

# Globalization and the Corporate Governance of Chinese Non-Financial Enterprises

---

Lawrence J. Lau, Ph. D.

President and Ralph and Claire Landau Professor of Economics  
The Chinese University of Hong Kong  
and

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

The Chinese University of Hong Kong Faculty of Business Administration Forum  
“Globalization-The Challenges and Opportunities to Corporate Governance in China”  
Beijing, January 19, 2008

Phone: (852) 2609-8600; Fax: (852) 2603-5230

Email: [LAWRENCELAU@CUHK.EDU.HK](mailto:LAWRENCELAU@CUHK.EDU.HK); WebPages: [HTTP://WWW.CUHK.EDU.HK/VC/](http://www.cuhk.edu.hk/vc/)

# A Preview

---

- ◆ Introduction
- ◆ The Impact of Globalization
- ◆ Corporate Governance in Enterprises with Many Shareholders
- ◆ The Advantages of an Active Controlling Shareholder
- ◆ Concluding Remarks

# Introduction

---

- ◆ In developed market economies, the corporate form of publicly listed enterprises, typically with many shareholders, has evolved over time and many features mandated by the regulatory and supervisory agencies are supposed to assure good corporate governance.
- ◆ However, not infrequently, a publicly listed enterprise has only the form but not the substance of good corporate governance.
- ◆ Despite the adoption of the publicly listed corporate form by an enterprise, good corporate governance cannot be taken for granted, even in the most developed market economies. The failure of the Enron Corporation in the United States and Parmalat in Italy, and the huge losses suffered by the many commercial and investment banks in the West as a result of the sub-prime mortgage loans and their derivative securities, are recent examples.
- ◆ Poor corporate governance can result in large losses for the enterprise, and even bankruptcy and closure, wiping out completely the shareholders' equity and the jobs and perhaps even the pensions of all the employees.

# The Impact of Globalization

---

- ◆ At the macroeconomic level
  - ◆ Increasingly the economies of the world tend to move together synchronously. This high covariance across economies greatly reduces the possibility of diversification of risks.
  - ◆ The global integration of the capital market magnifies problem of the herd instinct (the blind following the blind!).
- ◆ At the microeconomic level
  - ◆ Increased competition
  - ◆ Increased opportunities
  - ◆ Increased volatility (prices, demands, supplies)
  - ◆ Increased risks (credit, customers, suppliers, exchange rates)
- ◆ On the capital market
  - ◆ More diffuse and diverse ownership (domestic and foreign)
  - ◆ Increased competition with other enterprises, domestic and foreign, in the capital market for investors and potential investors

# What are the Implications for the Enterprise?

---

- ◆ Finding and focusing on core competence
- ◆ Continuous investment in innovation
- ◆ Need to act in a timely manner (information, delegation, and incentive structure)
- ◆ Hedging, managing and sharing risks (e.g., out-sourcing, avoiding currency mis-match and maturity mis-match induced by currency mis-match)

# What are the Challenges?

---

- ◆ How to design a system of remuneration and incentives so that the interests of the shareholders and the managers are as aligned as possible?
- ◆ How to assure that the focus is on the core competence and only on the core competence?
- ◆ How to encourage managers to think long-term?
- ◆ How to enable decisions to be made in a timely manner?
- ◆ How to avoid moral hazard?
- ◆ TO ACHIEVE THE ABOVE REQUIRES GOOD CORPORATE GOVERNANCE

# The Corporate Landscape in China

---

- ◆ China has two types of publicly listed enterprises—the one with an active, controlling public shareholder (often an unlisted state-owned enterprise), and one with an active, controlling private shareholder—Lenovo and Stone are two respective examples; as are Bank of China and Minsheng Bank.

# Corporate Governance in Enterprises with Many Shareholders

---

- ◆ These are several problems faced by enterprises with many shareholders—regardless of whether they are publicly listed—that prevent the achievement of full economic efficiency.
- ◆ Information asymmetry—the senior management of an enterprise typically has the best information and knowledge on the condition of the enterprise and on any investment project under consideration, followed by the lenders, with the small shareholders having the least information.
- ◆ Incentive incompatibility—even if information is perfectly symmetric, the rewards for success and penalties for failure for the senior management and the owner (shareholders) as well as their respective time horizons may be different, leading to possible conflicts of interest and inefficiency. (This is also known as the “principal-agent” problem.)

# Corporate Governance in Enterprises with Many Shareholders

---

- ◆ Moral hazard—because information is asymmetric, and monitoring is difficult and costly, the senior management of an enterprise has both the incentives and the opportunities to undertake hidden actions that are in its own interests but not necessarily in the interests of the shareholders. For example, the senior management usually has much to gain if an investment project succeeds but little to lose if an investment project fails. This encourages recklessness and the undertaking of projects with unduly high risks. Similarly, the high percentage “carry” (ranging from 20% to 44%) for hedge fund managers encourages excessive risk-taking.

# Corporate Governance in Enterprises with Many Shareholders

---

- ◆ The “Principal-Agent” problem has been widely studied, and there are so-called “optimal” contracts between the principal (owner or shareholders) and the agent (senior management). But in general, first-best efficiency cannot be fully achieved because of the differences in the objectives of the owner/shareholders and the senior management.
- ◆ This is really a matter of institutional design—how the structures of ownership and management of an enterprise and the division of gains and losses between them can and should be organized.

# Information Asymmetry

---

- ◆ Accurate, reliable and timely information is essential for the reduction of the degree of information asymmetry among the different players (and critical to good corporate governance).
- ◆ Important corporate decisions are generally reserved to the board of directors. But is there sufficient information for the members of the board, especially the non-executive independent ones, to make such decisions?
- ◆ Without adequate information, there cannot be effective risk control.
- ◆ Moreover, can important decisions be deferred until the next meeting of the board of directors?

# Incentive Incompatibility between Owners (Shareholders) and Managers

---

- ◆ This is a problem present in many countries in not only publicly listed enterprises, but also privately owned enterprises with professional managers.
- ◆ The incentives of the senior management are not necessarily the same as those of the shareholders and hence the policies adopted and the actions taken by the senior management may not be in the best interests of the shareholders.
- ◆ For example, senior management with relatively insignificant share ownership may want to invest regardless of whether the times are good or bad (since they have very little downside). Owners (shareholders) may wish to hold off for a better opportunity in the future.

# Incentive Incompatibility between Owners (Shareholders) and Managers

---

- ◆ Stock options for the senior management do not solve the problem because the senior management does not have any downside risks, only upside potential. Stock options thus encourage moral hazard and recklessness.
- ◆ Management-owned shares financed with loans with recourse can be a solution. A requirement on the senior management to own shares with a value significant relative to the individual net worth of the senior management and hence to participate in both the ups and the downs may be helpful. Managers with stock options tend to take higher risks than managers who own shares because the former have no downside.
- ◆ There is the possibility of mutual self-monitoring by senior executives if they all own significant stakes relative to their own respective individual net worth, in the enterprise .

# Moral Hazard

---

- ◆ The impossibility of continuous monitoring and of providing for all contingencies and the need for timely decisions imply the necessity of delegation and hence the agency problem: How should an incentive system be designed so that the senior management's interests and the shareholders' interests are more aligned? If interests are more aligned, monitoring will not be as necessary.
- ◆ It is not possible to rely solely on the monitoring and enforcement by the relevant regulatory and supervisory agencies.

# Internalization as a Solution

---

- ◆ Another obvious solution is “internalization”--if the senior management and the owner are actually one and the same person, then these problems are greatly reduced if not disappear altogether because the incentives of the principal (owner) and the agent (manager) are automatically aligned.
- ◆ Hence, in a family-owned and family-controlled enterprise, internalization can be achieved, and the inefficiency arising from the principal-agent problem can be greatly reduced.
- ◆ However, if the family-controlled enterprise is not wholly privately owned, but is publicly listed with minority shareholders, there needs to be safeguards on connected transactions between the family members and other entities owned by the family on the one hand and the enterprise on the other in order to protect the interests of the minority shareholders of the enterprise.

# Family-Controlled Enterprises versus Government-Controlled Enterprises

---

- ◆ One major difference between private and government-owned or controlled enterprises lies in their respective behaviour when mistakes are made. Private enterprises tend to correct quickly--they have to--whereas government-controlled enterprises continue to muddle through for a much longer time, frequently until the next government, because they have deeper pockets and can afford to and because of a general reluctance of government officials to own up to mistakes.
- ◆ When enterprises do well, there is not too much difference between the two types of enterprises, especially if they have good people running them. It is when they do not do well that they behave differently.

# Family-Controlled Enterprises versus Government-Controlled Enterprises

---

- ◆ The senior management of publicly listed but widely held and management-controlled enterprises has greater incentives than government-owned enterprises to correct mistakes more promptly. However, the senior management also has the incentives and opportunities to cover up the mistakes and to try to bail out before the mistakes become apparent or do major damage to the enterprise.
- ◆ It is almost impossible for a family to bail out of a family-controlled enterprise without destroying the value of the enterprise altogether, which is not in the family's interests. It therefore must deal with the mistakes squarely and expeditiously.

# Family-Controlled Enterprises versus Government-Controlled Enterprises

---

- ◆ For example, back in 1997, Samsung Corporation in South Korea wrote off its entire US\$5 billion investment in its automobile manufacturing division in one fell swoop. It is highly unlikely that the South Korean Government would have been able to do so if it had been the owner of the automobile manufacturing division.
- ◆ There are many examples of state-owned enterprises around the world that continue to operate after years and years of losses.

# Widely Held Enterprises without a Major Shareholder

---

- ◆ In a publicly listed and widely held enterprise without a major shareholder, no one has either sufficient information or sufficient incentive to pay close attention to the enterprise and act as if he or she is the “owner.” This is sometimes referred to as the “No-Owner Syndrome.” Government-owned and controlled enterprises suffer from the same problem.
- ◆ The problem with an enterprise like Enron is that, in addition to non-transparency and failure of disclosure (and fraud), there is no shareholder with sufficient stakes and long enough time horizon in the company to have the incentive to really monitor it. No one has or takes responsibility for the long-term viability and success of the enterprise. (Examples: Enron, IT&T, Worldcom).

# Widely Held Enterprises without a Major Shareholder

---

- ◆ With transparency and full disclosure, so that connected transactions are fully and fairly vetted, and the minority shareholders are adequately protected, a family-controlled enterprise can work out better because the interests of the owner and the manager are aligned and the owner usually takes a much longer-term view.
- ◆ Other (minority) shareholders, if any, and employees can “free-ride” on the fact that the active controlling shareholder takes a long-term view and ownership of the enterprise. They can piggyback on the due diligence of the active controlling shareholder because he or she stands to gain or lose much more. And that is a powerful incentive for the controlling shareholder.
- ◆ Independent directors, while marginally helpful, cannot solve the problem. If they are not paid enough, they do not pay enough attention. If they are paid too well, they are captured by the senior management. To assure fair treatment of minority shareholders, it is far more effective to have a substantial non-family shareholder with a long-term view with sufficient shares to assure representation on the board of directors.

# The Advantages of an Active Controlling Shareholder in the Age of Globalization

---

- ◆ One of the advantages of having an active controlling shareholder participating actively in the management of an enterprise, especially in this age of globalization, is that decisions can be made expeditiously.
- ◆ Moreover, a controlling shareholder or shareholder family tends to think in very long terms, taking into account the interests of not only the current family members but also his or her descendents in the future, and are more likely to invest in projects with long-term payoffs. They also tend to be more patient and do not worry about short-term fluctuations in either the revenue, profit, or the share price. A family-controlled enterprise is therefore much better positioned to survive and prosper in the long run.

# A Single Dominant Active Controlling Shareholder

---

- ◆ Furthermore, as already mentioned, since the major shareholder/owner is also active as the manager of the enterprise, the so-called principal-agent problem does not arise because the incentives of the owner and the manager are automatically aligned.
- ◆ An active controlling shareholder with significant equity has the incentive to acquire the necessary information to enable him or her to manage the enterprise properly.
- ◆ Such a shareholder also tends to be more careful because he or she has something to lose, his or her equity, if investments turn out badly. There is no moral hazard because both the benefits, the costs and the risks are all internalized.
- ◆ Family-owned and controlled enterprises generally pay lower salaries to their chief executives than publicly listed enterprises with widely diffuse share ownership.

# A Single Dominant Active Controlling Shareholder

---

- ◆ Other (minority) shareholders, if any, can “free-ride” on the fact that the controlling shareholder takes a long-term view and ownership of the enterprise and has both the incentive and the means to conduct “due diligence”.
- ◆ What is good for the controlling shareholder in the long run is good for the other shareholders. The other shareholders gain or lose in the same way as the controlling shareholder. There is therefore no conflict of interest between the controlling shareholder and the other shareholders in the long run, provided that the other shareholders are treated fairly.
- ◆ The only important issue then is full disclosure and transparency when it comes to connected or related-party transactions, that is, transactions between the enterprise and the controlling shareholder and entities controlled by the controlling shareholder, to ensure fairness to the minority shareholders.

# Maintaining Competitive Advantage: Investment in Intangible Capital

---

- ◆ Only a long-term holder with a long-term perspective, such as a controlling shareholder, will invest in projects with large benefits in the more distant future rather than the next quarter. These include investment in infrastructure projects and in intangible capital. (Examples: Wallenbergs in Sweden; Samsung in South Korea).
- ◆ Intangible capital includes education, human capital, Research and Development (R&D) capital, intellectual property (patents, copyrights, trademarks, trade secrets), goodwill, advertising (brand names), reputation, know-how, business models and methods, organization, and software).
- ◆ The development of an enterprise culture is also an important intangible investment with long-term benefits.
- ◆ Continuous investment in intangible capital is the key to innovation and the creation of and maintenance of long-term competitive advantage.

# Protection of Minority Shareholders

---

- ◆ Some powers are reserved to the shareholders at the annual general meeting (AGM)—for example, the confirmation of the selection of the outside auditor and changes in the by-laws of the corporation.
- ◆ Rules for protecting the minority shareholders, for example, only minority shareholders can vote on the approval of connected and related party transactions, with the advice of an independently retained financial adviser.
- ◆ Disclosure, notice and transparency requirements.
- ◆ Restrictions against insider trading, manipulation of the stock prices and other unfair market practices.

# The Weaknesses of the Family-Controlled Enterprise

---

- ◆ In a family-controlled enterprise, succession can sometimes be a problem—the next generation of family members may lack the ability, the interest, or fire in the belly.
- ◆ There are significant differences in the behaviour and performance of first-generation versus second-generation and third-generation family-controlled enterprises.
- ◆ Pride in the family tradition can both help and hurt the enterprise—the controlling shareholder may try harder (e.g., Ford Motors) or may stay the course for too long.

# An Active Controlling Public versus Private Shareholder

---

- ◆ Our above analysis is true only if the active controlling shareholder is a principal, i.e., the ultimate beneficial owner. If it were an agent itself, i.e., an employee of the government, or of a government corporation, or a non-profit corporation or foundation, there would then be yet another “principal-agent” problem but at a higher level.
- ◆ The objective of a controlling family shareholder is likely to be the maximization of the present value of the enterprise and not constrained by any other social objectives. The objective of a controlling government shareholder may be different. For example, it may be more concerned with creating employment or reducing pollution.
- ◆ A government shareholder may have special privileges—exclusive franchises, low-interest rate credit, protected sales and territories—but also special obligations.

# Two or More

## Active Substantial Shareholders

---

- ◆ Substantial shareholdings provide the incentive for information acquisition and active monitoring, and in the case of actively participating shareholders, including monitoring the actions of one another.
- ◆ “Substantial” means important enough for the shareholder to pay attention, perhaps 5 percent or more, and sufficient to assure a seat on the board of directors, and thus access to relevant information.
- ◆ Under these circumstances, the enterprise then works like a small partnership, with the active substantial shareholders as partners, even though it may have the corporate form.
- ◆ Small partnerships are amenable to mutual monitoring and mutual reliance. At least the incentives are right. For example, such an enterprise is less likely to have private jets for the senior management compared to an enterprise in which the ownership is diffused over many shareholders.

# Two or More

## Active Substantial Shareholders

---

- ◆ However, an enterprise may have two or more active substantial shareholders through corporate cross-holdings, i.e., Enterprise A owns shares in Enterprise B and vice versa. The management of each enterprise is then a substantial shareholder in the other. This allows corporate control to be perpetuated, regardless of corporate performance, and often leads to poor corporate governance.
- ◆ Ownership of shares in other enterprises by non-financial enterprises has not been allowed in the United States since the stock market crash of 1929. Japan has also outlawed cross-holdings in the 2000s, following the long period of stagnation that began in the 1990s with the bursting of the asset price bubble. Non-financial enterprises should focus on their core business and not on speculation in the stock market.

# Completely Diffuse Share Ownership

---

- ◆ Diffuse ownership is probably inevitable with the rise of very large enterprises—no one individual shareholder is wealthy enough to own a significant percentage of it.
- ◆ Such enterprises can be effectively captured by their senior management, who may have different interests and objectives from the shareholders. The senior management may enrich themselves at the expense of the shareholders.
- ◆ For these enterprises, the development of a corporate culture that emphasizes honesty and integrity is essential. The practice of regular and stable cash dividend payouts also helps. One can “cook” the books but cash dividends are real.

# Can Independent Non-Executive Directors Help?

---

- ◆ The presence of independent non-executive directors on a board of directors, whether in the majority (as in the United States today) or in the minority, can enhance corporate governance on the margin, but its usefulness is frequently over-rated (for example, the case of the Enron Corporation).
- ◆ This is because in general, independent non-executive directors only have access to information that the senior management wants to make available.
- ◆ Moreover, they do not necessarily have the incentive to monitor the affairs of the corporation closely. If they are not compensated sufficiently, they are unlikely to pay too much attention to corporate affairs. If they are compensated too well, they are then beholden to senior management, which has nominated them to serve on the board of directors in the first place.

# Can Independent Non-Executive Directors Help?

---

- ◆ Even if they own shares in the corporation, they do not typically own sufficiently large stakes to cause them to behave as if they own the corporation.
- ◆ They are also subject to potentially huge personal liabilities if something goes wrong, thus making it not worthwhile for able, experienced, successful and wealthy individuals without significant holdings in the corporation to serve.
- ◆ The only motivation for an independent non-executive director to execute his or her responsibilities properly is a desire to protect his or her own reputation.

# Can Independent Non-Executive Directors Help?

---

- ◆ The question arises as to whether having the independent non-executive directors paid by the public, e.g., through taxes, may help. This will take care of one problem: at least the independent non-executive directors are not beholden to the senior management (but probably beholden to the government or whoever have nominated them). But there is no assurance that they will act in the best interests of the shareholders because they do not have the incentives to do so. Information asymmetry will also continue to be a problem.
- ◆ Giving the independent non-executive directors a percentage of the profits also does not help unless they are also liable for a percentage of the losses. Otherwise there is only upside, no downside. It is like a stock option.

# Monitoring by Third Parties

---

- ◆ Can third-party monitoring help, for example, monitoring by outside auditors?
- ◆ The question is whether the monitors have any real incentive to monitor properly. After all, they are paid by the management. (Self-regulation seldom works.) Potential liability, including the ruin of reputation, can offer some incentive for auditors to monitor properly (but consider Arthur Anderson's role in the Enron case). But with increasingly large partnerships, accounting firms can no longer monitor all of their partners adequately.

# Monitoring by Third Parties

---

- ◆ The monitors themselves may also need to be monitored. This is known as the “monitoring the monitors” problem.
- ◆ Can rotation of the monitors and competition help? It is not so clear that rotation helps in an overall sense—it removes one difficulty, that the monitors have over time become too close to the monitored, but introduces another one, i.e., the new monitor has to start from scratch to learn about the monitored and may well miss something in the meantime.
- ◆ Some rules preventing “revolving doors” may help, i.e., preventing the former monitors from becoming employees of the formerly monitored.

# Building an Enterprise Culture

---

- ◆ Ultimately, one cannot motivate entirely with pecuniary incentives. Individuals who respond only to monetary incentives do not make good long-term “agents”. It is therefore essential to try to build an enterprise (corporate) culture.
- ◆ It is important for an enterprise to make sure that everyone speaks the same language, shares the same expectation and goals, complies with the same norms of behavior and standards, and moves in the same direction.
- ◆ And also to assure that everyone feels a sense of ownership towards the enterprise—that everyone is a “stakeholder” if not a shareholder—as well as a sense of mutual responsibility and obligation for the enterprise.

# Mutual Monitoring As an Alternative

---

- ◆ In a large North American commercial bank, the senior management is required to own shares in the bank with values that are substantial relative to the individual net worth of the respective executive, even though they may not be substantial relative to the total shares outstanding of the bank.
- ◆ The senior executives will thus incur significant losses just like the shareholders if the bank does not do well. This way, their interests and the shareholders' interest are better aligned. Because the senior executives, being shareholders, are now subject to both upside and downside risks, they will behave more like owners.
- ◆ The mutual monitoring by the senior executives keeps one and another honest. They are thus, for example, less likely to purchase corporate aircraft for their own use.

# Mutual Monitoring as an Alternative

---

- ◆ The enterprise works like a quasi-partnership even though it has a corporate form.
- ◆ There is need to guard against collusion by the senior executives--the “partners” getting together to take advantage of the other shareholders.
- ◆ It also helps if the CEO cannot dismiss the Deputy CEOs without good cause and on his own sole authority.
- ◆ Here monitoring by the board of directors and inculcation of an enterprise culture may be helpful.
- ◆ The “partners” will need to fully disclose their other financial investments to the enterprise (and hence to one another) to make sure that they have no conflicts or potential conflicts of interest.
- ◆ Mutual monitoring may be a model for state-owned enterprises in China.

# Concluding Remarks

---

- ◆ Family-owned and controlled enterprises may have advantages over government-owned and controlled enterprises and publicly listed enterprises with diffuse share ownership.
- ◆ However, minority shareholders must be protected through the requirement of transparency and full disclosure, the fair and thorough vetting of connected transactions, and the monitoring of insider trading and stock manipulation. The relevant regulatory and supervisory agencies must carry out their responsibilities.
- ◆ Small shareholders can then “free ride” on the active controlling shareholder—they can gain or lose in the same way as the controlling shareholder. Their interests are aligned with those of the active controlling shareholder.
- ◆ Organizing the senior management as a quasi-partnership with mutual monitoring may be a possible model for state-owned enterprises in China.