

**THE FALLACY OF BOARD SYSTEM IN
THE CHINESE LISTED SECTOR**

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Executive Summary

1. China imposes a two-tier board structure, consisting of a board of directors (BOD) and a supervisory board in its listed sector. Following the *Code of Corporate Governance for Listed Companies in China* (上市公司治理准则) issued in 2001, the board is recommended to have a minimum number, i.e. one-third, of independent directors.
2. According to China's company law, the BOD is accountable to shareholders, ensures equal treatment for all shareholders and safeguards interests of the firm's various stakeholders.
3. However, more than 30% of directors on the board of Chinese listed firms are affiliated with the firm's largest shareholder, and are unlikely to protect the interests of minority investors. Even independent directors are appointed by the largest shareholder. Boards in China thus generally lack independence and are usually rubber-stamps to the management and the largest shareholders.
4. Besides, a poor legal protection of the rights of investors, an inefficient monitoring imposed by (retail) investors in the stock market, and a lack of public enforcement by security market regulators cannot provide strong external institutional support to the governance of the BOD in China.
5. In Chinese listed state-owned enterprises (SOEs), the state as controlling shareholder uses its over 50% dominance in the BOD to achieve its social and political objectives at the expense of external investors. The state also cross-subsidizes other SOEs in financial difficulties to keep them afloat or to secure decision making power on retrenchment to maintain social stability.
6. As the government dominates economic resources allocation, private entrepreneurs tend to appoint politically connected directors to avoid government expropriation and gain access to state-controlled key resources.

Many independent directors in the non-state sector are former People's Congress and People's Political Consultative Conference members.

7. Future legal and financial development on China's board structure is desirable, as the effectiveness of one corporate governance mechanism, in particular the BOD, may largely hinge on that of others.
8. Policies aiming to improve the institutional environment, e.g., a stronger enforcement of legal rules and a more developed stock market, may help to better protect the rights of investors. Until these root tensions are fully addressed, there is an ongoing challenge to corporate governance reform in China.