible in China under both the stability of society and the maturity of the market. On the part of law, the Company Law of 1993 specifies that assets invested in companies by the state belong to the state, the state is still the owner of assets invested in companies, which contradicts the right of the owner of the company itself to its assets. In culture the collective spirit is very important to every worker, which is in conformity with concentrated share ownership in China. The argument shows that "a more complete explanation for the distribution of shareholdings must incorporate politics, law and efficiency, together with the serendipity of each country's initial conditions."[436]

The case of China shows history has a close relationship with the structure of state concentrated share ownership. The principle is applied to the East Asian countries and other countries in the world where the structure of share ownership is controlled by the state in listed companies.

In a word, history leaves a legacy that is passed from generation to generation and evolves as a particular society evolves. Initial conditions are one of the expressions of history, determined by historical accident or policy design, which could set an economy down a particular path in a given country or region at particular time. Following the path, the existing institution will develop and the new institution will emerge. In the process of reciprocity, the old institutions and the new ones have to interact deeply in particular circumstances. Especially, new institutions are always

[436] See Ronald J.Gilson, 2005, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy', Working Paper No.49/2005.

being affected by old ones (history) to a certain extent.[437] Therefore, the structure of share ownership is affected greatly by history in a given country or region.

5.4. Economy and structure of share ownership

Each system must create, evolve and prosper under peculiar economic circumstances[438] despite the tendency towards as integrated world economy. Political integration or globalization of the economy has not changed the existing structure of share ownership towards an efficient one in a country. The economy lays foundations for the development of the structure of share ownership. Why does a country have a certain structure of share ownership? Or say, why does a country have such model of corporate governance different from that of any other country in the world? Although they are affected by many elements such as history, culture, law, politics, and economy, the economy is principal determinant of them. The thesis will show the importance of the economy to the formation of the structure of share ownership through the following examples.

5.4.1. In the United States

In the United States, the structure of dispersed share ownership came into being due to its economic requirements: the growth of the public securities markets in the United

[437] See Ick Jin, TacHong Jin, and JeongHo Hahm, 2005, 'Path-dependency and Transition Strategy of Korean Financial System', The Journal of the Korean Economy, Vol. 6, No.1(Spring), p 6.
[438] See David Charny, 1998,'The German Corporate Governance System', Colum. Bus. L. Rev. No.1:145, p 146.

States in the 19th century was propelled by the enormous funding requirements of its railroads and by the similar funding needs of the steel, auto, and telephone industries in the early 20th century.[439] For example, the railroads were the first private business enterprises in the United States to need large amounts of capital from outside its territory,[440] and the enormous financing requirements of railroads in the United States (one billion dollars up to 1867 and 10 billion dollars up to 1890) resulted in the development of public markets for corporate debt and later for stock, with 40% of the capital coming from Europe.[441] The financing requirements of the railroads caused the establishment of the financial infrastructure of the United States, which provided good conditions for financing other industries that appeared later.[442]

In the United States, from the traditional business as a single-unit business enterprise to a modern, multiunit enterprise, it is the natural outcome of American economic development. As the 19th century was drawing to a close, family control of industrial enterprises was very popular in the United States and it was only very common to find examples of companies with the structure of concentrated shareholdings, but there were few well-developed managerial hierarchies. [443] Chandler has argued that the key reasons for the success of larger business enterprises

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[439] See John C. Coffee, 2001, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control.' Columbia Law School, The Center for Law and Economic Studies, 435 Wesr 116th St. New York, NY10027-7201, Working Paper No.182/2001.
[440] See Alfred D. Chandler, Jr., 1977, The Visible Hand: The Managerial Revolution in American Business, The Belknap Press of Harvard University Press, Cambridge, Massachusetts and London, England, , p 90.
[441] See Raghuram G.Rajan and Luigi Zingales, 2003,'The Great Reversals: The Politics of Financial Development in the 20th Century', 69 J.Fin.Econ.5,.(citing Eegelbourg and Bushkoff(1996) and Chandler(1990)).
[442] See Raghuram G.Rajan and Luigi Zingales, 2003.'The Great Reversals: The Politics of Financial Development in the 20th Century', 69 J.Fin.Econ.5,.
[443] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 475.(citing Navin & Sears, 1955, "The Rise of a Market for Industrial Securities, 1887-1902," 29 Bus. Hist. Rev. 105, 106-12; Werner, 1981, " Corporation Law in Search of its Future," 81 Colum. L. Rev. 1611, 1636-40).

during the early 20th century were the utilization of economies of scale and scope in production, the growth of suitable conditions for high-volume distribution, and the building of sophisticated managerial hierarchies.[444] In other words, it was the development of the economy that led to the change of structure of ownership and to the creation of professional managers in American history. As a result of fierce competition, a wave of mergers happened in America during 1897-1903. According to figures compiled by economic historian Naomi Lamoreaux, "more than 1,800 firms disappeared and well over half of the resulting consolidations absorbed over 40 per cent of their respective industries."[445] The merger movement that happened between 1897 and 1903 has been regarded as a crucial event in the formative era of American managerial capitalism in history.[446] The result of these mergers was creation of the existing structure of ownership, which thereby accelerated or invigorated a shift towards contemporary managerial arrangements.[447] So Chandler points out: "The merger movement was the most important single episode in the evolution of the modern industrial enterprise in the United States from the 1880s to the 1940s",[448]

[444] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 482.(citing Alfred D. Chandler, 1990, Scale and Scope: The Dynamics of Industrial Capitalism, pp 212-23)

[445] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 477.(Naomi R. Lamoreaux, 1985, The Great Merger Movement in American Business, 1895-1904, p2-4).

[446] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 478.(citing Hans B.Thorelli, 1954, The Federal Antitrust Policy: Origination of an American Tradition p 306; Willian G. Roe, 1997, Socializing Capital: The Rise of the Large Industrial Corporation in America , p 254 ; Alfred D. Chandler, 1990, Scale and Scope: The Dynamics of Industrial Capitalism 79).

[447] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 478.(citing Chandler, 1990, Scale and Scope: The Dynamics of Industrial Capitalism 79 ; Bittlingmayer, 1996, "Antitrust and Business Activity: The First Quarter Century," 70 Bus. Hist. Rev. pp363, 367-68; H.A.Marquand, 1931,The Dynamics of Industrial Combination, pp 40-45).

[448] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 483 (citing Alfred D. Chandler, 1990, Scale and Scope: The Dynamics of Industrial Capitalism 79)

which is the requirement of economic development.

The emergence of a market for industrial securities in the United States in the1890s, which was the result of economic development, facilitated the merger movement. The fact that the more important 1897-1903 consolidations were typically listed on the New York Stock Exchange (NYSE) or another stock market meant that the merger wave made sure that corporate equity was a more fungible asset class than had been the case before.[449] Thus economic development and fierce competition led to the acquisition of firms and also stimulated the prosperity of the stock market from which firms could get a huge capital, while the development of stock market promoted the wave of mergers. Then the proprietors received a package of common and preferred stock in the newly merged company instead of traditional payments in cash.[450] The founders had to sell off their holdings in order to pool enough capital to consolidate other enterprises in the case of mergers, and as a result the structure of concentrated shareholding was changed into the structure of dispersed shareholding, and ownership separated from control.[451] In other words, since the 1890s, the structure of share ownership gradually changed in the direction of the dispersed shareholding owning to mergers and the development of capital markets resulting from the requirement for development of the economy.

Although the common law principles and the Sherman Antitrust Act of 1890

[449] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 479.(citing Willian G Roe, 1997, Socializing Capital: The Rise of the Large Industrial Corporation in America , p 248).
[450] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 479.
[451] See Mark.J.Roe, 2004, 'The Inevitable Instability of American Corporate governance' Discussion Paper No.493, 09/2004. Harvard Law School, Cambridge, MA 02138. p 2.

governing cartel in restraint of trade are very important to the merger wave of 1897-1903, in a sense without the Sherman Act and these judicial interpretations, "the cartels of small family firms owning and operating single-function enterprises might well have continued into the twentieth century in the United States as they did in Europe."[452] Of course, on the other hand, in fact the legal environment was not desirable at that time.[453] Legal regulation of corporate disclosure was scant[454] before the enactment of the cornerstones of federal securities law, namely the Securities Act of 1933 and the Securities Exchange Act of 1934. Moreover, from the 1880s onwards, "competition between states seeking to supply law under which businesses would want to incorporate served to erode various legal constraints ostensibly designed to constrain irresponsible corporate behavior."[455] In particular, corporate law did nothing to help investors be "comfortable" about owning shares in companies during the merger wave.[456] From the perspective of the "law matters" thesis, dispersed ownership should not have arisen in the U.S. But it did! Because legal developments have attempted to go after rather than anticipate economic change[457] and law reform has been primarily responsive to economic change rather than initiating or guarding it.[458]

[452] See Alfred D. Chandler, Jr., 1977, The Visible Hand: The Managerial Revolution in American Business, The Belknap Press of Harvard University Press, Cambridge, Massachusetts and London, England, p375.
[453] See Cheffins, 2003, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies', 23 Oxf. J. Legal Study. 1, pp 8-10.
[454] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p489 (citing Bank, 2003, 'Is Double Taxation a Scapegoat for Declining Dividends? Evidence From History', unpublished working papers, 7-11).
[455] See Cheffins, 2003, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies', 23 Oxf. J. Legal Study. 1, p 9.
[456] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 491.
[457] See Stuart Banner, 1997,'What Causes New Securities Regulation?: 300 Years of Evidence', 75 Wash. U.L.Q pp 845- 850.
[458] See Katharina Pistor, 2000,'Patterns of Legal Change: Shareholder and Creditor Rights in Transition

In a word, the merger wave of 1897 to 1903 helped to prompt a transition to contemporary corporate ownership patterns under aid of law, or say, consolidation activity paved the way for further unwinding of the holdings of core shareholders and at last the structure of share ownership gradually became dispersed in the United States, which was a hallmark of the American version of capitalism. But the economic development and requirements played a pivotal role in this process. Of course, "the nature of separation and its degree got an extra push from American populist politics, which kept American financial institutions— banks and insurers at the turn of 20th century— small, weak, and generally unable to own stock."[459] But the function of politics is limited. As Chandler says, "The rise of modern business enterprise in American industry between 1880s and World War I was little affected by public policy, capital markets or entrepreneurial talents because it was part of a more fundamental economic development".[460] In short, since then, the structure of dispersed share ownership has remained till today in America mainly and ultimately due to the influence of the economy.

5.4.2. In Germany

In Germany, the structure of concentrated share ownership results from the requirements of the economic development and its history. As the 19th century drew to

Economies', EBRD Working Paper No.49/ 2000.

[459] See Mark.J.Roe, 2004, 'The Inevitable Instability of American Corporate governance' Discussion Paper No.493, 09/2004. Harvard Law School, Cambridge, MA 02138, p 2.

[460] See Alfred D. Chandler, Jr., 1977, The Visible Hand: The Managerial Revolution in American Business, The Belknap Press of Harvard University Press, Cambridge, Massachusetts and London, England, , p 376.

a close, manufacturers in both the U.S. and Germany were confronting competitive pressures that would have lessened the private benefits.[461] Railroad industries in Germany required enormous capital as in America, but the two principal German stock markets traded debt securities and commodities almost exclusively, namely the Frankfurt exchange which was founded in 1585 and the Berlin exchange which was established in 1685 [462] before the founding of the New York stock exchange and the London stock exchange. These companies in Germany had to expand their market by borrowing money from banks. According to Alfred Chandler, it was the ability of its entrepreneurs and managers to adopted new technologies readily and build the organizational structures necessary to exploit the effectively opportunities created by changing market dynamics that ultimately led to make Germany's economic success.[463] The economic development created the opportunities for entrepreneurs and managers, while the success of the economy was contributed by entrepreneurs and managers in Germany. When the 19th century was drawing to a close, German industrialists were confronting intense competitive pressures and were eager to maintain stability of conditions by limiting competition.[464] Although corporate acquisitions certainly did take place in Germany as they did in America during the late

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461 See Brian R. Cheffins, 2003,'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 502.

462 See John C. Coffee, 2001,'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control.' Columbia Law School, The Center for Law and Economic Studies, 435 Wesr 116th St. New York, NY10027-7201, Working Paper No.182/2001.(citing German Capital Market Law (U.Siebel, M.Prinz zu Lowenstain, and R.Finney,eds.) (1995), p 3.).

463 See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 492.(citing Alfred D. Chandler, 1990, Scale and Scope: The Dynamics of Industrial Capitalism at 428, 595-96)

464 See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51,p493 (citing J.Riesser, 1911,The Great German Banks and Their Concentration in Connection with the Economic Development of Germany , pp168-69).

19th century and early 20th century, collusive activity was widespread and served to promote de facto the structure of concentrated shareholding within the industrial economy as the preferred strategy. Autonomous and independent firms in the cartel would submit themselves to limitations regarding production, pricing and marketing.[465] Valid cartel arrangements and other alliances between competitors not only protected the vested interests of participating firms but also softened and stabilized the industrialization process.[466] As a result, control by founders and their offspring correspondingly stayed strong throughout the period up to World War I,[467] and the structure of concentrated share ownership continues as the norm till today. Of course, the structure of concentrated share ownership in Germany has a connection with history, namely because "industrialists tended to have deeply-rooted historical ties to the firms providing their income and believed that having a family business provided the basis for their social status."[468] In other words, the structure of concentrated ownership in Germany has a long history but it had become more

[465] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 493 (citing Robert Liefmann, 1932, 'Cartels, Concerns and Trusts' pp 10-11, 60-62, 278-79 ; Tilly, 1982,'Mergers, External Growth, and Finance in the Development of Large Scale Enterprise in Germany, 1880-1913' 42 J.Econ. Hist. 629, 640-41).

[466] See Brian R. Cheffins, , 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51,p 494 (citing Alfred D.Chandler, 1977, 'The Visible Hand: The Managerial Revolution in American Business, pp 316-17; McCraw, 1981,'Rethinking the Trust Question,' in Thomas K. McCraw(ed), Regulation in Perspective 1, 17-18 ; Jackson, 2001,'The Origins of Nonliberal Corporate Governance in Germany and Japan,' in Wolfgang Streek and Kozo Yamamura (eds.), The Origins of Nonliberal Capitalism: Germany and Japan in Comparison 121, 134).

[467] See Brian R. Cheffins, 2003,'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 494.(citing Alfred D. Chandler, 1977, 'The Visible Hand: The Managerial Revolution in American Business, pp 495, 500-1(); Jackson, 2001, 'The Origins of Nonliberal Corporate Governance in Germany and Japan,' in Wolfgang Streek and Kozo Yamamura (eds.), The Origins of Nonliberal Capitalism: Germany and Japan in Comparison 132 ; Church, 1993 , 'The Family Firm in Industrial Capitalism: International Perspectives on Hypotheses and History, 35(4) Bus. Hist. 17, 29).

[468] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, ,at494.(citing Alfred D.Chandler, 1977, 'The Visible Hand: The Managerial Revolution in American Business at 501; Chandler &Daems, 1979, 'Administrative Coordination, Allocation and Monitoring: Concepts and Comparisons,' in Horn & Kocka(eds.), Law and the Formation of the Big Enterprises in the 19th and Early 20th Centuries at28, 48; Martin J.Sklar, 1988, The Corporate Reconstruction of American Capitalism, 1890-1916: The Market, the Law, and Politics 165).

concentrated by the end of the 19th century through cartel arrangements due to the requirement of economic development.

Banks played a great role in the process of the structure of concentrated share ownership. In the years before World War I, Germany's largest deposit-taking banks were powerful financiers that were in control of the country's corporate economy.[469] Banks, it was said, were well-situated to sway matters in their favor in companies through their influential representation on the supervisory component of the two-tier boards which larger German companies used and through proxy votes at shareholder meetings.[470] The banks played a great role in promoting cartelization in German history.[471]

A striking feature of the legal milieu within which German companies operated at the turn of the 20th century was the degree of protection provided to shareholders. The investor protection reforms Germany enacted in 1884 (Corporate Law) and the Stock Exchange Law of 1896 were of the character that would be anticipated where regulators were seeking to strengthen securities markets by constraining misconduct by corporate insiders. However, the structure of concentrated ownership by family in companies preponderated in the German corporate economy throughout the period leading up to World War I.[472] In other words, the structure of dispersed share

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[469] See Brian R. Cheffins, 2003,'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 497.

[470] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 497 (citingW.F.Bruck, 1938, Social and Economic History of Germany from William II to Hitler 1888-1938: A Comparative Study pp 80-82; Chandler, 1984 ,'The Emergence of Managerial Capitalism,' 58 Bus.Hist Rev. 473, 499-500; Pohl, 1982 ,'On the History of Organization and Management in Large German Enterprises Since the Nineteenth Century' in Wolfram Engels & Hans Pohl(eds.), German Yearbook on Business History 91, 110-11).

[471] See Brian R. Cheffins, 2003, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, p 497.

[472] See Brian R. Cheffins, 2003,'Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century', The American Journal of Comparative Law, Vol. 51, pp499-500.

ownership never occurs in Germany, which is in contradiction with the "law matters" thesis, even if the legal environment in Germany was much better than that of America at that time. It shows that the law is very important but it can not displace the importance of the economy. Today the gradual change in the law from bank-based to market-oriented finance and the necessity to implement EC regulation has taken place fundamentally since the 1990s. For example, the Stock Exchange Act of 1896 was completely revised as part of the so-called "Fourth Financial Market Promotion Act in 2002; the enactment of the Securities Trading Act of 1994; Act on Improved Investor Protection of October 29, 2004; The New Takeover Law of 2002 etc.[473] But corporate governance is still as before[474] because the structure of concentrated share ownership is still as before. The structure of concentrated share ownership changes little.

5.4.3. In South Korean

Today South Korea has been a member of the OECD since 1996, having been a poor, agricultural economy in the past. Indeed, it seems there is no more striking example of how government policies can affect the economic development than the contrast between South Korea and North Korea. Prior to the Korean War, the two countries were obviously parts of one, so it is difficult to think of them as having different histories. They have the same background, such as tradition, culture, history, language.

[473] See Harald Baum, 2005, 'Change of Governance in Historic Perspective: The German Experience', Law Working Paper No.28/2005, March 2005, www.ecgi.org/wp.

[474] See Andreas Hackethal, Reinhard H. Schmidt and Marcel Tyrell, 2005, 'Banks and German Corporate Governance: On The Way To a Capital Market-Based System?', Corporate Governance, Vo.13, No.3, (May), pp 397-409.

They were exceptionally poor in 1950.They were separated from each other after the war. In 1980, South Korea grew rapidly, reaching per capita income level of US$1589 while North Korea only reached the level of income of US$768.[475] But the thesis argues the real distinction between South Korea and North Korea is to select different model of economic development. The former selected the market economy, the latter the planned economy. The choice of economic system is a matter of politics, but politics itself is not a panacea, why did crisis happen in South Korean in 1997-1998? Why did policy by politicians achieve nothing before the crisis? Why did the International Monetary Fund reach agreement with Korea on a $ 57 billion stabilization package that included conditions on financial, corporate, labor investment and other trade-related structural reforms[476] instead of political reforms? In fact the crisis directly came from the chaebols, where controlling shareholders borrowed excessively from banks. Maybe there are other reasons for the crisis that are beyond my thesis. Neither politics nor law could solve the crisis, but they were helpful for South Korea to get rid of the crisis. For example, many reforms have been proposed and enacted into law in South Korea since the crisis.[477] However, these proposals are put forward and laws are passed to help the rehabilitation of the economy in a sense.

As described above in Chapter 3, the chaebols are enormous and one of their most striking features is that most of their shares are dominated by the founder and his

[475] See Edward L. Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2004, 'Do Institutions Cause Growth?', Working Paper, (June).
[476] See Craig Ehrlich and Dae-Seob Kang , 2000, 'U.S. Style Corporate Governance in Korea's Largest Companies', UCLA Pac. Basin L. J.Vol18: 1, p 28.
[477] See Craig Ehrlich and Dae-Seob Kang , 2000, 'U.S. Style Corporate Governance in Korea's Largest Companies', UCLA Pac. Basin L. J.Vol18: 1, p 2.

family.[478] Or say the ownership of Korean conglomerates is concentrated in the hands of family members and the operation of chaebol firms is influenced heavily by the founder and his family.[479] Although the structure of concentrated share ownership in South Korea has been influenced by many elements, for example, by Confucianism, by Japanese keistu and by politics, the real and key reason is the outcome of the economy itself. Namely, South Korea is a small region politically and economically compared with many mainly developed countries after the Korea War, in addition to late development of the economy due to war, South Korea must organize companies like chaebol and win a global market facing intense competition in the world. The facts prove that some companies in South Korea are successful in the world. In the past twenty years, South Korea has made a dent in the international competition in a way that is intimately related to the indigenous patterns of social organization and corporate governance underpinning the rise of large, capital-intensive and diversified chaebol. Thus, the Koreans export mass-produced automobiles, consumer electronics, chemicals and steel.[480] In sum, the conglomerates with many subsidiaries in the hands of family could not have developed fast without requirements and growth of the economy in South Korea, although the conglomerates have received aid from the government in the course of their development, such as loans at a lower rate of interest from banks and preferential treatment of tax.

As some scholars from South Korea point out, a series of economic factors have

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[478] See Republic of Korea Ministry of Finance and Economy, Progress in Korea's Corporate Reform: Q & As (Sept. 1999)

[479] See Ungki Lim and Chang-Soo Kim, 2005, 'Determinants of Ownership Structure: An Empirical Study of the Korean Conglomerates", Pacific-Basin Finance Journal 13, pp 1-28.

[480] See Mauro Guillen, 1999, 'Corporate Governance and Globalization: Arguments and Evidence Against Convergence', Working Paper, (September).

encouraged Korean conglomerates to establish a highly agency problematic ownership structure (conflicts between controlling shareholders and minority shareholders in the structure of family concentrated share ownership) — the choice of a certain type of ownership pattern by entrepreneurs could be regarded as the rational response to the surrounding business conditions.[481] Therefore the structure of family-concentrated share ownership in companies like chaebol in South Korea is both the requirement of the economic development and the outcome of a competitive market.

5.4.4. In China

The economic reform in China is greatly affected by politics indeed. However, the economic conditions meant that there was no choice but to carry out the reform which the economy per se also required internally, otherwise the economy system would collapse. In order to carry out the state-owned enterprises (hereinafter "SOEs") reform due to capital shortage, the Shanghai Stock Exchange officially opened for business in December 1990, and the Shenzhen Stock Exchange officially began trading in February 1991 to raise funds through the stock market to maintain long-term sustainable growth in the economy. Maintaining economic growth is an essential task for the Chinese government. An important component of maintaining economic growth in China is to improve the performance of SOEs to make them adaptable to

[481] See Ungki Lim and Chang-Soo Kim, 2005, 'Determinants of Ownership Structure: An Empirical Study of the Korean Conglomerates', Pacific-Basin Finance Journal 13, pp 24-25.

the market.

Nearly all of the listed firms on the Shanghai and Shenzhen stock exchanges remained majority-owned by the state at the early stage. Furthermore, the shares owned by the state cannot be traded on the market. "One shareholder dominates the board of directors"(yi gu du da) , in many of the Chinese listed firms, insider control takes the form of overlap between the management and board of the listed firm and the firm's largest shareholder. In these cases, the board is able to ignore the interests of small shareholders.

In order to reduce the state shareholding in listed companies through market pricing, the "Provisional Measures on Management over the Reduction of State Shares to Raise the Social-Security Fund" was passed by the State Council on June 12, 2001. But investors reacted negatively to the plan and stock price fall sharply; the plan to sell off state shares was in fact suspended in October 2001. In June 2002, the government gave up and announced that the plan would be abandoned. The State Council had to formally cancel the provisional regulation requiring the sell-off of state shares. In this case, why did the policy fail? Neither politics nor law can explain this, only the economy per se. Because a high selling price for the state shares broke the rule of the market. The current market price for tradable shares was contingent on the fact that the large block of state shares was excluded from trading.

The structure of ownership in listed companies in China is concentrated and the state-owned shares account for more than 60% of all listed companies. How was the concentrated state ownership shaped? Relatively speaking, weak legal protection,

historically upholding the public ownership situation, cultural influence and political goals may offer a partial explanation of concentrated ownership in China. However, the key reason is that the market is unperfected and the economic conditions are too weak to take the risk, which is completely different from western countries because the market economy in western countries has a long history of practical experience while the market economy is at infant stage in China. Thus the design of concentrated ownership in listed companies met both the requirement of the market at that time and stability of society.

5.5. Conclusion

The above analyzes the effect of the economy, politics, law, culture and history on the structure of share ownership. The thesis argues that the formation of the structure of share ownership is a long process. Once it is stable, it is not easily changed forcefully by law or policy, through politicians who may affect the structure of share ownership instead of determining it. Because the right to a share is a vested right that is controlled by shareholders according to their requirements, the market and the state of development of the economy. So the thesis draws the conclusion: the structure of share ownership is affected by many elements, such as the economy, law, politics, history, and culture, but it is ultimately and mainly determined by economy.

What is the relationship between the economy, politics, law, culture and history? In theory, simply speaking, this thesis argues whether the economy develops, prospers,

retreats or deteriorates etc. in a given country or region, there will always be a conflict of interest between different groups of people, to a certain varying extent, who represent different political sectors or cliques in a society at any time. How to deal with the problem depends on the strength, power, or effect of political sectors or cliques. Compromise will be reached between the different political sectors or cliques through struggle, negotiation or other means. Law which binds all the people in the country is one of the outcomes of compromise between the different political sectors or cliques. While culture and history always leave a deep imprint which accompanies economy, politics and law all the time in a country. That is, economy, politics and law have a close relationship with their culture and history in a country. In practice, the relationship between the economy, politics, law, culture and history is much more complex. Economy, politics, law, culture and history per se will be affected by many elements in a society, but the economic conditions lays the foundation for politics, law, culture etc. in a country, while politics, law and culture etc may have a strong effect on the economy for better or worse. For example, politics may push for or retard the development of the economy, but can not determine the development of the economy because the development of the economy has its own rules of the game. Change in the economy, politics and law will create a new culture and history that will affect the later economy, politics and law in a country. As some scholars make the point, "The results hold strategic messages for policymaker. While a country cannot change its legal origin, it can— albeit with considerable effort— reform its judicial system by emphasizing the rights of outside investors, by making contract enforcement more

efficient and certain, and by creating a legal system that more effectively evolves to support changing economic conditions." [482] It sheds light on the relationship between economy, politics, law, history and culture in a sense. That is, politicians can not change the existing history, tradition, culture and legal origin, but based on the existing position, politicians can reform the existing culture and create as effective law to serve economic development.

In a word, the formation of the structure of share ownership in a given country or region is deeply affected by its economy, politics, law, culture, history etc. But it is determined by the economy ultimately. Once it is formed, the structure of share ownership is not easy to change because the owner of share will determine the fate of share in accordance with his requirement, market and economic development but politics, law, culture and history etc have an effect on it to the degree all the time.

[482] See Thorstem Beck, Asli Demirgüc-Kunt, and Ross Levine, 2001,'Law, Politics, and Finance', Working Paper.

Conclusion of Part One

The results of the first part of this thesis present a different picture about corporate governance in the world. That is, the model of corporate governance is determined by the structure of share ownership in place of the suggestion of Berle and Means. Secondly, the thesis casts doubt on the "law matters" theory of La Porta et al. and the "politics matters" theory of Mark J. Roe and emphasizes the importance of the economy ultimately. Thirdly, the thesis infers there is no best corporate governance in the world from the above analysis based on the different economy, politics, law, history, and culture etc. It is impossible to have the one-size-fits all view of corporate governance in the multiple world but some of the advanced contents of corporate governance could be transplanted to some countries or regions in the world according to their adaptability.

As we know, competition exists anywhere as the rule of nature. Competition is not just between animals, plants on our planet, between products, services, personnel etc, in the market in the world, but also between governance systems or other institutions across countries. But some scholars think the force of competition would lead national systems to adopt a single efficient form, namely the convergence of corporate governance. They further argued that the form on which systems would converge differed according to which national system appeared most successful at the time of the prediction. For example, before the bursting of the Japanese "bubble economy", the main bank system was regarded as representing the model in the

future.[483] That is to say, Japanese and German corporate governance looked good as models in the world in the 1980s when Japan and Germany were growing faster than the U.S. However, a significant decline in activity spread across the economy in Japan and German for a long time, namely more than a decade of economic recession in Japan, a decade of costly post-unification economic adjustments in Germany, and since the 1990s an unprecedented economic and stock market boom in the U.S., the American corporate governance model has been considered as the model to follow in the world. But how to explain the phenomenon such as Enron, WorldCom, Tyco, and Adelphia in the American corporate governance? “Had we been selecting at the end of the 1980s when the Japanese or German system was at its peak, then choice would have been very different from what we would have selected at the end of the 1990s, the winner (the Japanese or Germany system) at the end of the first decade of this century is likely to be different from what it appears to be today.”[484] The above cases show that there is no best model of corporate governance in the world. Because environment (economy, politics, law, and culture etc.) differs between countries, between industries within countries, and between countries at different stages of economic development. But some advanced experience could be learned from in corporate governance if it adapts to a given country or region.

As we know the institutions of all national systems are shaped not only by efficiency, but also by culture, history, tradition, politics etc. As Easterbrook pointed

[483] Ronald J. Gilson, ‘Globalizing Corporate Governance: Convergence of Form or Function’, Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 174, p 4.
[484] See Colin Mayer, Oren Sussman, 2001, ‘The Assessment: Finance, Law, and Growth’, Oxford Review of Economic Policy, Vol.17, Iss. 4, Winter, pp 466.

out, no global standards of corporate governance are required in our world because differences in markets more than differences in law or in politics lead to international differences in corporate governance.[485]

Ironically this part will end by the following words. As La Porta et al. point out, "This reasoning makes us skeptical about the imminence of convergence of corporate ownership patterns, and of governance systems more generally, to the Berle and Means model."[486] That is, there is no uniform model of corporate governance or structure of ownership in the world, though it is possible to learn from the experience of other systems. Lastly, the thesis argues that there is no best model of corporate governance in the world, there is only corporate governance which is adapted to the particular country or region because of particular structure of share ownership, whether diffuse or concentrated, that maximizes shareholders' expected returns that originate from the interplay of market forces.[487] In a word, markets will ultimately diminish the power of the state. The structure of ownership only changes towards its adaptability to the development of the economy, and so corporate governance will be improved in a market economy. Of course, the rationality of the structure of ownership and the improvement of corporate governance will have a strong relationship with politics, law, history and culture etc.

[485] See Frank H.Easterbrook, 1997, 'International Corporate Differences: Market or Law? Journal of Applied Corporate Finance9, pp 23-29.
[486] Rafael La Porta.et. al, 1999, 'Corporate Ownership Around the World', the Journal of Finance. Vol. LV, No.2, (April), p 513.
[487] See Harod Demsetz, and Belén Villalonga, 2001,'Ownership Structure and Corporate Performance', Journal of Corporate Finance 7, p 212.

Part Two

Practice: the structure of state-concentrated share ownership determines the majority shareholder (state) & minority shareholder (public) model of corporate governance in China

Introduction

The reform of the economy in China is actually the step by step process of privatization[488] with Chinese character, which is quite different from any other reform in the world because the history, culture, politics, law, economy etc. of China are different from those of any other country in the world. In particular, Chinese reform emphasized piecemeal incremental change. Today China is still simultaneously growing and transforming from a command to a market system. She is at the initial stage of a market economy. The process of reform in China began earlier than in Eastern Europe, but the state-owned enterprise (SOE) sector has retained an insoluble problem for a long time,[489] in particular and mainly concerning large state-owned enterprises or companies: the result of the reform of large state-owned companies and enterprises is not as good as expected due to the structure of ownership.[490] In fact, in many ways it is difficult to compare the cases of SOE reform in China with those in Eastern Europe and the Soviet Union, not only because of the very different approach but also because of the very different historical, political, legal, economic and cultural

[488] In China, before the sell-off of small and medium state-owned enterprises, in fact the privatization of SOE had begun. In informal privatization, property rights over public assets are conferred and regulated by social norms. As in squatter's rights, the community recognizes the property rights of individuals based upon customary use and de facto possession by managers. A common institutional means to privatize public assets through lease arrangements that give long-term rights over economic surplus to the lease-holder. Although the lease agreement does not entitle the lease-holder to formal property rights, in effect this is viewed in the community as equivalent to private rights over property. The extensiveness of informal privatization demonstrates the utility of the new institutionalist paradigm because informal privatization results from the social appropriation of rights over communal assets. See Victor Nee and Rebecca Matthews, 1996, 'Market Transition and Social Transformation in Reforming State Socialism', Annual Review of Sociology, Vol.22, p 416.

[489] As a matter of fact, small and medium state-owned enterprises have been privatized in China, here it refers to large enterprises.

[490] In this part, 'ownership' means share ownership when it is in relation to companies or SOEs, otherwise it means property

contexts.[491]

What has accounted for the remarkable rate of economic growth sustained over the last 20 years in China, is the spontaneous entrepreneurial effort of the collectively owned Township and Village Enterprises,[492] which is the result of privatization. However, the success of further economic reform will rely on how to deal with the Chinese people's stake in the future of their country.[493] It means the key problem that the reform will challenge in the future is the large state-owned or controlling enterprises or companies owned by the state.

As we know, unlike Russian and other East European countries that took a shock-therapy approach to economic transition, from 1978 onward China has adopted a gradual trial-and-error approach to the transition of its planned economy into a market-oriented one, starting with the agricultural sector under the household responsibility system, which represented the beginning of the process of privatization in China under the reform and opening-up policy.[494] After its success with reforming the agricultural sector in the early 1980s, China began to restructure its state-owned industrial enterprises into joint-stock corporations, which is a way of privatization in part too. But the corporate governance of large state-owned enterprises or companies is not of high quality. What reasons are there to cause such poor quality of corporate governance in China? Most scholars think it is a political reason that results in such

[491] See Buck, T., Filatotchev, I., Nolan, P., & Wright, M. 2000, 'Different Paths to Economic Reform in Russia and China: Their Causes and Consequences for Industry', Working Paper University of Nottingham
[492] Today the collectively owned Township and Village Enterprises are shared by employees and local groups, or local government, which is quite different from before, that is, they have privatized.
[493] See Thomas Clarke and Du Yuxing, 1998, 'Corporate Governance in China: Explosive Growth and New Patterns of Ownership', Long Range Planning, Vol. 31, No. 2, pp 239-251.
[494] Although the ownership of land belongs to the state or the collective according to law, as a matter of fact almost everything in community was divided among peasants in the rural area in China, including usage right of land, tools etc

corporate governance.[495]

This thesis argues that the success of economic reform in China is actually in a sense the success of gradual privatization. However, the reform of large state-owned enterprises or companies is slow and inefficient due to the special history, culture, politics, law and economy etc which affect the structure of ownership of state-owned enterprises or companies. It is the structure of ownership that leads to undesirable corporate governance in China. In other words, the structure of state-owned concentrated ownership determines the poor quality of corporate governance of listed companies in China. Therefore the development of the economy and the improvement of the ownership structure will enhance the quality of corporate governance of listed companies in China. Today the reform of the structure of share ownership in listed companies in China is under way and the corporate governance of listed companies will be improved soon, or at least it will be better than before if the reduction of the state share in large companies is successful.

[495] There are many papers or articles in economics in relation to the reform of China arguing politics or politician determine the reform of SOEs.e.g. Lisin Colin Xu, Tian Zhu, Yi-min Li, 200, 'Politician Control, Agency Problems, and Firm Performance: Evidence from a National Survey of Ownership Restructuring in China', Working Paper, (December); Qiao Liu, 2005, 'Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants', (May), Working Paper.

Chapter 6. The history of the structure of concentrated ownership

6.1. Introduction

The origin and development of an institution in a certain country has a close relationship with its history which I discussed in Chapter five. History is a mirror for today and the future. Therefore, the structure of concentrated ownership of SOEs in China will not be changed in a day as Rome was not built in a day. The structure of concentrated ownership is the natural and necessary result of history in China.

6.2. Ancient times

From ancient China onward, the emperor was supreme authority over the people, and the emperor managed and controlled the country on behalf of God or Heaven, and the country belonged to the emperor. Thus it was accepted conventionally that the emperor was the owner of everything [496] and a centralized mechanism of control was normal in China. The historical tradition has had a great effect on the people in China. It is not surprising for Chinese people that the structure of concentrated ownership in companies appears nowadays, since this is similar to that in family-held business since ancient times in China. Workshops as a unit based on the family were

[496] See 'Shi Jing Xia Ya Bei Shan' compiled by Confucian. But Shi Jing Anthology was edited by Yu Guan Yin and published by People's Literature Publishing House in 1965.

widespread in the Ming and Qing Periods (from 16 century through 19 century) and were quite different from the factories or capitalist institutions of the West. The concept and structure of a company as an impersonal and distinct legal and corporate entity for locating ownership rights and responsibility did not exist in traditional China until the late Qing dynasty period. That is, company incorporation was introduced into China by the Company Law of 1904 until the 1949 or later. However, family-held businesses had existed before companies were introduced into China and concentrated ownership[497] was the characteristic of society in China since ancient times. First of all, ownership of almost everything belonged to the emperor in a slave society. With the development and progress of society in a feudal society, most property was under the control of the rich. With regard to family-held businesses, the father was the owner of the property on behalf of the family. In other words, the family was basic unit of production in the society in China and most property of the family was controlled by the father before 1904, and this tradition was passed down even until 1949. In a word, concentrated ownership was traditional and conventional in Chinese society before 1949.

6.3. Current times

6.3.1. Introduction

[497] Here 'ownership' in the paragraph means property, which is different from 'ownership' in the other places of the second part.

In a gradual process, since 1949 SOEs were taken into absolute state ownership and became mainly a tool of economic and political development in a centrally planned economy. Eventually the SOEs become no more than a branch of government without independence. However, under the Chinese opening up and reform policy, the systematic ownership reform of SOEs has become the dominant theme, because economists and theorists have a belief that transformed-SOEs can be protected from government interference in their daily operation. By the reform of SOEs, they can be independent entities in law, their property right can be clarified, they can be helped to raise new capital from the public, they can operate the business at their discretion and the management can take more responsibility for the consequences of its decisions.[498] In fact, this thesis argues that economic reform in China is, in a sense, the reform of the structure of ownership of SOEs. That is, the process of reform is gradually underway from the wholly state-owned structure to partly state-owned structure.

6.3.2. Before the reform of economy

When the People's Republic of China (PRC) was founded in 1949, business corporations and enterprises that were left by former government and businessmen were gradually reformed and became state-owned enterprises (SOEs). Historically, the government played a key role in governance. In the period of the planned economy, civil society was almost replaced by the political state, and SOEs and government

[498] See Daqing Qi, Woody Wu, Hua Zhang, 2000, 'Shareholding Structure and Corporate Performance of Partially Privatized Firms: Evidence From Listed Chinese Companies" Pacific-Basin Finance Journal 8, p 588.

agencies were commingled to a great extent. Moreover, SOEs were generally regarded as government branches and SOEs did not have their own legal independence. Chinese SOEs were established to serve two major objectives: as the principal microeconomic foundation and instrument of central planning, and as the concrete manifestation of the socialist principle of ownership of the means of production by the whole people. SOEs were not complete business enterprises. State ownership deprived them of legal independence, and the state planning apparatus deprived them of economic independence. In other words, SOEs were only a tool of government instead of being independent enterprises. Indeed, terms like corporation, independent entity or legal person did not exist in China during the period of the planned economy. Most SOEs were referred to as factories, where there were small and independent societies with their schools, hospitals, kindergartens, shops and other service providers, but with regard to operation, they had no rights in purchasing, marketing, distribution, or strategic planning functions, and the factories were treated as government branches and were administered geographically. SOE managers were appointed, shifted and dismissed by government agencies and paid as government officials.[499]

In China, SOEs are firms legally owned by the state and administered either by various industrial ministries of the central government or by local (provincial or municipal) governments. Before the enterprise was reformed in the early 1980s, all production and distribution decisions were centrally planned and SOEs were merely

[499] See, Nolan, P. 1996, 'Large Firms and Industrial Reform in Former Planner Economies: The Case of China', Cambridge Journal of Economic, 20, 1, pp 1-29.

operated as cost centers. In the absence of market competition, the operation of most SOEs was inefficient. Such poor performance by SOEs was frequently attributed to their ownership structure in which the state was only owner. In other words, the problems faced by SOEs often resulted from their history as "pure" state enterprises within a centrally planned economy. As a result, their social obligations to their workers and families imposed a heavy burden on many enterprises. The output of SOEs moved towards being production-driven rather than market-focused, and often lacked adequate product quality. Additionally, the soft budget constraints, too many employees, the inflexible wage and life employment system, the heavy burden of a firm-based social benefits system, the use of out-dated technology, and the lack of quality controls, no one taking responsibility for production, all contributed to the planning system rather than the requirement of market.[500] In a word, it seemed everything in the SOEs was decided by the government.

The shortcomings of SOEs at that time were as follows: (1) there was no incentives for employees in an SOE under the principle of egalitarianism, let alone innovation; (2) it was very difficult for SOEs to operate purely as an economic unit seeking to maximize its economic efficiency objective because the cradle-to grave social services for workers were provided by the SOEs; (3) because SOEs had to answer to a multiplicity of superior authorities under the planning system, such as local government, banks, material supply bureaus, investment planners, it meant SOEs were "controlled by many and by none"; (4) as in the Soviet-type economies,

[500] See Martin Hovey, Larry Li and Tony Naughton, 2003, 'The Relationship Between Valuation and Ownership of Listed Firms in China', Corporate Governance, Volume 11, Number2, (April), pp 112-113.

SOEs in China were instruments of political and social control, in other words, the system of enterprise governance in China was a duplicate of the system of political governance, in particular during the Cultural Revolution (1966-76) when "politics was in command", and the objectives of SOEs were clearly subordinated to politics.

6.3.3. Reform times

China's SOE reform began in the late 1970s, shortly after the Maoist leadership fell from power, which was an unprecedented event described by the senior leader Deng Xiaoping as "crossing a river by groping for stepping stones". The following is the evolution of reform objectives.

> "(1) Pre-1970. A planned economy under the law of exchange value. (2) 1970 to October 1984. A planned economy supplemented by market regulations. (3) October 1984 to October 1987. A planned commodity economy. (4) October 1987 to June 1989. An economy where the state regulates the market and the market regulates the enterprises. (5) June 1989 to 1991. An economy with organic integration of the planned economy and market regulations. (6) 1992 to present. A socialist market economy with Chinese characteristics."[501]

Based on the above process of reform of SOEs in China, the SOEs governance models could be classified as follows.

(1) Traditional model (1950s-1984).That is to say, first of all, the time from 1950 to 1984, was mainly the traditional planned economy period, during which state ownership was the only legal form of ownership besides collective ownership. Under

[501] See Wing Thye Woo, 1999, 'The Real Reason for China Growth", The China Journal, No. 41 (Jan.,), p123.

this model, the State had ownership of the property of the SOEs and enjoyed managerial power. The SOE's executives were required to fulfill the production plans of the government according to plans and arrangement rather than enhance profits for the benefit for investors. Thus SOEs were not real business enterprises acting as profit maximizers, but government affiliates responsible for producing goods and rendering services. The input and output of SOEs were determined by the State according to the central planning instead of the market. The State decided what to produce and how to appropriate financial resources, set prices, distribute profits, and assume losses as planned.[502] Accordingly, the governance structure of SOEs was an integral part of the general governmental framework, SOE's executives were appointed and dismissed by government agencies and enjoyed the same political and economic treatment as government officials. The people who worked in the SOEs gained an "iron rice bowel" which could be kept for life. In a word, SOEs under the model were not really independent economic and legal entities but government branches. The State exercised public ownership and enjoyed control rights over SOEs, and managers had little discretion or incentives as to how a firm could be operated.

(2) Transitional Model (1984-1993). The aim of the model was to loosen the state's direct control and enlarge SOE's autonomy to an extent. That was, the reform was concentrated on "separation between state ownership and SOEs managerial rights". To accomplish the reform objectives, SOEs reform began with the Management Responsibility Contract System (MRCS), in which the government

[502] See Deboran Kay Johns, 1995, 'Reforming the State-Enterprise Property Relationship in the People's Republic of China: the Corporatization of State-owned Enterprises', 16 Mich. J. Int'l L. 911, p 912.

transferred management authority to the enterprises and allowed them to keep some of their profit. And then, the State-owned Industrial Enterprises Law of China was adopted in 1988. Pursuant to the law, "the property of an enterprise shall be owned by the whole people and shall be operated and managed by the enterprise with the authorization of the state in line with the principle of the separation of ownership and managerial authority. The enterprise shall enjoy the rights to possess, use, and dispose of, according to law, the property, which the state has authorized it to operate and manage. The enterprise may, in accordance with the decision of competent government agencies, adopt contract, leasing or other forms of systems of managerial responsibility." As a result of the series of enterprise autonomy expansion schemes and the "contract responsibility system", governmental intervention in the operation of SOEs was significantly diminished compared with previous reforms. Managers had a certain freedom to make their business decisions and the SOEs were allowed to keep part of their profit after completing the government's assignments. However, there were many drawbacks under the system, for example, the contractual relationship between managers and government was asymmetric and incomplete.

As we know there was an agency problem between the managers and SOEs due to the lack of effective supervision and asymmetric information during that time. That is to say, managers abused their position and misused their rights to plunder state assets. At the same time, political costs still played important role in the country under the influence of the traditions of the socialist planned economy, such as the state still retained certain control rights over enterprises and the operation of managers were

controlled by the Party.[503] In other words, the state was the only owner of SOEs, and this determined the manner of operation. Thus the function of managers was very limited because they were appointed and dismissed by the Communist Party, although the managers were given some autonomy, for example, the use of incentive contracts to govern the relationship between the state and SOE managers was very popular during this period.

As stated above, the reform of traditional SOEs in this period significantly lessened the role of governmental intervention in the management of SOEs, SOEs were given more autonomy and permitted to keep more of their profits, and the incentives of SOE workers were strengthened via bonus payments and differing work contracts, but there were many shortcomings including at least: the rights and responsibilities of SOE stakeholders and management were not well defined; there was no incentives for innovation and long-run investment; and there was opportunistic expropriation by managers.[504] In a word, owing to the structure of ownership being highly concentrated and the legacies of decades of central planning and traditions of administered allocations of resources, such as subsidized capital, skilled labour, and raw materials, some of these large- and medium-size, state-owned enterprises continued to hinder China's transition to an advance market economy. [505]

(3) Modern Corporate Model (1993-Present). As described above, managers were

[503] See Qian, Yingyi, 'The Process of China's Market Transition (1978-1998): The Evolutionary, History, and Comparative Perspectives', Working Paper, which is available at http:// www-econ.standford.edu/faculty/workp/swp99012.pdf, at 40.
[504] See Varouj A. Aivazian, Ying Ge, Jiaping Qiu, 2005, 'Can Corporatization Improve the Performance of State-Owned Enterprises Even Without Privatization', Journal of Corporate Finance.
[505] See Gary Jefferson, Albert GZ.Hu, Xiaoojing Guan, Xiaoyun YU, 2003, 'Ownership, Performance, and Innovation in China's Large- and Medium-Size Industrial Enterprise Sector', China Economic Review 14, p 90.

given some autonomy after the reform. However, a critical defect was that profit retention by management had no downside, because the state, in fact, remained responsible for final losses, mainly through the state-owned banks, which were not contractual parties in the enterprise-commercialization process. Thus, as of 1994, over 40% of SOEs were unprofitable, and while SOEs accounted for 34% of GDP, they absorbed three quarters of domestic credit. Their ever-increasing triangular debt (unpaid bills between state enterprises, state banks, and the government) had accumulated to over 4900 billion Renminbi Yuan (or 95% of GDP), and bad debt was estimated to be as much as 25% of state bank assets in 1996. Many troubled SOEs were unable to pay back these accrued loans, thus threatening the bankruptcy of China's banking system itself. MRCS did not reach the aim of effectively reforming SOEs and was halted nationwide in 1994.[506]

It demonstrated that the above reform of SOEs was not desirable. The process of partial privatization through the creation of joint-stock companies (corporatization) had to begin through the establishment of the Modern Enterprise System, or Cooperative Shareholding System. In order to address political costs and solve the agency problem, China decided to head for its socialist market economy reform by setting up the "modern enterprise system" in accordance with worldwide experience. Theoretically, the corporation as an independent legal person, and its rights, obligations, responsibility, ownership, and others are clarified by the law or private agreements, which will avoid government intervention and strike a balance between

[506] See Dongwei Su, 2005, 'Corporate Finance and State Enterprise Reform in China', China Economic Review 16, p 121

parties relating to the corporation. Accordingly corporatization is regarded as the best approach in theory to design modern enterprises.

In fact, early in November 1984, some SOEs became shareholding enterprises through a process called "gufehua" or "shareholding transformation" as an initial step in China but on a small scale. The new and significant wave of economic reform started with Deng Xiaoping's visit to south China in 1992, when he called for a continuation of the reform effort. From then the structure of ownership in SOEs has been changing greatly, or at least it provided a guiding theory for the reform of the structure of ownership in SOEs.

From the perspective of history, the market-oriented reform measures that China has taken have certainly fostered the economic efficiency of the state sector indeed. However, the optimal allocation of resources is unlikely to be achieved only by creating markets for products, workers, and managers without changing the concentrated ownership structure of SOEs. The state-owned highly concentrated structure must be reformed by privatization to a certain degree, such as diversifying state ownership by introducing other forms of large shareholders, including institutional investors. There would be the possibility of a Pareto improvement if the shares that are held by government in the stock companies could be decreased or sold off.[507]

In order to carry the economic reform further, in November 1993, the 14th Central Communist Party of China issued the Decision on Issues Concerning the

[507] See Xiaonian Xu, Yan Wang, 1999, 'Ownership Structure and Corporate Governance In Chinese Stock Companies', China Economic Review 10, p 94.

Establishment of a Socialist Market Economic Structure, which formally introduced the modern corporate system to SOEs. The major reform objectives of the system included transforming the SOEs into corporations by the separation of ownership and control and the establishment of an efficient corporate governance structure. And then the Corporation Law of 1993 provided a solid legal foundation for the transformation of SOEs into different types of business corporations, including wholly State-owned corporations, closely held corporations (limited liability companies), and publicly held corporations (joint stock limited companies) . In practice, the modern corporate model could not solve all problems that arose in China. (I will discuss this below in detail.) For example, when an existing SOE was incorporated as a limited liability company (LLC), it became either a wholly state-owned LLC (if there was only one state-owned investment entity) or an ordinary state-owned LLC (if there were two or more state-owned investment entities). In both cases the state was the sole owner of the enterprise, though it may have invested in the enterprise through different entities, such as local governments, central government or their departments. As a consequence, corporatization of SOEs into LLCs thus only limited the state's liability toward the enterprises but did not change their ownership structures. In other words, the corporatization program was not intended to be a major breakthrough in terms of state ownership. Accordingly, most of the corporations have almost been the same as SOEs of the previous reform.[508] The arbitrary government control over and intervention in the operation of the LLCs, which are still solely state-owned, have

[508] See Shu Y.Ma, 1998,'The Chinese Route to Privatization: The Evolution of the Shareholding System Option', Asian Survey, Vol.38,No.4 (Apr.,), pp381-382.

remained as before.[509] In a word, the success of the SOE corporatization program in improving the effectiveness of the governance system of SOEs and their performance has been largely illusory, and some problems still persist after corporatization, such as that of soft budget constraints and of government intervention. That is, the corporatization still leaves insoluble problems.

The shortcomings of corporatization are as follows: Improved corporate performance will ensure that the state can benefit through its shareholding in these SOE-transformed companies. However, the performance of SOEs can't necessarily be improved by setting up shareholding companies alone without reducing the rate of ownership by the state. First, traditional agency problems remain because the separation of ownership and control, and state control over firms continues to exist in these SOE-transformed companies if the state stays the controlling shareholder. As the state and its representative have inadequate resources and expertise in monitoring and disciplining the management, the conflict of interests between the state and the management persists. Second, the objective function of the state and its representatives is not to maximize shareholder value. For example, the state may want to keep redundant workers on the payroll of the SOEs and SOE-transformed companies in order to preserve social stability, even though such a policy offers companies less profitable. Third, it is well known that minority shareholders in corporations have no adequate incentives to monitor management decisions closely

[509] See Shu Y.Ma, 1998, 'The Chinese Route to Privatization: The Evolution of the Shareholding System Option', Asian Survey, Vol.38,No.4 (Apr.,), p382.(citing Chai and Docwra, "Reform", pp 173-175. More specifically, 68 of the 100 SOEs selected for the corporatization experiment have chosen the wholly state-owned LLC as their legal organization from. See Jinrong shibao (Financial news) (Beijing) , November 23, 1997).

due to the free-ride problems.[510] Fourth, a more serious problem is the conflict of interest between the state as a majority shareholder and the public as minority shareholders which will be discussed below.

As we know, China started the process of industrialization along the lines of the Soviet model much later than in Russia, and adopted a much modified structure due to prevailing conditions. But modeling after the Soviet model brought drawbacks, such as inflexibility and inefficiency, which needed to be reformed. China began to reform the economy much earlier than in Eastern Europe and Russia; and has experienced more rapid economic growth in recent years than the post-Soviet economies.[511] However, there are many problems remaining after the process of the reform, in particular the structure of concentrated ownership, which must be solved properly and reasonably if the reform of economy in China is to be as successful as expected.

In a word, the characteristics of reform in China include at least the following: (1) step by step. China has laid stress on gradual reform in order to keep the stability of society, which is in conformity with the traditional Confucian culture discussed below. Thus, when gradual experimentation at the local and sectoral levels is successful, the central government will endorse it or other departments or sectors will imitate it. For example, the reform in China began in rural areas, in one of the poorest villages, and after success, the experience was spread to the countryside all over the country. (2) The dual-track approach. The dual-track approach is an extension of gradual reform

510 See Daqing Qi, Woody Wu, Hua Zhang, 2000, 'Shareholding Structure and Corporate Performance of Partially Privatized Firms: Evidence From Listed Chinese Companies" Pacific-Basin Finance Journal 8, pp 588-589.
511 See World Bank, 1996, From Plan to Market, World Development Report, Oxford University Press,; J.Child, 1994, Management in China During the Age of Reform, Cambridge University Press; P. Bowles and X. Dong, 1994, Current Successes and Future Challenges in China's Economic Reforms, New Left Review 208 November-December, pp 49-77)

and is the most important aspect of Chinese reforms. The dual-track approach means partial reforms within sectors. In other word, when part of reform is under the way, the traditional or old way still remains alive. For example, the first time this tactic was used was with two-tier pricing, which was introduced in rural areas in 1979 along with the household responsibility system. Later it was applied to other sectors, such as industry (through the contract management responsibility system), the national budget payments (through the fiscal contract responsibility system), external trade and payments (through the sharing of foreign exchange between central and local governments, trade contracting, and foreign exchange trading centers), and labour markets (through the contract system for new hire in the state sector).[512] This thesis argues that, on one the hand, the dual-track approach is in line with gradual reform in China, and, on the other hand, it strikes the right balance between the old one (the vested interest of the bureaucracy) and new one. (3) The structure of ownership is the key and sensitive problem, because the reform of the structure of ownership is complex and has something to do with the stability of the whole society of China. That is, the structure of ownership in SOEs will be reformed comprehensively if the two conditions are met: one is a mature market, and other is the stability of society.

6.4. The history of listed companies

SOEs had no choice but to go public after many years of reform due to the heavy

512 See Stoyan Tenev and Chunlin Zhang with Loup Breform, 2002, 'Corporate Governance and Enterprise Reform in China Building the Institutions of Modern Markets', World Bank and the International Finance Corporate, Washington, D.C, p 8.

losses incurred by SOEs. The first example since the founding of the People's Republic of China in 1949 was a department store in Beijing, which was given permission for issuing share in 1984. In 1992, firms were permitted to issue so-called "B-shares" to foreign investors in addition to the existing "A-shares" issued to domestic investors. In 1993, "H-shares" were issued for the first time in Hong Kong by firms incorporated in China but listed on the Hong Kong stock exchange. In 1992, the government established the State Council Securities Commission (SCSC) and China Securities Regulatory Commission (CSRC). In April 1998, the SCSC and the CSRC were merged to form one ministry directly under the State Council as part of the government's plan for improving regulatory effectiveness. In November 1998, the authority responsible for supervising local securities regulatory departments was transferred from the People's Bank of China (PBC) to the CSRC.

During the initial period of stock market development China relied primarily on an administrative government structure built around the quota system.[513] With regard to the quota system, the State Planning Commission (SPC) and CSRC together determined how many shares in total should be issued each year. Then the total quota would be broken down and allocated among provinces and mega-cities such as Beijing, Shanghai and Tianjin. If an SOE wanted to be listed on the stock exchange, it had to get an approval from the local government, the State Economic and Trade Commission (SETC), the State Commission of Economic Restructuring (SCER) and the CSRC. In other words, under the quota system, firms must be granted the quota

[513] The quota system has been abandoned because it has many shortcomings.

before listing on the stock exchange in China. Although the quota system was beneficial to mitigate the asymmetric information problems investors and regulators faced, the adoption of a quota provided the local bureaucrats with 'rent-seeking' opportunities.

Today's results of ownership and governance characteristics of listed companies in China are largely shaped by the past reform of SOEs based on the market and the stability of society. Under the quota system, local government tended to give preference to state-owned companies in place of private sector companies. Such criteria would not necessarily lead to the selection of the most dynamic, successful, and high-growth companies. On the contrary, most of the companies under the control of local government were loss-making and urgently needed capital infusion, or were otherwise socially or economically important. In a word, the criteria of selection of companies for listing focused on not only the economy but also society.

During the process of listing, the initial public offering process tended to select companies that had strong links with local governments and fuzzy boundaries with their parent groups, which would create strong incentives and preconditions for the controlling shareholders to interfere with the affairs of listed companies and exploit minorities through related-party transactions. For example, Qingqi Group was appointed by the provincial government to manage the State-owned shares in Qingqi Motorcycle, which took up 53.58% of the total issued share capital of the Company before the B Share issue and 40.90% immediately after the completion of B Share issue. The chairman of Qingqi Group was also designated as the shareholder

representative of the State-owned shares.[514] Such cases are very common in listed companies in China. That is to say, the interference of the state in the affair of listed companies or by related-party transactions will take place easily due to the structure of ownership.

Because of the maturity of market and stability of society, equity ownership in a listed Chinese firm had to be divided into as many as five different classes: state-owned shares, legal-person shares, tradable A-shares, employee share, and B-shares only available to foreign investors. The phenomenon that is unique to the Chinese equity market maybe exists only in China. (referring to table below)

Table 1: Types of Common Stock Issued in China[515]

Tradable through exchange		Definition
No(private Block Transfer Possible)[516]	State-owned Shares(there are sub-categories under this definition)	Shares that are controlled by the central government during the process in which firms are reformed into a limited liability incorporation, but before they are listed. All these shares are managed and represented by the Bureau of National Assets Management. The Bureau also appointed board members on firms' boards
	Entrepreneur's share	Shares reserved for firms' founders during the same process

[514] See Ray Ball, Joanna Shuang Wu, 2004, 'Jinan Qingqi Motorcycle Co., Ltd', J.of Acc. Ed. 22, p 333.
[515] See Franklin Allen ,Jun Qian, and Meijun Qian, 2002,'Law, Finance, and Economic Growth in China', The Wharton Financial Institutions Center, Working Paper, (December).
[516] It should point out that non-tradable doesn't necessarily non-transferable, in fact the state and legal person shares can be transferred among various institutions subject to the approval of the China Securities Regulatory Commission (CSRS), but these shares still remain non-tradable and could not be directly traded as common tradable shares on the market after the transfer.

	Foreign owners	Shares owned by foreign industrial investors during the same process
	Legal Entity holders	Shares sold to legal identities(such as banks or other companies) during the same process
	Employee share	Shares Sold to Inner Employee during the same process.
Yes(New issued shares	Share A	Chinese Company listed in China (Shanghai or Shenzhen Exchanges), and shares are sold to Chinese investors
	Share B	Chinese Company listed in China, but shares are sold to foreign investors
	Share H	Chinese Company listed on Hong Kong, New York and London Stock Exchanges.(shares can only be traded on the above Exchanges but can be held by anyone). Since most of the shares are listed on Hong Kong, the H designation is used in this context.

Although listed companies in China are incorporated in accordance with laws and regulations in form, the operation of listed companies is not as desired. As a result, the characteristics of the equity market in China are as follows: (1) the transformation of SOEs into listed companies at the initial stage. As analyzed above, the result of the Management Responsibility Contract System was not desired and Central

Government had to terminate it in 1994. The aim of the reform concentrates on SOEs that only go listing due to their heavy loss. Therefore it is the reason why about 60% of shares are held by the state (so-called "non-tradable" shares), consisting of "state-owned" and "legal person" shares. State-owned shares refer to those held by the central and local governments, or departments designated by the State Council or governments. Legal person shares refer to those owned by SOEs or other economic entities— generally promoters of invested companies. (2) The state as the biggest shareholder controls most of the listed firms. Since most listed companies derive from the transformation of SOEs and most of shares were kept in the control of the state, it is not surprising that the proportion of non-tradable shares is concentrated in the 40-80% range in about 90% of listed firms that are controlled by the state in China. (3) The market requirement of one stock price, achieved through arbitrage instead of the market, does not prevail due to market segmentation, such as weakening the relation between the A- and B-share markets and between the domestic stock exchanges and Hong Kong stock exchange. The same company can issue both A-and B-shares (or both A- and H-shares), aimed at different types of investors. Domestic investors have been allowed to trade only A-shares, while foreign investors are restricted to trading B- and H-shares, even though the two shares are identical with respect to shareholder right. (But in March 2001, the government allowed individual domestic investor holding foreign currency accounts to purchase B-shares) [517]

As stated above, most state-controlled listed companies have been transformed

[517] See Sayuri Shirai, 2004, 'Testing the Three Roles of Equity Markets in Developing Countries: The Case of China', World Development Vol. 32, No.9, p 1471.

from SOEs previously solely owned by the state. After the initial public offering, shareholder rights of the state are represented by either local offices of the Bureau of State Assets Management (BSAM) of the central government or finance bureaus of local government, depending on the pre-IPO ownership of the SOEs. However, the performance of listed companies is not as good as expected due to ownership by state because the monitoring and control system has inherited most of the agency problems that existed before the listing of SOEs. First, local BSAM and finance bureau officials don't have adequate incentives to closely monitor management performance and decision-making because their personal prospects have no connection to the performance of state-controlled listed firms. Second, most local BSAM office and finance bureaus are understaffed, and the existing staff has limited expertise in the field of modern finance and investment theories and practices. Third, while in theory local BSAM and finance bureau officials have the right to appoint board members and disapprove financing and investment proposals by management, in reality all major decisions have to be made jointly with local party organizations; consequently the top priority is political goal instead of corporate profitability.

Although the quota system has now been replaced by the sanction system under law, getting approval is still quite difficult and competitive. Because listing on Exchange Stock is scarce resource in China so far.

Historically, actually the state shares were over-valued in the process of going public. Under a quota system controlled by all the level of governments and the focus of reform on SOEs, the government or an SOE as sole or major initiator of a PLC was

inevitable to be the largest shareholder, and endowed with strong bargaining power in its assets valuation and discounted its assets into shares due to drawback of the accounting system. Thus it was not surprising that the state shares were deliberately enlarged and over-valued from the beginning. As a result, the IPO price of common A-shares was much higher than its intrinsic value, which meant the individual investors had contributed too much to the PLCs. That was why investors reacted negatively to market when the State Council announced to sell state shares to publics on 12 June 2001.The Shanghai Composite Stock Index dropped dramatically by 32%, from 2245 on 12 June 2001 to 1514 on 22 October. At last, the China Securities Regulatory Commission had to suspend the reform in a hurry.

Initially one of the aims of listed companies from the transformation of SOEs is to enhance efficiency and productivity. However, on average, most of the listed companies in China after going public do not actually improve their performance as expected. They still face serious financial problems and still suffer from bad corporate governance due to the structure of concentrated ownership. That is, the dominant state shareholding justifies state intervention that results in the above outcome.

6.5. Conclusion

In China, concentrated ownership has been traditional since ancient times, which is normal and recognizable by Chinese people. At the early stage of the founding of the People's Republic of China, if the structure of ownership was influenced by politics

due to special environments, people were used to concentrated ownership, but after the reform of the economy, it is the structure of ownership of SOEs that will play the key role in the process of reform when the market develops. That is, the gradual reforms hit squarely at the heart of the central institutions around which Communist China was organized. However, "vestiges of the old system stayed and these legacies would potentially play fundamental roles in creating the transition from one system to the other."[518] In other words, the Communist Party has taken advantage of the structure of concentrated ownership of SOEs to control the economy, in particular, making listed companies the same as traditional SOEs. Namely, the state is the largest shareholder of most of listed companies, which results in the poor quality of corporate governance of listed companies.

[518] See Doug Guthrie, 2000, 'Understanding China's Transition to Capitalism: The Contributions of Victor Nee and Andrew Walder', Sociological Forum, Vol. 15, No.4. (Dec.,), p 729.

Chapter 7. The Relationship between culture and ownership

7.1. Introduction

Culture consists of the ideas, values, norms and meanings that are not only shared by members of a social entity, and transmitted through families, communities and organizations, but also have a profound effect on the behavior of members of a social entity. Culture is embedded in institutions such as general and vocational education, training, systems of industrial relations, and social stratification. These institutions are in practice consciously shaped and changed by a group of powerful and influential sectors in accordance with their own self-interest and cultural orientations.[519] In the long history of China, the culture has affected ownership deeply, especially Confucian culture.

7.2. Ancient times

A feature of traditional Chinese culture is a cosmic harmony (accommodation)[520], including a culture of harmony. Therefore a collective spirit has been main the culture or cultural environment in China over a long period of time from ancient times until

[519] See Trevor Buck, Igor Filatotchev, Peter Nolan, and Mike Wright, 2000, 'Different Paths to Economic Reform in Russian and China: Causes and Consequences', Journal of World Business, 35(4), p 381,(inciting Lane, C. 1989, Management and Labor in Europe. Cheltenham: Edward Elgar,).

[520] Zeng Xianyi, Ma Xiaohong, 2006, 'A Dialectic Study of the Structure and Basic Concepts of Traditional Chinese Law and an Analysis of the Relationship Between 'li' (ceremony) and 'fa' (law)', Front. Law China, 1:34-52.

now. "Collectivist cultural beliefs led to a societal organization based on the group's ability to use economic, social, and, most likely, moral sanctions against deviants. Individualist cultural beliefs led to a societal organization based on legal, political, and (second-party) economic organizations for enforcement and coordination."[521] In China, people's social values and institutions are mainly the set of beliefs first developed and formalized systematically by Confucius, who emphasized the cultivation of grace and amicability in order to achieve harmonious society. This means, on the one hand, honesty and sincerity in horizontal relationships, and on the other hand benevolence, faithfulness and hierarchy in vertical relationships as well as honesty and sincerity. This set of beliefs clearly regulates the behavior of individuals and defines family and social order. Confucianism has bred a highly hierarchical system of authority and control in which collective interests have assumed primacy over individual ones and individuals must obey authority. For example, Confucianism prescribes a strict hierarchical ordering among members of any organizational unit in order to maintain social order and harmony. Every member in society must absolutely be loyal to and submit to collectivism and authority to create a harmonized society. Thus, members of a collective or organization are expected to recognize, respect and obey a leading authority. Therefore, any member should recognize, respect and obey the directives of the organization, community, clan or village. In the past, it was customary and commonplace for conflicts within a unit such as the family, clan, community or village to be resolved not through the intervention of an external

[521] See Greif, A., 1994, 'Cultural beliefs and the organization of society: A historical and theoretical reflection on collectivist and individualist societies', Journal of Political Economy 102, p 942.

agency, but instead internally and confidentially through arbitration or conciliation by the clan elder, or a respected or recognized local or officer of the organizational unit. Once a decision is made, parties to the case or the members of unit have to obey it and it can not challenge it, otherwise the parties, or members should be considered as disloyal and disruptive, even treacherous. Safeguarding the interests of the unit or organization is the responsibility of every any member and every member should know his place, and what he should not disclose and what he should no inquire into. In accordance with customs, every member of unit should maintain the confidentiality of the internal affairs of the unit— dirty linen is never washed in public, and disclosures are regarded as a betrayal of the unit's interests.

According to Confucian principles, the life of each individual is only a link in that person's family lineage and each individual is a continuation of his or her ancestors. Therefore the ancestral hall has been especial significant in China in the past. From ancient times until the founding of the People's Republic of China in 1949, there was an ancestral hall that was used for public activities in every big village in rural areas, such as ceremonies for sacrifice and worshiping of ancestors, to commemorate ancestors and dead relatives and to express respect for their superiors, as well as for meetings for the discussion of key matters relating to public affairs. In terms of property and shareholding, under the influence of Confucianism from ancient China, private ownership of productive assets (especially land) from the late Ming Dynasty period onwards in China was typically held in the form of ancestral trusts by households or clans. In other words, property rights of a family or clan were held in

the name of a dead ancestor or in the form of a dead ancestor, with rules of equity built into rules of lineage and ritual association with ancestor worship, from generation to generation. Thus, while the West went by the route of law, on the contrary, China went by the route of ritual in the rules and conventions governing property and control rights. As mentioned above, property of clan or family was in the name of ancestors. Control rights were exercised by members of the trust (clan) on behalf of the dead ancestor, with senior members of the family clan taking turns in management— by what has been described as "stripes" or lineage lines. Shareholding was organized and exercised through religious conventions based on the rules of ancestor worship, and generally speaking, the property (in particular land) in the form of ancestry in ancestral hall could not be sold but lent with proceeds going to all public activities. The relationship between people in the same clan or village was strengthened and harmonized by activities in the ancestral hall where the family tree or family system (pedigree) that held detailed information about every person (mainly male) or family of the same clans was kept, and national administration of the people was much assisted by ancestral hall, where officials from the administrative office could know who is who. With the help of activities in the ancestral hall, the principle of collective responsibility in the form of lineage served to mediate between the individual and the state in order to keep law and order in the society. Meanwhile institutions of lineage provided some means for the organization of business, such as who should take responsibility for the property in the name of ancestry, announcing the balance between incomes and expenditures publicly. Of course lineage institutions

meant that an individual should be a member of the collective until one acquired seniority on behalf of the family or clan. An individual whose interest was violated and required remedies from the state, whether as a member of a family (clan) or of a family-held business, had to seek protection from the state through the lineage's private connections within the state bureaucracy.[522] Without relationship in bureaucracy, it was very difficult for an ordinary people to find remedial way when their property or rights were violated, which was distinct from that in Western countries via law.

In ancient China, the foundation of Chinese society was the family, based on filial piety, as advocated by Confucius, and the most important religion, as stated above, was ancestral worship for which the eldest male of the most senior line took the primary responsibility in each family in a form of ritual primogeniture in accordance with the patrilineal system, which was one of forms of filial piety. In fact, the whole of Chinese society was theoretically based on filial piety on which not only the well-being of the family but also the society in general was built. While rituals, ceremonies, laws, religions and even festivals or important occasions were simply different expressions of the filial piety in varying ways, which was the kernel or root-motive of all Chinese ethics.[523] The people could be united as one in the clan, village or community through the activity of filial piety, so that the society was much more harmonious. The above have held a long and deep-rooted history and are important aspect of Chinese culture, namely the reflection of collective culture.

[522] See Dr. Cyril Lin, 2001,'Private Vices in Public Places: challenges in Corporate Governance Development in China', Working Paper, (April), OECD Development Centre.
[523] See Edward H.Parker, 1906, 'The Principles of Chinese Law and Equity', 22 Law Q. Rev. 190 192 .

Therefore, it was not surprising that the modern business corporation never happened before the late 19th century in Chinese history but family businesses representing collective harmony in the society until modern times.[524] Or quasi-commercial enterprises, relatively large quasi-commercial enterprises organized in the name of the family and worship of ancestors. Although the dynasties and their policy on quasi-commercial enterprises changed greatly from time to time, the baseline for any change followed the indigenous traditions, such as filial piety and worship of ancestors that consolidated the spirit of collective culture. And all intelligent policy analysis must begin with an informed appreciation of those traditions, including culture. As described above, in the Confucian view, the collective was morally superior to the individual. That is to say, as a member of society a person must control his selfish desires so that the interests of the community or public good could be respected. Otherwise the member was not loyal. His true personhood was thus achieved by disciplining or controlling his desires so that he should serve interests of society and not clash with the public good.[525] It is not surprising that the attitude of orthodox Confucianism was anti-mercantile and hostile to profit-seeking because orthodox Confucianism was infused with idea that the most socially acceptable road to success was winning a post by imperial exam in the imperial bureaucracy and that merchants ranked lowest in the traditional four-tier hierarchy of social groups (the gentry occupied the top tier, peasants the second tier, artisan ranked third, and

[524] See Max Weber, 1954, 'Max Weber on Law in Economy and Society 185-186, Max Rheinstein ed., Edward Shils & Max Rheinstein Trans., Harvard Uiniv. Press.
[525] See Teemu Ruskola, 1999-2000, 'Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective', 52 Stanford Law Review, p 1673, (citing Wm. Theodore De Bary, 1983, The Liberal Tradition in China 27).

merchants last). The merchant was always despised in the society in the past.

In accordance with the spirits of Confucianism, when conflict of interest between the collective and the individual, the collective could seek profit at the expense of others because the collective reigned supreme in affairs familial and political, and then divided its profit unevenly among various classes of participants according to their status in society due to the "duty of submission to parental authority" etc. as influenced by Confucius. In other words, the Chinese household as a basic unit owned collective property that only was controlled by father in family and could engage in the pursuit of profit in place of the individual members of family, and kinship relationships were paradigmatically hierarchical, with the senior kin exercising authority over the junior kin. For example, the father-son relationship was governed by the master principle of filial piety. Thus, during the father's lifetime the son's personality was part of the father's, while after the latter's death his personality was extended into that of his son, not only rights but also liabilities, in particular before 1949 it was normal for a son to take responsibility for his father's debts after his father's death. Women were in effect non-persons, mere appendages of male persons. In a word, the family's collective responsibility for debt was made in the name of father on behalf of the whole family and father can sell his wife and children if he was in arrears, and membership in the lineage descended in the male line only, while kinship group and the larger sociopolitical communities could be interpreted as extended families which were loyal and owed fiduciary obligations to their superiors and even to the emperor. Even before the foundation of the People's Republic of

China in 1949, it was very popular in China for Chinese clans to own property jointly to provide for clan welfare and ancestral worship through the institution of ancestral trust by which the collective property would be protected properly. Generally speaking, the property in the trust derived from contributions by families, donations by the rich, proceeds of the use of public or previous trust proceeds etc. The property in the trust was to remain intact over generations and was used mainly for ancestral halls for worship, or other public services etc. From the Confucian perspective, an ancestral trust was the symbol of perpetuating family solidarity,[526] which was the symbol of the collective spirit. It shows that the collective spirit deeply affect the life of people through the ancestral trust in China. It also shows why China's traditional business culture is characterized by "discretionary power, secrecy, a substantial government role in large scale production, and personal connections."[527]

Thus, Chinese society is characterized by "(1) high power-distance, indicating a tendency for the less powerful members of institutions to accept that power is distributed unequally, (2) low uncertainty avoidance, whereby citizens have low levels of anxiety in relation to risk and change, (3) low levels of individualism and (4) medium to high masculinity."[528] This is why the society in some dynasties in China over a long history was so harmonious and orderly relatively speaking due to the influence of Confucian culture, although there were sometimes wars or peasant

[526] See Teemu Ruskola, 1999-2000, ' Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective', 52 Stanford Law Review, p 1646, (citing Chu His & Tsu-Ch' Ien, 1967, 'Reflection on Things on Hand 202', Wing-tsit Chan Trans., pp 228-29; Chu His, 1991, 'Family Rituals: A Twelfth-Century Chinese Manual for The Performance of Cappings, Weddings, Funeral, and Ancestral Rites', Patricia Buckley Ebrey Trans.,.etc).
[527] See, Walter Hutchens, 2003, 'Private Securities Litigation in China: Material Disclosure about China's Legal System", 24 U.Pa. J. Int'l Econ.L, p 621.
[528] See Hoon-Halbauer, S.K., 1994, Management of Sino-Foreign Joint Ventures, Lund University Press, p 290.

uprisings.

In a word, through the influence of Confucianism, the collective spirit became prevalent in ancient times in China, and it was traditional for individuals to succumb to collectivism and juniors to respect seniors. As a result, the property in the name of ancestry in a village or in the name of the father in a family was actually held in a concentrated form. Therefore concentrated ownership under the influence of culture was a very common phenomenon in Chinese society since ancient times.

7.3. In Mao's times

As described above, the deep influence of Confucianism, is endemic in Chinese culture, and the legacy of Confucian heritage is an ingrained tradition. China has been a highly centralized society since ancient time. It emphasizes the relationship of hierarchy, namely obedience of subordinates to the superior, and of the masses to officials. Under the centralized decision-making model the central government level has a strong influence on the belief and the behaviour of individuals at the lower organization level. The familial idiom as the symbol of a collective spirit has continued to influence Chinese economic organizations even though the traditional legal system was officially abolished after the foundation of the People's Republic of China. The collective spirit and interests are further reinforced by the post-1949 adoption of Leninist— Stalinist principles and Chairman Mao's thought. It is not surprising that a tradition of "rule by man" in place of the "rule of law" has been

prevalent in China in the long history. Because individuals and all kinds of entities have been influenced by traditional culture, the Communists' collective entities still inherit the spirit of traditional family: communities with shared collective interests, rather than contractual arrangements among self-seeking individuals with radically divergent aims in the West. Moreover, traditional clan corporations (quasi-commercial enterprises) were considered an organic part of the larger community. Therefore "Chinese socialist enterprises are expected to serve, or at least pay lip-service to, several constituencies in a similarly collectivist spirit."[529] Thus a fundamental identity in Confucian and Communist conceptions of virtues is "the utter subordination of individual interest" to that of the prince and the party respectively. In Mao's time, the collective spirit was advocated all over the country and collective interests were elevated over the individual interests. The theory of collective spirit thinks individual interests derive from the collective interests and there are no individual interests without collectivism. Thus individual interests must succumb to collective interests.

At that time, in order to promote collectivism, no person could keep expensive goods. Otherwise, he or she would be regarded as a person who did not love the motherland, society and the people. Under the guardianship of the collective spirit, all most entities belonged to the people who "eat from the same great pot", children often succeeded to their parents' jobs, and the people were the owner of the entities. Under socialist principles, the people were the ultimate owners of these enterprises. Thus, the

[529] See Teemu Ruskola, 1999-2000, 'Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective', 52 Stanford Law Review, p 1608.

people were the de facto bearers of residual risk, and, in principle, they entrusted the state in a stewardship role vis-à-vis the "state-owned" enterprises. In fact, the drawbacks of the collective spirit are apparent and everyone owned everything, but nobody took responsibility for everything; that is to say, no one owned explicit income rights, so that no one had any interest in operating these enterprises efficiently because the staff in factory still obtained the same result as specified, whatever state-owned enterprises make loss or profit. The factory directors and supervisors were not properly motivated to work hard because they were also paid a small and fixed wage.[530]

In a word, owing to the influence of the collective spirit, no one had any incentive to enhance enterprise efficiency in China. The line between government officials and SOE managers is ambiguous, and there are specialized salaries for different ranks of government officials. It often happens that a SOE manager is paid according to her rank as government official instead of her real managerial effort. Besides, the ideological thought was that "there is no intrinsic difference between jobs except for their functions". As a matter of fact, all the entities were both state-owned enterprises and collective-owned enterprises. There were almost no private enterprises. It was normal that enterprises could not gain independence from the administrative bureaucracy, and the structure of ownership in SOEs was concentrated highly.

[530] See Jon Cauley, Richard Cornes, Todd Sandler, 1999, 'Stakeholder Incentives and Reforms in China's State-owned Enterprises: A Common-Property Theory', China Economic Review10, p195.

7.4. After 1978

The reform of the economy in China has been influenced strongly by culture. In fact, from the perspective of the development, the reform of the economy would not be successful without the adjustment of culture properly. The beginning of market-oriented reforms was accompanied by an important shift in ideology. The new growth imperative was expressed most forcefully by Deng's (1994) proclamation that "development is the hard truth". But the spirit of Mao's times still remained during the modern reform period. For example, some members of the board of supervisors consist of employees as masters of enterprise, as was advocated as a slogan in Mao's times. The Company Law of the People's Republic of China of 1993 (hereafter "Company Law of 1993") (e.g. Art.52 and Art 124) still stipulates that corporate charters properly specify the proportion of employees' representatives on the board of supervisors (of course Company Law of 2006 also has similar provisions, e.g. Art.52 and Art 118).

The corporatization of enterprises is the key to developing socialized mass production and the market economy. However, the biggest ideological opposition to the share system is rooted in socialist orthodoxy that joint-stock companies are supposed to be a prominent feature of the capitalist system, which runs contrary to the socialist precept of ownership by the "whole people". In other word, the role of stocks and shareholding was hampered by ideological questions concerning public and private ownership of business enterprises in the Chinese economy. With regard to

stock and shareholding, some argued that the emergence of private ownership of stock was in conformity with socialist ideology as long as the overall national economy was controlled by the state.[531] Others contended that the emergence of a shareholding system of investment in economic enterprises was fundamentally contrary to the concepts of socialist ownership.[532] Proponents of the shareholding system sought to reconcile it with socialism by re-examining the concept of "socialist public ownership". For example, Tong Dalin, a well-known economist, quoted Marx as saying that the share system was private property's self-negation and was a form of property by which capital became the property of the organized working people and could serve the interest of the society. In his view, Marx's statement could be considered as the seminal basis for the corporatization of enterprises in a socialist country. Any possible dilution of public ownership under the share system could be limited by restricting individual ownership. Jian Yiwai, a prominent economist, argued that the character of ownership of corporatized State-owned enterprises was co-ownership of labor by the people (represented by the state), the collective and the individual. This was consistent with socialist public ownership because the co-owners were all working people.[533] All analyses above were beneficial to the corporatization of state-owned enterprises but it did not seem to find the key to problems until Deng's statement on the difference between socialism and capitalism. This thesis argues the

[531] See, Li Su, Gong Xiaoyuan, Du Feijing and Pan Yuexin, 1987, 'Legal Discussion of the Transformation of a Part of State Enterprises Into Stock Enterprises', Chinese Legal System Gazette, (June 10), p 3.
[532] Zheng Qing and Zhang Jie, 1987, 'Shareholding is not the correct direction for enlivening enterprises owned by the whole people,' in Wang Mengkui and Xing Junfang, eds., Questions about the Stock System, Beijing: Economy Publishing House, p 97.
[533] See Tan Lay Hong, 'The Legal & Regulatory Framework of the Securities Markets in the People's Republic of China', 8 China Law Report, 1994-1999, p 109.

structure of concentrated ownership of SOEs is influenced by the collective spirit and also represents the symbol of the collective spirit (e.g. Art 4, Art 16, Art 17 of Company Law of 1993). The Company Law of 1993 is good evidence for this, as will be discussed below.

As mentioned above, most scholars analyzed "socialist public ownership" on the basis of the classic statement of Marx, but in China, there still exits a conundrum in the theoretical bases of the post-Mao economic reforms, especially the difference between a "socialist market economy" and its progenitor "economic planning on the basis of socialist public ownership". The senior leader, Deng Xiaoping in his famous South China Tour gave the guidance for socialist market economy and broke the deadlock of theories on the structure of state-owned concentrated ownership.

> "If capitalism has something good, then socialism should bring it over and use it", he said, "a planned economy was not socialist— there was planning under capitalism too. The market economy was not capitalism— there were market regulations under socialism too. The plan and market were both means of controlling economic activities. Whether the emphasis was on the plan or on the market regulations was not the essential distinction between socialism and capitalism."[534]

Since then the reform is carried out under the guardianship of the new idea and in practice the emphasis of reform is on the socialist market economy and it is clear that

[534] See Tan Lay Hong, 'The Legal & Regulatory Framework of the Securities Markets in the People's Republic of China', 8 China Law Report, 1994-1999, p 110. (citing "Article Views Market Economy, Public Ownership" PBIS-CHI-93-159 19 August 1993 pp 20-26. Hence, the notorious anecdote of Deng's: "White Cat, Black Cat, Whichever Catches mice is a Good Cat).

tremendous changes have taken place in the structure of state-owned enterprises in China compared with the past. In particular, the structure of state-owned concentrated share ownership has changed greatly since then. However, the reform in China will continue to be hindered by its socialist ideology of "public ownership" such that the restrictions on the transfer of State and employee shares are impossibly to be removed at once.[535] In a word, the socialist culture, such as collective spirits and collective interests, has been a profound effect on the structure of concentrated ownership of the state-owned enterprises. It seems that only the structure of state-owned concentrated ownership symbolizes socialism.

7.5. Conclusion

Culture that evolves and develops gradually over a long period of time is traditional. Culture comes from the life of people but differs from the latter. In other words, culture deeply affects the behaviour, thought, and practices of people in a group or in a society. The people in China have been affected by Confucianism since ancient times, one of which is the mainly collective spirit. It is the collective spirit that influences the coming into being and existence of the structure of concentrated ownership. The structure of concentrated ownership of SOEs was the symbol of the collective spirit in the past. Today the traditional culture in China is in collision with the West or other world's culture after the reform and opening-up policy. The structure

[535] I guess the structure of state-owned concentrated share ownership of listed companies in China will be changed greatly in a few years, especially since 2007 for the sake of the funds for pension or social security. Namely share owned by state will be sold off for infusion of pension funds.

of concentrated ownership is undergoing change but slowly.

Chapter 8.The Influence of Politics on Ownership

8.1. Introduction

Some scholars argue that it is the Communist party and the mechanism through which it controlled the economy and society. The Party ruled the country, and influenced individuals and other entities, through its control of the state, the imposition of its ideology, the implementation of its policy, and the penetration of party-led mass organizations deep in society in the command economy.[536] In China politics have greatly influenced the corporate governance of listed companies indeed because the state which is controlled by the Communist Party on its own accounts for most of shares of listed companies. This thesis argues that politics' influences of corporate governance of listed companies through the structure of ownership.

The theoretical literature has always discussed the effects of the involvement of local party committees on the performance of China's firms. First of all, the grabbing hand theory proves that local party committee has an adverse effect on the firm's economic performance through using firms to serve political and social objectives. Second, the helping hand theory argues that local party committees have a favorable effect on firm performance because scarce resources can be allocated to firms safely

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[536] See Peck J. 1975, Revolution Versus Modernization and Revisionism. In China's Uninterrupted Revolution, ed V Nee, J Peck, pp 57-217. New York: Pantheon; Schurmann F. 1966, Ideology and Organization in Communist China. Berkeley: Univ. Calif. Press; Vogel EF. 1969, Canton under Communist, Cambridge, MA: Harvard Univ. Press; Walder AG 1986, Communist Neo-Traditionalism: Work and Authority in Chinese Industry, Berkeley: Univ. Calif. Press; Whyte MK, 1974, Small Groups and Political Rituals in China, Berkeley: Univ. Calif. Press.

in the quasi-market economy and agency problems can be lessened in firms with poor corporate governance with the help of local party committees.[537] Third, the ineffective hand theory considers that local party committees are only window dressing that influences firm performance neither negatively nor positively.[538]

The notion that politicians' control of firms' decision making that negatively influences firm performance is widespread in the literature on corporate governance and public choice. Most theoretical arguments are based on the assumption that politicians use firms in the pursuit of political and social objectives, e.g., to correct market failures, to reduce income and regional inequality, and to provide excessive employment, to stress the stability of society rather than efficiency of firms, and that these do harm to firms' economic performance.[539]

It seems scholars have reached the common view that state firms usually become worse and worse over time due primarily to political depredations and special-interest demands. Without such political pressures, however, state enterprises in some areas might hold their own and endure a certain amount of competition.[540] But how does the politics influence corporate governance in China? The thesis will discuss it in detail below.

8.2. How has politics influenced the corporate governance

[537] See, Qian, Yingyi, 1996, 'Enterprise Reform in China: Agency Problems and Political Control', Economics of Transition 4(2), pp 427-447.
[538] See McGregor, Richard, 2001, 'The Little Red Book of Business in China', Financial Times 6, (July).
[539] See Eric C.Chang, Sonia M.L. Wong, 2004, 'Political Control and Performance In China's Listed Firms', Journal of Comparative Economics 32, p 620.(Citing Boycko, Maxim, Shleifer, Andrei, Vishny, Robert W., 'A Theory of Privatization', Economic Journal 106(435), 1996, at 309-319; Shleifer, Andrei, Vishny, Robert W., 1994, 'Politicians and Firm', Quarterly Journal of Economics 109(4), pp 995-1025; Shleifer, Andrei, Vishny, Robert W., 1998, 'The Grabbing Hand: Government Pathologies and their Cures', Harvard Univ. Press, Cambridge, MA).
[540] See Vickers,J. and G.Yarrow, 1988, Privatization: an Economic Analysis, Cambridge: MIT Press.

through the structure of ownership?

8.2.1. Management and appointment of officers in firms controlled completely by the Party before the reform

Since the founding of the People's Republic of China, the Communist Party has been in power without opposition.[541] Before the enterprise reforms started in the early 1980s, the SOEs as a pillar of China's national economy, had significant social and political implications for contemporary China. Chinese SOEs were controlled by politicians who exercised almost all the formal authority over operating and personnel decisions. Thus SOEs were only tools of implementation to policy by politicians. At that time, the economy was an appendage of the state, and economic agents were manipulated and controlled completely by politician under administrative power.[542] In other words, the SOEs were completely controlled by the Communist Party before the reform of economy. As a result, such an allocation of authority resulted in a lack of managerial discretion on the one hand, and business decisions influenced by politicians on the other. Politicians had incentives to control and / or subsidize SOEs to achieve objectives for political purposes in place of economic purposes. Leaders of factories were often appointed, shifted or dismissed for political or other reasons, rather than their managerial qualifications for the job. Thus the person who was

[541] There are other parties in China and parties are legal according to the Constitution Law, but influence and function of other parties is very limited.
[542] See Victor Nee and Rebecca Matthuews, 1996, 'Market Transition and Social Transformation in Reforming State Socialism', Annual Review of Sociology, Vol.22, p 405.

appointed as a head of factory might not be the best person to manage the firm effectively. In particular, politicians might require an SOE to hire more staff than it needed or to maintain excess employment at the cost of firm efficiency.[543] Politicians did this in order to win political support, or to avoid the social instability that high unemployment caused. The political task was important than anything else at that time. Politicians might also ask an SOE to meet output growth targets, which they could show off as their own policy achievement, even if the enterprise could not sell all of its output at a profit. These political tasks had primacy over profit of SOEs, and this resulted in many problems among Chinese SOEs under the traditional command system.[544] In a word, the enterprises were controlled completely by the Party and as a tool only carried out the policy of the state at that time due to the state as only the owner of the state-owned enterprise.

8.2.2. The influence of the Party on enterprises was changed after reform

As mentioned above, Chinese SOEs before reform can be regarded as being controlled by politicians because politicians had not only almost all the formal authority but also most of the real authority over business and personnel decisions. China engaged in reform commencing in the late 1970s because, in a sense there was

543 See Shleifer, A. and Vishny, R.W. 1994, 'Politicians and Fims', Quarterly Journal of Economics, 109(4), pp 995-1025.

544 See, Lixin Colin Xu, Tian Zhu and Yi-min Lin, 2005, 'Politician Control, Agency Problems and Ownership Reform: Evidence from China', Economics of Transition, Volume 13(1), p5.

no alternative. But by contrast to the wholesale and "overnight" reforms undertaken in many ex-Soviet-bloc countries, China's reform process has been step by step. The Chinese Communist government, wishing to avoid the political and economic turmoil that accompanied the mass privatization of the former Soviet Union and other Eastern European governments, has chosen, as the cornerstone of its political survival, the commercialization and partial privatization of claims over assets and profits and of its state-owned enterprises. SOE reform began with the Management Responsibility Contract System (MRCS) in 1987, in which the government transferred some management authority to the enterprises and allowed them to keep some of their profits. But managers had few residual rights of control and were subject to strong political influence to accept SOE's social responsibilities as the most important assignment.

The government is unwilling to implement deep institutional reform and is reluctant to relinquish its control over enterprises, in order to keep society stable, otherwise it will incur the cost of winning political support from worker satisfaction and a "quiet" population. Therefore, the privatization of SOEs has been carried out in part because it is the only viable means to survive the existing political order definitely, which, in the case of China, means the survival of the Chinese Communist Party and the fortification of its authority over the nation. The government, on the one hand, by reforming the agricultural industry, rebuilding SOEs via partial privatization, and stimulating the rapid development of Township and Village Enterprises, attempts to gain the benefits of a market economy for the mobilization of private savings,

economic development and an improved standard of living; on the other hand the Party keeps political control over the society.[545] Therefore the society seems to develop without becoming unstable.

Prior to the adoption of the Company law of 1993, the main governance bodies in the traditional SOEs were the committee of the Communist Party, the trade union and the meeting of employees' representatives. It was thought that party organizations should perform duties according to the Party Constitution, for example, the appointment of managers by the standards of politics. More generally, it was believed that SOEs should forgo maximum profit in the pursuit of social and political objectives, such as full employment, income redistribution and political stability.

In China it is normal that managers under the communist system were selected for their political rather than their managerial skills as mentioned above. The party secretary was the ultimate decision-maker and managed the day-to-day operation in the enterprises. Since 1984 managers have been given greater autonomy in managing enterprise operation. In 1986 the central government issued the Regulations on the Work of Factory Directors in State-Owned Industrial Enterprises, in which directors had final operational authority. However, SOEs' party committees still played an important role in personnel issues etc.

When some enterprises were incorporated under the Company Law of 1993, companies would take into account responsibility not only to shareholders but also to others. According to Company Law of 1993, managers in the corporatized SOE are

[545] See Dongwei Su, 2005, 'Corporate Finance and State Enterprise Reform in China', China Economic Review 16, p120.

either elected or appointed by the board of directors. But actually managers are often appointed by the Communist Party's Organizational Department. For large SOEs or enterprise groups, the general manager is often also the secretary of the party committee. The party's standing committee usually consists of the general manager and senior managers, and is the ultimate decision-making body for important issues. The Communist Party Central Committee or provincial committees still control and determine the appointment, promotion, or dismissal of senior managers of large SOEs, listed companies or enterprise groups. In the case of Chinese listed companies, almost 50% of the directors in listed companies are appointed by the state and another 30% are affiliated with various layers of governmental agencies.[546] A survey showed that the Party still controlled most of listed companies through personnel, such as selecting, appointing and dismissing head of the managerial operational departments, branches, and subsidiaries and CEOs.[547]

Even today most corporate managers in the big SOEs still aspire to a civil service rank and hope they will be promoted to be a higher official in governments, and therefore they are concerned more about how their superior in the political and administrative hierarchy assesses their performance rather than others. The assessment may be quite arbitrary or subjective and be based on such indicators as profits, the number of employment, implementation of political policy, and the discharge of social responsibilities. For instance, in many cases the government still

[546] Qiao Liu, 2005, 'Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants', (May), Working Paper.

[547] See Wong Sonia M.L., Sonja Opper, and Rujin Hu, 2003, 'Shareholding Structure, Depoliticization, and Firm Performance: Lessons from China's Listed Firms', Working Paper 1066, Hong Kong Institute of Economies and Business Strategy, Hong Kong University.

evaluates the success of listed companies or the achievement of managers based on their total profits and taxes paid instead of companies' return on equity or earnings per share growth. As a result, in order to fulfill the profits and taxes as political expectations or tasks, companies want to issue new shares as often as possible to increase investment, which results in overstating the earnings at the expense of outsider investors.

With the development of the economy and the depth of reform, the influence of the Party on firms has gradually changed. For instance, as stated above, the power to appoint or remove, reward and punish managers was explicitly transferred to the board of directors according to the Company Law of 1993. However, in Chinese history, the legal system has never been independent of the state or political leadership and has been uninterruptedly regarded without interruption as part of the executive branch. The law still gave sufficient legal grounds to back the Party's involvement in enterprise decision-making (e.g. Art.17 and Art.31 of Company Law of 1993). The Communist Party had to approve the senior level appointments. On average, 90% of the board members in Chinese joint-stock companies are government officials and delegates of other state enterprises. As a matter of fact, all top managers must be approved by the Organization Department of local or central government if the listed companies are controlled by the state through the structure of ownership. In other words, due to most stock companies controlled by the state, political consideration is still superior to the economic performance in the selection of managers, as a result managerial incentives are adversely affected. Therefore, managers in listed companies

who want to be promoted quickly, in particular to be official in governments, no doubt, have to care more about carrying out the wishes of the Party and government, such as keeping more workers in employment and maintaining some level of worker social security, paying more tax, than about the concerns of shareholders. It is no surprising that management decisions always reflect the old political concerns (political cost).[548] But in more recent years, its role in appointing top managers and directors has diminished compared with the past owing to the change of ownership structure.

8.2.3. The influence of the Party on firms is declining through changes in ownership structure

Even today the Communist Party in China has a profoundly influence on the corporate governance in listed companies by way of policy and law, because of the state policy of maintaining a full or controlling ownership interest in enterprises. This is the cause of a fundamental dilemma for Chinese SOEs. The state wants the enterprises it owns to be run efficiently, but not solely for the purpose of wealth maximization, it is also concerned with the maintenance of urban employment level, direct control over sensitive industries, and politically motivated job placement. From the central government's perspective, any SOE reform program must be designed to ensure the continuing political power of the Chinese Communist Party. However, this thesis argues that the long-term sustainability of economic growth, the well-being of citizens

[548] See Dongwei Su, 2005, 'Corporate Finance and State Enterprise Reform in China', China Economic Review, Vol. 16, Issue 2, pp 118-148.

and stability of society are really the aim of SOE reform, although China's SOEs were created to function not just as production units, but also to carry out social and political functions.

Some scholars consider that firms perform better when the managers have decision-making autonomy over business operations, particularly over labour deployment, and when the state's share of ownership is low, and that firms whose CEOs are appointed by the government have significantly worse performance. That is to say, the higher the ratio of state-owned shares, the worse the firm is performance.[549] This shows that it is very necessary for SOEs to be reformed, by the reduction of state-owned share in listed companies.

Due to the under-performance of SOEs, China committed itself to carrying out a significant reform of state-owned enterprises in 1997. The fifteenth Congress of the Chinese Communist Party (CCP), held in September 1997, endorsed a major policy shift. It involved a commitment to an immense privatization program made under the slogan "zhuada fangxiao", — "protect the large, release the small"[550] or "grasp the big, enlivening the small".[551] This meant, firstly, providing assistance to the 500 to 1,000 large "pillar industry" SOEs in the government's effort to restructure the state sector and allowing many of them to be listed on the stock exchanges. Secondly, it meant allowing small enterprises, over which the state was willing to give up control,

[549] E.g. Xu, X.N.. Wang,Y. 1999, 'Ownership Structure and Corporate Governance in Chinese Stock Companies', Chinese Economic Review10, pp 75-98; Lisin Colin Xu, Tian Zhu, Yi-min Li, 2001,'Politician Control, Agency Problems, and Firm Performance: Evidence from a National Survey of Ownership Restructuring in China', Working Paper,(December).
[550] See Ho, S.P.S., P.Bowles, and X.Dong, 2003, 'Letting go of the Small: An Analysis of the Privatization of Rural Enterprises in Jiangsu and Shangdo', The Journal of Development Studies 39(4), p 1.
[551] SeeSmyth, R, 1998, 'Toward " the Modern Corporation": Recent Developments in the Institutional Reform of State-Owned Enterprises in Mainland China", Issue & Studies, 34(8), pp 102-131.

to determine their own path. In late 1998 the central government ordered all party and government administrative organs to sever links with the enterprises they control. However, it is impossible for party and government administrative departments to sever links with enterprises if the state has big shares in them, especially owning big shares in listed companies.

The SOEs reforms require enterprises to set up a "modern enterprise system" which is characterized by four attributes: clearly defined property rights, clearly defined rights and responsibilities, the separation of politics and government from business activities, and the use of scientific management. But actually it is impossible to do these in China due to the structure of ownership by the state and intervention by the Communist Party. In a sense, Shanghai and Shenzhen securities exchanges and the initial listings of public companies were politically driven. In particular, the selection process for listing companies was historically political in nature. The central government gave priority for listing to SOEs, while the quota system and the provincial recommendation format encouraged bribery at the different local government level. As a result, rampant corruption, false documentation, a convoluted selection process and interference in operation resulted in the overall disappointing performance of the listed companies. Therefore, at the beginning of IPO, without the settlement of the structure of ownership of listed companies, politics' influence on the management of firms still remains and leads to many problems today.

Politics has influenced all walks of life in China indeed. We must pay attention to this fact when the reform was under way. At the early stage of the reform, China's

economic institutional environment discriminates against non-state-owned enterprises (NSOEs). The legal status of SOEs is well protected, and SOEs enjoy preferential access to capital, scarce materials, and favorable government policies, while NSOEs suffer under insecure property rights and are at a disadvantage in China's immature markets in securing capital and raw materials. In other words, the conditions of SOEs are much better than those of NSOEs at that time. As a result, SOEs and NSOEs rely on the support of politicians and bureaucrats to different extents.[552] However, NSOEs develop fast under the same environments; in a sense, SOEs enjoy better treatment or preference (of course SOEs bear historical burdens such as redundant employees), but their performance deteriorates, and one of reasons is that NSOEs are not controlled by the Communist Party and the state has no share in them at all, although they are also influenced by politics through law, regulation, and policy.

As we know the corporate governance of listed companies has been affected by politics based on the above analysis. The Communist Party is the governing party or ruler, and it is the structure of ownership controlled by the Communist Party through the state that leads to the control of listed companies. Supposedly if listed companies are privatized completely or only some of the shares are controlled by the Communist Party as ruler, for example only 10% instead of 30 % or more, the listed companies will not be controlled or interfered with by politicians, or at least, influence by Communist Party will be very limited. NSOEs are interfered with by politicians, but they are not controlled by Communist Party and their performance is very good in the

[552] See Sonia M.L.Wong, Sonja Opper and Ruyin HU, 2004, 'Shareholding Structure, Depoliticization and Firm Performance: Lessons from China's Listed Firm', Economics of Transition, Volume 12(1), p 36.

market economy. In other words, the poor quality of corporate governance of listed companies is determined by the structure of concentrated ownership which is controlled by the Communist Party.

Today the situation in listed companies is changing with the development of the economy and the maturity of the market. In other words, the development of the economy has brought about a change in the structure of concentrated ownership that is controlled by the Communist Party. Once the structure of concentrated ownership adjusts properly in the market, the influence of the Party on corporate governance will decline soon. In particular the opportunity for appointment of board of directors and managers is declining as the amount of the share holding of the state is reduced in listed companies. In fact the influence of the Communist Party on corporate governance is declining now.

8.3. Conclusion

Since the founding of the People's Republic of China, the Communist Party as the only ruling party could determine the governance of state-owned and collective enterprises through the state that reflects the willingness of Communist Party sufficiently. Thus, politics indeed have a great effect on enterprises in China. Historically, the Communist Party completely controlled the governance of SOEs due to ownership by the state. However, with the gradual development of the privatization of enterprises in China, the influence of politics on governance of enterprises

decreases step by step. In particular, when enterprises are corporatized, politics only influence the governance by the structure of ownership because the state is still the largest shareholder in most listed companies in China. But the influence of the Party on company will fall when the market is mature and structure of ownership is changeable because the market reforms give rise to the adjustment of the structure of ownership that leads to altering relations of dependence on the government hierarchy, greatly affecting the Party's ability to monitor, sanction, and reward its members, and that this will in turn reduce its capacity to govern the companies from the perspective of both its legitimacy and its monitoring and enforcement.[553] Then if the structure of ownership of listed companies in China changes from concentrated ownership to dispersed ownership to a certain degree and the model of corporate governance will change too. So it is the structure of ownership that determines directly the governance of the corporation.

In a word, in China the problems of corporate governance in listed companies are rooted in the structure of concentrated ownership. The structure of concentrated ownership by the state provides potential justifications for political intervention. That is to say, the Communist Party as a ruler in China leads the country, and the state controls listed companies through its the shareholding. Therefore political intervention into the affairs of listed companies leads, as the logic result, to political costs. But with the maturity of the market economy in China, the ownership structure of listed companies will adjust reasonably and efficiently, and the influence of the

[553] See Nee V and Lian P, 1994, 'Sleeping with the Enemy: A Dynamic Model of Declining Political Commitment in State Socialism', Theory Soc. 23, pp 253-96; Walder AG, 1994, 'The Decline of Communist Power: Elements of a Theory of Institutional Change', Theory Soc. 23, pp 297-323.

Communist Party on it will drop greatly.

Chapter 9. Law, ownership and corporate governance

9.1. Introduction

A good quality legal system will improve the corporate governance of listed companies because complete and effective laws will provide all the shareholders with equal status, and in particular give the minority shareholders protection against tunneling, exploitation, and other illegal transactions by the controlling shareholders. However, the law only provides the platform for the protection of all shareholders. In reality, the share as a kind of property, and especially according to the principle of one share-one vote, big shareholders always control the company and its organization. Therefore laws have to be subject to the rule of the market in the economy.

9.2. The characteristics of Chinese law

The Chinese legal system is of great antiquity in the world since ancient times compared with the West. However, since the late Qing dynasty, China started to learn from the legal system of the West, except for in Mao's times. In fact even during Mao's times, China learned from the legal system of the former Soviet Union in the 1950s at least. Therefore in contemporary times, China has constantly learned from the legal systems of other countries but retains its own character.

In ancient China, the legal system was a combination of 'li' (ceremony, or morality and virtues) and 'fa' (law, or punishment). The former is the spirit of Confucianism (soul), or at least, it is the value and spirit of traditional Chinese law that is enforced by morality or other local ways, and the latter is the body (system) that is enforced by officials at all levels of governments. The Confucian spirit ('li') and the Legalist system ('fa') constitute the primary content of traditional Chinese law.[554] With regard to 'fa' (law), a distinctive feature of China's legal tradition is that the legal system is not separated from, or independent of, the administrative system. At least since the Tang Dynasty (818-906 A.D.) and until the end of Qing in 1911, the system of government in China consisted of a strong central government headed by the Emperor, who ruled through a bureaucracy and with absolute power. The lowest ranking officials at the county level represented the central government and in effect exercised all of the power of the state, including tax collection, public works, and even deciding lawsuit cases. Thus, adjudication was simply one of many administrative duties. Since there was no doctrine of the separation of powers among government institutions as in the West, the country magistrate's power was virtually unchecked except that the subjects could technically and luckily appeal to a higher level official. Another distinctive feature is the emphasis on administrative and criminal sanctions, with a lack of formal development in civil liability and procedural law.[555] The traditional Chinese view, even as of today, is that the law is considered as

[554] Zeng Xianyi, Ma Xiaohong, 2006,'A Dialectic Study of the Structure and Basic Concepts of Traditional Chinese Law and an Analysis of the Relationship Between 'li' (ceremony) and 'fa' (law)', Front. Law China, 1:34-52.

[555] Some Jurists in China do not agree with the above opinion, they think law system in China is very complete in ancient times with its civil law and procedural law.

a tool used by the ruler to enforce its power and authoritative control over people and to maintain social order. For example, the central part of the Qing Dynasty's legal system, the Qing Code was a collection of rules that were predominantly concerned with official activities, in particular punishment imposed on wrongdoings or illegal actions, and the functions of bureaucrats within the government apparatus, not with disputes and relationships between and among private citizens. The imperial law involved private matters only so far, as the matters were considered to influence imperial policies. Thus, the code was primarily of an administrative nature, and it attempted to rely only on administrative and criminal penalties. In other words, the Qing Code seemed to be mixture of administrative law and criminal law instead of civil law that regulates equal civil relationship of rights and obligations between entities. This is distinct from the Roman law tradition, from which most Western laws are originated. As regards Roman law, civil law rather than administrative law is at the heart of law systems. Even today's law in China is still regarded a tool of the ruling class.[556] In brief, with regard to the Chinese legal system in the past, there is no distinction between substantive law and procedural law; inadequate differentiation between different fields of law; the emphasis on the importance of the administrative law and punishment; and'li' (ceremony, or morality and virtues) plays an important role in the regulation of people's behaviour in daily life.

9.3. What is the relationship between law and ownership in

[556] See Zhiwu Chen, 2003, 'Capital Markets and Legal Development: The China Case', China Economic Reveiw14, pp453-454.

China today?

It seems that there is the same status in protection between controlling shareholders and minority shareholders under the Company Law of 1993 and the Securities Law of 1998. That is to say, all of shareholders of listed companies seem to be treated equally in terms of the rights attached to their shareholding. However, given that most legal-persons or corporations are state-owned or state-controlled, about two thirds of most corporations' shares are state-controlled directly or indirectly. In fact this ownership structure has been a major factor that restricts private securities litigations in court, because granting damage awards in private litigation would amount to the loss of state assets, which puts the court in a conflicted situation. It is logically normal that law protects the state-owned assets because the very justification for starting a stock market in China was to help the SOEs raise capital from the general public and solve the money-losing SOEs' financial problems instead of offering the general public a means to diversify investment portfolios and hedge future consumption/income risks. Therefore, it is very difficult for injured shareholders on behalf of the company to bring suit against the management of listed companies when management breaks some provision of the law, such as self-dealing, false representation, or manipulation. For example, Mr. Shao, a shareholder in a listed company called Sanjiu Yiyao, lodged a suit against the chairman of the listed company before Shenzhen Intermediate Court. The plaintiff claimed that the listed company engaged in illegal lending to its controlling shareholder, and the listed

company failed to disclose it publicly according to laws and regulations, and the chairman of the controlling shareholder broke his fiduciary duty towards the listed company. However, the court refused the case.[557] Later, a lot of cases in relation to state assets or state-controlled assets in listed companies were rejected by the courts. Until on 15 January 2002, the Supreme People's Court issued officially the Circular on Accepting Civil Compensation Cases Arising from Securities Market False Representation. Under the Circular, an investor could bring an action for false representation only, but subject to the condition that administrative sanctions have been imposed on the alleged false representation only and reason is that litigation in relation to securities is specially complicated and needs to be investigated fully before courts accept them, which is in conformity with the nature of classic law in China. That is to say, law has been subject to administrative authority since ancient times. Thus in China the strategy, policy and operations used to be decided in an arbitrary manner, which seems to be the conventional way to settle problems rather than by outsider scrutiny, specially under the law. For instance, even claimants on the firm's resources who should have the right and power to ensure the firm's sound operation may have their claims be dismissed by companies or courts. In general, this hinders the efficiency of SOEs and creates moral hazard easily.[558]

As we know, it has been implausible to talk about transplanting legal norms and institutions from developed to developing countries without the caveat that the functioning of such imported legal rules and institutions will, of course, be affected by

[557] See Wang Lu, 2003, 'First Derivative Suit refused by Court' Shanghai Stock News, (22 April).
[558] See World Bank, 1997, 'China's Management of Enterprise Assets: The State as Shareholder(Country Study), Washington DC: The World Bank.

the local political, historical, traditional, social, economic and cultural contexts. "The evolution of Chinese business, financial, and commercial law during China's transition from economic planning is a wonderful illustration of this complexity."[559] In other words, law is subject to the special environments. In China, the law seems to protect more the interests of the state rather than any other interests in the certain environment.

9.4. Corporate governance

9.4.1. Background

The corporatization program was launched by the Chinese government under the law in response to the unsatisfactory results of the incentive contract system that I discussed above. In theory, corporatization may enhance efficiency through better monitoring of managers, improvements in information-sharing channels, reduction of agent cost and a reduction in governmental political intervention, without changing state ownership, by structuring the internal governance system of SOEs according to that of a modern corporation. That is, the main strategy and aims, are to turn SOEs from sole state proprietorships controlled by industry-specific government agencies at various administrative levels to modern-form corporations with a Western-style corporate governance structure, without serious erosion of the dominant public, but

[559] See John K..M.Ohnesorge, 2003, 'China's Economic Transition and the New Legal Origins Literature', China Economic Review 14, p 486.

not necessarily state, ownership. However, in practice the legislation in China is not consistent with this theory. For example, sometimes there is a conflict between laws: the shareholding system raises questions as to who should hold the property rights in state assets when state enterprises convert to the shareholding system. Article 2 of the State-owned Enterprise Law of 1988, one the one hand, provides that the state is the owner of the property of the state-owned enterprise, as well as exercising the rights of ownership over state-owned enterprises. On the other hand, the state-owned enterprise has a legal person status but does not own the property it manages. Thus, it seems that there is no true conversion of state-owned enterprises into modern corporations as that in Western public corporations.

Of course, corporatization has many purposes, but the chief one is the promotion of higher efficiency through better management. Corporatization is intended to address through structural reform three features of the traditional system of state ownership that are blamed for the inefficiency of that sector. First, commentators criticize the problem of efficiency of SOEs, because the state controls and interferes in the operation of SOEs through the structure of ownership, with the resultant imposition of non-profit-maximizing objectives on enterprise managers. Second, they point to the problem of conflicts of interest between agencies. The conflicting objectives from multiple state agencies with authority over the enterprise often occurred. Third, they point to the problem of monitoring. The state agencies consist of varying departments, who should monitor managers and who can policy the monitor

of the managers?[560] Corporatization can transform most SOEs into three types of shareholding companies: limited liability companies, joint stock limited companies, and employee-owned stock cooperatives. In other words, Corporatization of SOE stated in 1992 as a way of clarifying property rights of SOEs and improving their performance. There are provisions on joint stock limited companies and limited liability companies in The Company Law of the People's Republic of China of 1993. According to the Company Law of 1993, the corporatization of SOEs has provided a potentially superior institutional arrangement for corporate governance, with more rigorous requirements in terms of the duties of directors and required disclosure called for. But in fact Chinese companies are mainly controlled or fully owned by the state and characterized by insider control, priority of political aims, weak oversight mechanisms, inadequate safeguards for outsider and minority shareholders, excessive power of CEOs and the lack of transparency. In a word, corporatization is not as successful as people expect on account of the state as controlling shareholder, especially listed companies in China.

9.4.2. The Concept and character of corporate governance

The study of corporate governance in China started in the mid-1990s. One of the most influential viewpoints, of the famous economist Wu Jianlian, is as follows: corporate governance as the organizational structure which consists of shareholders, the board

[560] See Donald C. Clarke, 2003, 'Corporate Governance in China: An Overview', China Economic Review 14, p 497.

of directors and senior managers. Within the structure, shareholders entrusts their capital to the board of directors that has the power to appoint, reward and penalize managers.[561] He emphasizes the corporate governance is one kind of system or arrangement.

According to the Company Law of 1993, Chinese listed companies adopt a two-tier board structure, a Board of Directors and a Supervisory Board. It seems that the corporate governance structure in China bear resemblance to the two-tier system of corporate governance in Germany. There are a board of directors and a supervisory board in both countries. However, there are substantial differences in corporate governance structure between the two countries, for instance, in China, there is no hierarchical relationship between the board of directors and the board of supervisors, although the latter can supervise the former, and both directors and supervisors are appointed by, and may be dismissed by, shareholders at general meeting according to company law. In contrast, the German supervisory board can not only monitor the managerial board and but also appoint, dismiss, the members of the managerial board.[562]

Although many SOEs have been transformed into corporations according to the company law, their managements still attempt to evade the corporate governance requirements stipulated by law and regulations, and companies remain like the traditional SOE governance model.[563] In some corporations, some directors who do

561 See Wu Jianlian, 1994, 'The Focus of the Reform in 1995', Mimeograph, p 185.
562 See Cindy A. Schipani and Junhai Liu, 2002, 'Corporate Governance in China: Then and Now', Columbia Business Law Review, Vol. 1:1.
563 See, wang Yanchun et al. 2000, 'Listed Corporations Walking on the Old Way in New Shoes', China Economic Times, (Jan. 20), p 1.

not take the board meeting rules seriously get used to the way of management and operation as before.[564] In addition, companies establish shareholders' general meeting, the board of directors, and board of supervisory according to laws and regulations, but they are more a matter of form than substance. The Board of Directors is controlled by the company's parent company. In some companies, directors are managers or executives, and the excessive overlap in these positions causes corruption. In a word, the corporate governance of listed companies is very poor because of the structure of concentrated ownership in China.

9.4.3. The structure of corporate governance[565]

9.4.3.1. Shareholders' general meeting

According to the Company Law of 1993, the shareholders' general meeting is the most powerful organ of a listed company, but this is not always the case in reality. For example, some scholars conducted a survey based on 248 listed companies accounting for about 25% of listed companies in China, and came to the conclusion that it was the board of directors that had the highest average level of decision-making power, second place was managers, followed by the shareholders' general meeting and supervisory board respectively.[566] The reason is that it is prevalent that controlling

[564] See Chen Qingtai, 2000, 'The Chair is Not the Number one Leader in the Corporation', People's Daily, (Jan. 10), p 12.
[565] Compared with Company Law of 1993(effective as of 1994), Company Law of 2005 (effective as of 2006) has been revised a bit, in particular with respect to the protection of minority shareholders and requirement for the amount of legal capitalization. However, the structure of corporate governance is the same.
[566] See Opper Sonja, Sonia M. L. Wong, and Ruyin HU, 2001, 'The Power Structure in China's Listed Companies: The Company Law and its Enforcement', Working Paper No.1039, Hong Kong Institute of Economic and Business

shareholders may enrich themselves at the cost of listed companies and other minority shareholders by manipulating the board of directors. In China, the corporate bodies of some SOEs subsidiaries are under the direct control of their parent corporations, which are owned by the state. The listed companies should be independent from their parent corporations and shareholders in terms of "independent personnel, independent assets and independent finance" in accordance with laws and regulations. However, the excessive connections between the listed companies and parent corporations have caused serious problems for some of the creditors and the minority shareholders of the listed companies. Because companies are always interfered with by government as the largest shareholder, some scholars argue that the incorporation of SOEs in China should be viewed as "nothing different but the logo" or "new bottles with the old wine".[567] That is, the corporate governance structure of listed companies is the same as that of the SOEs was before and the state as biggest shareholder can control most listed companies in China.

Poor governance practices are rampant among Chinese listed companies because the state is the largest shareholder. For example, in 2001, the largest shareholder of Meierya, which had been a profitable company, colluded with other related parties and appropriated $ 44.6 million or 41% of the listed company's total equity. In the same year, the largest shareholder of Sanjiu Pharmacy embezzled $ 301.9 million or 96% of this listed company's total equity.[568] This shows that a shareholders' general

Strategy, University of Hong Kong.

[567] See Xianian Xu and Yan Wang, 1997,'Ownership Structure, Corporate Governance, and Corporate Performance , the Case of Chinese Stock Companies', Policy Research Working Paper, The World Bank Economic Development Institute Office of the Director,(June).

[568] See, Chong-En Bai, Qiao Liu, Joe Lu, Frank M.Song, Junxi Zhang, 2004, 'Corporate Governance and Market

meeting of a listed company controlled by the largest shareholder can not exercises its power properly, although its right is the most powerful according to law. Therefore improving corporate governance should be the crucial objective of China's further economic reform.

9.4.3.2. Board of directors

Although listed companies are set up in accordance with laws, under the current corporate governance structure of listed companies in China, the board of directors is dominated by the controlling shareholder. A survey of corporate governance for both Southern China and Eastern China showed the boards of directors and other departments of both Southern China and Eastern China were controlled by insiders at the time of listing. This situation has remained essentially unchanged after the listing.[569] This lack of change in leadership leads to bias against change of the model of operation and management, which can hinder performance improvement following privatization.[570] It is common in China that the Chairman of the board is also the CEO of the company. According to theory, this "duality" must give rise to benefits as well as costs.[571] Duality makes no distinction between shareholding and management functions, which brings unity of action but at the cost of board independence.[572]

Valuation in China', Journal of Comparative Econimics 32 , p 600.

[569] See Pamela Mar, and Michael N. Young, 2001,'Corporate Governance In Transition Economic: A Case Study of Two Chinese Airlines', Journal of World Business 36(3), pp 288-289.

[570] See Andrews, W. A., & Dowling, M.J. 1998, 'Explaining Performance Changes in Newly Privatization Firms, Journal of Management Studies, 35(5), p 601.

[571]See Boyd, B.K. 1995,'CEO duality and firm performance: A Contingency Model', Strategic Management Journal, p 16.

[572] See Boyd, B.K. 1995,'CEO duality and firm performance: A Contingency Model', Strategic Management Journal, , p 16; Finkelstsin, S., & D' Aveni, R. 1994, 'CEO duality as a double-edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command', Academy of Management Journal, 27(5),

International evidence suggests that corporate boards need directors who are not just independent of management, but take direct responsibility for the company and are indirectly accountable to shareholders, in particular to minority shareholders. China models itself after the West and introduces the independent director system to strengthen the independence of the board, limit abuse by controlling shareholders and protect the interests of minority shareholders. In 2001 the CSRC issued the Proposed Guidelines on Establishment of the Independent Directors System in Listed Companies. According to the Guidelines, all listed companies in China must amend their articles of association and employ independent directors including at least one professional accountant, there must be at least two independent directors on the board prior to 30 June 2002, and least one-third of the board must be independent directors prior to 30 June 2003. But the function of the independent directors system is limited and the independence of independent directors is sometimes in doubt because in practice independent directors are usually nominated by the board of director, and then elected by the shareholders' general meeting, which is influenced by controlling shareholders.[573] The empirical evidence showed that about 67% of independent directors admitted that major interference with their work came from the state as a controlling shareholder and then from management.[574] So it is impossible for the independent director system to play a positive role in improving the quality of listed companies without a fundamental change in the current ownership structure, which

pp 1079-1108.

[573] See Jin Yonghong and Xi Yuqin, 2003, 'The Independent Directors System and Corporate Governance of Chinese Listed Companies', Lixin Accounting Press, pp 172-173; Kong Xiang, 2001 'A Study on the Independent Director System' Research Report of the Shenzhen Stock Exchange.

[574] See Tong Lu, 2002, 'Development of System of Independent Directors and the Chinese Experience', Working Paper, Chinese Academy of Social Science.

results in insider control problems and the ineffectiveness of the board of directors.[575]

In addition, regarding wholly state-owned companies, the Company Law (both 1993 and 2005) has special stipulations. The Corporate Law as originally enacted only required two corporate bodies in a wholly State-owned corporation: the board of directors and the CEO. Because there are no general meetings of shareholders in state-owned corporations, the board of directors and the CEO have more governing powers that their counterparts have in other types of corporations. Instead of the general meeting of shareholders, the boards of director, state-authorized investment institutions or government agencies under authorization have the power to make decisions on important corporate issues as the shareholders' meeting does in normal companies.[576] Therefore, such corporations are completely controlled by the state.

9.4.3.3. Board of supervisors

What about the board of supervisors of listed companies? In fact, the supervisory board has little influence on the company's activities. The effectiveness of the supervisory board's monitoring function has attracted much widespread criticism since its inception.[577] Because the supervisory board has limited power under the Company Law of 1993 and could not carry out the monitoring function. Pursuant to law, one of the functions of the supervisory board is to review the financial statements

[575] See Wan Cuiying, 2002, 'Skepticism on the Introduction of Independent Director System: Perfecting the Supervisory Board of listed Companies in China', Journal of Hebei University of Economics and Trade, Vol. 23 No.2, pp 56-58.

[576] company law (1993), article 66; company law (2005), article 67.

[577] See Lin Cyril, 2001, 'Private Vices in Public Places: Challenges in Corporate Governance in Development in China', Working Paper, The OECD Development Centre Research Project on Corporate Governance in Development and Emerging Economics.

and the auditor's report. In addition, the composition of supervisors usually consists of officials chosen from government offices at various levels or from the parent company, although the company law also stipulates the representative of employee must be members of the supervisory board, such as accounting for not less than 1/3. How can the supervisors monitor the managers appointed by governments? In brief, the board of supervisors has assumed largely decorative functions. How to improve the Supervisory Board? To enhance the usefulness of the Supervisory Board, it must be independent, in particular, not subordinate to the Party Committee and the board of directors, and then it will be given more power.

According to law, the supervisory board consists of at least three members in listed companies, who are either shareholder representatives or employee representatives. It means they are dominated by controlling shareholders, or the majority of the supervisors have less business experience and no management background at all. Some scholars drew the conclusion: in practice there are four types of supervisory board in listed companies as follows.

> "(1) an honored guest, this type is only a mere physical existence, and the supervisory board briefly meets twice a year. They are technically incompetent, or retiring with little motivation. (2) A friendly advisor, in this type of supervisory board, they are free to air their views, but they are strongly dependent on the board of director and CEO. Here, the supervisory board typically consists of representatives of the dominant shareholder or friendly outsiders. (3) A censored watchdog, the supervisory board in this category is particularly strong in terms of technical expertise and they attempt to undertake their legal duties diligently, but they are not allowed to disclose faithfully their findings. (4) An independent watchdog, very few supervisory boards fall into this group except that companies issue B-share, H-shares, or shares listed in

foreign exchange." [578]

Although many SOEs have been changed into business corporations according to the company law, these listed companies are still controlled by the state as the biggest shareholder, which leads to the operation of companies in the best interests of the state, meaning sometimes the maximization of social interests instead of economic efficiency. Meanwhile most members of the supervisory board in listed companies are designated by the state. As a result, it is impossible for the supervisory board to play its supervisory function.

9.5. The future of corporate governance

It is not difficult to draw the conclusion that the major impediment to corporate governance development is the continued excessive ownership by the state which undermines and distorts the market in China. It is the structure of concentrated ownership which is the main reason for poor corporate governance of listed companies in China. Thus, ownership diversification and the reduction of state ownership of listed companies are necessary for the reform of listed companies.

What model of corporate governance will China follow in the future? Scholar Xu suggests that China should model itself after the Germany/Japan bank model and set up corporate governance mechanisms with institutional or legal investors as its main

[578] See, Jay Dahya, Yusuf Karbhari, Jason Zezong Xiao and Mei Yang, 2003,'The Usefulness of the Supervisory Board Report in China', Corporate Governance, Volume11, Number 4, (October), pp 313-315.

body.[579] But scholar Zhang argues that the main bank model cannot work effectively unless commercial banks in China are privatized as the first step.[580] Some people argue that China should adopt a mixed model of corporate governance. This hybrid model puts the emphasis on managers' self-realization of internal motivation and control, should be more effective than the UK/US external market mechanism. First of all, since financial institutions in China have incentives to supervise firms, China's current institutional environment seems to be more like that of Japan and Germany in the early days of their success than those of the United State or the United Kingdom. But when the long privatization process is successful and most shares are tradable, and when both the market is relatively mature and individual investors are more sophisticated, then the US/UK model should replaces the former one. Currently, it seems that the market regulatory framework in China tries to follow more the UK/US model, while the internal and external monitoring mechanism is more similar to the Germany/Japan model. However, with a view to long-term development, it is desirable for China to create its own model that matches its unique environments.[581] Some scholars suggest that there are five conditions upon which China should base its choice of a generic corporate governance model: (1) the model must match China's economic development and maturity of its capital market (stock or securities market); (2) the model can make sure that firms promote long-term stable growth and

[579] See Xu. X.N, 1997, 'Establishing Corporate governance Mechanism and Capital Market with Legal Persons as Its Main Body', Journal of Reform No.5(in Chinese),.
[580] See Zhang, Weiying, 1998, 'China's SOE Reform: A Corporate Governance Perspective', Working Paper, Institute of Business Research, Peking University.
[581] See Simon S.M.Ho, 2003, 'Corporate Governance in China: Key Problems and Prospects', Working Paper, Centre for Accounting Disclosure and Corporate Governance School of Accountancy, The Chinese University of Hong Kong,

development; (3) the model can guarantee that investors monitor management effectively; (4) the model can make sure that management has the autonomy to operate the business independently; (5) the model can offer incentives and control mechanisms effectively to stimulate or regulate the behavior of investors, the management and employees.[582] This thesis argues that corporate governance must be adapted to the reality of China. But the precondition is that the structure of concentrated ownership by the state must be reformed and adjusted properly.

9.6. Conclusion

The new Company Law of the People's Republic of China, which came into force on 1st January 2006, will provide more protection of investors, in particular minority shareholders compared with the old one. Meanwhile the reform of previous non-trade shares owned by the state and legal person was finished by the end of 2006 and those non-traded shares will be traded on stock exchanges three years later. Maybe the next step is to determine how to sell off the shares owned by the state according to law and regulation and the rule of the market. What will the result be for the corporate governance of listed companies in China in the future? This will remain to be seen.

[582] See Simon S.M.Ho, 2003, 'Corporate Governance in China: Key Problems and Prospects', Working Paper, Centre for Accounting Disclosure and Corporate Governance School of Accountancy, The Chinese University of Hong Kong.(citing He, S.W. and Xu, M.B. 2000, 'State-owned Enterprises Reforms and Strategic Re-organizations', China Financial and Economic Publisher.).

Chapter 10. Disadvantages of the Structure of Concentrated Ownership

10.1. Introduction

China has started focusing on its economic development by adopting reform and an open policy since 1978. Before the reform, the input and output of SOEs were determined by the state according to central planning. A study shows that "the share of the state-owned sector is approximately 71.4% to 99.7% in various socialist countries in the 1970s and the1980s, whereas it is the percentage of the private sector in capitalist countries."[583] Traditionally, the state had public ownership and enjoyed control rights over SOEs in China. SOEs, not only considered as working units and tools of policy but also serving as a platform to link the state and public, were the basic units for the state to organize society and offer social welfare responsibility, such as employment, housing, schools, kindergarten, shop and hospital for enterprises' employees and families, which were very heavy burden for SOEs.[584] In other words, SOEs were viewed as a tool of implementation of state polices in place of the maximization of profitability. As a result, the socialist economy is no way to go under the central planning system.

The success of China's economic reform in a sense is dependent on restructuring

583 See Kornai, J., 1992, The Socialism System: The Political Economy of Communism, Clarendon Press, Oxford, p 72.

584 See Schipani A. and Liu J.H. , 2002, 'Corporate Governance in China: Then and Now', Colum. Bus. L. Rev. 1, p 9.

state-owned enterprises. There are two competing approaches regarding China's economic reform suggested by economists: the market approach and the ownership approach. On the former approach, it is believed that if the markets for products, for factors of production, and for corporate control are created and function well, efficiency improvements of SOEs can be achieved without dramatic changes in ownership that will be improved and adjusted correspondingly. This market-oriented approach posits that if competitive markets are shaped for products or factors of production, SOEs can be successfully transformed from loss-making cost centers into profitable, return-oriented investment centers without radical changes in the ownership structure but the structure of ownership will adjust properly with development of market. In fact the market-orient approach seemed difficult to be implemented in the late 1999s without a change in the structure of ownership of SOEs. On the latter approach, it is argued that private ownership is a necessary condition for enterprise efficiency, and enterprise efficiency will not be fostered without a change of ownership of SOEs. China has implemented a reform strategy that, at the initial stage, gives priority to developing markets and facilitating institutional changes in place of a change of ownership, characterized as the "gradualism" strategy controlled by government.[585] However, the practice proves that the reform of SOEs seems no progress in the late 1990s without the change of ownership.

Although the Company Law was enacted in 1993, state-dominated PLCs were popular. The 15th Congress of the CCP in the fall of 1997 announced the policy of

[585] See Qu Qiang, 2003, 'Corporate Governance and State-owned Shares in China Listed Companies', Journal of Asian Economic 14, p 778.

ownership diversification in the state sector, and made it explicitly clear that "shareholding system" meant SOEs would be reformed completely. While many researchers considered it as turning on a green light to massive privatization, it also restated that public ownership should continue to keep dominant in the Chinese economy. Similarly, a decision of the 4th Plenum of the 15th Party Congress (September 1999), and the State Planning and Development Commission (SPDC) January 2000 statement elaborating on this decision, reaffirmed that while state ownership would be lessened in a number of sectors, it would keep dominant in industries of strategic importance such as infrastructure, key producer goods, etc. Few specific practical measures for divestiture have in fact been formulated. The 16th CPC Congress held in November, 2002 called for establishing a new state asset management system, "unifying the duty of managing assets, personnel and affairs"; and as late as 2003, in the news conference held by the newly established state-owned Assets Supervision and Administration Commission (SASAC) on 22 May 2003, the controlling role of state assets was once more emphasized.[586] Today reform of the structure of ownership of listed companies has been under way since 2005; as mentioned above, all state-owned and legal persons' shares can be traded on a stock exchange soon. In a word, this thesis thinks optimal resource allocation is unlikely to be achieved simply by creating a market without changing the ownership structure of SOEs in China.

586 See Qu Qiang, 2003, 'Corporate Governance and State-owned Shares in China Listed Companies', Journal of Asian Economic 14, p 780.

10.2. Ownership, market and competition

In theory, the market is viewed as the most efficient mechanism to allocate resources based on the fundamental assumptions of perfect competition, no agency costs, low information costs, good price mechanism, and no public goods. In reality, there will be market failure, which can result from a number of causes including asymmetries of information, agency problems, incentives to shirk and cheat, motives for free-riding and other risks that will not be expected,[587] and which can lead to divergence between profit and welfare objectives in private firms. Thus the market may not function properly to effect in resource allocation as supposed, especially under non-competitive conditions, for example, where there is a centrally planned economy, and so governments may intervene to avoid the market failure by administrative orders or ways.[588] Effective markets would facilitate ownership reform and the enforcement of property rights while clarified ownership and property rights would improve the efficiency of markets and competition. However, an unreasonable structure of ownership will do harm to the market and competition, for example, a highly concentrated state-owned share in a sector will strangle competition and result in monopoly. Competition can greatly improve monitoring possibilities and incentives for productive efficiency. In general, the logic of competition suggests that a more complete specification of individual property rights decreases uncertainty and will

[587] See Alchain, Armen and Harold Demsetz, 1972, 'Production, Information Costs, and Economic Organization', American Economic Review 62, pp 777-95; Williamson, Oliver, 1975, Markets and Hierarchies; Analysis and Antitrust Implications, New York: Free Press; North, Douglass C, 1981, Structure and Change in Economic History, New York: Norton.

[588] See Willian L. Megginson and Jeffry M. Netter, 2001,'From State to Market: A Survey of Empirical Studies on Privatization', Journal of Economic Literature, Vol. 39, No.2.

expedite efficient allocation and use of resources in market.[589] In particular, among firms with private ownership, competition facilitates performance comparisons, which can generally strike a balance between incentives and risk when several agents (managers) confronting correlated uncertainties are being policed in a market economy. [590] Some scholars, in their international cross-section analysis of competitive industries, find that private enterprises are more profitable and more efficient than state-owned enterprises.[591] That is to say, in competitive industries private ownership is generally preferable on efficiency grounds. Therefore, ownership, competition and market are interrelated. A mature market can promote sufficient competition and facilitate the clarification of ownership rights; clarification of ownership rights will make the market reasonable and competition efficient, while sufficient and efficient competition will strengthen the development of a dynamic market and the structure of scientific ownership.

China has been successful in economic reform in the past thirty years, and the small and medium SOEs have been sold off and this has made a great contribution to the progress of the economy, but it seems that there will be no final success of reform without a change of the ownership structure of big SOEs. Therefore this thesis argues that the structure of ownership of the big SOEs should be changed greatly once China has become a member of the World Trade Organization (WTO), otherwise the big

[589] See Eirik GFurubotn and Svetozar Pejovich, 1972, 'Property Rights and Economic Theory: A Survey of Recent Literature', Journal of Economic Literature, Vol.10, No.4. (Dec.,), p 1141.
[590] See Hart, Oliver, 1983, 'The Market Mechanism as an Incentive Scheme', Bell Journal of Economics, Autumn, 14, pp 366-82; Holmstro, Bengt, 1982(a), 'Moral Hazard in Teams', Bell Journal of Economics, (Autumn), 13, pp 324-40; Nalebuff, Barry, and Joseph Stiglitz, 1983, 'Prizes and Incentives: Towards a General Theory of Compensation and Competition', Bell Journal of Economics,(Spring 14), pp 21-43.
[591] See Boardman, Anthony, and Aidan Vining, 1989, 'Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed and State-owned Enterprises', Journal of Law and Economics, (April 32), pp 1-33.

SOEs will be ineffective and uncompetitive compared with other forms of enterprises at home and aboard in the circumstances of globalization. It will not be enough simply to create markets for products, workers, managers and other factors of production because the structure of concentrated ownership by the state not only influences the market and competition negatively, but also makes the market and competition out of order which will result in regression in economy.

In the past, most Chinese firms were controlled by the government and had little flexibility in making decisions on hiring/firing or on business operations. There was no market and no competition at all because the SOEs and collective enterprises were under the central planning economy. After the reform and opening up to the outside world, product-market competition was always highly uneven and segmented across sectors and regions due to the protection of the interests of sectors or regions without the unification of the market. With the development of the market, intense competition, and change of ownership, the need for autonomy to enable firms to make labour and business decisions to achieve their profit maximization objective is very important in the transition process from a centrally planned to a market economy. In China, the stock market is the symbol of the reform of economy. The securities market can be viewed as a first step toward creating domestic capital markets. Of course, the securities market can be a tool through which the government can shift some of its SOE responsibilities to economic forces because most SOEs were performing poorly, and the securities market became an easy avenue for companies to raise funding from the public and shape some independence from political influence through the modern

corporate system. Generally speaking, good corporate governance must offer the appropriate market incentives. For a firm's corporate governance practice to have a positive effect on its market value, two conditions must be met. First, good governance must constantly increase the returns to the firm's shareholders and stakeholders; second, the share prices should efficiently represent the fundamental values of listed companies in the stock market. These conditions are more likely to be met in mature markets than in emerging markets. In fact, share prices on China's stock market are often considered to be driven by more purely speculative activities rather than the fundamental value of listed companies.[592] This shows that the stock market is not mature, and the structure of concentrated ownership by state is one of reasons why the market is immature in China. In other words, the immature market includes at least: share prices can not reflect the true value of listed companies; managers of a number of firms own a very small percentage of shares and they have virtually no incentive to increase the stock prices of their firms; institutional investors have little voice on some boards; bank debt does not provide monitoring of management, and the market for public debt is yet to be developed; and there is no active merger or takeover activity in the stock market to discipline managers. According to these the standards, the stock market is indeed not mature in China.

Today the local party committees still succeed in maintaining their interference in the decision-making process, which affects competition in the market, even after two decades of economic transition. In particular, the decision-making power of local

[592] See Qu Qiang, 2003, 'Corporate Governance and State-owned Shares in China Listed Companies', Journal of Asian Economic 14, p 780.

Party committees is dominant in China's listed companies, due to diverse lock-in effects between the Party and various areas of the institutional environment. However, some scholars have found that the decision-making power of the local party committees on the operations of listed companies is declining as the market improves and private power emerges in the process of economic reform.[593] It shows that the market is improving, the structure of ownership is changing and competition is being enhanced.

In a word, once the reform of the structure of concentrated ownership is successful, the market will be mature and competition will be effective. Accordingly the corporate governance of listed companies in China will be improved.

10.3. The structure of share ownership

10.3.1. General conception

Most previous studies based on the theories and practice of developed economies regarding corporate governance ascribe these shortcomings to factors such as the uncompetitiveness of markets, poor legal enforcement, and an inefficient debt and equity market. Maybe the analysis of the above by some scholars is reasonable. However, without the understanding of the fundamental underlying issue, namely the share structure, especially the role played by state-owned shares in the operate

[593] See Sonja Opper, Sonia M.L.Wong, and Ruyin Hu, 'Party Power, Markets and Private Power: CCP Persistence in China's Listed Companies', Working Paper, http://www.no-big-bang.com/krug/publications/Opper-CCP%20and%20Co.pdf

governance of Chinese publicly listed companies, it might be impossible to reach meaningful conclusions. I can say, without an understanding of the structure of ownership in China, one knows nothing about the socialist economic market because "ownership reform is a precondition of the creation of a fair competitive environment."[594]

In China, SOEs have concentrated ownership by the people, but ownership by "all of the people really means in a sense ownership by none of the people." SOEs represent the classic case of ambiguous property rights and principal-agent failure. That is to say, property rights in SOEs are owned by everyone and by no one in particular. It is known that the improvement of governance of SOEs in China has been limited to clarifying property rights through a process of corporatization without any significant change in ownership or privatization in the 1990s, but most divested jointed-stock companies remain under major state ownership and control. Therefore, the poor performance of listed companies can be blamed on the ambiguity of property rights. That is to say, who actually owns the property rights in listed companies: the whole people, the government or others?

According to the ownership view, private enterprises are inherently more efficient than state-owned firms. This view can be dated back to early work by Hayek and Friedman.[595] Later, some scholars' studies have demonstrated that state ownership was in fact linked with poor SOE performance, further in support of a policy that state

594 See Xu Dianqing, 2000, 'The Agent Vacuum' in Corporate Governance of Chinese Enterprises in Liang Neng (ed), Corporate Governance: the China's Practice and the American Experience, People University of China Press Ltd, p 163.
595 See Yifan Hu, Frank Song and Junxi Zhang, 2004, 'Competition, Ownership, Corporate Governance and Enterprise Performance: Evidence from China',(November). Working Paper, http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1111.pdf

ownership should be reduced in these firms.[596] These scholars' studies show that ownership structure appears to have a great influence on profit reinvestment. The correlation with the share of private ownership is not only a fundamental representative of the security of property rights but also active and significant in the creation of property.[597] But other scholars have different views on ownership.[598] This thesis argues that the experience shows that private firms are more efficient than state-owned enterprises from an historical world perspective, in particular in China. So far privatization seems to be the speedy way to solve the property rights problem. It aligns the control right and cash flow right immediately and is supposed to lead to restructuring the firm toward efficient production. Some Chinese scholars believe that privatization is the obvious solution to the SOEs' inefficiency. Privatization might be the right way toward restructuring. However, "Shock Therapy" is not best choice for China because of its different history, culture, politics, economy etc. Since theory and empirical evidence from international experience show that "examples of effective corporate governance and performance— except in cases of market failures, externalities or public goods— in state-owned corporations are few and far in between, and that pervasive state ownership undermines the effective functioning of

596 See, Sun, Q., Tong, W.H., 2003, 'China Share Issue Privatization: The Extent of Its Success', Journal of Financial Economics 70, pp 183,-222; Wei, Z., Varela, O., D'Souza, J., Hassen, M.K., 2003, 'The Financial and Operating Performance of China's Newly Privatized Firms', Financial Management, pp 126-197.

597 See, Robert Cull, Lixin Colin Xu, 2005, 'Institutions, Ownership, and Finance: The Determinants of Profit Reinvestment Among Chinese Firms', Journal of Financial Economics 77, p 135.

598 E.g.some scholars support the view that state-owned enterprises are inherently less efficient that private. For example, Boycko, Maxim, Andrew Shleifer and Robert W.Vishny, 1996,' A Theory of Privatization', Economic Journal 106(435), pp 309-19; Krueger, Anne O, 1990, 'Government Failures in Development', Journal of Economic Perspectives 4(3), pp 9-23. But some scholars have different view, for example, Vickers, John and George Yarrow, 1991,' Economic Perspectives on Privatization', Journal of Economic Perspectives 5(2) , pp 111-132; Chang, Ha-joon and Ajit Singh, 1997, 'Policy Arena: Can Large Firms Be Run Efficiently Without Being Bureaucratic?', Journal of International Development 9(6), pp 865-875.

markets."[599] Therefore reform of the structure of state-owned concentrated ownership must be carried out by means of privatization in China.

10.3.2. The disadvantages of concentrated ownership

Ownership reform among China's SOEs is a process in which state-owned capital, originally the exclusive preserve of state-owned industry, has migrated outside the traditional state sector into the new forms of enterprise ownership. As large numbers of major enterprises are state-owned and have the state as a majority shareholder in listed companies, there is often an intertwined relationship between the state as participant and regulator. As a participant, the state owns majority of the shares so that it offers the possibility of the state's dominant position in the general meeting. That is to say, the state has the power to appoint and dismiss the supervisory board and the board of directors, and to determine major business decisions. As a regulator, some business decisions in relation to state assets made by the board of directors and endorsed by the general meeting are required to be approved by government agencies, or government agencies abuse power to inspect and examine the operation of listed companies in order that the listed companies are controlled by the state.

Why did the structure of public listed companies come to be concentrated in China? As I described in chapter six, the state-owned enterprises reform started in China about two decades ago, the government was concerned about the stability of society and maturity of market. With regard to maturity of the market, the problem is the

[599] See Dr. Cyril Lin, 200, 'Private Vices in Public Places: challenges in Corporate Governance Development in China', Working Paper, (April), OECD Development Centre.

potential loss of state assets if all shares of a restructured SOE were to be freely traded when market is at the stage of infancy. As a concession, the ownership of each enterprise was mainly split into (1) state shares; (2) legal person shares and (3) common domestic A-shares. But only A-shares were tradable since then. This special institutional arrangement became deeply ingrained in Chinese political system and ideology, as well as in the economic reform strategy.[600] The designation of shares into state, legal entity, and individual is enshrined in China's company law. According to modern company law, legal entities are usually charged with making profits, whereas for state stockholders profit may not be the sole goal. Thus the current ownership structure of listed companies in China is mostly shaped by its unique listing process in a sense because most Chinese listed companies have a strong link with the state and their parent companies controlled by state.

In China, generally speaking, the state controls about 60% of the share of listed companies. But some scholars have a different opinion, that the state's statistics fail to manifest the ultimate shareholders genuinely, for example, some think the state is ultimately in absolute control of 81.6% instead of 60% of all publicly listed companies via two control patterns: (1) government direct owns 9.0% of the listed companies, and (2) government indirect owns 72.6% of the listed companies via stock pyramids (the figures for state ultimate controls of listed companies is for the end of 2001). However, the Chinese official shareholding classifications, which state shares, legal person shares, employee shares and the tradable A shares (issued for individual

[600] See Qu Qiang, 2003, 'Corporate Governance and State-owned Shares in China Listed Companies', Journal of Asian Economic 14, p 772.

investors) respectively accounted for 46 per cent, 18 per cent, 0.5 per cent and 25 per cent of the total shares outstanding in 2001, are not correct. For instance, Inner Mongolia Mengdian Huaneng, a thermal power corporation, was listed on the Shanghai Stock Exchange. The state asset bureau, as the third largest equity holder, directly possessed 7.9% of the voting rights in 2001, while the two largest shareholders are the Inner Mongolia Electricity Company (62.4% of shares outstanding) and the Huaneng Group Corporation (13.2% of total shares) respectively. According to the official classification of state shares and legal person shares, the firm should be considered as under the control of the legal person— the Inner Mongolia Electricity Company, since it is the majority shareholder of the firm. A closer study, however, demonstrates that in fact the firm is controlled ultimately by the state, because its two largest legal person shareholders, the Inner Mongolia Electricity Company and the Huaneng Group Corporation are themselves respectively controlled solely by the Inner Mongolia local government and the central government (the State Council). Hence, the ultimate voting rights the state has in the thermal power corporation seem to amount to 83.5% (62.4%+13.2%+7.9%) instead of only the 7.9% shown in the official statistical record, and the company in question should be regarded as operating as a wholly state-owned company.[601] In fact, there are many case like the one above, that is, where the state has extended its ownership from direct control to indirect control via a pyramid shareholding scheme. This has become prevalent in Chinese publicly listed companies. In China listed company groups are

[601] See Guy S. Liu and Pei Sun, 2005,'The Class of Shareholdings and its Impacts on Corporate Performance: a Case of State Shareholding Composition in Chinese Public Corporations", Corporate Governance, Volume 13, Number1, (January), pp48-49.

usually headed by a holding company. These holding companies are usually controlled and majority-owned by a state-controlled company, such as a government asset management company, an investment company. The listed companies are usually majority-owned by the holding company directly, and thus are indirectly controlled by the local or central governments. For example, Kelon Electronics, a listed company, and one of the top refrigerator sellers in China, is majority-owned by Kelon (Yongshen) Holding company, and this holding company in turn is 100% owned by the town municipal government. Such a pyramiding structure is very prevalent among listed companies in China. The ultimate controller might have an interest different from that of the company and its small shareholders, and it would be very difficult to prohibit it from making decisions that fail to maximize corporate value. In other words, it is normal to have a conflict of interest between the government and other stakeholders because the state as the majority shareholder or the controlling minority shareholder of listed companies is prone to make decisions on the operation of the company which are in conflict with the interests of shareholders and corporate development.[602]

Commonly, securities markets permit private entrepreneurs to access public equity and debt markets to raise capital. In China, however, listed companies are almost never private companies at the initial stage of the securities market. Rather, they are state-owned enterprises that have been transformed into joint stock companies under PRC Company Law of 1993 and regulations. And then listed companies remain

[602] See Mariko Watanabe, 2002, 'Holding Company Risk in China: A Final Step of State-owned Enterprises Reform and an Emerging Problem of Corporate Governance', China Economic Review13, pp 373-381.

state-owned as they were before, through unlisted shares, an "overhang" of unlisted, illiquid shares which negatively influences China's securities markets.[603] Of course this phenomenon is changing now.

Despite accounting for a declining share of national output, the state-owned enterprise sector still continues to control the national economy in terms of fixed assets and the allocation of financial capital. A major characteristic of China's enterprise reforms is the state's retention of a controlling stake in listed firms. On average, about 30% of the shares are held by the state (central government), its ministries, and local and regional government. Another 30% of the shares are owned by legal entities and most of these entities are ultimately held by the state. In a word, this stake is owned directly or indirectly by central government and its associated ministries, or by city, regional, and local government. In practice, the state and legal entity shareholders are typically blockholders and the largest blockholder often controls the firms as a dominant or blockholder's stockholdings far exceed the second largest stockholder. Blockholder among the "new" agency problems diverts resources to itself, manipulates stock prices, and expropriate minority stockholders compared with traditional agency problem, namely conflicts between managers (agent) and state (principal).[604]

According to China's Securities Regulatory Commission, the government owns more than 47% of the shares of all the public listed companies in 2003. In 35% of all

[603] See Walter Hutchens, 2003,'Private Securities Litigation in China: Material Disclosure About China's Legal System", 24 U.Pa. J. Int'l Econ.L, pp 612-613.
[604] See Gongmeng Chen, Michael Firth, Daniel N.Gao, Oliver M.Rui, 2005, 'Ownership Structure, Corporate Governance, and Fraud: Evidence from China', Journal of Corporate Finance, www.elsevier, com/locate/econbase.

public listed companies, the government shares owns more than 50% of all the shares, in 54% of them, it owns more than 30% of the shares.[605] This shows that state is absolutely the biggest shareholder in most listed companies in China.

After many years of practice, it has proved impossible to improve SOE performance only through increased autonomy of companies by political push and by legal regulation. It was recognized that the crux of poor SOE performance was the ambiguity in property rights inherent in the structure of share ownership in companies. That is to say, ownership by "the whole people is almost equivalent to free goods, since nobody possesses it".[606] Some scholars have done research on the listed SOEs from 1990 to 2000 and found that the financial performance of SOEs became worse and worse after being listed. Measured in terms of return on sales and return on assets, the post-IPO performance of listed SOEs trends worse than the results in the periods leading up the IPO. The table below shows that the average return on assets (ROA) drops steadily, from 19.6% in the year prior to IPO to 2.7% in the sixth year after IPO. The average return on sales (ROS) also decreases from 16.6% one year before listing to 0.2% in the sixth year after listing.[607] Why did listed companies deteriorate like that? One of the reasons is as follows: In accordance with requirements under laws and regulations, a company had to show three years of continued profits to qualify for listing on the exchange stock. Because listing is scarce, and there were quotas for companies at the time, provincial government often bundled companies which had

[605] See www.csrc.org.cn
[606] See Nakagane, Katsuji, 2000, 'SOE Reform and Privatization in China: A Note on Several Theoretical and Empircal Issues. Working Paper, University of Tokyo.
[607] See Wang, Xiaozu, Lixin Colin Xu ,and Tian Zhu, 2001,'Is Public Listing a Way Out for State-Owned Enterprises? The Case of China'.

profits with poorly-managed companies that need money in order to make best use of the quotas and go public. No surprisingly, the performance of listed companies became poor after listing because of the structure of ownership by state. That is, the process of listing is controlled by governments, often in contradiction of the law and regulations on the one hand, on the other hand, the process of operation after listing is often controlled by state for its goal instead of profit.

Table 2: Selected Mean Performance Statistics of Listed SOEs

	Year-1	Year 0	Year 1	Year 2	Year 6
ROA	19.6%	15.4%	9.7%	7.4%	2.7%
ROS	16.6	16.2	13.7	7.8	0.2
Capex/Assets	74.3	57.7	43.1	28.2	3.8
Annual Sales Growth	28.7	47.8	22.2	10.5	16.5

Source: Wang, Xu and Zhu (2001), World Bank

On account of highly concentrated share and non-tradable share, share splitting must result in serious consequence. Some shares for individuals can be traded on the stock exchange while others for state and legal entities cannot; some shares (A shares) can only be issued for domestic residence, while others (B shares) can only be issued for foreigners. Empirical evidence shows that the unique ownership structure of listed firms affects firm value and share prices. Some scholars have found a significant price discount for Class B shares held by foreign investors as compared to Class A shares

held by domestic investors. (Mainland "persons" are able to trade B shares since 2001 February if various eligibility requirement are met and now share owned by state can be traded). One possible explanation of the price difference is the illiquidity of the B-share market. However, B-shares move more closely with market fundamentals than A-shares, suggesting that there is a premium for A-shares (due to excess demand for these shares from domestic investors) rather than a B-shares discount. A related question is how government ownership affects firm value. To this end, Tian (2002) uses Tobin's Q[608] as proxy for firm value and finds that there is a U-shaped relationship between government ownership and firm value. For firms with low levels of state ownership, firm value is negatively related to state ownership. This might show higher government ownership is connected with a higher degree of interference with managers.[609] From the perspective of performance, scholars examined the cross-sectional relationship between ownership structure and corporate performance for a sample of 434 manufacturing firms listed on the Chinese stock exchange, and then drew the conclusion that a high percentage of state shareholding, either in the form of direct state agency holding or in the form of holding by state solely controlled institutions, led to inefficient resource allocation. That is, shares held by the state play a negative role in corporate governance.[610] Some scholars studied the relationship

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[608] Tobin's q, is the ratio of the market value of a firm's assets (as measured by the market value of its outstanding stock and debt) to the replacement cost of the firm's assets (Tobin 1969). This measure of performance is not used as often as either rates of return or price-cost margins. If a firm is worth more than its value based on what it would cost to rebuild it, then excess profits are being earned. These profits are above and beyond the level that is necessary to keep the firm in the industry.
http://wps.aw.com/aw_carltonper_modernio_4/0,9313,1424978-content,00.html

[609] See Franklin Allen ,Jun Qian, and Meijun Qian, 2002, 'Law, Finance, and Economic Growth in China', The Wharton Financial Institutions Center, Working Paper, (December).

[610] See Jian Chen, 2001, 'Ownership Structure as Corporate Governance Mechanism: Evidence from Chinese Listed Companies', Economics of Planning 34, p 68.

between state ownership and corporate performance on China's listed companies based on the panel dataset of China's listed companies during 1994-2000, and showed a significantly negative relationship between the state shareholding ratio and corporate performance, namely the higher state shareholding ratio, the worse performance.[611]

The present structure of state ownership and control of enterprises accounts for some of their poor performance and bad corporate governance. This results from weak incentives for managers to maximize value for all investors and creditors, and from the protectionist practices of government agencies that shield firms from market discipline and laws. Today reforming China's state-owned enterprise sector is at the core of China's economic reform. The core of the problem lies in the difficult tasks of reforming the SOE ownership structure and improving corporate governance. This thesis argues that the privatization should be done in a way that is different from that in the former Soviet countries through the reform of the corporate system, because incorporation of private ownership interests through listing would provides the checks and balances on management to improve performance.

Based on the analysis above, the drawbacks of the ownership structure in listed companies where the state is the controlling shareholder as in China are at least as follows. (1) Lack of incentive is a fundamental issue because managers have a small share in listed companies and it is the same for them whether listed companies is profitable or not. (2) The dominant state ownership tends to erode the credibility of

[611] See Laixiang Sun and Tao Li, 2005,'State Ownership and Corporate Performance: A Quantile Analysis on China's Listed Companies', Discussion Paper 55, Centre for Financial and Management Studies, SOAS, University of London, (14 April).

the threat of market failure and the regulatory capacity of the state. Because the state is both the biggest shareholder in most listed companies and also the regulator, on the one hand, the state will realize its political goals through listed companies instead of pursuing profit maximization; on the other hand, how will the state inspect or regulate listed companies as a regulator, and who will monitor the state under the circumstances? (3) It is impossible in China for mergers, acquisitions, tender offers, and corporate takeovers to restructure really the allocation of resources and improve the management of enterprises because these transactions are largely dependent on alienability of ownership in the enterprise. However, in China, state shares and legal person shares, which comprise the preponderance of all outstanding stock, because of the characters mentioned above, are critical impediment to alienability. (4) The victims of fraudulent disclosure will not be compensated properly because listed companies are likely be substantially government-owned at all levels, especially provincially-owned. It is widely believed that false accounting and financial misreporting are pervasive among Chinese SOEs and companies. The China National Audit Office (CNAO) stated in December 1998 that "cooked books", embezzlement, fraud and "irregularities" in financial management were widespread among Chinese firms. After scrutiny of 110 trust and investment companies, 88 securities companies and life and property business subsidiaries of the People's Insurance Company of China (PICC) in 1998, the conclusion was drawn that the financial and accounting management in many of these firms were "chaotic and inaccurate" and many securities companies misappropriated clients' money and conducted illegal fund

raising.[612] In China, a fundamental obstacle to the progress of the rule of law is that local courts are subject to the control of local governments. That is, local governments in China appoint judges to local courts and control the promotion of such judges, and local governments in China also control the budgets of local courts. Therefore, almost all judges who will adjudicate private securities litigation cases against government-owned corporations are subject to substantial influence from government cadres at the same level, which is very normal in China. (5) Intervention in operation. According to company law, the general meeting of shareholders is very powerful in China, but in fact the meeting is often simply a rubber stamp for the wishes of the majority of shareholders. There is little or no opportunity for minority shareholders to be heard. Thus minority shareholders and potential investors may be concerned about potential misuse of the controlling shareholder position by the state when the state owns a large portion of the shares of SOE-corporatized corporations, and it is very easy for the state to exercise dominant influence on the corporation. (6) Expropriation of assets. In most listed companies, the largest shareholder is the state. As a result, the controlling shareholder can dominate the firm's decisions and expropriate other investors. The fact that most listed firms in China are spin-offs from large SOEs with parent groups serving as their largest shareholders compounds expropriation problems between controlling shareholders and minority investors. Many controlling shareholders treat listed firms as cash cows from which they can benefit themselves at the expense of other investors. Documented abused by controlling shareholders

[612] See Dr. Cyril Lin, 2001, 'Private Vices in Public Places: challenges in Corporate Governance Development in China', Working Paper, (April), OECD Development Centre.

include obtaining soft loans from listed firms, using listed firms as guarantors to borrow money from banks, and buying and selling goods, services, and assets at unfair prices.[613] For example, a listed SOE may be forced by the dominant shareholder to lend its own funds to the parent or affiliates of the group and lending usually carries a zero interest rate. Related-party transactions and loans from listed companies to their state-owned parents are very serious problems in listed companies. For example, New Fortune reported 159 new loans (guarantees) disclosed in 2001, which amounted to Rmb 23.1billion. The following table shows how serious the problem of loan guarantee is in China.

Table 3: Examples of Chinese Companies Making Guarantees

Company	Guaranteed amount(Rmb m)	Guaranteed amounts/Equity
FounderTechnology(600601,SS)	465	82%
Lujiazhui (600663.SS)	1962	46%
Xinye Property (600603.SS)	878	232%
China High Tech (600730.SS)	494	150%
ChinaWestMedicine(600842.SS)	593	270%
China Kejian(0035.SZ)	820	also received counter guarantees
China Tech Venture(0058.SS)	415	249%

[613] See Tam, On Kit, 2002, 'Ethical Issues in the Evolution of Corporate Governance in China', Journal of Business Ethics 37(3), pp 303-320; Tenev, Stoyan, Zhang Chunliln, 'Corporate Governance and Enterprise Reform in China: Buiding the Institution of Modern Market', World Bank and International Finance Corporation, Washington, DC; World Bank, 1997, 'China's Management of Enterprise Assets: The State as Shareholder', World Bank, Washington, DC.

Shanghai Ninth Department Store	567	84%
Hero Corp(600844.SS)	472	82%
Shenzen Petrochem(0013.SZ)	1673	307%
Tongji Tech(600846.SS)	2240	67%

Source: New Fortune, December 2001, UBS Warburg

According to a survey conducted by CSRC in 2002, the sum of interest coverage and bad-loan provisions accounted for almost one-third of the net profit on average among the surveyed companies during the period of 1998-2002.[614] In addition to the direct lending, the dominant shareholder tends to extract more funds from its listed SOE when the listed company performs well. Lianhua Gourmet Powder Company provides an instructive example. The parent of the company is a fully state-owned firm. By August 2003, the parent had held 65.73 per cent of total outstanding shares of the company and extracted RMB 858 million. Most of these fund extractions occurred during 1998-2000, a period when the company performed very well, and were in the form of direct lending to the parent and of guaranteeing bank loans to the parent. The default on these loans by parent put the company into a cash-flow crisis and the attention of CSRC and other monitoring agents was consequently drawn in. Once the source of its financial trouble was revealed, a rescuing and restructuring plan was drawn up and carried out by the provincial government.[615] (7) Conflict of interest

614 Shanghai Securities Daily, 2 April 2004.
615 Shanghai Securities Daily, July 29, 2004.

between governments. In theory, where different departments, agencies or governments are the representative owners of the state assets or are shareholders in the same listed company or different listed companies, they should serve together in the best interests of the state. However, in practice, conflicts of interest between them often happen and leads to the loss of state assets due to the divergence of interests. (8) Appointment of personnel. As analyzed above, the appointment of persons in listed companies is influenced by politics through the structure of ownership. In addition, from an operational perspective, there are the puzzles of distributing stock dividends and issuing uninsured rights in China. In the United States, stockholders respond positively to stock dividend announcements, which can be explained by the signaling theory. But in China, on the contrary, stockholders react negatively to stock dividend distributions. If a stock dividend does not signal good news, why do so many Chinese firms bother to distribute stock dividends? While fewer and fewer firms issue uninsured rights in the United States and elsewhere, Chinese firm predominantly use uninsured rights in seasoned equity offerings. With regard to the above puzzles, which are quite different from what has happened in advanced markets, a scholar thinks dividend policies and financing choices are influenced by ownership conflict (agency and political costs) and the ineffectiveness of monitoring.[616] That is to say, the puzzles of distributing stock dividends and issuing uninsured rights is the result of political interference. In fact it is affected by politicians through the structure of ownership.

[616] See Donwei Su, , 2005, 'Corporate Finance and State Enterprise Reform in China', China Economic Review 16, p 119.

This thesis argues that the puzzles of distributing stock dividends and issuing uninsured rights in China lie in the structure of share ownership. In other words, it is the structure of share ownership that leads to the difference between the market in China and other advanced markets. The structure of share ownership is concentrated in the form of ownership by all levels of governments, namely by the state in China. That government ministries and commissions and securities regulatory authorities enjoy substantial decision-making power is the logical result of ownership. Since the state accounts for the most of the share ownership in listed companies in China, it is normal for the state to control the listed company and select the members of the board of directors, who will decide how to distribute profit and how to exercise the rights of listed companies, which will be in interests of the largest shareholder in return.

10.4. Conclusion

The development of the economy is based on the adequate competitive market, and the progress of society is built on an excellent environment, such as culture, politics and law. Across the world, history has proved that there are more effective methods of macroeconomic management, utilizing the market, than a planned economy. Today economic reform in China is relatively successful, but there are many problems which will have to be overcome during the process of reform, and one of the biggest problems is SOEs, and in particular listed companies, because the state is the largest shareholder of most listed companies. If the structure of concentrated ownership of

listed companies controlled by the state is not adjusted properly in accordance with the rules of the market, corporate governance will deteriorate further, the stock market will be suffocated greatly, and the development of the economy will be affected negatively beyong question because there are many disadvantages derived from the structure of concentrated ownership of listed companies which has been analyzed above in detail. Thus the structure of concentrated ownership must be reformed at once in order to improve corporate governance and the market economy. Now it has been under way since 29 April 2005.

Chapter 11. The reform of ownership is a precondition for the improvement of corporate governance

11.1. Agency problem

There are different agency problems in listed companies in China due to the structure of share ownership. As we know there are different ownership forms in listed companies which have created additional incentives and opportunities for managers to realize their benefits from their control over state assets. For instance, by using the appraisal and valuation process to sell state assets to their relatives or their affiliate enterprises at low prices and diverting them for private use. But the main agency problem is the conflict of interest between majority shareholders and minority shareholders. For example, parent companies as majority shareholders often borrow money as soft loans from listed companies on a long-term basis; or use listed companies as guarantors to borrow money from banks, or sell assets to listed companies at a higher price or buy assets from listed companies at a lower price without any appraisal by an independent evaluator. In other words, there are two kinds of agency problem in listed companies in China. One is the traditional one: the state as principal and managers as agents. Another involves the controlling shareholder as agent and minority shareholders as principal. The latter is more serious than the former one.

11.2. How to solve the agency problem?

With regard to the agency problems in listed companies, some scholars suggest ways to solve the agency problem in China as follows: (1) The complete separation of listed companies' managers from the civil service system. It will decrease the scope of political and government control over managerial appointments, prevent politicians from interfering in their operations and expedite the development of a managerial labour market. (2) Separation of government control rights from government cash flow rights. It will lessen political control over companies' behaviour and prevent government from intervening in management: for example, transforming government equity claims into preferred nonvoting share.[617] This thesis argues that the above suggestions may be useful as transitional mechanisms in China because they could send a powerful signal that the government is committed not to interfere with market forces. But if most of the share ownership in listed companies is still controlled by governments, it will be impossible for governments not to interfere with the operational business of listed companies because interference is the natural logic according to the principle of one share-one vote, or the principle of property rights. Therefore the complete and perfect way of solving the agency problem is to change the structure of share ownership in listed companies. That is, governments should not be controlling shareholder except for special cases. In other words, neither the internal

[617] See Stoyan Tenev and Chunlin Zhang with Loup Breform, 2002, 'Corporate Governance and Enterprise Reform in China Building the Institutions of Modern Markets', World Bank and the International Finance Corporate Washington, D.C, pp 129-133.

nor the external monitoring mechanisms that are very common in western countries or in other advanced countries can solve the agency problem that derives from concentrated ownership without fundamentally changing state ownership in China. Perhaps the most appealing way of reducing the state share is to privatize through institutional investors etc, which will be discussed below in detail.

11.2.1. Privatization

More and more scholars' research shows that there is a great amount of empirical evidence that public firms perform worse than private firms in terms of productive efficiency both in the developed and the developing countries.[618] Because under public ownership the firm is run by a minister or government bureaucrat who maximizes an objective function that is a weighted average of social welfare and his or her personal agenda in place of firms or other shareholders. By contrast, under private ownership, the firm is run for the maximization of profit. Thus "the root problem of the inefficiencies of SOEs is the state ownership and its bureaucratic economy." [619] However, privatization could reduce the transaction costs of

[618] E.g. See Dewenter Kathryn and Paul H. Malatesta, 1997, 'Public Offerings of State--- Owned and Privately---Owned Enterprises: An International Comparison', Journal Finance, 52, pp 1659-1679; Tian George Lihui, 2000,'State Shareholding and Corporate Performance: A Study of a Unique Chinese Data Set', Working Paper, London Business School, London; Megginson, W. L., R.C. Nash and M. Van Randenborgh, 1994, 'The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis', Journal of Finance, Vol. 49, pp 403-52. However, some scholars argue that public ownership is not inherently less efficient than private ownership. For example, Caves, Douglas, and Laurits Christensen, 1980, 'The Relative Efficiency of Public and Private Firms in a Competitive Environment: The Case of Canadian Railroads', Journal of Political Economy, (October), pp 958-976; John Vickers and George Yarrow, 1991,'Economic Perspectives on Privatization', The Journal of Economic Perspectives, Vol.5, No.2. (Spring), p 130(They argue that it would be simplistic to view privatization as a universally effective remedy for agency problems in the public sector.

[619] See Kornai Janos, 1992,Socialist Systems, Cambridge University Press, New York.

government intervention in enterprise decision-making.[620] That is, private firms could prevent government from directly interfering in the decision-making of the firm except by law or policy, because private property means that the right to make decisions willingly and independently regarding the uses of a resource under the principle of the maximization of profit, and the distinguishing characteristic of a private property system is that there is the strong positive relationship between the wealth of an individual and the consequences of his decisions on the value of resources.[621] In a word, the maximization of profit will promote the level of management and reduce the transaction costs as much as possible in private firms.

The Chinese government carries out the privatization of State-owned Enterprises through a gradual way, which has made a great contribution to the achievements of the reformed economy.[622] Since 1978, the Chinese governance has been trying different strategies or ways to revitalize SOEs, but all the previous reform concentrated mainly on the managerial aspects of enterprises, it is only the reform of the shareholding system that touches on the nature of ownership of SOEs but is, in a sense, only superficial to large SEOs in China. One of the most important market-oriented strategies of economic reform is the establishment of a shareholding system that is learned from West. The essence of the shareholding system reform is to convert SOEs into shareholding enterprises. Shares are issued to the state, enterprises, and individuals. This has made it possible for private individuals to acquire at least

620 See Sappington, David, and Joseph Stiglitz, 1987, 'Privatization, Information and Incentives', Journal of Policy Analysis and Management, 6, pp 567-82.
621 See Louis De Alessi, 1973, 'Private Property and Dispersion of Ownership in Large Corporations', The Journal of Finance, Vol. 28, No.4, (Sep.,), p 844.
622 See Louis Putterman, 1995, 'The Role of Ownership and Property Rights in China's Economic Transition', The China Quarterly, No.144, Special Issue: China's Transitional Economy, (Dec.,), p 1047.

partial ownership of formerly completely state-owned enterprises. In a sense, the shareholding system reform is a form of privatization in part, which offers a way by which state assets are transferred to private individuals and private firms.[623] Although the establishment of the first Chinese shareholding company was in 1984, it is 15th Chinese Communist Party Congress that endorsed the shareholding system as the "mainstream reform program" for state-owned enterprises.

Selling shares of stock on stock exchanges, which is considered to be a possible solution to some of the dilemmas faced by Chinese SOEs, is a form of privatization, which could force and speed Chinese firms to converge toward global "best practice" standards.[624] The importance of privatization to the success of the post-communist reforms has been the subject of some controversy because some countries are not as successful as expected. But as analyzed above, with regard to SOEs, the bureaucrat's main concern is to achieve their political objectives, which do not necessarily agree with the profit maximization objective. Privatization means the state-owned ownership will be transferred to outsider investors, who place greater emphasis on the primacy of profits and efficiency.[625] Some scholars provide strong empirical evidence that private ownership dramatically enhances the most essential aspects of corporate performance in the countries undergoing post-communist transition.[626] But the empirical evidence on the privatization methods appears to be mixed. Megginson et al.

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[623] See Shu Y.Ma 1998,'The Chinese Route to Privatization: The Evolution of the Shareholding System Option', Asian Survey, Vol.38,No.4 (Apr.,), pp 379-380.
[624] See Allen, J., 2000, 'Beyond Best Practice. Company Secretary: The Official Publication of the Hong Kong Institute of Public Secretaries', 10(11), pp 14-18.
[625] See Boycko, M., Shelifer, A., Vishny, R., 1996, 'A Theory of Privatization', The Economic Journal 106, pp 309-319,.
[626] See Roman Frydman, Cheryl Gray, Marek Hessel, Andrzej Rapaczynski, 1997, 'Private Ownership and Corporate Performance: Some Lessons from Transition Economics', Working Paper,(June).

show that privatization through private sale is more likely to happen and more efficient when the investor is protected well, for example in common law countries.[627] Bortolotti et al. argue that a higher frequency of direct sales takes place in civil law countries.[628] Dyck and Zingals study the effects of private benefits of control on ownership structure of firms and choice of privatization means, and draw a conclusion that privatization through public offerings is impossible in countries that lack adequate legal protection.[629]

Some scholars do not think of ownership as a key issue in the SOEs' inefficiency, they believe the stock market system will help China's SOEs get out of difficulty.[630] However, the reform of SOEs by the stock market system has not been successful as expected so far due to the state-owned shareholding in listed companies.

Over the past decade or so, China SOEs underwent significant reform, about 80% of all small and medium-sized enterprises have been sold to employee and outside investors. During this time, the yearly growth rate of China GDP has been about 8%, and township and village enterprises and foreign invested enterprises have performed quite well. But Chinese public listed companies (PLCs) have performed so poorly. For comparison, from year 1998 to 2000, ROE of collectively owned medium and small enterprises was 11.03, 12.96 and 13.61%, and the ROE of foreign invested enterprises was 4.05, 8.19 and 12.37%, and the ROE of PLCs was 7.36, 8.06 and 7.52%,

[627] See Megginson, W., Nash, R., Eetter, J.N., Poulsen, A.B., 2002, 'The Choice of Private Versus Public Capital Markets: Evidence From Privatization. Working Paper, University of Oklahama, Wake Forest University and University of Georgia.

[628] See Bortolotti,B., Fantini, M., Siniscalco, D., Vitalini, S., 'Privatization and Institutions: A Cross-county analysis', CESif Working Paper Seriers No. 375.

[629] See Dyck, A., Zingales, L., 2002, 'Private Benefits of Control: An International Comparison', Journal of Finance,.

[630] e.g. Qian, Y. 1996, 'Enterprise Reform in China: Agency Problems and Political Control', Economics of Transition, 4(2), (October), pp 427-447.

respectively.[631] It is hard to attribute this to macroeconomic factors. Generally speaking and theoretically, only a clean and perhaps better performed group of SOEs could be selected to be listed according to law and regulation. How to explain the poor performance of China PLCs? In addition to the reasons of analysis above, this thesis argues that they lie largely in themselves intrinsically. Namely the poor performance of China PLCs lies in their poor corporate governance, mainly due to their unique shareholding structure where the state is the controlling shareholder. The prominent feature of the ownership structure of China PLCs is that the state could be identified as the ultimate controlling shareholders that can control the fate of the company. In other words, the Chinese government not only controls the process of listing but also interferes with the operation of listed companies through the structure of concentrated ownership, which leads to the poor performance of listed companies.

Some economists think the state-dominated PLCs share the traditional and main principal-agent problem of SOEs, in which there exists a long and multiple series of principal-agent problems among central government, line ministries, local governments and managers. But this thesis argues that actually the main principal-agent problems of the state-dominated PLCs are the state (including central government, line ministries, local government) as controlling shareholder and ordinary investors as minority shareholder because it is very prevalent for controlling shareholders in PLCs to abuse their rights including taking soft loans from listed companies on a long-term basis; using of listed companies as guarantors to borrow

[631] See Qu Qiang, 2003, 'Corporate Governance and State-owned Shares in China Listed Companies', Journal of Asian Economic 14, p 773.

money from banks; and the sale of assets to listed companies at unfair prices, usually without an appraisal by an independent evaluator; management appointment, etc. at the cost of minority shareholders ultimately.

At beginning of 1997, there have been the estimated 308,000 state-owned enterprises that were privatized.[632] Vast numbers of small and medium sized SOEs have been merged, formed into joint ventured or sold under this plan. Today the private sector has been developing rapidly and thereby providing many new employment opportunities since China's economic reform began. The functions of the privatization of listed companies are as follows at least: there will be changes in the structure and quality of boards, and it will increase monitoring by shareholders and financial intermediary, and improve transparency and disclosure in line with global standards and practices which are beneficial. The logical result of privatization for Chinese SOEs will be to decrease the ownership of the state, but the privatization will be necessary for improving and upgrading the performance of firms or companies. Without doubt, the quality of corporate governance will be fostered.

When looking back to past decades, China's gradual economic reforms have fostered a variety of firm ownership types, including private firms (domestic or foreign). In fact, it shows the gradual result of privatization. The emergence of the non-state sector is in part due to the reorganization of SOEs, and in part to industrial deregulations and open-door policies that have permitted the entry of millions of new enterprises. Private-owned firms have played a great role in the deregulated domestic

632 Morrison, W.M. 1999,'China's Economic Condition, Congressional Research Service Issue Brief for Congress: 98014.

markets, and have grown rapidly for the past two decades.[633] This demonstrates that private firms are more efficient than state-owned enterprises in China.

Of course, the main argument for the sale of state shares is to improve corporate governance of listed companies and to align their objective more with profit maximization, as a consequence the improvement of efficiency. On the other hand, the state-shares sale may cause a problem of social stability.[634] It seems it is not necessary to worry about the latter.

This thesis believes that the privatization of state-owed shares should be carried out. A lot of small and medium state-owned enterprises have been privatized successfully, which will provide rich experience for the reform of listed companies controlled by the state. In addition, the reform and opening up to the outside and the development of the economy have laid down the foundations for the privatization of the state-owned shares in listed companies.

11.2.2. Institutional investors

Today shareholder activism can be viewed as a better mechanism by which investors have a strong effect on their company's behaviour without a fundamental change in control of the company, for the purpose of improving performance of companies.[635]

[633] See Qunyan Sun, Anming Zhang, Jie Li, 2005, 'A Study of Optimal State Shares In Mixed Oligopoly: Implications for SOE Reform and Foreign Competition', China Economic Review, 15, p 3.

[634] See Qunyan Sun, Anming Zhang, Jie Li, 2005, 'A Study of Optimal State Shares In Mixed Oligopoly: Implications for SOE Reform and Foreign Competition', China Economic Review, 15, p 2.

[635] See Gillan Stuart L. and Starks Laura T., 1998, 'A Survey of Shareholder Activism: Motivation and Empirical Evidence', Contemporary Finance Digest, Autumn 1998 2, 3, pp 10-34; Bhagat S. and Back J., 1998, 'Shareholder Litigation: Share Price Movements, News Releases, and Settlement Amounts', Managerial & Decision Economics, Vol. 18, pp 293-340.

Generally speaking, once shareholders have substantial shares in which the potential gains outweigh the cost incurred, they will take part in the supervisory activities over management. Thus it is possible for institutional investors to monitor management because they own relatively large shareholdings and have advantages over smaller shareholders, such as time, information, skill and incentives. In the 1990s some examples suggest that American institutional investors with large stakes sometimes intervene in the affairs of public companies, e.g. the California public employees pension fund (CalPERS), Putnam Management (a mutual fund manager), J.P.Morgan (a bank holding company). These institutions lobbied for the removal of CEOs at several large, poorly performing firms, including Kodak, IBM, Westinghouse, Borden, American Express and GM.[636] The above experiences will provide use for reference for China.

Institutional investors in China are primarily comprised of insurance companies, pension funds, securities investment funds, trust and investment companies, securities companies and qualified foreign institutional investors etc.

In 2002, the CSRC and the Peoples' Bank of China issued jointly, the Interim Measures of Securities Investment Management of Qualified Foreign Institutional Investors (QFII), which allows foreign institutional investors, including fund management companies, securities companies, and commercial banks to invest in the A share market. This thesis argues that the developing more institutional investors could improve the ownership structure in China so that different major shareholders

[636] See Charles Kahn and Andrew Winton, 1998, 'Ownership Structure, Speculation, and Shareholder Intervention', The Journal of Finance, Vol.53, No.1, (February), pp 99-129.

could monitor each other and reduce the agency costs in order to play an important role in China's future corporate governance development. According to international practice, institutional investors pool together funds of many individual investors and this can become a powerful investment force and protect minority shareholders' interests. In addition, if there are more and more institutional investors in China, when they really become large enough, they will compete with each other and this will enhance the rationality and stability of the capital market.

The Qualified Foreign Institutional Investor Scheme has opened up China's domestic securities markets for the first time to institutions oversees. That is to say, it will open up the largest sector of the tradable securities market: the A share market. If QFII results in major ownership changes in Chinese enterprises, the nature of corporate governance will be irrevocably altered. In other words, QFII is likely to accelerate the diversification of ownership in China's SOEs, and as a result, it will transform corporate governance.

According to QFII, there are some restrictions on investment activities. For example, Article 20 stipulates equity ownership ceilings: first, it states that "shares held by each QFII in one listed company should not exceed 10 percent of total outstanding shares;" second, "total shares held by all QFIIS in one listed company should not exceed 20 percent of total outstanding shares." However, the role of QFIIs in molding disclosure and governance standards will be great. The QFII scheme, and the concomitant increase in such demand, carries the potential to play a significant role in China's further evolution from state-run to market-driven economy and in

improvement of corporate governance. Much will rely on its probable influence on the three key determinants: "(1) demand for further financial disclosure reform; (2) manager's incentives to comply with disclosure requirements; (3) managers' incentives to voluntarily disclose additional information."[637] In a word, the QFII scheme will carry tremendous potential as a vehicle for raising corporate governance standards in China; in particular, maybe institutional investors will facilitate the speed of privatization of state-owned shares and be beneficial to the improvement of corporate governance. That is, if the shares of the state in listed companies in China are privatized, institutional investors will play great role in the improvement of corporate governance, although institutional investors may bring about negative effect too, such as short-termism and the abuse of information.

11.2.3. The role of commercial bank

Creditor banks can exert control over corporate governance in debtor enterprises in several ways in some countries.[638] Banks play an important role in corporate governance in Germany and Japan, and banks as both shareholders and creditors can enjoy access to extensive information and have representatives on the board. Banks as creditors can exercise influence over companies as borrowers based on laws and contracts, in particular banks can exercise influence over corporate governance in the

[637] See Michael J. Ferguson, Paul B. McGuinness, 2004, 'Chinese Securities Reform: The Role of QFIIs in the Corporate Governance Process. *Business Horizons*, Vol. 47, No. 2, (March-April), pp 53-61.
[638] See Cheryl Gray, 1997, 'Creditors Crucial Role in Corporate Governance', Finance and Development 34, pp 29-32.

case of default, for example, once a debtor defaults on repayment or on the verge of bankruptcy, the bank can trigger court actions, such as foreclosure on collateral, liquidation, or reorganization of the firm. The mere threat of such an action by the bank will make managers run the companies more efficiently rather than in interests of themselves so that corporate governance could be improved. With regard to the above methods of banks, legislation, the court system and the history of the countries or regions will determine their effectiveness to the extent.[639] However, banks in China have little influence on corporate governance or companies' strategic decisions, because until the mid-1990s the credit decisions of state-owned commercial banks (SOCBS) were often not driven by the borrower's creditworthiness or the financial merits of their projects, but mainly by governments. In addition, the Commercial Bank Law prohibits commercial banks from having ownership of shares in non-financial institutions. Bank loans have traditionally been regarded as grants from the state designed to rescue failing firms. State-owned banks still remain a monopoly in the Chinese banking sector, and profit is not their paramount objective, but such cases are changing greatly after China became the member of WTO. The banking system can not have any real effect on the operation of companies because the share ownership of the four biggest banks is held by the state.[640] Of course, the market for private, non-bank debt has yet to be established, and there is no active merger or takeover activity in stock markets to discipline management.

[639] See Stoyan Tenev and Chunlin Zhang with Loup Breform, 2002, 'Corporate Governance and Enterprise Reform in China Building the Institutions of Modern Markets', World Bank and the International Finance Corporate Washington, D.C p 56.
[640] Some of banks have been or will be listed on the Stock exchange, for example, the bank of China, bank of industry and commercial, bank of construction have been listed on Hong Kong Stock Exchange.

In China, the state used to have to subsidize losses, either in the form of grants or policy bank loans due to the poor performance of a SOE. Generally speaking, the state was responsible for SOEs' performance due to policy burdens, by providing financial support. However, no matter whether the bad performance was caused by policy burden, or by the management's incompetence or opportunistic behaviours due to information asymmetry, the state would provide financial support for the SOEs loss. Not surprisingly, SOEs accumulated enough non-repayable bank loans to qualify the major banks in China for bankruptcy, by any criteria. According to a survey by China central bank (the People's Bank of China), by the end of 2000, 51.2% of the 62.656 enterprises had failed to repay bank debts. The non-performing loan ratios in the state-owned banking system were up to between 25 and 30%. In other word, the poor financial performance of a large number of SOEs, including state-controlled listed companies, led to huge risk that was beyond the capacity of the banking system, and was also a potential menace to financial stability.[641]

In the context of China, why did state banks often make "soft loans"to SOEs to save them from possible bankruptcy?[642] This was because SOEs always made a great contribution in offering a wide range of social services to employees and their families and in maintaining social stability.[643] The loss-making enterprises always made a contribution to the stability of society. But "soft loan" is in contravention of the rules of a market economy.

641 See Qu Qiang, 2003, 'Corporate Governance and State-owned Shares in China Listed Companies', Journal of Asian Economic 14, at 781.
642 See Lu, D.,&Tang,Z., 1997, 'State Intervention and Business in China', Cheltenham, UK: Edward Elgar.
643 Bai, C., Li,D.,Tai, Z., & Wang, Y. 2000, 'A Multi-task Theory of the State Enterprise Reform', Journal of Comparative Economics, 28(4), pp 716-738.

So far in China banks do not play as prominent a monitoring role as they do in Japan and Germany. This is because who and how much should be loaned were often steered by politics or policies of the past and because of the "soft budget" constraint of SOEs.[644] Banks typically played a role in the restructuring of SOEs only at times of distress or near-insolvency. In other words, when SOEs were at the edge of bankruptcy or in financial trouble, banks were forced by governments to support them.

Today China seems to be relaxing the strict separation between commercial and investment banking. The PBOC issued the Provisional Regulations on Intermediary Business of Commercial Banks, which states that following PBOC approval, commercial banks can engage in financial derivatives, securities, investment fund trusteeships, and information and financial consulting. This will be an open new mechanism for bank involvement in corporate governance. Now some banks have been listed or will be listed on a stock exchange and this means that state-owned banks have been or will be privatized in part. Maybe banks will play a positive role in the corporate governance of listed companies in the future.

11.3. Conclusion

In order to improve the corporate governance of listed companies in China, the structure of concentrated ownership must be adjusted properly. Therefore two steps

[644] See Qian, Y., & Roland, G 1998, 'Federalism and the soft budget constraint', American Economic Review, 88 (5), p 1143.

must be taken at least. First of all, all of the non-tradable shares must, bit by bit, be made tradable on a stock exchange (now these measures are under way by the Chinese Government and all shares owned by state will be tradable soon). Secondly, most of the state-owned shares in listed companies must be sold off. If the above is successful, the following results are possible: (1) The opportunity for direct interference by governments in the management of listed companies will be impossible or very limited, because governments have no share or only a small share in listed companies. Governments will be able to influence the listed companies only by means of policies and laws instead of by the way of share ownership. For example, governments will have no right to appoint, or dismiss the members of the board of directors, or managers. (2) Reducing illegal or immoral transactions by governments directly or indirectly. Because the state as the largest shareholder always engages in transactions which are harmful to other shareholders, for example, related-party transactions, parent company or holding company borrowing money from banks but using assets of listed companies as pledge, tunneling. (3) Listed companies will be managed in accordance with the rules of the market. Because listed companies are controlled by the way of shares owned by the state, governments always require listed companies to focus on more employment and stability of society rather than profitability. If the largest shareholder is not the state, listed companies will have the aim maximizing profits according to the rules of the market.

In a word, if the problem of the structure of concentrated ownership of listed companies is settled, there will be a chance for the improvement of the corporate

governance of listed companies in China. The solution to the improvement of the corporate governance of listed companies in China is the reform of the structure of concentrated ownership. That is to say, privatization, growth of institutional investors, and the promotion of the role of commercial banks will be beneficial to the improvement of corporate governance in China.

Conclusion of Part Two

In order to support the argument that the structure of share ownership determines the model of corporate governance in the world, this part has shown that the argument is correct and reasonable based on the analysis of listed companies in China.

This thesis argues that the structure of ownership in China has been concentrated since ancient times, which has had a close relationship with history, culture, politics, law and economy etc. But the structure of concentrated ownership in China is determined ultimately by economy. Whether in ancient times, in the central planning economy, or in the socialist market economy, only the structure of concentrated ownership could adapt to the particular requirements of the economic surroundings. But the structure of concentrated ownership must now be reformed to adapt to the development of the economy, although the structure of concentrated ownership has been influenced by other elements such as politics, law, history, culture.

The quality of corporate governance of listed companies in China is so poor because the state is a majority shareholder in most listed companies, which are controlled by the state through shares. In other words, the state always interferes in the operation of listed companies for the sake of its goals instead of the maximization of profitability. The state as the biggest shareholder, governed by the Communist Party, has completely controlled most of the listed companies in the interests of political aims, and the major agency problem is the conflict of interest between the state as the majority shareholder and other shareholders as minority shareholders in

listed companies. Therefore it is not surprising that the corporate governance of listed companies is poor in China. The structure of share ownership directly determines corporate governance.

If the corporate governance of listed companies in China is to be improved, the structure of concentrated share ownership must be reformed properly as a precondition. The thesis argues that most shares owned by the state must be sold off in accordance with the rules of the market, as one kind of privatization. Only when the reformation of the structure of concentrated share ownership is successful, is there a possibility of the improvement in corporate governance of listed companies in China.

Part 3

Concluding remarks

Chapter 12. Conclusion

12.1. Final Remarks

Corporate governance is a very hot topic in the fields of economics, jurisprudence, management etc. How to improve corporate governance has been emphasized by all the countries and some international organizations in the world. This thesis argues that the structure of ownership determines the model of corporate governance all over the world.

In 1932, Berle and Means put forward the famous theory of "separation of ownership from control". According to the theory, the agency problem is the conflict of interest between shareholders and management. Berle and Means laid emphasis on the importance of supervision over management. Since then, management has become mainly the objective of the discipline of the articles, memorandum, law and policy. This conventional view is built on the proposition that the agency problem arises between shareholders and management in an efficient market through which managers will be disciplined or threatened to be replaced due to their poor performance by takeover and shareholders are able to exit freely by selling their shares. However, the theory of "separation of ownership from control" can only be applied to the structure of dispersed ownership in some countries, which are fewer compared to those where there is a structure of concentrated ownership. Thus the theory of "separation of ownership from control" has been doubted by many scholars

since the 1970s. In other words, there are more countries where the structures of ownership of firms is concentrated and the major agency problem is conflict of interest between the largest shareholders and minority ones, while there are countries where the agency problem arises between management and shareholders.

Corporate governance is so important that almost all countries and some international organizations are studying it. However, what determines corporate governance? Is there a best form of corporate governance which should be followed? Different scholars in varying disciplines have given distinct answers on these questions. With regard to the determinants of corporate governance, there are two influential theories, namely "politics matters" by Mark. Roe, and "law matters" by La Porta et.al. with which this thesis does not agree. As a rule, the thesis argues that it is the structure of ownership that directly determines the model of corporate governance in place of the theory of "separation of ownership from control" by Berle and Means, politics by Mark. Roe, and law by La Porta et.al.

Maybe the theory of "separation of ownership from control" by Berle and Means, politics by Mark. Roe, and law by La Porta et al. could be applied to particular countries or regions at particular times. But as a rule, it is the structure of ownership that determines the model of corporate governance. Because the structure of ownership is composed of shares that are derived from, but differ from, rights of ownership, they are property rights and are not changeable except under special conditions such as war and revolution. Thus, selling, buying, donating and giving up or other transactions in shares can only be carried out legally by owners in person or

by their agents. Although sometimes owners of shares may not be concerned about what happens to the firm due to costs and information asymmetry, they do care about the share itself and they vote with their feet when they have no choice but to sell it. In fact, the model of corporate governance is the result of the compromise between shareholders and stakeholders in a given firm.

This thesis argues that politics and law only create a bad or good environment for corporate governance. This environment may be in good condition, leading to the improvement of corporate governance, or in a bad condition, leading to the deterioration of corporate governance. But it can not determine corporate governance. If politics or law can determine corporate governance, why are they not transplanted into countries where corporate governance is poor? It is impossible. In practice, former Soviet Union countries and Eastern European countries tried to follow the model of Western law and politics, but this corporate governance is not good as expected. In these countries the structure of ownership becomes concentrated again soon after the reform, although the law and politics in the countries have changed to follow Western countries, because the structure of ownership is affected by many facts, such as politics, law, culture, history and the economy, but mainly by the economy.

China, the biggest developing country, has been ruled by the Communist Party only since 1949, and according to the logic of politics by Mark Roe or law by La Porta et al., corporate governance should be better because the Communist Party as ruler could determine or make law and policy on corporate governance. In fact, the politics and laws of the Communist Party have profoundly influenced firms but have

not improved the corporate governance of listed companies. On the contrary, the state as a tool of the Communist Party, has a large shareholding in firms, and firms are controlled by way of this shareholding to realize the aims of employment and stability of society in place of the profit of enterprises. Why does the Communist Party only control listed companies and interfere in the management of listed companies and not other forms of enterprises? The answer is simple: through their shareholding. As a result, the corporate governance of listed companies is very poor, because the state is the biggest shareholder in most listed companies and the Communist Party controls these listed companies through the shares owned by the state. Therefore, the structure of concentrated ownership of listed companies must be reformed properly by diversification before the improvement of corporate governance of listed companies in China is possible.

In a word, by analysis based on the experience of corporate governance across the world, this thesis draws a conclusion: the structure of ownership determines the model of corporate governance. There is not a best form of corporate governance for companies all over the world, only a form of corporate governance suitable for a given country or region in the world.

12.2. The contribution of this research

To my knowledge, with regard to corporate governance and the structure of corporation, Berle and Means put forward the famous theory of separation of control

from ownership in 1932, which for the first time is recognized the cause of conflict of interest between shareholders and management. However, the theory only applies to countries which have the structure of dispersed ownership of the corporation. Although the theory is very significant, its function is very limited. With the development of economics, more and more scholars doubt the theory of Berle and Means. Influenced by Berle and Means and Coase's theory, and based on the theory of Alchian and Demsetz from the 1970s onward, agency theory argues that the relationship between shareholders and management is a relationship of principal and agent, which explains the cause of conflict of interest in detail and suggests the solution to the agency problem by various ways, such as market, contract, and compensation. The representatives of the agency theory are Jensen and Meckling. The agency theory is very popular even today. Since the 1980s more and more scholars have analyzed corporate governance from different perspectives across the world, but the most influential research of the 1990s was from the perspective of law and politics, the representatives of the former are La Porta et al. and the latter are Mark J.Roe etc. Of course, there are many other scholars who do research on corporate governance by means of other methods.

The above theories do not explain perfectly the phenomenon or the puzzle of corporate governance. I have tried to work hard at it from the perspective of the structure of share ownership. So this thesis has for the first time carried out comprehensive research on the relationship between corporate governance and ownership through the structure of share ownership, based on the achievements of

other scholars. The thesis argues that the structure of share ownership determines the model of corporate governance all over the world and the argument is supported by the case of Chinese listed companies.

12.3. Limitation of the research

Although there are many scholars from varying disciplines who are studying corporate governance, few are doing research on the relationship between ownership and corporate governance from the globe perspective. Most scholars study the relationship between ownership and performance in a few listed companies in a given country or countries by econometrics or economic analysis. Or some scholars only study corporate governance in a country or a few countries with dispersed share structure, or in a country or a few countries with concentrated share structure country. With regard to research on corporate governance in the jurisprudence, scholars in law focus on the study of whether a model of corporate governance will be divergent or convergent, or how to improve corporate governance in traditional ways such as the enforcement of disclosure, the strength of the fiduciary duty of loyalty and care of directors, the improvement of independent directors, the control of management, etc. Therefore materials which could be referred to by this thesis are limited in extent, particularly with respect to helpful materials from the viewpoint of law.

12.4. Suggestions for further research

For the first time, I have come to the conclusion that the structure of share ownership determines a model of corporate governance and there is no best model of corporate governance. The model of corporate governance adapts to the economy in the country in question.

Although the thesis comprehensively analyzes the relationship between ownership structure and corporate governance, it seems it is true, namely ownership structure determines corporate governance. If a mathematical model can be designed in the future to demonstrate the relationship between ownership structure and corporate governance, the scholars in all disciplines will be convinced of the fact that ownership structure determines the model of corporate governance, this will be my next research project.

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