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Corporate Governance in China: A Survey*

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Abstract

This article surveys corporate governance in China, as described in a growing literature published in top journals. Unlike the classical vertical agency problems in Western countries, the dominant agency problem in China is the horizontal agency conflict between controlling and minority shareholders arising from concentrated ownership structure; thus one cannot automatically apply what is known about the USA to China. As these features are also prevalent in many other countries, insights from this survey can also be applied to countries far beyond China. We start by describing controlling shareholder and agency problems in China, and then discuss how law and institutions are particularly important for China, where controlling shareholders have great power. As state-owned enterprises have their own features, we separately discuss their corporate governance. We also briefly discuss corporate social responsibility in China. Finally, we provide an agenda for future research.

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1. Introduction

Corporate governance has received increasing attention in recent decades, particularly since the 1997 Asian financial crisis and the early 2000s corporate scandals (e.g., Worldcom and

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Enron in the USA, and other firms globally). Since it was in the early 1990s that China launched its stock market and began to establish modern enterprises, corporate governance practices in China have grown alongside this global trend. In the meantime, China has experienced spectacular economic growth and given rise to a large number of influential corporations operating worldwide. Hence, the underlying governance mechanisms and problems of Chinese corporations have garnered significant interest from researchers, and top journals have published a large body of work on this topic in recent years. In this article, we survey this growing literature with the aim of providing a clear and thorough picture of the current findings and future research implications.

This survey is important for at least three reasons. First, China is now the second largest economy in the world and has many globally influential corporations, so corporate governance in China cannot be ignored if one wants to understand world business. Second, China's capital market is young, but its corporate governance, including the institutional and regulatory environment, has evolved dramatically. This indicates that many facts and findings from the early stage may no longer hold, and it is critical to keep abreast of the recent literature on the topic. Third, China is different from the USA, albeit similar to many other non-US countries. Unlike the classical vertical agency problems in Western corporate governance, the dominant agency problem in China is the horizontal agency conflict between controlling and minority shareholders owing to China's concentrated ownership structure. Thus, what is known about the USA cannot simply be applied to China. As the features revealed for China are also prevalent in many non-US countries, insights from this survey can be applied to countries far beyond China.

The origin of corporate governance in China springs from the existence of large controlling shareholders. Ownership is highly concentrated in China compared to the USA and many other developed economies. The data we analyze from the China Stock Market and Accounting Research (CSMAR) database[1] show that during 2003–18 >99% of listed companies had at least one shareholder with >10% of the shares. Even if we use a threshold of 20% shareholding, which is regarded as sufficient for effective control of a firm (La Porta, Lopez-de-Silanes, and Shleifer, 1999), >80% of firms had at least one large shareholder in 2018 (down from >90% in 2003). Although the share held by the controlling shareholder has decreased over recent years, the average (median) value of this fraction was still ~33% (31%) in 2018. Thus, in China, controlling shareholders, rather than managers, and dominate corporations (Jiang and Kim, 2015). Controlling shareholders have both incentives and power to monitor managers effectively (Shleifer and Vishny, 1986, 1997); hence, managers' expropriation is unlikely to be a serious problem in China. However, it is very likely that large controlling shareholders may use their power to expropriate wealth from minority shareholders (La Porta, Lopez-de-Silanes, and Shleifer, 1999). Therefore, the primary agency problem in China is the conflict of interest between controlling and minority shareholders, while vertical agency problems are largely alleviated owing to effective discipline of managers by controlling shareholders. While managers may still have their own private interests, they may act in the interests of controlling shareholders to expropriate from minority shareholders, thus exacerbating the horizontal agency conflict. Referring to the extant literature, we discuss the evidence and consequences of this agency conflict, and its sources in institutional factors and the limited role of potential monitors. In addition, we

1 The CSMAR database, developed by GTA Information Technology, covers Chinese publicly listed firms and has been used in studies published in leading journals (Fang, Lerner, and Wu, 2017).

discuss circumstances under which a controlling shareholder can solve problems rather than cause them—that is, the bright side of having a controlling shareholder.

Shleifer and Vishny (1997) argue that legal protection of investor rights is one essential element of corporate governance. Given the existence of dominant controlling shareholders, legal protection seems to be the most important, albeit imperfect, solution to agency problems in China. When controlling shareholders take full control of corporate boards and management teams, it is difficult for internal corporate governance to work effectively, as is also the case in the USA, where managers dominate corporate decisions and reduce the effectiveness of internal corporate governance (Allen and Gale, 2000). Meanwhile, external corporate governance mechanisms, like takeover threats, which are popular in the USA are ineffective in China, because the ownership structure is so concentrated that takeovers rarely occur.[2] Thus, corporate governance in China is left with another external mechanism, namely, law and institutions. In the past three decades, since the launch of the Chinese stock exchanges in the early 1990s, legal protection in China has dramatically improved. We survey whether and how law and regulations help to alleviate agency conflicts in China.

SOEsState owned enterprises (SOEs) are worthy of a separate discussion for their importance and uniqueness. First, SOEs are undeniably important to China's economy, to state controlling shareholders, and to minority shareholders. At the start of China's capital market, all listed companies were SOEs, and SOEs currently account for one-third of firm numbers but two-thirds of market capitalization. Second, SOEs differ markedly from non-SOEs in corporate governance. As the government is obliged to maintain social stability (Lin, Cai, and Li, 1998; Bai, Lu, and Tao, 2006), the departure of SOEs' political objectives from value maximization may jeopardize corporate performance and thus create conflicts of interest between the state controlling shareholder and minority shareholders. In response to these problems, a series of reforms have been undertaken to improve SOE performance, leading to a large number of relevant studies (e.g., Li, 1997; Bai, Lu, and Tao, 2006; Gan, Guo, and Xu, 2018). Meanwhile, since state owners do not actively oversee day-to-day operations, managers may be able to engage in self-serving behavior at the expense of both state and minority shareholders. Thus, SOEs in China face a vertical agency conflict similar to those in many developed countries, like the USA. We survey the literature on Chinese SOEs and their agency problems, as well as some governance mechanisms for this special kind of entity.

Corporate governance is closely related to corporate social responsibility (CSR), a company's commitment to not only shareholders, but also stakeholders, such as employees, customers, suppliers, and communities. Indeed, Tirole (2001, p. 4) defines corporate governance as "the design of institutions that induce management to internalize the welfare of stakeholders". There is some evidence that stakeholder value improves shareholder value in the long term; thus, a well-governed firm should care for its stakeholders. However, in a developing economy such as China, where citizens may not prioritize social concerns, the determinants and effects of CSR may differ from those in other countries. We discuss CSR in China in this survey.

While research to date has provided much insight on corporate governance in China, there are still many potential topics for future research, especially as China continues to

2 In saying that takeovers are rare, we refer to listed firms; mergers and acquisitions involving non-listed firms and overseas firms are quite active (see Section 6).

transition from a control economy to a market economy, and as corporate governance in China continues to evolve. Hence, we include a section discussing directions for future research.

Most studies on corporate governance suffer from endogeneity issues. For example, omitted variables such as firm, market, or country characteristics could simultaneously affect the adoption of better corporate governance mechanisms and better performance. Alternatively, there may be reverse causality if better-performing firms attract or have the ability to employ better corporate governance. Many studies we review in this survey address these endogeneity problems through instrumental variables, difference-in-differences methods, or regression discontinuity designs. Some studies use fixed effects and matching methods. We describe these strategies, not only to show which studies document causal relationships, but also to generate ideas for future research. For ease of presentation, we provide a separate Appendix A to show the techniques used in each paper.

This survey builds on, but significantly expands, our earlier survey on corporate governance in China (i.e., Jiang and Kim, 2015). However, we focus here mainly on academic literature published in top journals, and provide directions for future research, rather than institutional background. Two recent surveys on corporate governance in China are by Morck and Yeung (2014) and Wong (2016). Focusing on accounting-related issues, Wong provides detailed descriptions of institutional features (as we have previously done in Jiang and Kim, 2015) and discusses previous research on SOE performance, managerial turnover and compensation, and accounting. Morck and Yeung (2014) focus on China's political economy, which we do not emphasize in this survey, and target a practitioner audience, whereas our target is an academic audience.

2. Controlling Shareholders and the Agency Problem in China

This section discusses the agency problem in China, the incentives and evidence for controlling shareholder expropriation, and the limited role of potential monitors that facilitates expropriation. We then consider the bright side of controlling shareholders.

Controlling shareholders in China have at least three important broad features. First, there are two types of controlling shareholders, the state and the family. SOEs, which are controlled by the state, have two primary objectives: to generate profit and to carry out state policies. Naturally, the two objectives may conflict. Family-owned enterprises have only the profit objective. Therefore, research on controlling shareholders in China should differentiate these two groups.

Second, controlling shareholders are the primary decision-makers. Some researchers have assumed, either explicitly or implicitly, that CEOs, general managers, and/or chairs of the board (hereafter chairs) are the primary decision-makers or controllers of firms. However, those who make the final decisions are always the controlling shareholders, especially in non-SOEs (SOEs usually delegate control to the chair, a practice we discuss in Section 4). Often, the controlling shareholder is also the chair, but even when she/he is not, she/he is still the primary decision-maker and should be treated as an insider in any study of insider–outsider conflict.

Finally, controlling shareholder entrenchment significantly contributes to the agency problem in China. Since controlling shareholders have large equity stakes or are the state, outside investors, or boards cannot fire insiders for poor performance, nor can there be an effective market for corporate control (outsiders cannot obtain enough shares to seize control, nor can they seize control of an SOE). That is, the ways to resolve the agency problem in China are limited.

2.1 Conflict of Interest between Controlling and Minority Shareholders

While China's concentrated ownership empowers controlling shareholders to discipline managers, it also leads to conflicts with minority shareholders. This is similar to how large managerial ownership can lead to entrenchment in the USA (Morck, Shleifer, and Vishny, 1988). Just like controlling managers, a controlling shareholder may extract private benefits at the expense of minority shareholders, especially when the ratio of control rights to ownership or cash flow rights is very high. Expropriation of minority shareholders by controlling shareholders is known as tunneling (Johnson *et al.*, 2000) or self-dealing (Djankov *et al.*, 2008).[3]

One way in which controlling shareholders may expropriate minority shareholders is outright theft. A less detectable way is through intercorporate loans, which were common practice in China before the mid-2000s. Jiang, Lee, and Yue (2010) find that during 1996–2006, controlling shareholders borrowed tens of billions of RMB, usually interest free and almost never paid back, from hundreds of Chinese listed companies. These intercorporate loans were typically reported as "other receivables" (OREC). In their sample, OREC balances averaged 8% of total assets. Jiang, Lee, and Yue (2010) further found that during 1999–2002, a substantial portion of OREC (30–40%, for firms in the top three deciles of other receivables scaled by total assets) went directly to controlling shareholders or their affiliates.

Although this brazen form of tunneling has now been eradicated under strict rules and regulations from the Chinese Securities Regulatory Commission (CSRC) and other government ministries (Jiang, Lee, and Yue, 2010), tunneling by controlling shareholders still persists through other means. Nowadays, related party transactions (RPTs) are perhaps the most common channel of minority shareholder expropriation. A related party may be a substantial shareholder, a director, a top manager, or a close relative to any of these people, or another firm in which the listed firm owns a stake. RPTs include asset acquisitions, asset sales, equity transfers, cash payments, loan guarantees, and trademark rights transfers. Controlling shareholders can use RPTs as a tunneling tool through favorable transaction terms. For example, the listed firm may buy (sell) assets or products from (to) a controlling shareholder at a high (low) price. However, it is difficult to identify whether controlling shareholders are using RPTs to tunnel because it is not obvious whether these transactions are favorable to them or not. Therefore, researchers can only infer tunneling from negative abnormal announcement returns surrounding RPTs. For example, Peng, Wei, and Yang (2011) find that when financially healthy Chinese listed firms announce a transaction whose value is >10% of the firm's total assets, the average $(-5, +5)$ cumulative abnormal return is -3%. Similarly, Cheung, Rau, and Stouraitis (2010) find a negative wealth effect of RPTs when firms are controlled by the local government.[4]

3 Bertrand, Mehta, and Mullainathan (2002) and Bae, Kang, and Kim (2002) provide some of the earliest empirical evidence on tunneling in their study of Indian firms and Korean firms, respectively.

4 Cheung, Rau, and Stouraitis (2010) measure the wealth effect as the ratio of the total value change to the announced size of the related party transaction, where the total value change is the abnormal announcement return multiplied by the firm's market capitalization.

Controlling shareholders have incentives to hold excessive amounts of cash for their private benefit, as Jensen's (1986) free cash flow hypothesis suggests for managers. Cash provides more tunneling opportunities because it can be more conveniently transformed into private benefits than other assets (Myers and Rajan, 1998). Providing indirect evidence of this agency problem, Chen *et al.* (2012) find that firms held significantly less cash after the split-share structure reform aligned incentives between controlling and minority shareholders.[5]

Controlling shareholders may also manipulate information disclosure to hide their self-dealings. When they withhold information, the firm's stock price movements will mimic overall market movements. Gul, Kim, and Qiu (2010) find that such price synchronicity increases with controlling shareholder ownership up to a ceiling of ∼50%. Moreover, controlling shareholders can manipulate information with the help of outsiders. Chan *et al.* (2019) find that, to cash in their original non-tradable shares (NTSs) after the split-share structure reform, controlling shareholders use affiliated analysts' optimistically biased recommendations to keep stock prices high until the end of lock-up periods, when they can sell.

The self-serving behavior of controlling shareholders can harm listed firms and the overall capital market in at least three ways. First, it can hinder firm performance. For example, Jiang, Lee, and Yue (2010) find that companies with larger intercorporate loans exhibit worse future operating performance, as measured by both accounting rates of return and the likelihood of entering financial distress. Specifically, they sort firms into deciles based on their amount of intercorporate loans in Year t, and they find that the ROA difference in Year $t+1$ between the top decile (those with the most intercorporate loans) and bottom decile is −4.9%. Furthermore, 14% (4–5%) of firms in the top decile (other deciles) receive "Special Treatment" status from market regulators within 3 years.[6] Second, this behavior can drive down the market value of listed firms. Specifically, for top (bottom) decile firms, the average market-value-to-earnings multiple is 4.0 (13.8). Jiang, Lee, and Yue (2010) find a higher implied discount rate in the valuations of earnings of firms that have large amounts of intercorporate loans. Third, this behavior can reduce price informativeness as Gul *et al.* (2010) show. This can damage market efficiency and hinder the capital market from allocating scarce capital.

2.2 Institutional Sources of Agency Problems in China

We now discuss the institutional features of China which exacerbate the conflicts between controlling and minority shareholders.

2.2.a. Poor liquidity of the controlling shareholder's share

Stock illiquidity could trigger agency problems of controlling shareholders. At the start of China's stock market, when all listed companies were SOEs, in order to retain control, the government established a split-share structure under which shares owned by the state controlling shareholders could not be traded in the secondary market. Thus controlling shareholders were unable to benefit from stock price appreciation by selling shares. The only

5 The split share structure reform converted nontradable shares owned by controlling shareholders into tradable shares. We discuss this reform in more detail in a later section.

6 Normally a firm receives ST status if it experiences two consecutive annual losses. If it experiences another annual loss, then trading is suspended; a fourth annual loss leads to delisting.

legal means for controlling shareholders to realize returns from their NTSs was dividends, but these have to be shared with all other investors. They thus have strong incentives to realize returns through expropriation.

Several studies provide empirical evidence for this argument, using the 2005 split-share structure reform, which converted all NTSs into tradable shares (TS) and thus allowed the controlling shareholders to obtain returns through capital gains rather than expropriation. For example, Chen *et al.* (2012) find that average cash holdings and the average corporate savings rate were significantly larger before the reform, indicating self-serving cash holding due to poor liquidity of shares. Campello, Ribas, and Wang (2014) find that real corporate activity was substantially hindered before the reform, as reflected in lower fixed assets investment, firm productivity (measured by the ratio of sales to capital), profitability, and firm market value.

Although the split-share structure no longer exists, controlling shareholders' shares remain illiquid: since they are insiders, they cannot sell without adversely moving the price. Thus the agency problem triggered by illiquidity persists.

2.2.b. Pyramid ownership structures

Pyramid ownership structures (where control of a firm is obtained through a chain of companies) are common in many countries (La Porta, Lopez-de-Silanes, and Shleifer, 1999). They can worsen conflicts between controlling and minority shareholders, by allowing controlling shareholders to gain control rights in excess of their cash flow claims. For example, if Firm C owns 51% of Firm B, and Firm B owns 51% of Firm A, then Firm C is ultimately the controlling shareholder of Firm A, yet owns only 26%. Lemmon and Lins (2003) find that firms with pyramid ownership structures suffered a 10–20% greater performance decline (measured by cumulative stock returns) than other firms in the Asian financial crisis. They explain that when a crisis eradicates investment opportunities, controlling shareholders have more incentive to expropriate wealth from minority shareholders. Fan and Wong (2002) find that firms controlled through a pyramid ownership structure have less informative earnings (measured by the earnings–return relationship). They argue that controlling shareholders with control rights that exceed their cash flow rights have incentives to misreport accounting information, so their reported earnings have low credibility.

Pyramid ownership structures are also common in China. According to our statistics, from 2003 to 2018, about half of Chinese A-share listed-firms had a divergence between control rights and cash flow rights.[7] Wang *et al.* (2015) find that firms with a pyramid ownership structure underperform firms without it by 30% for a 3-year period following their initial public offerings (IPOs), in buy-and-hold returns adjusted by market, industry, and size. They further find that when the divergence between the controlling shareholder's control rights and cash flow rights increases, so does the likelihood of tunneling through value-destroying RPTs.

2.2.c. Political connections

Politically connected firms may circumvent regulations or may enjoy favors, such as easy access to debt financing (Fisman, 2001; Khwaja and Mian, 2005), which distort the

7 We obtain pyramid ownership structure data from CSMAR. Fan and Wong (2002) find that one-quarter of the seven East Asian firms display cash-vote divergence, and the mean ratio of cash flow right to voting right (the CV ratio) is 0.85. In our data, the mean CV ratio of Chinese listed firms is ~0.83.

efficient allocation of capital in the economy. For example, Faccio, Masulis, and McConnell (2006) find that politically connected firms are more likely to receive bailouts than matched unconnected firms, but they underperform after bailouts. In China, many controlling shareholders also have political connections. While controlling shareholders of SOEs, that is, the government, are naturally politically connected, it is also common for controlling shareholders of non-SOEs to build connections with the government through connected CEOs, top managers, or directors. For example, Fan, Wong, and Zhang (2007) find that almost 27% of the CEOs in their non-SOE sample are former or current government bureaucrats.

While firms can benefit from political connections, minority shareholders may be hurt. For example, a politically connected firm is more likely to receive approval to go public when it is not ready for an IPO. Piotroski and Zhang (2014) study impending political promotions in China. They find that when local politicians anticipate a promotion, they may encourage local firms to go public to show their ability to develop local capital markets.[8] On the firm's part, when it anticipates the loss of a political connection, it may capitalize on the connection before its local politician's departure to prematurely seek—and receive—IPO approval. Piotroski and Zhang (2014) find that these early-IPO firms subsequently experience poor performance (in terms of both future financial performance and long-run stock returns), and controlling shareholders are more likely to divert proceeds away from their intended use after the offering.

Political connections may induce controlling shareholders to believe they can get away with tunneling. For example, Fan, Wong, and Zhang (2007) find that newly partially privatized firms with politically connected CEOs (defined as former or current government bureaucrats) underperform those without by almost 18% in 3-year post-IPO stock returns. The authors argue that this is because politically connected CEOs are likely extracting resources from the listed firm at the expense of minority shareholders to satisfy state objectives or to seek rents. Cheung, Rau, and Stouraitis (2010) find that Chinese listed firms are more likely to engage in value-destroying RPTs with their local government controlling shareholders when >10% of their directors are affiliated with the local government.

Political connections may also discourage high-quality corporate financial disclosures or even induce information manipulation. Tellingly, Hope, Yue, and Zhong (2019) find that after China's national anticorruption campaign cut such connections by forcing official directors to resign (Rule 18),[9] their firms started to improve financial reporting quality. Furthermore, Piotroski, Wong, and Zhang (2015) show that during meetings of the National Congress of the Chinese Communist Party, and during times when high-level promotions of politicians take place, politically connected firms suppress negative information, perhaps to protect those connections. However, this is followed by an increase in the flow of negative information after the event, as previously suppressed information is subsequently released. Such suppression harms minority shareholders.

Political connections may harm firm value, given that they can facilitate tunneling and discourage transparency. Event studies based on China's national anticorruption campaign

8 This is similar to Bertrand *et al.*'s (2018) finding that French firms maintain high employment and plant creation rates to help regional politicians in their re-election efforts.

9 As an important component of the anticorruption campaign, in October 2013, the Organization Department of the Central Committee of the CPC issued Rule 18, to prohibit party and government officials from serving as directors for publicly listed firms.

provide indirect evidence. On December 4 2012, the Chinese Communist Party unexpectedly announced its “Eight-point Policy”.[10] In general, the policy prohibits government officials and top executives of SOEs from demanding or accepting extravagant perks. Lin *et al.* (2018) find that the Chinese stock market experienced ∼3–4% return over the 3-day and 5-day windows surrounding the announcement date, suggesting that political connections, and corruption in general, can destroy firm value. On May 17 2013, the Central Commission for Discipline Inspection (CCDI) announced that it would conduct inspections of provincial governments.[11] This surprise announcement meant the government’s anticorruption campaign was not just talk. Ding *et al.* (2020) find an overall positive return around the announcement date. The positive returns were significantly higher for non-SOEs, small firms, and non-connected firms, which are the firms most vulnerable to tunneling (or resource extraction by the government).

Political connections can also hurt firms once the connections are lost. Yan (2019) studies firms that lost their political connections due to Rule 18 of China’s national anticorruption campaign. She finds that these firms subsequently found it difficult to obtain bank loans. Political connections can also impose a negative externality onto other firms, especially to small firms that do not have the resources to curry favor with connected officials. Giannetti *et al.* (2017) study firms that lost their political connections due to the Eight-point Policy of the anticorruption campaign. Before the policy, large firms that could spend more on entertainment expenses, which is a proxy measure to capture the extent that firms spend on “greasing” government officials, enjoyed lower financing costs. After the policy implementation, these large firms lost their ill-gotten financing advantages.

2.3 The Limited Roles of Possible Monitors

In Western countries, corporate insiders may be effectively monitored—though this is still debatable—by boards; institutional investors, including banks; and information intermediaries, including security analysts, independent auditors, and the media.[12] In China, these mechanisms seem to play a rather limited role in monitoring controlling shareholders.

2.3.a. Boards as internal monitors

Boards of directors are supposed to monitor firm management on behalf of investors. However, whether they are effective in this role is widely debated (for a survey of the evidence, see Adams, Hermalin, and Weisbach, 2010). Some scholars find that independent directors may be particularly effective monitors, especially for Western countries (e.g., Weisbach, 1988, using US data; Dahya, McConnell, and Travlos, 2002, using UK data). However, as Jiang and Kim (2015) have pointed out, it may be difficult for directors in China to be active and effective monitors, for three reasons: First, board nominations and appointments are largely made by controlling shareholders. Second, the main role of independent directors in China is to monitor controlling shareholders, even though these

10 For details about the Eight-point Policy, see http://cpcchina.chinadaily.com.cn/2012-12/05/content_15991171.htm

11 Information about the CCDI can be found at this website (in Chinese): http://www.ccdi.gov.cn/

12 Dyck, Morse, and Zingales (2010) show that some purported monitors in the USA are slow (or they fail) to bring corporate fraud to light. Therefore, corporate governance mechanisms sometimes also do not work effectively in the USA.

directors were likely nominated and appointed by controlling shareholders. Third, even if independent directors are active, they represent the minority on most boards.[13]

Nevertheless, some types of directors still conduct partially effective monitoring. Jiang, Wan, and Zhao (2016) study the voting behavior of independent directors of listed firms in China. Their sample includes 609 board meetings, in which voting takes place on 859 proposals, with at least one independent director voting "abstain" or "against". The study finds that only 6% of independent directors dissent even once, particularly those who are career cautious and highly reputed—and most of these dissents occur during the independent directors' second terms (there is a two-term limit for directors in China), when they are less beholden to controlling shareholders. Furthermore, 92% of the proposals eventually pass despite dissent. This high pass rate is not surprising given that insiders control the board meeting agenda and independent directors constitute only a minority on the board. Nonetheless, the authors argue that director dissent helps to improve corporate governance, as it conveys value-relevant information to outsiders.

Another important type of director who may monitor effectively is one with experience of superior corporate governance and advanced management practices from abroad. Giannetti, Liao, and Yu (2015) study the impact of these emigrant directors on Chinese listed firms. During the 1980s and 1990s, many Chinese went abroad for education and then subsequently remained abroad for employment. In the early to mid-2000s, various Chinese provinces started implementing policies (e.g., tax breaks and subsidized housing) to entice these overseas Chinese to return to China. If emigrant directors are less likely to have local ties, then they may be less beholden to controlling shareholders and thus more effective as directors. Giannetti, Liao, and Yu (2015) find that when an emigrant director joins a board, the firm's valuation, total factor productivity, and profitability improve, partly because governance improves (as revealed by a reduction in earnings management), but mostly because the firm's international activities increase. For example, these firms are more likely to engage in foreign mergers or acquisitions, raise capital internationally, and increase exports. Therefore, it may be emigrant directors' overseas expertise, rather than their independence or innate ability, which makes them effective monitors.

Board monitoring effectiveness may also vary with different forms of board meetings. Cai, Jiang, and Kang (2019) study differences in directors' monitoring of corporate insiders between remote and face-to-face meetings in China. Since social context cues and visual images are not observable in remote board meetings, such meetings encourage independent directors to think more independently and feel less pressured to agree with inside directors and CEOs. The authors find that remote board meetings are associated with improved meeting attendance by independent directors, higher likelihood of dissent on monitoring-related proposals, and higher sensitivity of forced CEO turnover to performance.

13 In our own check of the data on CSMAR, in 2018, 4.27% of the listed firms have boards with at least 50% independent directors, and 1.51% of listed firms have boards with >50% independent directors. Since June 30 2003, one-third of listed firms' boards must be independent (CSRC board regulations can be found here (in Chinese): http://www.cninfo.com.cn/finalpage/2001-08-22/605382.html). Since 2003, the annual median ratio of independent directors to total directors is 0.333, with mean ratios being slightly higher (see Jiang and Kim, 2015). While some boards have extra independent directors, another reason why mean ratios are slightly >0.333 is because boards with five, seven, and ten members cannot have an independence ratio <0.4.

In addition to boards of directors, under China's two-tier board structure listed firms are also required to have a board of supervisors. Members of both boards are determined by a cumulative voting system, where the number of votes per share is equal to the number of directors or supervisors to be elected. However, there are different membership restrictions placed on each board. The regular board must have a minimum of five directors and a maximum of nineteen. A senior manager can sit on the regular board, but at least one-third of its members must be independent directors. The supervisory board must have at least three members and must include representatives of shareholders, but at least one-third of the supervisors must be employees. However, supervisors cannot include current directors or senior managers, because the supervisory board's primary responsibility is to oversee and evaluate directors and senior managers.[14] The rationale for a supervisory board is especially strong for SOEs, in which the chair of the board of directors is appointed by the state, and she/he is the inside controlling agent of the outside state principal. However, for the supervisory board to be effective, its chair should be as powerful as the chair of the board of directors.[15] In many companies, especially non-SOEs, since Chinese company law gives substantial power to the board of directors and the controlling shareholder is usually its chair, she/he outranks the chair of the supervisory board. Thus, in most cases, the supervisory board may be redundant or pointless.

2.3.b. Institutional investors as external monitors

Institutional investors, such as mutual funds or pension funds, can be active and effective monitors in Western countries (Smith, 1996; see Edmans and Holderness, 2017, for a review of the literature on shareholder activism by institutional investors). However, in China, no institutional investor is permitted to own >10% of a listed firm's shares[16]—and every listed firm has a controlling shareholder that owns >10%. In our own check of data from CSMAR, from 2003 to 2018, the average total ownership of all institutional investors in a listed firm is only 6%, while the average percentage of shares held by the controlling shareholder is 36%. Therefore, institutional investors may not have either the incentive or the power to exert active and effective governance. As Jiang, Lee, and Yue (2010) note, the low presence of institutional investors partly explains why controlling shareholders are able to get away with brazen tunneling.

However, even when they have the opportunity and power to make decisions,[17] institutional investors in China may not be effective monitors, owing to their short-run investment

14 The primary responsibilities of regular boards in China are the same as those of boards in Western countries. For example, boards in China convene meetings, implement shareholder resolutions, make major operational and investment decisions (e.g., capital expenditures and acquisitions), make major financial decisions (e.g., budgets and raising capital), and evaluate the firm's top managers.

15 Conventional thought is that financial companies, such as the Industrial and Commercial Bank of China, have effective supervisory boards because their chairs are high-ranking government officials, like regular board chairs.

16 For regulations on institutional investor ownership, refer to (in Chinese): http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgz/jjl/201505/t20150511_276612.html and http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418_14496.htm

17 According to the Guidelines for Articles of Association of Listed Companies launched by the CSRC in 1997, when a shareholders' general meeting deliberates on matters pertaining to related party transactions, related shareholders should abstain from voting, and the total number of valid votes

horizons (Jiang and Kim, 2015) and, sometimes, to political pressures. For example, in the split-share structure reform, in order to convert NTS to TS, NTS holders have to offer TS holders a compensation plan, which needs approval from two-thirds of the total voting shares as well as from two-thirds of total TS voting shares. As mutual funds are typically the largest institutional investors in TS, they are supposed to negotiate fair compensation for themselves and for other holders of TS. However, in the case of SOEs, the government is the controlling shareholder as well as the largest owner of NTS. Firth, Lin, and Zou (2010) find that mutual funds bow to political pressure to help these firms implement the reform quickly and at relatively low cost. Therefore, the authors conclude that minority shareholders cannot count on institutional investors in China to monitor effectively.

As large creditors, banks in theory might also be effective monitors. Like large shareholders, banks have large investments in firms, and want returns on their investment. In addition to the incentives to monitor, they may also have the ability through their access to inside information and stable relationships with borrowing firms. In Japan, where banks are the most important providers of capital to firms, banks have been shown to be active and effective monitors (e.g., Hoshi, Kashyap, and Scharfstein, 1990). Banks are also the most important providers of capital to Chinese firms (Jiang, Jiang, and Kim, 2017).[18] However, in China, it is difficult for banks to play a monitoring role, since most large Chinese banks are state owned and therefore are obliged to help keep firms afloat to maintain employment. Indeed, using a sample of bank loans during 1999–2004, Bailey, Huang, and Yang (2011) find not only that poorly performing firms are more likely to obtain bank loans, but also that these borrowers continue to perform poorly, suggesting that the loans are made only to keep the firms afloat. The stock market reaction to these loan announcements is negative. The authors contend, therefore, that market participants know these loans are being given to noncredit-worthy firms, and that these firms will continue to perform poorly. Finally, the authors also find that many borrowers frequently engage in RPTs, suggesting that Chinese banks do not monitor.

Although the total value of nonperforming loans (NPLs) and the ratio of NPLs to GDP in China have both declined since their peak in 2000–01, as Allen *et al.* (2012) have shown, it would be wrong to think that banks are becoming better monitors. These reductions are largely due to actions by the Chinese government, to reduce the NPLs of the Big Four state banks before their public listing. During 2003–08, the Chinese government injected large amounts of foreign currency reserves into these banks, and it also created asset management companies to assume and then to liquidate the NPLs (Allen *et al.*, 2012). Over time, bank competition has also increased, and this could lead to changes in bank behaviors. However, Gao *et al.* (2019) find that after bank entry was partially deregulated in 2009,[19] entrant

should not include the shares with voting rights held by related shareholders. In such cases, institutional investors are supposed to be a powerful and influential party, since they are typically one of the largest groups of unrelated shareholders. http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/DepartmentRules/201904/P020190524606840462980.pdf

18 Having decreased substantially since 2002, loans from commercial banks in 2015 were 73.1% of total new external financing, whereas equity financing was only 4.9% (Jiang, Jiang, and Kim, 2017).

19 Before 2009, the big four state-owned commercial banks (i.e., Bank of China, Agricultural Bank of China, China Construction Bank, and Industrial and Commercial Bank of China) dominated China's banking system, while the twelve joint equity banks faced great limitations when opening new branches. In April 2009, the China Banking Regulatory Commission partially lifted this entry barrier.

banks preferred to lend to inefficient SOEs over more productive private firms. To receive bank loans from entrant banks, private firms have to provide more guarantees and higher internal loan ratings to indicate their credit worthiness, while SOEs do not. Nevertheless, the authors find that in the long run, entrant banks accumulate more information on local private firms and eventually lend more to them, suggesting that some banks are starting to use their inside information and stable relationships with borrowing firms to play a monitoring role.

2.3.c. Information intermediaries as external monitors

Securities analysts can monitor insiders through at least two channels: directly by raising questions in conference calls and indirectly by distributing public and private information to investors to help them detect insiders' misbehavior (Chen, Harford, and Lin, 2015). However, in China, controlling shareholders' ability to choose what they disclose hinders securities analysts from monitoring insiders effectively. In addition, in China, securities analysts can work at investment banks, a practice that compromises their objectivity. Huyghebaert and Xu (2016) find that securities analysts affiliated with Chinese investment banks issue positively biased earnings forecasts for firms that have had their IPOs underwritten by the affiliated bank. Evidence from Chan *et al.* (2019) also shows that, in China, analysts who have had previous underwriting relations with listed firms provide more optimistic recommendations before large shareholders sell their restricted shares. These findings are similar to Lin and McNichols (1998) and Michaely and Womack (1999) that find that analyst recommendations in the USA can also be obscured by a conflict of interest.

Independent auditors, in their roles of reviewing, checking, and confirming the accuracy of financial statements, can be effective monitors. As Fan and Wong (2005) note, by increasing the quality and integrity of disclosures about RPTs, auditors can discourage tunneling-motivated RPTs, as minority shareholders discover this self-serving behavior through financial statements and react to it by exiting. The authors find that external auditors play a crucial monitoring role in East Asia (excluding mainland China), where the agency problem of controlling shareholders is high. However, in China, some listed firms can simply shop for favorable audit opinions (Chan, Lin, and Mo, 2006; Chen *et al.*, 2016); the Big 4 accounting firms may assign their less experienced partners to audit firms that are listed only in mainland China, compared to firms that are cross-listed in Hong Kong (HK), where the institutional environment is better (Ke, Lennox, and Xin, 2015); and some controlling shareholders may hire auditors to which they have school ties, leading to favorable auditor opinions (Guan *et al.*, 2016). That is to say, independent auditors cannot be effective monitors in China. For an in-depth discussion of this strand of the literature, see Wong's (2016) survey of mostly accounting literature on China.

The media is potentially important monitors, playing a corporate governance role that affects firms' reputation and may force regulators to take action (Dyck, Volchkova, and Zingales, 2008). In China, however, many media outlets are controlled by the government and thus may be biased in their reporting. You, Zhang, and Zhang (2018) review 210,199 articles published in state-controlled financial newspapers and market-oriented financial

Joint equity banks are allowed to open branches in cities in which they had already had branches, and allowed to enter all cities in a province in which they already had branches in the capital city.

newspapers,[20] and find that the articles published in state-controlled newspapers are less critical, less accurate, less comprehensive, and more subject to reporting delay. The authors also find that the articles in market-oriented newspapers are followed by stronger stock market reactions than those in state-controlled newspapers, and that market-oriented newspapers are better at predicting firms' future performance.

2.4 The Bright Side of Controlling Shareholders

In Western countries, where ownership of publicly listed firms is dispersed, large shareholders are often viewed as a potential solution to the vertical agency problem between inside managers and outside investors (Edmans, 2014; Edmans and Holderness, 2017). In China, because controlling shareholders have full control rights, they can just as easily exert effective governance over firms as they can expropriate from firms. The question is, when and how might controlling shareholders use their power to improve firm value, rather than to expropriate?

One such situation occurs when the controlling shareholder is also the majority owner. Some researchers argue (e.g., Jensen and Meckling, 1976; Stulz, 1988) and empirically show (e.g., Morck, Shleifer, and Vishny, 1988; Claessens *et al.*, 2002) that the alignment-of-interest effect (entrenchment effect) occurs when a large shareholder has a high (low) level of ownership. Gul, Kim, and Qiu (2010) point out that when a large shareholder in China owns >50% of the firm, her/his significant cash flow rights make expropriation costly. When controlling shareholders do not engage in expropriation, they have nothing to hide; and accordingly, Gul, Kim, and Qiu (2010) find that Chinese listed firms with majority shareholders have more firm-specific information incorporated into their share prices. Similarly, Jiang *et al.* (2017) find that listed firms with a majority owner have the best performance (measured by return on assets, ROA), and listed firms with a controlling shareholder that owns <50% of the firm have the worst performance. In addition, while RPTs are an efficient way to allocate resources between a controlling shareholder and the listed firm, the authors find that controlling shareholders with >50% of the firm use RPTs to enhance firm performance, and those with <50% of the firm use RPTs to tunnel. In other words, high cash from ownership leads to effective governance; low cash from ownership leads to expropriation.

Controlling shareholders may benefit minority shareholders when the firm is in poor financial health, because they do not want their firms to fail. Peng, Wei, and Yang (2011) describe two major risks that controlling shareholders face in China: delisting and losing the right to issue new shares. Both can occur if a firm suffers from poor earnings. Therefore, the authors hypothesize, when firms are in poor financial health, controlling shareholders conduct RPTs on favorable terms to temporarily prop up earnings. Examples include buying firms' assets at high prices, exchanging good assets for a firm's bad assets, and lending to firms at favorable interest rates. Indeed, when firms in poor financial health conduct RPTs, the abnormal return surrounding the announcement is positive. Jian and Wong (2010) also find that firms use RPTs to prop up earnings to meet earnings targets. However, as Peng, Wei, and Yang (2011) find, propping is temporary. In some cases, after

20 State-controlled financial newspapers include the *China Securities Journal, Securities Daily, Securities Times*, and *Shanghai Securities Journal*, and market-oriented financial newspapers include the *China Business Journal, First Financial Daily, Economic Observer*, and *21st Century Business Herald*.

propping, cash is transferred back to the controlling shareholder. Therefore, propping may benefit minority shareholders only in the short run.

Controlling shareholders may also benefit minority shareholders if the firm and the controlling shareholder are part of a business group. The business group is a type of corporate organization in which member firms are linked through cross-ownership and internal factor markets, such as financial markets, and it can help to relax financial constraints and enhance investment (Hoshi, Kashyap, and Scharfstein, 1990, 1991). Business groups are common in emerging economies, perhaps because they substitute for weak institutions (Khanna and Palepu, 2000). In China, it is well known that the state largely controls natural and financial resources, and business groups may form in order to acquire and share these resources. He *et al.* (2013) find that about one-third of listed Chinese firms in their sample are affiliated with a business group, and that such firms experience lower financial constraints because of their internal capital markets and have lower risk because of coinsurance among member firms. Jia, Shi, and Wang (2013) argue that RPTs can be used to provide coinsurance among business group members. When the parent (subsidiary) firm experiences a credit crunch (performance challenge), the subsidiary (parent) firms may provide funds (support) in the form of loan-based (nonloan-based) RPTs.

Another situation in which the controlling shareholder may be of benefit occurs when a firm has other blockholders to monitor expropriation by the controlling shareholder (Pagano and Röell, 1998; Laeven and Levine, 2007). Multiple blockholder ownership structure is very common in China.[21] Hope, Wu, and Zhao (2017) find that Chinese listed firms with outside (i.e., noncontrolling) blockholders have better ROA than firms without such blockholders—even though their tests find no indication that the outside blockholders govern through active intervention. The authors conclude that the threat of blockholder exit is what mitigates agency problems. That is, controlling insiders may worry that outside blockholders will sell their shares, driving down prices, and therefore may focus on maximizing value (Admati and Pfleiderer, 2009; Edmans, 2009; Edmans and Manso, 2011).

3. Law and Institutions

Laws and the quality of their enforcement by the regulator and courts are essential elements of corporate governance (La Porta *et al.*, 1997, 1998). Strong law and well-developed institutions can help resolve agency problems and protect minority shareholders. This may be especially true for China, where the controlling shareholder is overly powerful, takes full control of the board and management, and is difficult to govern, either internally or externally (through takeover). In this section, we first discuss the importance of legal protection for the development of markets, and how they are particularly important for China. Then, we describe how legal protection in China has evolved and improved.

21 According to our statistics, of all Chinese A-share listed firms from 2003 to 2018, 34.28% have at least two blockholders that hold at least 10% of the firm's outstanding shares (a threshold following Faccio and Lang, 2002), and 56.65% of firms have at least two blockholders with an ownership >5% (a threshold following Edmans and Manso, 2011 and Hope, Wu, and Zhao, 2017). The data come from CSMAR, which specifies share ownership of the top ten largest shareholders for all listed firms in each year. We manually group parties related to the controlling shareholder and sum their shareholdings using the financial statement disclosures on related parties.

3.1 The Importance of Legal Protection

Much research has been undertaken in the past two decades to highlight the importance of law and institutions for finance and economic growth. La Porta *et al.* (1998, 2002) provide empirical evidence that countries with stronger legal protection have better economic outcomes at the aggregate and firm levels. La Porta *et al.* (1998) study forty-nine countries and measure their minority shareholder rights, creditor rights, and enforcement of those rights. The authors find that legal protection and enforcement differ markedly around the world and are relatively strong (weak) in countries with common (civil) law. In a follow-up study, La Porta *et al.* (2002) find higher valuation of firms in countries with better protection of minority shareholders.

Is this the case for China? During the 1990s and early 2000s, China's legal protection of shareholders and creditors was poor, compared to that in the rest of the world. Allen, Qian, and Qian (2005) compare China's shareholder and creditor rights to rights in other countries studied by La Porta *et al.* (1998). For shareholder rights, the mean score for all countries (English-origin countries) according to La Porta *et al.* (1998) is three (four) out of five, but China's score is only three. Almost two-thirds of the countries studied by La Porta *et al.* (1998) have superior shareholder rights. For creditor rights, the mean score for all countries (English-origin countries) according to La Porta *et al.* (1998) is 2.3 (3.11) out of 4, but China's score is only 2. Over two-thirds of the countries they studied have superior creditor rights. Perhaps most importantly, when it comes to law enforcement, China rates much lower than other countries studied by these authors. For example, the mean rule-of-law score for all countries is 6.85 out of 10 and the mean corruption score for all countries is 6.9 out of 10, while China's scores are only five and two, respectively. Even when China is directly compared to six other emerging economies (India, Pakistan, South Africa, Argentina, Brazil, and Mexico), it ranks only fifth in shareholder rights and creditor rights, and ranks last in one of the enforcement measures.

Although neither China's shareholder rights nor its creditor rights are well protected, China remains a fast-growing economy with substantial market development. Therefore, the evidence provided by Allen, Qian, and Qian (2005) poses an important question for both researchers and policy-makers: is legal protection important in China? Some empirical research considers this question and concludes that it is.

Poor investor protection harms not only share value, but also share liquidity. For example, when investor protection is poor, minority shareholders do not invest (La Porta *et al.*, 1998), which implies low share liquidity. Brockman and Chung (2003) compare HK-based blue chip firms and China-based firms that are listed on the HK Stock Exchange. They find that stocks of China-based firms have larger bid–ask spreads and thinner depth than stocks of HK-based firms.

In contrast, strong protection for investor rights can promote investment. For example, protection for property rights is an important precondition for economic growth, especially for countries transitioning from planned to market economies (Johnson, McMillan, and Woodruff, 2002). Entrepreneurs have little incentive to start businesses or reinvest in their businesses if the risk of expropriation is high. During the early 2000s, property rights started to improve in China, but to varying degrees. Cull and Xu (2005) consider two aspects of property rights: risk of expropriation by the government and the ease and reliability of contract enforcement. Using data from a survey of firms based in eighteen cities in China during 2000–02, their study finds that when managers perceive the risk of expropriation to be low and the ease/reliability of enforcement to be high, they reinvest more of their firms' profit back into their firms—as Johnson, McMillan, and Woodruff argue.

Furthermore, strong legal protection can encourage corporate innovation, by reducing the risk that other firms will imitate or steal intellectual property. To test the importance of intellectual property rights in China, Fang, Lerner, and Wu (2017) use survey data from sixty-six prefectures to examine the privatization of SOEs.[22] They find that on average, firms' patent stock increases by 200–300% in the 5 years after privatization compared to the 5 years before—and, importantly, that the increase in innovation is significantly larger in prefectures with higher IPR protection.

Recent research shows that the capital market reacts positively to promulgation of laws and regulations, which confirms the importance of legal protection in another way—improved access to finance. In 2007, China enacted the Property Right Law, which makes it difficult for local governments to expropriate assets from firms, but easier for creditors to seize firms' assets if they default on loans. When owners feel that their firms' assets will not be expropriated by the government, they are more willing to invest in their firms. When creditors feel that they can easily seize assets from firms that are in default, they are more willing to lend to firms. This greater access to finance should enhance firm value. Berkowitz, Lin, and Ma (2015) study announcement returns on December 29 2006, the day when a draft of the Property Law was accepted by the Standing Committee of the National People's Congress (NPC). The acceptance of the draft was a surprise as this law had been debated by the NPC for many years. On that day, the mean stock market return was almost 4%. For event windows of (−2, +2) and (0, +5), where Day 0 was December 29 2006, the mean cumulative stock returns were >6% and >15%, respectively. These announcement returns are higher for firms with more tangible assets (that could have been expropriated by the local government), and without political connections (to prevent such expropriation).

3.2 The Improvement of Legal Protection

Aware of the importance of legal protection, policy-makers in China began to establish a modern framework for legal protection in the mid-1980s. Since then, the Chinese government has promulgated a series of laws and regulations to enhance investor protection and to improve corporate governance.

The Accounting Law, promulgated in 1985 to ensure the quality of accounting information (amended in 1993 and 2017, and revised in 1999), was the start of building an integral law system in China. In 1986, China first introduced the concept of reorganization and bankruptcy of SOEs, and enacted the Enterprise Bankruptcy Law (revised in 2006), which suggested a new way to improve the quality of enterprises by eliminating inefficient ones. It is widely accepted that the introduction of company law and securities law is one of the most important elements in the process of legal reforms (MacNeil, 2002). Accordingly, in 1993, the NPC enacted China's Company Law, and in 1998 the Securities Law. To improve investor protection, both laws have been updated many times. The Company Law has been amended four times, in 1999, 2004, 2013, and 2018, and revised once, in 2005,

22 In China, a prefecture is an administrative division. It ranks below a province and above a county. It comprises a main central urban area (such as a city) and its larger surrounding rural area, containing smaller cities, towns, and villages.

while the Securities Law has been amended three times, in 2004, 2013, and 2014, and revised once, in 2005. The Contract Law was promulgated in 1999. In 2007, the Property Right Law was enacted to strengthen the protection of property rights, benefiting both listed firms and their investors and creditors. In sum, in ~20 years, China has set up an integrated law system.

In addition to law, securities regulations and enforcement by the CSRC have also been improving. A well-known CSRC regulation requires firms to show that they are profitable before being allowed to issue new equity to existing shareholders. This regulation aims to guide capital to more efficient sectors of the economy. During 1996–98, the CSRC required listed firms wishing to make such offerings to achieve an annual return on equity (ROE) >10% for each of the preceding 3 years. The previous requirement had been that firms must average >10% ROE over the preceding 3 years. Chen and Yuan (2004) find that during 1996–98 (the more stringent period) many firms managed earnings by using excessive amounts of nonoperating income to achieve the annual 10% ROE goal. During 1996–97, the probability of CSRC approval was negatively correlated with indicators of earnings management. This negative correlation was even stronger in 1998, suggesting that the CSRC became better at detecting managed earnings. Perhaps, more importantly, during 1998 (1996–97), those firms that received CSRC approval subsequently outperformed (did not outperform) those firms that were denied of CSRC approval. These results imply that the CSRC became better at identifying which firms deserved approval. However, after 1998, the requirement reverted to the previous status, a change that may have reduced firms' incentives to manage earnings.

The Securities Law, passed in December 1998, empowered the CSRC to oversee securities markets and to enforce the law and its subsequent regulations. Since then, the CSRC has introduced a series of regulations to improve minority shareholder protection. For example, in the second quarter of 2000, the CSRC announced three new regulations.[23] The first substantially increases the voting rights of minority shareholders at annual shareholders' meetings by prohibiting shareholders involved in RPTs from voting on those transactions; empowering small shareholders to propose motions; requiring candidates for director to be elected individually rather than as a group; and granting new legal standing in courts to shareholders disputing procedures used or resolutions passed. The second new regulation prohibits listed firms from guaranteeing loans to controlling shareholders or related parties. The third greatly improves the transparency and regulation of asset transfers to related parties. Berkman, Cole, and Fu (2010) find that the 5-day cumulative abnormal returns surrounding the announcement of the first, second, and third regulations were 9.9, 1.1, and 2.3%, respectively. They further find that firms with weaker corporate governance (proxied by a high level of RPTs) enjoyed significantly larger abnormal returns than firms with stronger governance. That is, the minority shareholders who are most vulnerable to expropriation benefited most from the new regulations.

To further strengthen the power of minority shareholders against expropriation, the CSRC introduced a new voting regulation in 2004. For a long time, controlling shareholders had the power to approve RPTs. This new regulation required that major corporate

23 For regulations on minority shareholder protection, refer to (in Chinese): http://www.csrc.gov.cn/pub/shenzhen/xxfw/tzzsyd/ssgs/sszl/ssgsfz/200902/t20090226_95510.htm, http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167718.html, and http://www.gov.cn/gongbao/content/2001/content_61338.htm

decisions be separately approved by the owners of TSs who participated in the voting. Chen, Ke, and Yang (2013) find that the passage of the segmented voting regulation deterred corporate insiders from submitting value-decreasing proposals, and that the mean announcement returns for submitted proposals were significantly negative before the regulation but significantly positive after, which suggests that giving minority shareholders more power can improve corporate decisions.

The CSRC continuously tries to improve the functioning and capabilities of financial intermediaries and other institutions. For example, it has given investment banks more power to identify and develop IPO candidates (Jiang and Kim, 2015). Another example is the CSRC's 2003 requirement for mandatory rotation of audit partners. There is a debate on whether mandatory rotation is harmful due to lost experience or beneficial due to a fresh perspective. Lennox, Wu, and Zhang (2014) study >6,000 audits of Chinese firms between 2006 and 2010. They find that audit adjustments, where the auditor detects and corrects any misstatement on the pre-audit financial statement, occur relatively frequently during the final year of an outgoing auditor. This result implies that outgoing auditors conduct high-quality audits in their final year because they know their work will be evaluated by incoming auditors. They also find that audit adjustments occur relatively frequently during the first year of an incoming auditor. This result implies that incoming auditors provide a useful fresh perspective. Overall, the authors find that the CSRC's regulation is beneficial in China.

Strong laws and regulations are useless without strong enforcement. In China, owing to the lack of an effective private securities litigation system and other market mechanisms, private enforcement is largely absent (Jiang and Kim, 2015). Government regulators, including the CSRC and the two domestic stock exchanges, play a dominant role in enforcing securities law. Using hand-collected data on comment letters (CLs) on annual reports issued by the Shanghai Stock Exchange, Duan *et al.* (2018) study the efficacy of public enforcement in China. Although CL announcements elicit a negative stock price reaction, the authors find no significant effect of the exchange's oversight on CL firms' financial reporting practices, including earnings management and disclosure quality. Nor do they find any market-discipline effect on bid–ask spreads and cost of borrowing or equity issuance activities. Instead, they show that CL firms, especially those receiving more severe CLs (more pages and more questions), are more likely to be subject to another CL in the near future as well as to be sanctioned by the regulators. In sum, their findings show that public enforcement cannot function effectively without market discipline.

In recent years, Chinese regulators have recognized the deficiencies in relying solely on public enforcement, and therefore have continuously taken various new steps to reform the enforcement regime. For example, to increase the timeliness and quality of public disclosure, from July 1 2013, and January 13 2014, respectively, the Shanghai Stock Exchange and Shenzhen Stock Exchange began to allow all listed firms to release their semi-annual and annual reports directly to the public without the need to seek a review by the stock exchange. Huang and Ke (2018) examine the consequences of this exogenous shift from public to private enforcement. Contrary to the regulators' intention, both disclosure timeliness and disclosure accuracy worsen after the change. Moreover, the authors find no evidence that the major market institutions, including external auditors, independent directors, mutual fund managers, and financial analysts, significantly mitigate this trend. These results suggest that market institutions in China are still not ready to substitute for public enforcement.

4. Corporate Governance of SOEs

SOEs are some of the largest and most important Chinese firms, and they have their own unique and significant agency problem. For one thing, the state may extract resources from SOEs to satisfy state objectives (Shleifer and Vishny, 1998, call this the government's "grabbing hand"). This type of tunneling hinders SOEs from maximizing profits. For another, the owners of SOEs are the citizens in general, which breeds the problem of owner vacancy. Therefore, SOE managers, who control firm resources, have both incentive and opportunities to tunnel. These unique features warrant separate discussion of SOEs.

Before the mid-2000s, the Organization Department of the Chinese Communist Party and many different ministries, such as the ministry of finance, oversaw SOEs. Since the mid-2000s, the State Assets Supervision and Administration Commission (SASAC) has been tasked with overseeing SOEs on behalf of the state owner. Behind the two types of tunneling in SOEs are four possible agency conflicts: (i) between the state (represented by the SASAC) and minority shareholders; (ii) between SOE managers and the state (the SASAC); (iii) between SOE managers and minority shareholders; and (iv) between the state and the SASAC. To develop deep insight into corporate governance of SOEs in China, it is necessary to discuss the first three conflicts. We do not discuss the last conflict, as it is not a corporate governance issue. In the following subsection, we address the agency conflict between the state and minority shareholders, describing Chinese SOEs' problems and reforms. Thereafter, we discuss SOE managers, emphasizing their incentives and agency problems.

4.1 SOEs in China: Problems and Reforms

As government enterprises, SOEs have two primary tasks: (i) capital investment and production and (ii) maintaining social stability. The main ways that SOEs provide social stability are by maintaining excess labor and providing welfare to retired employees (there was no well-functioning independent social security system in China before the 1990s). Bearing the responsibility and costs of maintaining social stability diminishes SOEs' ability to generate profit, which harms minority shareholders. Consequently, SOEs have long been notoriously poor performers (Lin, Cai, and Li, 1998; Bai, Lu, and Tao, 2006).

Since late 1978, SOEs have undergone several stages of reforms, including initial decentralization in the 1980s; partial privatization, such as share issue privatization (SIP) in the early 1990s; further privatization via negotiated transfer of nontradable controlling stakes in the mid-1990s; and the split-share structure reform, initiated in 2005.

From the late 1970s and throughout the 1980s, the Chinese government promulgated a series of policies on the reform of SOEs (for a detailed description of the reforms, see Groves *et al.*, 1994; Li, 1997; Lin, Cai, and Li, 1998; Sun and Tong, 2003). The earliest policies aimed for administrative decentralization and profit retention (*fangquan rangli*). Control rights over most SOEs were transferred from central government to local governments, primarily at the municipal level, and these local governments started allowing SOEs to retain earnings for the purposes of paying bonuses to workers, supporting welfare programs, and investing in growth. However, as a result of this profit-retention system, SOEs began to bargain with or hide profits from the government. Hence, the government carried out two more reforms: requiring SOEs to pay taxes rather than profits to government (*ligaishui*) and changing their funding sources from government grants to bank loans (*bogaidai*). After these two policies failed to achieve the desired effects, a contractual management system (*chengbaozhi*) was put into practice, under which SOEs deliver promised revenues to the state and retain the residuals. With both control rights and claims on residuals, local governments effectively own SOEs, and therefore should have incentives to maximize their value.

At first, the gradual reforms increased SOEs' productivity (Li, 1997), largely because bonus schemes and other incentives motivated workers (Groves *et al.*, 1994). However, during the mid-1990s, >40% of SOEs were loss making (Lin, Cai, and Li, 1998) as strong non-SOE competitors entered the market. Non-SOEs have to obtain financing and sell output in a competitive environment, so they have to be excellent performers to survive. Meanwhile, SOEs still carry heavy policy burdens and experience soft budget constraints. Lin and Tan (1999) argue that owing to information asymmetry, it is very difficult for the state to determine whether the losses of SOEs are caused by policy burdens or by managers' opportunism. This accountability problem makes the state take responsibility for all the losses, which further induces SOEs to overinvest, because they know that the state would always provide additional funding if they were to incur large losses.[24]

Many economists consider that privatization may be the most effective way to improve SOE performance (e.g., Megginson, Nash, and Van Randenborgh, 1994; Dewenter and Malatesta, 2001; for a survey of empirical studies on privatization, see Megginson and Netter, 2001). Simply, the argument is that private investors have greater incentive to maximize firm value than state owners do. Because so many Chinese SOEs suffered from deteriorating performance during the mid-1990s, a wave of privatization took place between the late 1990s and the mid-2000s. Rather than full privatization, China chose partial privatization of SOEs. Specifically, private ownership and state ownership coexist in the firm after privatization. Bai, Lu, and Tao (2006) propose a multitask theory to explain the rationale for this partial reform policy; that is, SOEs have the dual objectives of production and social stability, whereas full privatization would increase the unemployment rate, which might lead to social upheaval.

One important form of partial privatization in China is public offerings, or SIPs. On December 19 1990, and July 3 1991, respectively, the Shanghai and Shenzhen Stock Exchanges were launched—China's most significant steps toward market-oriented reform and privatization. Many SOEs listed on the exchanges, but as the Chinese government wanted to retain control, the majority shares held by the state were nontradable. The SIPs could best be labeled as "partial", because they transferred only a small portion of SOE ownership to public investors and did little to lessen the state's dominant role in corporate decision making (Liao, Liu, and Wang, 2014). Sun and Tong (2003) study the performance

24 Some studies provide evidence that SOEs continued to over-invest in later periods. Liu and Siu (2011) study >36,000 Chinese firms during 2000–05 and find that SOEs used a much lower discount rate to guide their investment decisions than non-SOEs. That is, SOEs overinvested. More recently, in the wake of the 2008 global financial crisis, the Chinese government ordered state-owned banks to lend and ordered centrally controlled nonfinancial SOEs to invest. However, Cong *et al.* (2019) find that during the stimulus plan years (2009–10), more bank credit flowed to firms with lower initial average capital productivity, and around 70% of this misallocation was driven by credit reallocation from private firms to SOEs. This is similar to Duchin and Sosyura's (2012) finding that political connections led to inefficient government bailouts in the USA. Furthermore, Deng *et al.* (2015) show that SOEs' primary response to the increased funding was simply to make highly leveraged purchases of real estate, even though they had no experience in property development.

of 634 SIPs during 1994–98. Immediately after the exchange listings, SOEs' earnings, real sales, and employee productivity rose, but returns on sales and earnings on sales declined. Therefore, the authors conclude that SIPs had "only limited success".

Sale of shares by the state controlling shareholder to private investors is also a form of privatization. From the mid-1990s, the state began to allow the controlling nontradable ownership stake to be sold to private investors via negotiated transfer, marking a new stage in the privatization of SOEs. Chen *et al.* (2008) study 156 control transfers that took place during 1996–2000. In sixty-two cases, control was transferred from state entities to private entities, while in ninety-four cases, control was merely transferred from state entities to other state entities. Given that private owners have cash flow rights, while state shareholders may not, the authors hypothesize that firm performance improves when control is transferred to private entities.[25] They find evidence consistent with their hypothesis. The sources of the improvements brought by private investors include CEO turnover, labor cost reductions, and changes in industry (private entities often merged their own private businesses into their acquired firms, and therefore, the firm changed its primary industry).

There are many other methods of partial privatization, including direct sales to inside managers, direct sales to outside investors, public offerings, joint ventures, leasing, and employee shareholding. Among these methods, management buyouts (MBOs) transfer the most control rights to private owners (managers), so the government provides the least support (in the forms of subsidies, loans, and protected entry) to the buyers and imposes the most stringent budget constraints on them. For other privatization methods, the government tends to retain its influence in key corporate decisions. Surveying about 3,000 firms in more than 200 Chinese cities, Gan, Guo, and Xu (2018) study choice of privatization method and its outcomes. They find that cities with the least pressure to maintain excess labor and with strong fiscal capacity are more likely to choose MBOs. The new private owners restructure their firms by turning over management teams, strengthening manager incentives through new compensation policies, establishing boards of directors, and introducing international accounting standards and independent auditing. As a result, the performance of MBO firms (operating profits over assets and operating profits over the number of employees) significantly improves after their privatization. Other privatization methods do not yield statistically detectable improvement in firm performance.

The split-share structure reform initiated in 2005, which is thought to be the second most important privatization, further diluted the state-owned shares in listed SOEs. Li *et al.* (2011) document that average compensation from NTS holders amounted to a 30% increase in the number of shares held by TS holders. Thus, the shares held by the state controlling shareholder were diluted by the reform. Liao, Liu, and Wang (2014) find that SOEs' performance (output and profit) increased substantially after the reform because the interest of government agents became better aligned with the interest of public investors. They find that privatization-led improvements to post-reform SOE performance correlate positively with government agents' support (asset injection) to SOEs and financing opportunities.

25 Chen *et al.* (2008) use many variables to measure performance, such as operating ROA, ratio of operating cash flows to assets, return on sales, asset turnover, ratio of cost to sales, ratio of capital expenditure to fixed assets, employment, sales per employee, assets per employee, and sales growth.

However, SOEs may be reluctant to be privatized. In China, the state can provide subsidies, favorable tax treatment, industrial license approvals, and loans—what Shleifer and Vishny (1998) call the government's "helping hand". Therefore, when firms lose their connection to the government, they may find it difficult to generate sustainable profit. Offering strong evidence for this view, Calomiris, Fisman, and Wang (2010) study a surprise announcement on July 24 2001, when four partially privatized SOEs announced that their state shares would be sold in the A-share stock market. Because these sales could dilute the value of A-shares, the authors study the announcement effect by considering B-share returns. The China B-share index declined by 10.5% during a 3-day window surrounding the announcement. That is, shareholders feared the loss of the state's helping hand. On June 23 2002, the SOEs suddenly canceled their plans to sell their state shares, and the B-share index increased by 12.7% during the 3-day window surrounding the announcement. Cheung, Rau, and Stouraitis (2010) study RPTs between partially state-owned publicly listed firms and their wholly state-owned controlling shareholders during 2001–02. They find that minority shareholders benefit from RPTs with central government shareholders.

Overall, despite undergoing a series of reforms, including partial privatization, SOEs continue to underperform, especially compared to non-SOEs. For example, in 2015, the median ROAs of listed SOEs and non-SOEs were 2.2 and 3.5%, respectively (Jiang, Jiang, and Kim, 2017). This difference is economically large. Note that the underperformance of SOEs is not mainly the result of expropriation by the state controlling shareholder because the state does not have a strong incentive to tunnel (Jiang and Kim, 2015). Although the state's objective of maintaining social stability sometimes departs from value maximization and may harm the interests of minority shareholders, in many cases, SOEs enjoy a variety of compensating benefits, such as preferential bank loans and more government subsidies (Lin and Tan, 1999; Gan, Guo, and Xu, 2018). Thus, on balance, the conflict of interest between the state and minority shareholders is far less detrimental to SOEs than are the agency problems surrounding SOE managers.

4.2 SOE Managers: Problems, Incentives, and Monitoring

It is important to clarify who manages Chinese SOEs. The answer is not obvious. SOE chairs are appointed by the state, and they are explicitly tasked with running the firm. Therefore, research about managers in SOEs should place greater emphasis on the board chair than the CEO. Many SOE chairs give themselves the CEO title. Even when the chair is not the CEO, she/he is still the controller. Hence, in this article, we use the expressions "SOE managers" and "SOE chairs" interchangeably.

Agency problems involving SOE managers can be categorized into two types. First, owing to the Chinese government's unique promotion system for SOE executives, SOE managers prioritize the interests of the state controlling shareholder above those of minority shareholders, thereby sometimes benefiting the former and harming the latter. In other words, this type of agency problem can trigger conflicts between SOE managers and minority shareholders but not between SOE managers and the state controlling shareholder. Overinvestment (Liu and Siu, 2011; Deng *et al.*, 2015; Cong *et al.*, 2019) and higher tax payments (Bradshaw, Liao, and Ma, 2019) by SOEs are telling examples.

Second, because most SOE managers do not own many or any shares in their firms (Jiang and Kim, 2015), they may have incentives to use their control to serve their own interests, to the detriment of both state controlling shareholders and minority shareholders—behavior akin to the vertical principal–agent problem common in Western countries. SOE managers may be tempted to expropriate wealth from their firms as the state owner does not actively oversee day-to-day operations. For example, during partial privatization, SOE managers may have an incentive to manage earnings to drive down the price of shares sold to private investors (Shleifer and Vishny, 1992, 1993), because undervaluing the firm's assets makes it easier for managers to extract private rents later. Fisman and Wang (2015) study such corruption during negotiated transfers of NTSs in Chinese partially privatized SOEs. The study focuses on transfers in which the underlying seller (owner of the listed firm's NTSs) is an SOE but disguises itself as a private firm. Since sales by private firms face less regulatory scrutiny, SOE managers, who can dispose of state assets but do not bear the costs of low transfer price, then underprice the transfer in exchange for side payments or sell the assets to friends or family. The authors find that transfers by these "disguised" sellers are discounted by 5–7 percentage points more than transfers by SOE sellers that have honestly represented their ownership. Moreover, these discounted and disguised transfers are followed by increases in insider tunneling (RPTs) and not associated with improved profitability (ROA). The SOE managers eventually harm both the state and minority shareholders.

Resolving the agency conflict between state controlling shareholders and SOE managers differs from resolving the agency conflict between minority shareholders and SOE managers. Minority shareholders, having little power to exert effective corporate governance over SOE managers, must rely on strong laws and regulations to protect their interests and rights (see Section 3). However, the state controlling shareholder can set incentives for, give rewards to, and exercise supervision of SOE managers.

One common way to align managers' interests with shareholders' interests is to tie pay to performance; many studies on US firms find that CEO compensation is positively correlated with firm performance (e.g., Edmans, Gabaix, and Jenter, 2017). However, in China, SOE managers are not incentivized by pay. Ke, Rui, and Yu (2012) study manager pay at state-controlled A-share, H-share, and Red Chip firms. A-share (H-share) firms are incorporated in China and listed on the Chinese (HK) stock market. Red Chip firms are incorporated outside of mainland China and listed on the HK stock market. As we explain briefly in Section 3, investor protection is stronger in HK than in mainland China. Ke, Rui, and Yu (2012) find little (some) manager pay-for-performance sensitivity for A-share and H-share (Red Chip) firms—and *no* sensitivity of manager turnover to performance for any of these state-controlled firms. That is, Chinese SOE managers are not paid much more for good performance, even if the SOE is listed in a stock market with strong investor protection, nor are they fired for poor performance.

What about other forms of Western-style managerial incentive compensation, like stock and stock options? Chen, Guan, and Ke (2013) study executive stock option grants to SOE managers of state-controlled Red Chip firms. Given that SOE managers are not incentivized by pay (Ke, Rui, and Yu, 2012), one might ask why these options are granted in the first place. Chen, Guan, and Ke (2013) find that large foreign investors in HK pressure these firms to adopt executive stock options. However, once the options become vested and are in the money, the SOE managers do not exercise them. The authors find no correlation between option grants and subsequent firm performance.

Instead, managers' main incentive is political promotion. First, in China, whose government dominates the economy, high political ranking can bring huge benefits, such as privileges, perks, and social status. Second, as many SOE managers are government bureaucrats with training and experience only in the state sector, they have almost no outside opportunities (Chen, Guan, and Ke, 2013). Thus, the incentive for doing a good job as a SOE manager is to get promoted to a high-level government position (Jiang and Kim, 2015). Cao *et al.* (2019) study the relationship between political promotion and firm performance of Chinese SOEs during 2005–11. They find that the likelihood of an SOE manager's receiving a political promotion increases with firm performance. Furthermore, manager pay-for-performance sensitivity is higher when the SOE manager has a lower likelihood of receiving a political promotion—that is, incentives for political promotion substitute for explicit compensation incentives. This is similar to Gibbons and Murphy's (1992) finding of career concerns substituting for compensation incentives in the USA.

However, the motivation of a manager's political promotion may harm minority shareholders, whose interests sometimes run counter to those of the state. Bradshaw, Liao, and Ma (2019) find that SOEs exhibit less tax avoidance than non-SOEs (at the expense of minority shareholders), and that SOE tax rates are positively associated with the promotion frequencies of SOE managers. That is, promising SOE managers political promotion if they meet state objectives may only exacerbate the agency problem.

If the promise of political promotions incentivizes SOE managers to enhance firm performance, can minority shareholders rely on the government to evaluate SOE managers effectively? Since 2004, the SASAC has been charged with appointing and evaluating SOE managers. If it monitors effectively, then all shareholders will benefit. However, recent research raises doubt about the SASAC's ability to evaluate SOE managers objectively, accurately, and effectively. Du, Tang, and Young (2012) study the SASAC's performance evaluation of sixty-three SOEs during 2005–07. They find that SOE managers receive higher evaluation scores, ratings, and ex-post score adjustments when managers have political connections, the firm is geographically near the central SASAC office, the SOE fulfills state objectives, and/or the SOE has a high political rank.[26]

In particular, subjectivity in the SASAC's appraisal process manifests in its discretionary adjustment of the appraisal criteria. For example, in 2010, the SASAC replaced ROE with economic value added (EVA) as one of the measures used in the formula to compute initial performance scores for SOEs. Although the intention was to improve capital efficiency, this change opened the SASAC to allegations of manipulation. Du *et al.* (2018) study the performance evaluation of eighty-two SOEs during 2007–12. They find that when EVA is unfavorable but ROE is favorable, the SASAC shifts more weight back to ROE from EVA. The authors argue that the SASAC makes these adjustments in the interest of fairness, and perhaps partially because its members do not understand the importance of what EVA captures. However, tellingly, these adjustments are more pronounced for SOEs with political connections and SOEs located geographically near the central SASAC office.

5. CSR in China

Above, our central concern has been outside investors. However, many people believe that companies have a responsibility to all their stakeholders, including society at large, not only

26 Chinese SOEs are classified by administrative rank. Du, Tang, and Young (2012) use two criteria to code the political rank of individual SOEs: whether an SOE is a "vice-ministerial level" firm and whether the Organization Department of the CPC Central Committee assigns its CEO.

shareholders. Is CSR important in China? If so, then does it improve shareholder value, and what are the factors leading to improved CSR?

Since managers, shareholders, and creditors do not suffer directly from negative externalities created by firms (e.g., environmental damage and poor labor conditions), it is usually ordinary citizens who call on government to regulate or tax such behavior. Is CSR important to ordinary Chinese citizens? Given that China is still a developing economy, they may not currently be in a position to make social concerns a high priority. Bartling, Weber, and Yao (2014) experimented using college students in Zurich, Switzerland, and Shanghai, China. Almost half of the Zurich students were willing to purchase a high-priced good as long as the firm's production process did not damage a third party. In other words, Zurich students were willing to share the firm's CSR cost. Among Shanghai students, only 16% were willing to buy the high-priced product. One reason for the difference may be different perceptions about fairness. However, to conclude from this result that Chinese people do not care about social concerns would be premature. Chinese consumers may simply feel that either the firm or the government should bear the costs and burden of social responsibility.

When firms embrace social responsibility on their own, it is always unclear whether they are truly interested in making a social impact or whether they are merely concerned with their reputations and long-run profits. Skeptics may argue that firms engage in CSR only when it is profitable to do so. Lins, Servaes, and Tamayo (2017) find that high-CSR firms were much more profitable than low-CSR firms during the 2008–09 financial crisis, when trust in corporations dropped. Edmans (2011) finds that firms with satisfied employees enjoy long-run stock outperformance. However, given that CSR activities are not costless, whether CSR leads to profitability and higher firm values has been a subject of longstanding debate (e.g., McWilliams and Siegel, 2000; Servaes and Tamayo, 2013).

Does CSR improve shareholder value in China? On the one hand, engaging in CSR may harm the interest of shareholders, since CSR is driven primarily by political and social factors rather than economic considerations. Chen, Hung, and Wang (2018) find that firms affected by China's mandatory CSR disclosure regulation in 2008 increased CSR spending but decreased profitability, as reflected in a decrease in ROA, ROE, sales revenue, and capital expenditure and an increase in operating costs and impairment charges. On the other hand, CSR may create value for shareholders by nurturing political connections. Since government officials are evaluated by measures of regional economic development and social welfare, listed firms might enjoy more political privileges if they were to help these officials meet such requirements. Lin *et al.* (2015) find that firms that increase CSR (proxied by corporate charity donation) to build new political connections after mayoral transitions are subsequently more likely to receive government subsidies than firms that do not. The donating firms also have better future performance as measured by ROE, ROA, and return on sales.

These findings shed light on the role that the Chinese government plays in improving CSR. In fact, the government is likely the most important promoter of CSR in China. Since public concern regarding environmental issues has grown rapidly in China along with the growth of its manufacturing sector and economy, the government has adopted a series of actions to improve CSR. The January 2002 Code of Corporate Governance for Listed Companies of China,[27] for example, includes a specific chapter concerning CSR, called

27 http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.html

"Stakeholders", which is renamed "Stakeholders, environmental protection and social responsibility" in a September 2018 revision.[28] According to the 2006 General Meeting of the Central Commission of the Chinese Communist Party, a key goal of Chinese socialism is "building a harmonious society". Meanwhile, the Company Law of the People's Republic of China revised in 2005 has the following general provision: "In its operational activities, a company shall abide by laws and administrative regulations, observe social morals and commercial ethics, persist in honesty and good faith, accept supervision by the government and the public, and assume social responsibility".[29]

For now, these regulations launched by the government have been shown to lead to improved CSR (Chen, Hung, and Wang, 2018; Zhang, Chen, and Guo, 2018). As Chen, Hung, and Wang (2018) note, the government first mandated CSR disclosure by a subset of listed firms in 2008. The authors find that this disclosure requirement led to a significant decrease in subsequent pollution by affected firms, indicating an increase in spending on CSR activities. In addition, supervision from the central government enhances the environmental enforcement of local government, which can be weak because of the decentralization of environmental regulation, as part of the state power delegation mentioned in Section 4. To solve this problem, in 2007, the central government launched a National Specially Monitored Firms program, which placed industrial polluters under special monitoring at the national level. Zhang, Chen, and Guo (2018) find that this direct central supervision reduced industrial water pollution by at least 27%. The authors suggest that central government supervision and local government enforcement are necessarily complementary, and lead to a better outcome overall.

China will continue to emphasize CSR as its economy continues to grow in both size and importance, especially as air quality, food safety, human rights, and corporate misconduct come under the spotlight. Nevertheless, CSR activities are costly in China (Chen, Hung, and Wang, 2018), because Chinese consumers currently seem unwilling to share the cost of CSR (Bartling, Weber, and Yao, 2014) and because some firms engage in CSR merely to nurture political connections (Lin *et al.*, 2015). Thus, it appears that China must continue, at least for now, to rely on the government to promote CSR. At this stage, the government seems to be somewhat effective at doing so (Chen, Hung, and Wang, 2018; Zhang, Chen, and Guo, 2018). However, there is a long way to go for firms to be truly interested in CSR. As Edmans (2011) points out, it may take time for shareholders to realize the benefits of CSR. We believe that shareholders in China will gradually recognize the importance of CSR and invest more in it.

6. Conclusion and Directions for Future Research

China's corporate governance problem stems from its concentrated ownership structure and imperfect law and regulations. Given this typical ownership structure, the main agency problem in China is the conflict of interest between the controlling shareholder and minority shareholders. The controlling shareholder holds power through control of the board and managers, and many monitoring mechanisms that are arguably effective in developed countries do not work well in China. Thus, law and institutions are particularly important. In recent decades, legal protection of investors has improved a lot. For SOEs, corporate

28 http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/DepartmentRules/201904/P020190415336431477120.pdf

29 http://english.sse.com.cn/laws/framework/c/3978492.pdf

governance is more complicated, since they face conflict of interest between the state and listed firms, as well as agency problems involving SOE managers. As to CSR, government is likely the most important promoter in China.

While research to date has provided much insight on corporate governance in China, there are still many potential topics for future research, especially as China continues to transition from a control economy to a market economy, and as corporate governance in China continues to evolve. Here, we provide a brief agenda.

First, the effect of the political system should be emphasized. Corporate governance mechanisms that prove effective in capitalist countries may differ from those in China. The political system of China is typically socialist, and under the new political leadership in China, SOEs have come under tighter control by the state. The new leadership's massive anticorruption campaign raises the question of whether a less corrupt government will lead to less corrupt SOEs. Shleifer and Vishny (1997) point out that political pressure is just as important as economic pressures in shaping corporate governance systems. Roe (2003) argues that politics played a greater role than economic efficiency did in shaping US corporate law. What effects will the current political leadership's objectives have on corporate governance in China? Will the mechanisms behind these effects be different from those in Western countries? Answering these questions might help build a new corporate governance model, say a Chinese model, alongside the current Anglo-American and German–Japanese models.

Second, the heterogeneity of controlling shareholders should be taken seriously. SOEs account for around two-thirds of market capitalization in China, and they are very different from non-SOEs in many respects, including primary tasks (Lin, Cai, and Li, 1998; Bai, Lu, and Tao, 2006), financing and investment (Liu and Siu, 2011), and performance (Jiang, Jiang, and Kim, 2017). Thus, corporate governance in SOEs is largely different from that in non-SOEs, as we explain in Section 4. However, many studies have simply included a dummy in their regression models to designate SOEs versus non-SOEs. A more appropriate strategy is to separate these two types of firms as sub-samples when conducting analyses. For example, to study the effect of political connections, we should focus on non-SOEs since all SOEs are naturally politically connected; and to study the effect of government intervention, we should recognize that the mechanisms used in SOEs and non-SOEs are completely different because the government is the controlling shareholder of SOEs while in non-SOEs it is an outsider. Thus, separate analyses on these two types of firms could provide a clearer picture of corporate governance in China.

Third, studies on institutional investors need to consider investor heterogeneity. Firth, Lin, and Zou (2010) find that mutual funds are ineffective monitors in China, but the Wind database identifies eleven other types of institutional investors, including private equity, insurance companies, trust companies, financial companies, nonfinancial listed companies, state asset management, and so on.[30] Do any monitor firms? Using a cost–benefit framework and US data, Chen, Harford, and Li (2007) find that independent institutions with long-term investments do monitor. For China, we do not even know which institutions are longer term investors, let alone whether and how they monitor. Perhaps it is difficult for institutional investors to influence firms in China today, but as they become larger, research should revisit their investing and monitoring behavior (e.g., collaboration among several large institutional investors to monitor firms). Moreover, although no single institutional

30 Wind's website (in English): www.wind.com.cn/en/about.html

investor is permitted to own >10% of a listed firm's shares, the shares institutional investors hold allow them to place directors on the board, and this is currently happening, as shares held by controlling shareholders gradually decrease. Exit is another important way for shareholders to monitor in addition to voice, and institutional investors may govern through exit. We need to know more about these questions to deepen understanding of the role of institutional investors.

Fourth, we need to learn more about the role that legal protection plays in corporate governance. China has long been criticized for its weak investor protection (Allen, Qian, and Qian, 2005), though legal protection is one of the most important solutions for agency problems in China. However, in recent years, law, institutions, and regulations have improved significantly, and have largely increased the costs of violation. While previous studies provide evidence of the effective role that some specific regulations play in corporate governance (Chen, Ke, and Yang, 2013; Lennox, Wu, and Zhang, 2014; Berkowitz, Lin, and Ma, 2015), a broader question is how corporate governance in China is influenced or shaped by the costs of violation. Papers on law and finance rarely discuss punishment, which seems like a glaring omission. A time-series study, or a cross-province study, or even a cross-country study, in which punishment for white-collar crimes vary may yield insight into whether a "big stick" can deter inside controllers from engaging in self-serving behavior to the detriment of outside investors.

Fifth, it is important to examine the interaction between corporate governance and stock markets. China is now the second largest stock market and has the highest fraction of the world's largest 500 companies[31]; thus, it provides a good opportunity to study how corporate governance affects and is affected by stock markets. For example, the increased liquidity on the stock market after the split-share structure reform strengthens the links between real and stock market performance, improves real corporate activities, and eases firms' external equity finance (Campello, Ribas, and Wang, 2014; Liao, Liu, and Wang, 2014). Conversely, corporate ownership structure and political connections may influence the amount of firm-specific real information incorporated in stock prices (Gul, Kim, and Qiu, 2010; Piotroski, Wong, and Zhang, 2015). Many other interesting subjects are still under debate. For example, will investors price SOEs and non-SOEs differently? Will agency problems be alleviated by other stock market reforms, like the recent commencement of short selling? How does ownership structure dynamically interact with stock liquidity? Further research can utilize the unique features of corporate governance and stock markets in China.

Sixth, the market for corporate control can be explored further. While this market in China has been quite dormant given the concentrated ownership, M&A volume in China has been growing over time, as Chinese firms are increasingly acquiring nonlisted firms and foreign firms. Jiang, Jiang, and Kim (2017) report that recently, each year, more than one-third of listed firms have acquired another firm. While these acquired firms are not Chinese-listed firms, could this rise in M&A activity in general, and foreign acquisitions in particular, eventually change the governance practices of the acquiring firms? Might these

31 In 2019, there were 129 Chinese firms and 121 US firms in the list. https://enapp.chinadaily.com.cn/a/201907/24/AP5d376510a3106b83cdbf8a27.html

changes eventually spill over to other listed firms? More importantly, would underperformance increase the likelihood of takeover? Do takeovers create value, and how does corporate governance affect the returns to takeovers? Sophisticated analyses of these takeovers could at least provide some insights for the market for corporate control in China.

Seventh, more research is needed to understand the role of banks. In China, banks are the dominant providers of capital to firms (Jiang, Jiang, and Kim, 2017) and therefore have the potential to be effective monitors. Surprisingly, little research has been conducted on the governance role of banks in China. Bailey, Huang, and Yang (2011) find that the Chinese banking system is subject to political goals, so that poorly performing firms are likely to obtain bank loans and be kept afloat. However, their findings are based on only 285 publicly announced bank loans between 1999 and 2004—before the transition from wholly state owned to shareholder owned corporations and the public listing of the Big 4 state banks from 2004 to 2010; before the loosening of many restrictions on foreign banks, including the full opening to foreign banks' involvement in the RMB business in 2006; and before the introduction of nonstate-owned banks in 2014. Given this dramatic evolution of the Chinese banking system, the corporate governance role of state-owned, private-owned, and foreign banks requires sophisticated analysis. Moreover, shadow banking activities in China have grown tremendously in recent years.[32] The fact that most lending firms in the shadow banking system are not financial firms raises not only the question of whether they can properly monitor borrowers but also concern about the diminution of the banks' role as potential monitors. While the shadow banking system continues to flourish, more studies are needed on the relationship between the official banking system and the shadow banking system, and the role of law in both.

Eighth, the corporate governance of unlisted firms needs to be explored. Even though there are more than 3,000 listed firms in China, the listed sector is merely the tip of the iceberg. There were more than 30 million registered corporations at the end of 2018, according to statistics from the China State Administration for Market Regulations. Do unlisted firms suffer more or less than listed ones do from agency costs? What do their boards look like, and are they effective? Where does their debt come from, and do creditors actively and effectively monitor them? Where does their equity come from, and do these equity providers actively and effectively monitor? Jiang, Jiang, and Kim (2017) state that venture capitalists and private equity investors are becoming important investors in young, fast-growing firms in China, but we do not know what roles they play. Do they actively monitor, or are they just passive investors? What rules and regulations pertain to unlisted firms, who are the enforcers, and are they effective? It is possible that listed firms can learn lessons from unlisted firms, and vice versa.

Ninth, there should be more attention paid to changes in law and regulations, and to exogenous policy shocks. While China has been developing rapidly during the past three decades, changes in law and regulations and exogenous policy shocks provide opportunities for

32 A major feature of shadow banking is the entrusted loan, in which a privileged nonbank firm (such as a large industrial SOE) with access to cheap capital lends to a less privileged nonbank firm (such as a small or medium sized non-SOE). A bank plays the role of a servicing agent, in exchange for a fee, but does not bear the investment risk. See Allen *et al.* (2019) for an overview of China's shadow banking system.

researchers to address endogeneity problems. Already, many studies have exploited China's privatizations of SOEs (Fang, Lerner, and Wu, 2017; Bradshaw, Liao, and Ma, 2019) and split-share structure reform (Chen *et al.*, 2012; Campello, Ribas, and Wang, 2014) as identification methods. While most studies in corporate governance suffer from serious endogeneity issues and many early studies do not take these issues seriously, new opportunities for identification deserve more attention.

Last, there should be more attention to how corporate governance has contributed positively to the prosperity of Chinese corporations and the Chinese economy in the past several decades. Some studies have found that improvement of law and regulations has positively affected Chinese corporations; what about other factors? For example, RPTs can be used to prop up a company facing negative industry earnings shocks (Jian and Wong, 2010), which suggests that under some circumstances, controlling shareholders could be problem-solvers rather than problem makers. Many studies criticize *guanxi* (informal social networks and personal connections) for the costs it imposes on firms, especially on minority shareholders (Berkman, Cole, and Fu, 2010; Piotroski and Zhang, 2014; Guan *et al.*, 2016; Brockman, *et al.*, 2019). However, it also improves efficiency—for example, by reducing information asymmetry and thereby reducing adverse selection in the appointment of CEOs or other top managers. Such positive experiences could be particularly instructive for other emerging markets.

Overall, a great deal of literature has studied corporate governance in China, and more and more papers have been accepted by top journals. However, many fields are still in their infancy, and many important and interesting subjects are still worth investigating as the real economy develops, data become available, and new opportunities open up for identification strategy. We hope that this survey attracts more interest on this topic, and stimulates more researchers to study corporate governance in China.

Appendix A: Identification Strategies

This appendix presents the identification strategies used to address endogeneity concerns in the papers (concerning corporate governance in China) we discuss in this survey. We list the strategies and show a tick in the corresponding columns if the authors explicitly state that they use the relevant method to address endogeneity issues or to identify the causal relationship. Since some of the studies do not mention how they deal with endogeneity, we do not report them in this appendix. Column *IV* indicates use of an instrumental variable. Column DID indicates use of the difference-in-differences method. Column RDD indicates use of a regression discontinuity design. Column FE indicates use of fixed effects. Column MM indicates use of the matching method. Column ES indicates use of an event study. Column Others indicates other strategies, including adding explanatory variables; using an alternative proxy, an alternative regression model, subsample analysis, or a placebo test; or giving reasons why there are no endogeneity concerns. Column Description presents detailed information of the methods used, including the specific instrumental variable(s) in the IV approach, the exogenous treatment in the DID methods, the cut-off in the RDD design, the level(s) of fixed effect in the FE approach, the specific matching method in the MM methods, and the event in the ES approach. We list the papers alphabetically.

Paper	Description	IV	DID	RDD	FE	MM	ES	Others
Bai, Lu, and Tao (2006)	DID: Privatization (single difference)	–	√	–	√	–	–	–
Berkman, Cole, and Fu (2010)	ES: Three regulations designed to improve protection for minority shareholders	–	–	–	–	–	√	–
Bradshaw, Liao, and Ma (2019)	(1) IV: CPC Meeting, Split share structure reform, regulated industries; (2) DID: Privatization (industry matched); (3) MM: PSM	√	√	–	–	√	–	√
Brockman and Chung (2003)	MM: PSM	–	–	–	–	√	–	–
Brockman *et al.* (2019)		–	–	–	–	–	–	√
Cai, Jiang, and Kang (2019)	(1) IV: Severe weather; (2) FE: Firm/proposal level; (3) MM: PSM	√	–	–	√	√	–	–
Calomiris, Fisman, and Wang (2010)	ES: Announcement of proposed sales of government-owned shares and cancellation of this plan 11 months later	–	–	–	–	–	√	√
Campello, Ribas, and Wang (2014)	Generalized PSM matched DID: Split share structure reform	–	√	–	–	√	–	–
Cao *et al.* (2019)	IV: Central government turnover, central state ownership	√	–	–	–	–	–	√
Chen *et al.* (2012)	DID: Split share structure reform	–	√	–	–	–	–	√
Chen *et al.* (2008)	DID: Changes of ownership (single difference)	–	√	–	–	–	–	–
Chen, Hung, and Wang (2018)	PSM matched DID: Mandatory CSR reporting	–	√	–	–	√	–	–
Chen, Ke, and Yang (2013)	DID: Segmented voting regulation (single difference)	–	√	–	–	–	–	√
Cong *et al.* (2019)		–	–	–	–	–	–	√
Ding *et al.* (2020)	ES: Announcement of inspections of provincial governments by the CCDI	–	–	–	–	–	√	–
Fan, Wong, and Zhang (2007)		–	–	–	–	–	–	√
Fang, Lerner, and Wu (2017)		√	√	–	–	√	–	√

(continued)

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Paper	Description	IV	DID	RDD	FE	MM	ES	Others
	(1) IV: The number of Christian colleges, British settlement; (2) PSM matched DID: The privatization of SOEs							
Fisman and Wang (2015)		–	–	–	–	–	–	√
Gan, Guo, and Xu (2018)	(1) IV: % SOE employment, fiscal revenue/GDP, government allocation of land, loan guarantees; (2) DID: Change of control right; (3) FE: City-by-year level	√	√	–	√	–	–	√
Gao *et al.* (2019)	DID: 2009 partial bank entry deregulation	–	√	–	–	–	–	–
Giannetti *et al.* (2017)	DID: Launch of the Chinese anti-corruption campaign in 2012	–	√	–	–	–	–	√
Giannetti, Liao, and Yu (2015)	(1) IV: Staggered provincial policies to attract highly skilled emigrants; (2) FE: Firm/province level	√	–	–	√	–	–	√
Groves *et al.* (1994)	(1) IV: 1 or 2-year lagged bonus payments and contract workers; (2) FE: Firm level	√	–	–	√	–	–	√
Guan *et al.* (2016)	(1) IV: Sum of percentile ranks of a firm's executive team, where the rank for each executive is based on the number of managers and auditors graduating from his/her school; (2) FE: Firm level; (3) MM: PSM	√	–	–	√	√	–	√
Gul, Kim, and Qiu (2010)	IV: Likelihood of Big 4 auditor choice	√	–	–	–	–	–	–
Hope, Wu, and Zhao (2017)	(1) DID: Split share structure reform; (2) FE: Firm/year/industry level; (3) MM: PSM	–	√	–	√	√	–	–
Hope, Yue, and Zhong (2019)	(1) DID: Rule 18 issued by the CPC; (2) MM: PSM; (3) FE: Firm/year level	–	√	–	√	√	–	√
Huang and Ke (2018)	DID: Regulatory reform (single difference)	–	√	–	–	–	–	–
Huyghebaert and Xu (2016)	DID: Investment banks become fully responsible for fixing IPO offer prices	–	√	–	–	–	–	–

(continued)

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Paper	Description	IV	DID	RDD	FE	MM	ES	Others
Jia, Shi, and Wang (2013)	FE: Firm/year level	–	–	–	√	–	–	–
Jiang *et al.* (2017)	(1) DID: Ownership structure transitions; (2) FE: Firm/year/industry level; (3) MM: PSM	–	√	–	√	√	–	–
Jiang, Wan, and Zhao (2016)	FE: Proposal level	–	–	–	√	–	–	–
Ke, Lennox, and Xin (2015)	MM: PSM	–	–	–	–	√	–	√
Ke, Rui, and Yu (2012)	–	–	–	–	–	–	–	√
Lennox, Wu, and Zhang (2014)	–	–	–	–	–	–	–	√
Li (1997)	IV: Changes in quota allocations, market price inflation in the intermediate inputs	√	–	–	–	–	–	–
Liao, Liu, and Wang (2014)	DID: Split share structure reform (size and industry portfolio matched/size and M/B ratio portfolio matched)	–	√	–	–	√	–	–
Lin *et al.* (2015)	(1) IV: Mayor's age; (2) DID: Turnover of mayors (single difference)	√	√	–	–	–	–	–
Lin *et al.* (2018)	ES: Announcement of the "Eight-Point Policy"	–	–	–	–	–	√	–
Liu and Siu (2011)	–	–	–	–	–	–	–	√
Piotroski and Zhang (2014)	–	–	–	–	–	–	–	√
Sun and Tong (2003)	–	–	–	–	–	–	–	√
Wang *et al.* (2015)	ES: IPO events of 636 non-state-controlled firms	–	–	–	–	–	√	–
You, Zhang, and Zhang (2018)	IV: Hometowns of newspaper editors, introduction of high-speed rail between media and firms	√	–	–	–	–	–	–
Yan (2019)	DID: Issuance of Regulation No. 18 (Rule 18)	√	–	–	–	–	–	√
Zhang, Chen, and Guo (2018)	RDD: The 65th percentile of firms ranked by their amount of water pollutants discharged in 2005	–	–	√	–	–	–	–

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