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CONVERGENCE OF CORPORATE GOVERNANCE: COMPARATIVE STUDY IN CANADA AND IN CHINA

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Résumé

Le présent mémoire vise à faire enquête sur de tels débats dans le domaine de gouvernance des sociétés pour le fait qu'il y a ou aura de changements dramatiques dans la structure des acticités des sociétés, par exemple, la nature de travail et l'organisation des corporations, ainsi que les influences des reformes financières. De plus, l'émergence de l'investissement institutionnel dans le marché financier, le progression de globalisation et le développement de commerce électronique ont d'influence sur gouvernance des sociétés tant au Canada qu'en Chine.

Il y a une magnitude immense de discussion sur les aspects variés de gouvernance des sociétés dans le domaine académique. Ce mémoire présente une étude de comparaison détaillée sur les deux systèmes différents de gouvernance des sociétés concernant trois aspects spéciaux de gouvernance des sociétés, y compris le conseil d'administration, les rôles des banques et les investisseurs dans les deux états, ainsi que les reformes en Chine, de plus, la convergence des deux systèmes de gouvernance des sociétés est introduite.

Mots-clés : Gouvernance des sociétés, convergence, conseil d'administration, actionnaire, reforme, Canada, Chine

Abstract

This thesis aims to consider the debates in the field of corporate governance in the fact that there have been and will be dramatic changes in the structure of corporate activities, such as the nature of work and the organization of corporations, as well as the influences of reforms in the financial reforms. Moreover, the emergence of institutional investment in the financial markets, the process of globalization and the development of electronic commerce have the influences on the corporate governance both in Canada and in China.

There is an immense magnitude of discussion on various aspects of corporate governance in the academic field. This thesis will focus on comparing two rather distinctive systems of corporate governance, with respect to three specific aspects of the corporate governance. Those are: the board of directors, the role of shareholders, the roles of banks and investors in the two countries, also the reforms in China. Moreover, the convergence of the two corporate governance systems is introduced.

Key words : Corporate governance, convergence, board of directors, shareholder, reform, Canada, China.

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INTRODUCTION

The Perspective

Corporate governance is presently one of the major issues in corporate law. One could argue that its importance may arise from the fact that many academics and capitalists[1] at the beginning of last century could not imagine the nascent division between ownership and control lasting to give rise to the issues of corporate governance that we have today. It is a field which concentrates on the relationship between various participants in determining the direction and performance of corporations. Sheridan and Kendall, suggest that "... different countries have different ideas as to what constitutes good corporate governance ... nowhere does anyone appear to have defined corporate governance per se."[2]

Most of the traditional academic researches with regards to the corporate governance concern the two mains models of corporate governance in the world, i.e. the convergence or comparison between the Anglo-Saxon system and the Continental-European system. Compared with these types of studies, there are few papers using empirical evidence to examine the corporate governance convergence between China and Canada. In the former country, corporate governance is at its emerging stage; in the latter country, corporate governance is not a typical Anglo-Saxon model. During the recent years, with the development of the economic growth and the rapid economic reform in China, the Chinese system of corporate governance attracts much more attention in academic studies.

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[1] See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance* (1989) 75 Iowa L. Rev. 1 at 2-3. The authors state that both Adam Smith and Adolf Berle and Gardiner Means questioned the viability of large corporations where ownership was separate from control.

[2] See Sheridan, T. and Kendall, N. *Corporate Governance, An Action Plan for Profitability and Business Success*, (London: Financial/Pitman Publishing, 1992).

In North-America, as Enron slid into bankruptcy in the fall of 2001, it had devastating effects on the American system of corporate governance. The focus on corporate governance in the "post-Enron era" also follows a pattern of renewed interest in corporate governance after other corporate failure in the United Stated. Failures in corporate governance have been linked to corporate performance in the United States as well as in Canada. It is inevitable for the academic research to doubt the effectiveness of American system of corporate governance and also the cleanness of the Canadian system of corporate governance which is considered to possess similar characteristics to the United States, provoking widespread demands for governance reform globally. However, it is not the case and various Canadian attributes differ from American ones because of distinct local input.

Despite different starting points, different political and economic systems, there has been a trend toward the convergence of different systems of corporate governance around the world in recent years.[3] T rade and investment liberalization has put increasing pressure on firms to adapt and adjust. Moreover, the global providers of market finance, most Anglo-Saxon or other Organization for Economic Cooperation and Development (OECD) based institutions are increasingly demanding uniformity of different systems of corporate governance. All these are the key drivers for the convergence of corporate governance. In the past one or two decades, corporate governance has become one of the dominant policy issues in the United States, United Kingdom, and lately particularly in Continental Europe and Japan. It has also been one of the most hotly contested issues in the transitional economies since mid-1990s and caught a great deal of attention in the development debate in the wake of the Asian financial crisis.[4]

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[3] See Nestor, Stilpon, and John Thompson, *Corporate Governance Patterns in OECD Economies: Is Convergence Underway?* In Nestor, Stilpon, and Takahiro Yasui, eds., *Corporate Governance in Asia: A Comparative Perspective* (Paris: Organisation for Economic Co-operation and Development, 2000), at 19-43.

[4] Berglof, Eric and Ernst-Ludwig von Thadden. 1999. "The Changing Corporate Governance Paradigm: Implication for Transition and Development Countries". Working Paper, Stockholm

The choice and purpose of a research direction is a personal and political one. It must fulfill certain academic requirements yet should also relate to the interests of the writer if he is to engage with his subject matter. Thus, the choice of this thesis is to analyze the convergence and comparison of two different systems of corporate governance both in Canada and in China.

Since each countries and economic systems around the world face the same problems with regards to the corporate governance, the comparative approach to corporate governance has attracted considerable attention over the 90's of last century. Since that time, the increasing awareness around the world of issues with regards to corporate governance has been reflected in different official reports. Some of these reports include American Law Institute Report (1992),[5] NACD Reports (1994 and 1996) in the United States, the Cadbury Report (1992), the Greenbury Report (1995), the Hampel Report (1998), the Smith Report (2003) and the Higgs Report (2003) in the United Kingdom. Dey Report[6] (1994) in Canada, Vienot Reports (1995 and 1999)[7] in France, etc.

The purpose for the ongoing debates of this thesis in the field of corporate governance is the fact that there have been and will be dramatic changes in the structure of corporate activities in the areas such as the nature of work and the organization of corporations, as well as the influences of reforms in the financial reforms. Moreover, the emergence of institutional investment in the financial markets, the process of globalization and the development of electronic commerce have the influences on the corporate governance both in Canada and in China. All

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School of Economics.

[5] American Law Institute ("ALI"), Principles of Corporate Governance: Analysis & Recommendations.

[6] Toronto Stock Exchange Committee on Corporate Governance in Canada, Where Were the Directors: Guidelines for Improved Corporate Governance in Canada (Dey Report) 1994

[7] Conseil National du Patronat Français (CNPF) & Association Française des Entreprises Privées (AFEP), Report of the Committee on Corporate Goverance (Vienot II) (July 1999), The Boards of Directors of Listed Companies in France (Vienot I) (July 1995).

these changes will lead the good corporate governance both in Canada and in China, however, the good corporate governance will not result from mere changes. Good corporate governance will also depend heavily on the successful reform of government agencies and the legal system. From this point of view, a legal framework of corporate governance plays an important role in the good corporate governance construction.

Methodology

The volume of materials concerning corporate governance is vast and growing exponentially around the world. Besides the related articles and treatises on the topic of the two countries, the economic, political and legal literature of the different countries and different institutional organizations, the numerous laws, listing requirements regulations address corporate governance issues. Among all these literature, a unique group of corporate governance recommendations called "codes," "reports," "principles," or "guidelines," has appeared in the 90's of last century. This systematically arranged set of principles, standards, best practices or recommendations is universally considered the basis of comparative study between different systems of corporate governance.

As this is a comparative thesis, the comparative method, as form of the sociological method, is the main methodology of this thesis. The term "comparative method" refers to social scientific analysis concerning "observation in more than one social system, or the same social system at more than one point in time".[8] In other words, comparative sociology concerns making generalizations about what is true of all societies and what is true of one society at point in time and space.[9] In

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[8] D. P. Warwick & S. Osherson, at 8.

[9] R. Bendix, at 532.

this thesis, I will draw the comparison between the two systems of corporate governance with regards to methodology. The thesis will compare the legal, economic as well as political systems of corporate governance found in Canada and in China. We will discuss the legal and institutional contexts, the legal, economic, political and cultural literature of the two countries, seeking answers to questions like these: What are divergences and convergence between the systems of corporate governance in the two countries? How are national economic growth and corporate governance related? What are the future developments of the two different systems of corporate governance? Etc.

In considering the fine point of corporate governance in this way, theory, history, doctrine, and politics are used in this thesis as a framework for discussing and dispelling myths about the nature of the corporation, initiating corporate law reform, and dealing with modern concerns about corporate governance.

Generally, the study of corporate governance has been performed at two levels of analysis. At the firm level, governance structures refer to the mechanisms intended align the interests of managers of a particular firm with those of its other shareholders. At the macroeconomic level, the research work has put forward the concept of "national system of corporate governance", thus focusing on the influence of national legal and institutional frameworks upon managerial discretion. This thesis will also focus on the two levels.

Two levels study method will also apply to the thesis. At the firm level, the comparative study of firm corporate governance performances in the two countries will be introduced; at the macro level, the economic and political background of corporate governance and the legal framework will be touched.

The Thesis

There is an immense magnitude of discussion on various aspects of corporate governance in the academic field. The present study does not attempt to cover all of these subjects with regards to the corporate governance. It will focus on comparing two rather distinctive systems of corporate governance, with respect to three specific aspects of the corporate governance. Those are: the board of directors, the ownership structure, the roles of institutional investors as well as the stock exchange in the two countries, also the reforms in China. Moreover, the divergence and convergence of the two corporate governance systems will be introduced.

With respect to the issues at stake, I will touch on the general concept of corporate governance, the origins and the features of Canadian and Chinese systems of corporate, comparative study of the two systems of corporate governance. Further, the divergence and convergence of the two systems of corporate governance will be analyzed. The convergence in this study does not at all mean the victory of one system of corporate governance over another, it means that the corporations and investors are able to increasingly cooperate and trust each other across the border, by respecting and learning from each other. In this thesis, we do not intend to render a judgment as to which of the two systems is better in the context of corporate performance and national capital markets. Instead, we choose to focus on a set of corporate governance mechanisms and assess their divergence and convergence. We also come up with overall governance advices based on the set of comparison.

The thesis is broken down into four parts excluding introduction and conclusion. The definition of corporate governance raises the age-old question of what a corporation is. This question is also central to corporate governance. The general study of corporate governance is the subject of Part One, it includes the theoretical basis of company and its corporate governance, the fashionable and somewhat ambiguous concept of corporate governance.[10] It will also deal in depth with the global institutional organization with regards to the corporate governance, elements of the theory of firm as well as related theories of corporate governance as an understanding of this correlation is a prerequisite for any further discussion on corporate governance. The function of effective corporate governance in one corporation will also be touched.

Corporate governance can not develop without the contribution of other elements. The historical, economic, political and social factors are the very important elements in the formation and development of a system of corporate governance of one country. Culture is also a factor that significantly influences the development of a corporate governance system.[11] A ll these elements make the system of corporate governance in Canada and in China so distinctive. Part Two introduces the specific features of corporate governance both in China and in Canada. It includes the corporate environments, legal framework of corporate governance, ownership structure, the board of directors as well as the role of institutional investors in corporate governance, both in Canada and in China.

Part Three describes the comparison between Canadian corporate governance system and Chinese corporate governance system with regards to legal framework, recent development of corporate governance, and divergence. The foregoing comparative analyses allow for a suitable model of corporate governance to be deduced. However this kind of governance is merely in the theoretical and hypothetical meaning and inevitably influenced by the author's values. The purpose of the comparative analyses in this part is to provide a basic knowledge regarding the two different systems of corporate governance and establish a foundation for the

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[10] For the discussion of this ambiguity see, K. Keasey, S. Thompson and M. Wright in the introduction to *Corporate Governance – Economic, Management and Financial Issues,* Oxford University Press, Oxford, 1997, at 2.

[11] See O. E. Williamson, *Transaction Cost Economics: The Governance of Transactional Relations* (1979) 22 Journal of Law and Economics at 239-242.

ongoing analyses of possibilities and tendencies of convergence in the nest part. In this context, the differences concerning origins and backgrounds of the Canadian and Chinese systems of corporate governance will be discussed.

The development of corporate governance has shown some empirical evidences for gradual integration of different systems. In recent years, the corporate governance development in different systems has been moving to convergence. Part Four is the simple and more difficult task which utilizes the results of the comparison in Part Three to present the possibilities and empirical evidences of the convergence of the Canadian and Chinese systems of corporate governance. Some thoughts about various outstanding barriers to the convergence of different systems corporate governance will also be introduced.

Finally, the thesis concludes that the convergence between two systems of corporate governance means neither the victory of one system over another, nor the uniformity of corporate governance norms and behaviors. Even the possibilities and evidences of convergence, divergent corporate structures and governance will still tend to persist. Either Canadian system or Chinese system of corporate governance will keep or evolve into its own model reflecting the country's traditions, values. It is hoped that this thesis will illustrate the importance of corporate governance in discussions to the two countries, as well as providing a starting point for a larger inquiry into the nature of the corporation and its place in society, especially for the China's economic reform in the transaction era.

PART ONE: FRAMEWORK: LEGAL THEORY, DEFINITION AND MECHANISMS OF CORPORATE GOVERNANCE

The concept of firm can be traced back to Roman law, but it was not used as a common business vehicle until the nineteenth century. C.A. Cooke, wrote in 1950, 'In less than three hundred years the social institution connoted by the words "company" and "corporation" has undergone mutations in form and application which placed it among the most influential of social groupings'.[12]

I. Theories of Corporation

The concept of corporation can be traced back to Roman law, but it was not used as a common business vehicle until the nineteenth century. The modern corporate systems were built by the earliest industrial countries on a common foundation and had a fundamental similarity.[13] There is a fundamental difference in legal structure between the traditional firm and modern incorporation. While the first consists of a single ownership relation between owners and assets, the latter consists of two overlapping ownership relations, including: the relation between shareholders and the corporation, and the relation between the corporation and corporate assets. The latter legal relation is indirect and exists only through the intermediary of the corporation that performs the dual role of a thing and a person.

Corporate structures depend in part on the structures a country had in earlier times, in particular the structures with which the economy started.[14] Thes e structures

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[12] C. A. Cooke, *Corporate, Trust and Company – An Essay in Legal History,* Manchester University Press, Manchester, 1950, at 7.

[13] See P. I. Blumberg, *The multinational Challenge to Corporation Law, The Search for a New Corporate Personality.* (New York: Oxford University Press, 1993) at 3.

[14] Bebchuk LA and Roe MJ *A Theory of Path Dependence in Corporate Ownership and Governance*

also bias the legal rules in terms of what is efficient in any given country and the interest group politics which determine which rules are chosen.[15]

There are various theories and many arguments with regards to the nature and origins of corporation. Only a few have stood the test of time and evolved as currently influential. So far, the academic field has not yet provided a satisfactory theory. Various theories interact and influence each other.

1. The Nature of Corporation

We may hold that the legal doctrine which sees in the corporation a distinct person is contrary to truth and fact; then a supplementary question will be: what is the truth which the doctrine veils and obscures? Or we may ask further: of what nature the distinctive person, which appears in the corporate holding of rights?[16] From these views, the nature of corporate existence can be concluded the fiction theory from the first case; and the organic theory[17] from the second case.

a). Fiction Theory[18]

The fiction theory can be traced to the canon law of the Roman church of the 13th century and earlier. With this theory, corporations are simply legal fictions, created and sustained by an act of the state.[19]

The fiction theory asserts that the legal person has no substantial reality, no mind,

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(1999) 52 Stanford L Rev, at 127;

[15] *Ibid.*

[16] Ernst Freund, *The Legal Nature of Corporations,* (Kitchener: Batoche Books Limited, 2000; also Chicago, IL: University of Chicago Press, 1897), at 9.

[17] The organic theory is sometimes referred to as the "real entity" theory or "natural entity" theory

[18] It is sometimes suggested that there is separate theory which sees the corporate merely as an aggregate of individuals; but this is really the corollary of the fiction theory, for if the corporation is a legal fiction, which will leave the people involved with it as merely an aggregate of individuals.

[19] Stokes, M. "Company Law and Legal Theory" in Twining, W. (ed). *Legal Theory and the Common Law.* Basil Blackwell, Oxford, 1986, 155, 162

no will; it exists only in law. It regards a corporation as a creation of law, and presumes that it is an artificial or fictional creature, possessing only those properties and rights that are conferred upon it by law or are incidental to its existence. It is a theory which asserts that the corporate body is merely a creature of the intellect.[20] This theory thinks that the legal conception of a corporation cannot be reconciled with fundamental truth and logic; it has no basis in the reality of facts. It is a fiction adopted for the purpose of deducing rights and obligations which could not be deduced with equal facility from a conception corresponding to the true nature of things.[21]

This theory forms the basis of the fiction that corporations are persons that they possess the legal rights they do, such as private property rights. However the fiction theory affords no basis for the recognition of moral rights of corporations. On the fiction view, "corporations, as creatures of the State, have only those rights granted them by the State."[22]

b). Organic Theory

The organic theory views a corporation as a real being in society, irrespective of whether or not the law recognizes it. In this theory, corporation has been seen as a social organism with a real life, like a human being with a physical body. Martin Wolff pointed out in his article that "the subjects of rights need not be human beings, that every beings which possesses a will and life of its own may be the subject of rights and that States, corporations, foundations are beings just as alive and just as capable of having a will as are human beings...Man uses his bodily organs for the

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[20] See John. Dewey *The Historic Background of Corporate Legal Personality,* 35 Yale L.J. 655 (1926) at 667. He pointed out that the fiction theory is ultimately a philosophical theory that the corporate body is but a name, a thing of the intellect.

[21] Ernst Freund, J. U. D. *The Legal Nature of Corporations,* (Kitchener: Batoche Books Limited, 2000) at 9.

[22] *First National Bank v Bellotti* (1978) 435 US 765, 55 L Ed 2d 707, 778 (US) per Powell J, characterizing the stated view as "extreme".

purpose. Corporation use men".[23] The rise of the organic theory of the corporation was a major factor in legitimating big business and that none of the other theoretical alternatives could provide as must sustenance to newly organized concentrated enterprise.[24]

The organic theory is generally regarded as the work of 19th century German realists, particularly professor Gierke,[25] the most prominent representative of this theory, saw corporate personality not merely as a juristic conception, but as a social fact with an actual living nature. The function of law is to recognize and declare the existence of the personality.[26] The theory's basic flaw is that it treats an analogy with a human being as the basic of a parallel reality, thus the approach does not solve the issue of the nature of the corporation.[27]

2. Origins of Corporation

The arguments concerning the nature of corporation have relation with and sometimes are confused with another separate issue, namely the origins of the corporation. Two main theories had been developed with regard to the origins of corporation, namely the concession theory and the contract theory.

a). Concession Theory

Concession theory, having its zenith of support in the mid-nineteenth century, sees the corporation as having granted its identity by concession of the State. What the

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[23] See Martin Wolff, *On the Nature of Legal Persons* (1938) 54 Law Quarterly Review, at 498.

[24] See Morton J. Horwitz, *SANTA CLARA Revisited: The Development of Corporate Theory,* 88 W. Va. L. Rev. 173 (1985), at 176.

[25] *Das Deutsche Genossenschaftsreche* (1887). Translated in O. Gierke *Political Theories of the Middle Age* (F.W. Maitland (ed.),

[26] Ernst Freund, *The Legal Nature of Corporations,* (Kitchener: Batoche Books Limited, 2000; also Chicago, IL: University of Chicago Press, 1897), at 13.

[27] See Martin Wolff, *On the Nature of Legal Persons* (1938) 54 Law Quarterly Review, at 498.

concession theory must insist upon is that its legal power is derived.[28] The essence of this theory is that the corporation's legal power is derived from the state.

Concession theory holds that corporation, as an artificial entity, whose separate legal personality is granted as a privilege by the state.[29] There are two ideas in the concession theory. First, the notion that the corporation is an artificial or fictional entity exists "only in the contemplation of law."[30] The second element is that the corporation is "an emanation of the state, created by revocable grant."[31]

b). Contract Theory

Corporation is an association formed by the agreement of its shareholders.[32] The contract theory sees the corporation is no different from the partnership, because the corporate structure is the outcome of a series of contracts between the shareholders and the managers.[33] That is to say, this theory emphasizes that the corporation is, in reality, a private arrangement of individuals contracting with each other. A modern version of the doctrine has recently developed to view a corporation simply as a "nexus of contracts".[34] In the nexus of contracts view, the firm "is just a legal fiction which serves as a focus for the complex process in which the conflicting objectives of individuals ... are brought in equilibrium within a framework of contractual

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28 John. Dewey *The Historic Background of Corporate Legal Personality,* 35 Yale L.J. 655 (1926) at 668

29 Stokes, M. "Company Law and Legal Theory" in W. Twining (ed.), *Legal Theory and Common Law* (1986) at162.

30 Y aron, G. *Awakening Sleeping Beauty: Reviving Lost Remedies and Discourses to Revoke Corporate Charters*, (LL.M. Thesis, University of British Colombia, 2000) at 21 which cited from Chris Tollefson, *Theorizing Corporate Constitutional Rights: Revisiting 'Santa Clara' Revisited* (LL.M. Thesis, York University, 1992) at 13 citing *Dartmouth College* v. *Woodward*, 17 U.S. 518 (1819) at 636 (per Marshall Ch. J.).

31 *Ibid.*

32 See Morton J. Horwitz, *SANTA CLARA Revisited: The Development of Corporate Theory,* 88 W. Va. L. Rev. 173 (1985), at 203, which attributes the theory to a work by V. Morawetz *A treatise on the Law of Private Corporations* 2nd edn (Boston, MA: Little, rown, 1886).

33 See Ben Pettet, *Company Law* (Pearson Education Limited, 2001) at 54.

34 Jensen & Meckling, *Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J.Fin. ECON. 305 (1976).

relationship".[35] A ccording to this theory, each party of corporation is fully protected by its contract, with the exception of the shareholders, who accept a residual payoff because they have a comparative advantage in diversifying risk. As a result, shareholders need the protection ensured by control.

The contract theory maintains the fictitious entity element of concession theory. However, it discards the notion of incorporation as a matter of privilege, rather viewing the creation of the corporation as a contractual arrangement between individuals.[36]

II. Definition of Corporate Governance

The term "corporate governance" has no universally accepted definition, but instead, experts in the area have subjected its boundaries to different prescription.[37] Generally, corporate governance is susceptible to both broad and narrow definitions. The classic and simplest definition of corporate governance as defined by the Cadbury Report is: "The system by which companies are directed and controlled for the benefit of shareholders." The term "corporate governance" appears to have arisen and entered into prominent usage in the late 1970's in the United States in the wake of the Watergate scandal and the discovery that major American corporations had engaged in secret political contributions at home and corrupt payments abroad.[38]

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[35] Jensen M. C., and W. Meckling. 1976. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." Journal Of Financial Economics 3: 305–360. at 312.

[36] GI L YARON, *AWAKENING SLEEPING BEAUTY: REVIVING LOST REMEDIES AND DISCOURSES TO REVOKE CORPORATE CHARTERS* (LL.M. Thesis, University of British Colombia, 2000) at 22.

[37] Enoch Larbi Aboagye, Debt Financing: An Emerging Influence on Corporate Governance? (LL.M. Thesis, McGill University, 2001) at 17, citing Brian R. Cheffins, *Teaching Corporate Governance* (1999) 19 Legal Studies 515 at 517.

[38] E. Norman Veasey, *The Emergence of Corporate Governance as a New Legal Discipline,* 48 The Business Lawyer. 1276 (1993). Also see Henry J. Braker, *Corporate Governance, Culture and Convergence: Corporations American Style or with a European Touch?* presented at the conference on "Transatlantic Perspectives on US – EU Economic relations: Convergence Cooperation and Conflict",

Since its emergence, corporate governance has increasingly succeeded in attracting public attention because of its importance for the corporate performance and society development. However, due to its potential extensive coverage of different economic phenomena, the corporate governance is poorly defined so far. A few of the different definitions rather than just one should be introduced here depending on different perspectives for understanding the definition of corporate governance

Generally, Corporate Governance is a set of systems and processes for ensuring proper accountability, probity and openness in the conduct of a corporation. The OECD provides the most authoritative functional definition of corporate governance:

> "[c]orporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."[39]

The definition in the preamble of the OECD principles[40] encompasses: "Corporate Governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performances are determined."

According to the World Bank Group, corporate governance is about maximizing

April 11-12, 2002, hosted by the John F. Kennedy School of Government, Harvard University.

[39] OECD April 1999. OECD's definition is consistent with the one presented by Cadbury (1992, page 15).

[40] OECD principles provides a standard framework to analyze corporate governance practices. These principles acknowledge not only the importance of legal protection, but also of other mechanisms of corporate governance. The principles are structured in 5 categories that look at shareholders rights, board responsibilities and disclosure of information among others.

value subject to meeting a corporation's financial and other legal and contractual obligations. This inclusive definition stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders such as employees, customers, suppliers, investors and creditors, in order to achieve long-term sustained value.

Corporate governance is defined as the system by which companies are directed, controlled and evaluated. Corporate governance should affect every area of management of a corporation. It includes the review and approval of plans of action, corporate objectives, internal control systems and the engaging of regular management performance reviews. It also encompasses the timeliness and accuracy of corporate disclosure.[41]

In academic field, scholars have defined corporate governance from different perspectives. The different views on corporate governance can also be related to their different cultural contexts, intellectual backgrounds and interests. There is often little, or incomplete integration between the different disciplines. The overlap of corporate governance with other disciplines is rarely articulated or even recognized.

For some from the financial perspective, such as Anfrei Shleifer and Robert W. Vishny, corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[42] Demb and Neubauer (1992) state, "Corporate governance is the process by which corporations are made responsive to the rights and wishes of stakeholders."[43]

Tricker (1994) states from stakeholder perspective that corporate governance addresses the issues facing the Board of Directors, such as the interaction with top

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[41] This quotation is taken from a discussion of corporate governance to be found at the website of the Ontario Teachers' Pension Plan, at www.otpp.com

[42] Shleifer and Vishny *The Journal of Finance*, (1997, page 737).

[43] Demb,A. and Neubauer, F. F., *The corporate Board: Confronting the paradoxes*, (Oxford: Oxford University Press 1992).

management, and relationship with the owners and others interested in the affairs of the company, including creditors, debt financiers, analysts, auditors and corporate regulators. Such wider concerns reflect the audience for company financial reports, consistent with both Trickers' accounting background and the target audience for his publication.[44]

Monks and Minow (1995) have an interest in 'relationship investing' as described by Monks (1994).[45] They wrote that 'Corporate governance is the relationship among various participants in determining the direction and performance of corporations. Their definition of corporate governance is based on 'relationships' as quoted earlier.

Different entities and experts necessitate consideration of different perspectives and priorities on corporate governance. However, in a wide sense, corporate governance includes "the entire network of formal and informal relations involving the corporate sector and their consequences for society in general."[46] Every country tends to approache corporate governance from the background of its own distinctive culture.[47] F rom the beginning of corporate practice, China has constantly adopted corporate forms and practices from both the Angle-Saxon system and Continental-German system. For example, it imports two types of companies that are indicative of Angle-Saxon system; it also adopts the two-tier board structure of Continental-European system. Chinese definitions of corporate governance in the study tend to cover the system regulating relationships among all parties with interests in a business organization, usually spelling out shareholders as a particularly important group.

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[44] Tricker, R.I., *International Corporate Governance*, (Singapore: Simon & Schuster, 1994)

[45] Monks, R.A.G. 1994, 'Relationship Investing', *Corporate Governance: An International Review*, vol. 2, no. 2, pp. 58–76

[46] See K.Keasey, S,Thompson and M. Wright in the introduction to *Corporate Governance – Economic, Management and Financial Issues*, Oxford University Press, Oxford 1997. at 2.

[47] John H. Farra, *Corporate Governance in Australia and New Zealand*, (Oxford: Oxford University Press, 2001), at 3.

Canada's geographic proximity to US has determined that its system of corporate governance would inevitably close to the Anglo-Saxon model. However, Canada's corporate governance does not resemble that of US. As a result, Canadian corporate law adopts different approaches to regulate issues such as shareholder litigation and markets' securities. In Canada, corporate governance is defined as:

> «Corporate governance» means the process and structure used to direct and management the business and affaires of the corporation with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directors and management. The direction and management of business should take into account the impact on other stakeholders such as employees, customers, suppliers and communities.[48]

III. Theories of Corporate Governance

The standard agency theory of corporate governance focuses on the separation of ownership and control and investigates the mechanisms via which the suppliers of capital – diffuse and concentrated debt and equity holders – influence managerial decisions with varying degrees of success.[49] O n this view, the key function of corporate law is to devise strategies and mechanisms to ensure that those who are in control of the shareholders' property use it strictly for the shareholders' benefit.[50] As the various definitions of corporate governance presented by different institutions and scholars, there are various theories of corporate governance. A summary of the various theories of corporate governance that have been developed over the last

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[48] Toronto Stock Exchange Committee, *Where were the directors?,* Report of the Toronto Stock Exchange Committee on Corporate governance in Canada, Toronto, 1994, p.7. (Dey report).

[49] Shleifer and Vishny, 1997

[50] Terry O'Neill, *The Patriarchal Meaning of Contract: Feminist Reflections on Corporate Governance Debate,* in Fiona Macmillan, ed., *Perspectives on Company Law,* Vol. 2, (The Hague-London-Boston: Kluwer Law International, 1997) at 27.

century are useful in this context in order to fully understand how the different cultural and economic factors influence the corporate governance; and enable us to critically analyze the move to general principles on corporate governance.

However, the modern theory of corporate governance is challenging the traditional corporate doctrine which has taken the separation of ownership from control as the core problem of corporate governance. Dodd has argued that the modern corporation should be seen as existing for the benefit of society generally, and that the board of directors should have the board description to manage the corporation for the benefit of all.[51] The directors' fiduciary duties are owned to the corporation and to the corporation alone and not to any particular member.[52] This thesis summarizes and subsequently analyzes the two theories of corporate governance in the world today. They are contractarian model and communitarian model. The first one is shareholder-oriented model which means that the shareholder's interest comes first, and managers should be accountable primarily to the shareholder; the second one is stakeholder-oriented model. Even if we assume a shareholder-oriented model is the most efficient system because it reduces capital costs, scholars continue to argue that there are certain path dependent forces that may prevent a country from developing a dispersed-ownership model despite market pressure.

1. Contractarian Model

The contractarian model of corporate governance is generally followed by the Anglo-Saxon system of corporate governance. There are many benefits to this model, such as efficiency and innovation. The central principles of contractarianism are to

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[51] See E. Merrick Dodd Jr., *For Whom are Corporate Managers Trustees?* (1932) 45 Harv. L. Rev.at 1145.

[52] See L. C. B. Gower, *Principles of Modern Company Law,* 5th ed. (London: Sweet & Maxwell, 1992) at 551.

give its view of the corporation as a nexus of contracts,[53] voluntary agreements and market forces. Accordingly, this schematic relies on law and public policy to protect freedom of contract.[54] In recent years it has become common for both economic and legal theorists to view a corporation as a 'nexus of contracts', explicit and implicit.[55]

The Canadian model can be described as a model of shareholder-oriented and is premised on the firm as a nexus of contracts. It operates through contracts between the employees, shareholders, and management, seeking maximum profit. The firm is described as a nexus of contracts, a legal fiction. This is a very financial view of the firm and its function.

2. Communitarian Model

The theory of communitarians, with the view of the corporation as a separate entity with rights and responsibilities as a natural person, is becoming increasingly recognized and now serve as an alternative to the contractarian position.[56]

Different from contractarian model which is rooted in assumptions of utilitarian and methodological individualism, communitarian model finds its roots in humanism and methodological holism.[57] In the communitarian model, the firm is not considered as an economic aggregation of individuals but rather as an entity, connected in some

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[53] In 1976 Michael Jensen and William Meckling first formulated the conception that the corporation is a nexus of contracts in their famous article *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure.* 3 J. FIN. ECON. 305 (1976).

[54] See Michael Bradley, Cindy A. Schipani, Anant K. Sundaram & James P. Walsh, *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads,* 62 Law & Contemp. Probs. 9, 11 (1999). At 40.

[55] The idea that a firm is a "nexus of contracts" is usually traced to Alchian & Demsetz. See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. Rev. 777 (1972).

[56] M. Bradley, C. Schipani, A. Sundaram and J. Walsh,, *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads* (1999) Law and Contemporary Problems, at 17.

[57] *See* Antonin Wagner, *Communitarianism: A New Paradigm of Socioeconomic Analysis*, 24 J. SOCIO-ECON. 593, 598 (1995)

organic fashion with our social, historical, and political world, ask how economic activity serves society.[58] A multifiduciary duty to not only the shareholders, but to all of the firm's stakeholders is the manager's duty under communitarian theory. That is to say, the corporate managers' duties should be seen as owned to the corporation as an institution, rather than to the shareholders alone.[59] Responsibility is emphasized in the communitarian model, while the norms of freedom is more important in the contractarian model. The Communitarian theory argues that liability rules and judicial review are necessary to constrain the behavior of corporate managers. Without legal constraints, it is feared that management will be accountable neither to stockholders nor to society in general.[60] U nder communitarian theory, firms are guided to be more community-conscious and called to pursue community (stakeholder) -oriented instead of shareholder-oriented model.

3. Implication of the Contractarian and Communitarian Theory in Canadian and Chinese perspectives

As the Canadian and Chinese systems of corporate governance contain elements of both the contractarian and the communitarian theories, in the following discussion, the implication of these two theories on the development of Canadian and Chinese systems of corporate governance will be briefly outlined.

B efore the decision of *Peoples Department Stores v. Wise*, Canadian courts and legislatures had demonstrated a preference for the contractarian theory, which holds that the corporation is a nexus of contracts, and that firm managers should prioritize

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[58] See Michael Bradley, Cindy A. Schipani, Anant K. Sundaram & James P. Walsh, *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads,* 62 Law & Contemp. Probs. 9, 11 (1999). At 42.

[59] See A.A. Berle, *The Twentieth Century Capitalist Revolution* (New York, Harcout, 1954), at 169.

[60] *See* M. Bradley, C. Schipani, A. Sundaram and J. Walsh (1999), p. 35. citing Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1409 (1985); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 663-72 (1974).

its contract with its shareholders, governing the corporation so as to maximize shareholder wealth.[61] Sha reholders' interests alone should be the focus of managers' duties.[62] How ever, in the decision in the case of *Peoples Department Stores v. Wise*, the Supreme Court of Canada's rejection of shareholder primacy is couched as an endorsement of a doctrine already established in Canada before this case.[63] F rom this case, the corporation's interests should be read not simply as the shareholders' interests. It can be concluded that prior to *Peoples,* Canadian system of corporate governance was deeply influenced by contractarian theory; since *People,* communitarian theory influences the Canadian system of corporate governance.

Originated from the old Confucianism which has influenced China for thousands years and generally referred to as Asian values, communitarian theory distinguishes itself from the contractarian theory identified with individualism and liberal democracy.[64] Chines e system of corporate governance is deeply influenced by communitarian spirit which transpired in the historical experience of East Asian countries strongly indicates that corporate management can be more long-term minded. Under communitarian theory, the firm is a legal entity which has limited liability and various constitutional protections.[65] Th at is to say, China is often viewed as a "stakeholder" model of corporate governance. The ownership of Chinese companies is highly concentrated. Banks, sometimes also the state are argued to provide most long-term external corporate finance, act as stable shareholder and protect companies against hostile takeovers.

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[61] See the abstract of Lori Charvat, *Promises and Challenges of Internal Dispute Resolution in the Corporate Workplace,* (LL.M. University of British Columbia 2002).

[62] See *Teck Corp. Ltd. v. Millar,* (1973), 33 D.L.R. (3d) 288. and *Parke v. Daily News Ltd.* (1962) 1 Ch. 927 (Ch.D.).

[63] See *Peoples Department Stores v. Wise,* 2004 SCC 68 (October 29, 2004). Also see Lan B. Lee, *Peoples Department Store v. Wise and the "Best interests of the Corporation"* 41 Canadian Business Law Journal 212-222 (2005)

[64] For details, see De Bary, William Theodore. (1998*). Asian values and human rights: A Confucian communitarian perspective*. Harvard University Press.

[65] See M. Bradley, C. Schipani, A. Sundaram and J. Walsh (1999), p. 18.

IV. Essential Principles for Good Corporate Governance

The national governments and the global or regional organizations are serious in moving towards establishing good corporate governance. Various laws, rules, reports and principles had been enacted over the past years to control, regulate and facilitate corporate affairs, thus to create suitable environment for good corporate governance. Good corporate governance is valuable not only to shareholders, but also to governments and listed companies themselves. Corporate governance is strongly related to a firm's potential market value. Research concluded that corporate governance practices can have a powerful effect on market value in countries with weak legal and cultural constraints on corporate behavior.[66] Other research has shown that the quality of corporate governance influences firms' cost of capital, as well the size and vibrancy of a country's capital markets.[67]

The principles of corporate governance have been stipulated and prescribed by various company laws and organizations. However, from the view of the practices of corporate development, better corporate governance should have the following common elements:

1. Accountability & Responsibility

Generally, the essence of accountability is described as an obligation to present an account of and answer for the execution of responsibilities to those who entrusted those responsibilities.[68] A ccountability belongs to an important category of social

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[66] See Black, B. (2001) The corporate governance behavior and market value of Russian firms. *Emerging Markets Review* 2.

[67] See Garten, J. (2002) Corporate standards: raise the bar around the world. *BusinessWeek*, May 13, p. 30.

[68] See Gray, Alan (1998), *Management, Accountability and Public Sector Reform,* in Boyle, Richard and McNamara, Tony (eds.), *Governance and Accountability – Power and Responsibility in the Public Service,* (Dublin: Institute of Public Administration).

norms that may collectively be called "norms of governance"[69]. Norms of governance prescribe legitimate modes of wielding power—that is, they deal with use and abuse of power. Accountability means that the Board of Directors is accountable to the shareholders, and the management is accountable to the Board of Directors. It includes the elaboration of the board of directors' responsibilities, aggrandizement of directors' loyalty, assurance of the supervision and control of board of directors to the managerial staffs.

An effective supervision and control mechanism can prevent misuse of power, facilitate timely management response to change, and ensure that business risks are preventively and effectively managed. With accountability and responsibility, managers and controlling shareholders view their stewardship of the firm not as an entitlement but rather as a privilege that must be constantly earned through excellent performance and results.

2. Fairness

Protection of shareholder rights is a primary aim of corporate governance. Shareholders especially minority and foreign shareholders need to be assured that their assets are well protected against fraud, managerial or controlling shareholder self-dealing and insider wrongdoing. In this regard, the good corporate governance protects the rights of shareholders and ensures the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violations of their rights. Fairness is important for a corporation to perform well. However, good corporate governance is not simply about fairness in the allocation of a limited fruits of a corporation but rather about the enlargement of those fruits. Corporations that adopt fairness will have a strong and sustained impetus to perform well and create value for the long term.

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[69] Behn, Robert. *Rethinking Democratic Accountability*. Brookings Institution, 2001, at 5

With fairness, the fruits of the corporation's endeavors are equitably shared by all, in accordance with the risks taken and the efforts extended by the various stakeholders of the corporation.

3. Transparency and Disclosure

It would not be an exaggeration to point out that accounting is the soul of corporate governance because without accounting, corporate management cannot be monitored and corporate performance cannot be assessed in today's situation where companies are facing the challenge of operating in a transparent and global marketplace. Greater transparency acts as a driving force for enhancing corporate accountability. Shareholders demand that companies offer them more complete, credible, comparable and verifiable information regarding corporate performance.

Transparency means explaining Company's policies and actions to those to whom it has responsibilities. Therefore transparency must lead to maximum appropriate disclosures without jeopardizing the Company's strategic interests. Internally, transparency means openness in Company's relationship among its board of directors, executive staffs, shareholders and employees, as well as the conduct of its business in a manner that will bear scrutiny. Corporate transparency has three main elements: 1) corporate reporting (voluntary and mandatory), 2) information dissemination via the media and Internet channels, and 3) private information acquisition and communication by financial analysts, institutional investors, and corporate insiders.[70]

With transparency, there is little room for sweeping problems under the rug, making imperative prompt corrective actions when performance falters. In the fast changing world of business, this can spell the difference between survival and

[70] Bu shman, R., J. Piotroski, and A. Smith. 2001. "What Determines Corporate Transparency?" Unpublished paper. Quoted from Robert M Bushman, Abbie J Smith, *Transparency, financial accounting information, and corporate governance,* Economic Policy Review - Federal Reserve Bank of New York. New York: Apr 2003. Vol. 9, Iss. 1; pg. 65

continuing decline.

PART TWO: SPECIFIC FEATURES OF CANADIAN AND CHINESE SYSTEMS OF CORPORATE GOVERNANCE

I Overview of Canadian and Chinese Corporate Environments

1. Types of Firm

a). Canada

In Canada, firms are free to organize under the laws of federation and any province. Generally to say, there are three forms of business organization in Canada: sole proprietorships, partnerships, and corporation.

An unincorporated business owned by one person is called a sole proprietorship. The owner also acts as the manager of firm. From a legal viewpoint, the owners of such unincorporated business are held personally liable for any and all debts of their businesses. The partnership is a form of business organization other than a corporation existing between two or more persons with the view to profit. One significant feature of a partnership is that a partnership is not a separate legal entity in itself but merely a voluntary association of individuals. Neither proprietorships nor partnerships are entities separate from the owners as individuals.

Corporations are different from proprietorship and partnership in the sense that they are legally distinct entities under legal system. Corporations can be created under federal, provincial or special laws in Canada. The owners of a corporation are called shareholders as they are entitled to share the profits of business. The following four types of corporation can be found in Canadian corporations including privately held corporations[71], publicly held corporations[72], crown corporations[73], and Non-profit

[71] Privately held corporations are those whose shares do not traded on public exchanges and are

corporations and foundations[74].

With regard to the corporate governance issues in the context of fiduciary obligations of the separation of ownership and management in this thesis, we concentrate thereafter on the corporation as such, and more particularly on publicly-held corporations.

b). China

China's current corporate system is in the process of corporatization reform. The reform program envisions distinct forms of the modern enterprise system applicable to State-owned enterprises (SOEs).[75] Large SOEs may be transformed into either of the following two forms: Limited Liability Company and Joint Stock Company.[76]

Limited Liability Companies do not issue shares to the public. They remain wholly-owned by one or more state shareholders. This form of organization is appropriate for "corporations producing special categories of goods and enterprises producing armaments."[77] According to the 1994 Company Law, each shareholder is liable toward the company to the extent of its respective capital contribution.

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therefore not subject to securities legislation.

[72] Publicly held corporations are the main trend of Canadian firms and the main focus of this thesis. The characteristics of Canadian publicly held corporations compared with the other types can be summarized four aspects: limited liability, a legal personality distinct from and which survives its individual owners, the need for centralized management of a large enterprise, and the need to raise capital in public markets.

[73] Crown corporation is the Canadian terms for a company whose shareholder is the government (the "Crown") itself.

[74] Non-profit corporation and foundations are entities with a social purpose that nevertheless operated by most of the rules of marketplace.

[75] According the company law, a state-owned enterprise is not a company. If a state-owned enterprise is to be reorganized into a company, it must, in accordance with the conditions and requirements prescribed by national statutes and administrative regulations, change its operating mechanism, and orderly identify and verify its assets, determine the respective owners of the property rights therein, settle its creditor's rights and liabilities, conduct assets appraisal, and set up standard internal management organs. See article 7 of company law of China.

[76] Also the article 2 of company law of China prescribes that a company means a limited liability company or a joint stock limited company established within China.

[77] Gao, Shangquan, and Fulin Chi. Reforming China's State-Owned Enterprises. (Beijing: Foreign Languages Press, 1997), p. 32.

Joint Stock Companies include a combination of state and public ownership. During the corporatization process, the company's total capital is divided into equal shares, which are then distributed to various shareholders. Each shareholder is liable toward the company to the extent of their respective shareholdings.

Despite of the stipulation concerning the company in the company law, in China, the enterprise concept covers a broader scope than *company*. Many of the operations generally known as enterprises have existed beyond the scope of company law. Although a number of entities may use the term "company" or "incorporation" in their names, in a legal sense many of them are state-owned enterprises. With the process of corporatization reform, this phenomenon should be changed.

2. Legal Framework of Corporate Governance

a). Legal Framework in Canada

Company law and the legal system play a key role in corporate governance. Company law lays down the "rules of the game" for the internal operation of the corporation including such important issues as the nature of shareholder rights and duties, the organizational structure of the corporation, etc. The legal system is important for corporate governance not only insofar as it plays am important role in the enforcement of company law, but also to the extent that it is charged of enforcement of a wide range of contracts which corporations make with various external actors (e.g., suppliers, partners in joint ventures, etc.).

The Constitution of Canada grants both provinces and federation the power to regulate corporations. According to the *Constitution Act 1982,* each province has the right to make law in relation to the creation of companies that intend to operate within the boundary of the particular province.

The key legislations with regard to Canadian corporate governance are the business corporation acts of the federal and provincial parliaments[78] and, for publicly traded companies, the securities acts of the various provinces. In addition, there are a variety of other statutes that impose duties on corporate directors and thus have an impact on corporate governance. The most important of these are the laws relating to employment standards (provincial), environment (provincial and federal), and insolvency (federal). Statutes governing certain sectors, such as banking, insurance and telecommunications impose further obligations.

Besides the federal and provincial legislation concerning the corporate governance, other corporate governance codes and principles in Canada include: *Corporate Governance Policy - New Disclosure Requirements and Amended Guidelines;*[79] *Beyond Compliance: Building a Governance Culture (Saucier Report);*[80] Five Years to the *Dey;*[81] *Where Were The Directors? Guidelines for Improved Corporate Governance in Canada (The Toronto Report).*[82] Th ese codes and principles will be introduced in the following chapters.

In Canada, corporate legislation has historically been strongly influenced by the example of U.K. As a result of this, shareholders have in principle enjoyed many of the same legal rights as shareholders in other Angle-Saxon countries despite of the concentration of ownership in Canadian forms. Canada uses US law and practice as a model for its corporate reform. However, Canada's corporate legal framework does not resemble that of US. As a result, Canadian corporate legal framework adopts

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[78] Federally, the *Canada Business Corporations Act* (CBCA) is the principal statute, but the *Canada Corporations Act* is often used for non-profit organizations, foundations and the like. All provinces have their own parallel acts, such as the *Ontario Business Corporations Act* and the *Quebec Companies Act.*

[79] On March 26, 2002 the Board of Directors of the Toronto Stock Exchange approved amendments of the corporate governance disclosure guidelines.

[80] The Joint Committee on Corporate Governance (known as the "Saucier Committee" for its chair, Guylaine Saucier) issued its final report in November 2001.

[81] Report on Corporate Governance, 1999

[82] Toronto Stock Exchange published *"Where Were The Directors?"* in 1994, which was a landmark study on corporate governance. Since then, standards of corporate governance have improved in boardrooms across Canada

different approaches to regulate matters such as shareholder litigation and securities markets.

b). Legal Framework in China

The legal framework for corporate governance in China is based primarily on the following national laws and regulations: the *Certified Accountant Law* (issued in 1993), *Audit Law* (1994), *Company Law* (1994), *People's Bank of China Law* (1995), *Commercial Bank Law* (1995), *Securities Law* (1998), and *Accounting Law* (1999). The key regulatory bodies involved in the lawmaking process are CSRC, the State Economic and Trade Commission, the Ministry of Finance, and the People's Bank of China. Since establishment of CSRC, more than 300 laws, regulations, rules, standards, and guidelines concerning the securities and futures market have been stipulated by the China legislative and administrative authorities. All these laws and regulations form the fundamental framework of Chinese system of corporate governance.

The importance of corporate governance has been recognized in the continuous development of the Chinese capital market, the Chinese Securities Regulatory Commission (CSRC) recently issued two corporate governance requirements: *Code of Corporate Governance for Listed Companies in China* enacted by both the CSRC and State Economic and Trade Commission in 2002 and *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* issued by CSRC in 2001.

Code of Corporate Governance for Listed Companies in China is based on the guideline issued by Shanghai Stock Exchange at the 2000 international conference on corporate governance. It aims to introduce solid corporate governance in listed companies by elevating requirements on accounting procedures and information disclosure, introducing independent directors' systems, and tightening the supervision of corporate management. It stipulates the code of conduct of all the following parties in the listed companies: shareholders and shareholders' meeting, directors and board of directors, and the supervisors and the supervisory board. The code sets out both the rules for establishing performance assessment and incentive and disciplinary systems and the rules for disclosing information and maintaining transparency.[83] In particular, the stipulation with regard to the listed company in which the controlling shareholder owns a stake in excess of 30 percent should adopt a cumulative voting mechanism to ensure the voting interests of minority shareholders.[84]

China's Company Law of 1994 follows the old Continental style of company legislation. According to the Company Law,[85] there are three tiers of control over corporate operations: the shareholders' general meeting, the boards of directors and supervisory board, and management. The general shareholders' meeting has final right over the key issues of the corporation, such as approval of the management strategy, the financial budget and key investment plans, and the nomination of the boards of directors and supervisors. The board of directors makes key investment plans and the supervisory board oversees the decision-making process and performance of senior management and directors. And management is responsible for corporate operations and for implementing the decisions of the board of directors.

[83] See Ruyin Hu, *Shareholder Rights and the Equitable Treatment of Shareholders,* The Fourth Asian Roundtable on Corporate Governance of OECD. At http://www.oecd.org/dataoecd/49/11/2484867.pdf (access date: Feb. 25, 2004)

[84] See article 31 of *Code of Corporate Governance for Listed Companies in China*

[85] F or an assessment of the company law see Ong, Kingsley, and Colin Baxter. (1999). "A Comparative Study of the Fundamental Elements of Chinese and English Company Law." *International and Comparative Law Quarterly* 48(January): 88–126; Nicholas C. Howson, "China's Company Law: One Step Forward, Two Steps Back? A Modest Complaint" 11:1 *Columbia Journal of Asian Law* 127 (1997); Png Cheong Ann, "Some concerns about Chinese company law", 17(7) *Company Lawyer* 199 (1996); Liu, Lawrence s. "Chinese Characteristics Compared: A Legal and Policy Perspective of Corporate Finance and Governance in Taiwan and China" at ssrn.com (http://papers.ssrn.com/sol3/delivery.cfm/delivery.cfm/SSRN_ID273174_code010612560.pdf?abstractid=273174 access date: Apr. 26, 2004).

II Ownership Structure of Canadian Corporations and Chinese Corporations

The ownership structure is an important component of corporation governance, the corporate world today subdivides into rival systems of dispersed and concentrated ownership, each characterized by different corporate governance structures.[86] In concentrated ownership structures, ownership and/or control is concentrated in the hands of a small number of individuals, families, managers, directors, holding companies, banks and/or other non-financial corporations. In dispersed ownership structure, a large number of owners each hold a small number of company shares. Small shareholders have little incentive to closely monitor a company's activities and tend not to be involved in management decisions or policies. It is well known that there are two different models in corporate governance: the bank based and the market based model. The distinction Angle-Saxon model and Continental-European model mostly corresponds to the distinction. In the Anglo-Saxon model, share ownership is dispersed and unsatisfactory performance is sanctioned by shareholders selling shares or by hostile takeovers. In the Continental-European model, core investors own significant stakes. The more recent focus on ownership structure has been on two issues. First, to compare the operation of market-based systems of corporate governance, in which share-ownership is relatively dispersed and financial markets play a major role in monitoring company performance, with "blockholder" systems, in which most public companies have a controlling shareholder and banks play a more significant role in corporate governance than financial markets. Many researchers have already studied whether ownership structure significantly affects corporate governance.[87]

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[86] John C. Coffee, *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. LAW 1, 1-2 (1999).

[87] See generally, M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a CrossRoads" 62(3) (1999) *Law and Contemporary Problems 9.*

In this part, we examine the ownership structure of Canadian corporations and Chinese corporations. On the one hand, a generalization within North America would see different: the ownership structure of Canadian corporations does not follow the feature of market based governance model characterized by widely held corporations; the other part, the situation of core owner of state in a corporate is changing. On the other hand, the ownership structure setting in China is quite different from the west and from the countries of the former Soviet bloc. China has not, as was the case in the former Soviet-bloc countries, undergone a rapid transition from a planned economy to a market economy.[88]

1. Ownership Structure of Canadian Corporation

Canada's geographic proximity to the United States has determined that its corporate law would inevitably move closer to the US model. For example, Canada adopted a mandatory securities regime which is "very much American in concept and approach".[89] But there are some differences between the Canadian model and the Anglo-Saxon model.

a). Concentrated Ownership

Like other Anglo-Saxon countries, Canada is a country characterized by an active stock market. However, the main difference between Canadian system and the other Anglo-Saxon countries (i.e. the United States) is that Canada has experienced a rapid concentration of stock ownership in the hands of controlling shareholders. Although some studies show that the ownership concentration of public companies in Canada

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[88] The inherent pragmatism of China's reform process is typified by the analogy used by Deng Xiaoping in 1962 to refer to reform of the system of production. He used a popular Chinese saying, "It does not matter if it is a white cat or a black cat as long as it catches mice." While this may have lacked resonance in the 1960's (Deng was purged during the Cultural Revolution), it did not came to typify until the 1978 economic reform. See Lan Cao, "The Cat that Catches Mice: China's Challenge to the Dominant Privatization Model" (1995) 21 *Brook. J. Int'l L 97.*

[89] See C. Jordan, *International Survey of Corporate Law in Asia, Europe, North America and the Commonwealth* (Centre for Corporate Law and Securities Regulation Faculty of Law, The University of Melbourne, Melbourne, 1997), p. 32.

has lessened in recent years,[90] a significant number are still owned by a small group of controlling shareholders. The fact is that the nature of corporate ownership structure in Canada has changed significantly over the past decade with the replacement of the retail investor by the institutional investor as the major player in Canadian equity markets.[91] Th at is to say, most Canadian companies do not have dispersed shareholdings, and are usually controlled by a principal shareholder. In the United States, large share holdings, and especially majority ownership, are relatively majority uncommon.[92]

A Royal Commission on Corporate Concentration reported in 1978 that among Canada's 100 largest non-financial corporations, 48% were either wholly owned or controlled by a majority stockholder.[93] A later study in 1985 found that nine Canadian families held control over 46% of the top 300 companies traded on Toronto Stock Exchange.[94] More recent data shows that 382 out of Canadian 400 largest public corporations are controlled by a majority shareholder, and only 15 of the 100 largest corporations are widely held by numerous shareholders.[95] The controlling shareholders, through board representation, have a powerful influence on corporate governance.[96]

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[90] R. Daniels & J. MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime" (1991) 29 *Osgoode Hall Law Journal* 863; R. Daniels and P. Halpern, "The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy (1995) *Can. Bus. L.J.*

[91] J.G. MacIntosh, "The Role of Institutional and Retail Shareholders in Canadian Capital Markets" (1993) 32 *Osgoode Hall L.J.* 371 at 411.

[92] Probably due to legal restrictions on high ownership and exercise of control by banks, mutual funds, insurance companies, and other institutions, the concentration of corporate ownership is uncommon. For detailed, see Roe, Mark, 1994, *Strong Managers Weak Ownership: The Political Roots of American Corporate Finance* (University Press, Princeton, N.J.).

[93] See the *Report of the Royal Commission on Corporate Concentration*, 1978.

[94] See D.A. DeMott, Comparative Dimensions of Takeover Regulation, in J.C. Jr. Coffee et al. eds., *Knights, Raiders and Target: The Impact of the Hostile Takeover* (New York: Oxfort University Press, 1988) at 398, 400.

[95] R.A.G. Monks & N. Minow, *Corporate Governance* (Blackwell Business, Massachusetts, 1995), p. 39.

[96] A review of 795 corporations listed on the TSE300 in 2000 found that 25% of companies had no shareholder with more than 10% of all outstanding voting shares in the company; 52% of companies had no shareholder with more than 20% of outstanding voting shares; and 77% had no shareholder with

The concentration of corporate ownership is one of the main characteristics of bank-based systems of corporate governance existing mainly in Europe. The effects of ownership concentration on firm performance are theoretically complex and empirically ambiguous. Conceptually, concentrated ownership may improve performance by increasing monitoring and alleviating the free-rider problem in takeovers.[97]

This concentrated ownership results in some differences in Canadian corporate governance and practice. The first difference is that the Canadian corporate management does not need statutory discretion to operate a firm "because it has the votes to change statutory default rules as it please".[98] A detailed study of Roth..[99] shows the relation between the ownership structure concentration and corporate decision-making and performance. In the concentrated ownership companies, large shareholders may help reduce the free-rider problem of small investors, and hence are value-increasing in the economic hypothesis.[100] This concentrated nature of ownership structure and control of Canadian public companies decreases the likelihood of shareholder approval for any shareholder proposal to which a controlling shareholder and management object.[101]

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more than 50% of voting shares. This, however, does not account for the cooperation of shareholders in practice. The current data contrasts starkly with early studies that found in more than 3/4 of Canadian corporations reviewed, one large blockholder controlled 20% or more of the voting shares, and in over half of the firms a single blockholder controlled more than 50% of the voting shares. See William M. MacKenzie, "Out of Control" (October/November 2000) 12(6) *Corporate Governance Review* 1 at 2; MacIntosh (1995-96), for detail.

[97] Shleifer, Andrei, and Robert W. Vishny (1986), "Large Shareholders and Corporate Control." *Journal of Political Economy*, 94(3), 461-488.

[98] R. Romano, *The Genius of American Corporate Law* (The AEI Press, Washington, D.C., 1993), p. 124.

[99] Roth.Chris W. Concentration of ownership and the composition of the board: An examination of Canadian publicly-listed corporations, The Canadian Business Law Journal. Agincourt: Feb 1996. Vol. 26, Iss. 2; pg. 226.

[100] See, Shleifer, A, and Vishny, R. W (1986), "Large Shareholders and Corporate Control." *Journal of Political Economy*, 94(3), 461-488.

[101] S. Rousseau, L'influence des Investisseurs Institutionnels sur la Régie d'Entreprise au Canada, (1996) 37, *Les Cahiers de Droit Université Laval* 305-376, p. 329. cite PA Koval, "Trends in Canadian Shareholder Activism" in The Canadian Institute, Duties and Liabilities of Officers and Directors, *Toronto, Canadian Institute Publication*, 1992, 55-57.

The concentration of ownership structure in Canada also affects the country's corporate litigation patterns. Due to the power of controlling shareholders in Canadian forms, unlike other Anglo-Saxon countries; Canadian law does not provide great incentives for shareholder litigation.[102] Another difference is that there are provincial securities laws respectively instead of one federal securities law in Canada.

b). Interconnected Corporate Relationships

Although Canada and the United States are economic identical in many ways, Canadian corporate ownership structure differs radically from that of the United States. Canada permits vast interconnected groups of corporations. Moreover, Canadian large, interventionist government makes ties between business and political insiders important.[103] Interconnected corporate relationship between the corporations is another particularity of Canadian corporate ownership. Many corporations are linked through ownership relationships. In the late 1980s, 5305 corporations were already tied to each other.[104]

2. Ownership Structure of Chinese Corporation

The success of Chinese economy depends on good performance and efficient growth of the Chinese companies. Corporate success requires sufficient and proper investment activity, which is largely made possible by expansion of opportunities for raising equity capital through the capital market. All these depend on the terms and conditions of corporate governance. However, all these successes do not mean that successful system of corporate governance has been established in China. Chinese

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[102] R. Romano, The Genius of American Corporate Law (The AEI Press, Washington, D.C., 1993), p. 126-127.

[103] See Morck, R. *It's Time for Canada to Distance Herself from the Third World*, at: http://www.bus.ualberta.ca/rmorck/

[104] See Burcu Inal, *Corporate Governance in the United States, Canada and French*, (LL.M. Thesis, McGill University, 2000), p. 38, cited C.N. Sargent, *Corporate Groups and the Corporate Veil in Canada: A Penetrating Look at Parent-Subsidy Relations in the Modern Corporate Enterprises* (1988) 17 Man. L. J. 156.

system of corporate governance has its own characteristics. Chinese corporate ownership structure has its own characteristics which are similar to and also different from that of Canadian system in the following two aspects.

a). Assorted Ownership

In China, the ownership structure of listed companies consists of mainly state ownership, legal persons' ownership and public ownership. This is quite different from Canadian situation.

State ownership is the result of the share conversion process, and is represented by the state asset management unit or their authorized agencies or investment companies. Legal person ownership includes state-owned legal persons' ownership and non state-owned legal person ownership that are not state owned. State owned legal person ownership came about as a result of investment by state-owned enterprises into joint stock companies. Non state-owned legal person ownership can be divided further into "insider legal person ownership", and "outsider legal person ownership". The former represents ownership by legal persons who have operating or long-term relationship with the listed company; the latter represents ownership resulting from public fundraising activities.

Shares are classified into state-owned shares, state-owned legal person shares, and shares of members of the Chinese public according to this corporate ownership structure in China.[105] While members of the public can trade their shares among themselves on the securities market, state-owned share is prohibited, and state-owned legal person shares can only be traded among state-owned legal persons.[106] With such ownership structure, the securities market can not operate well in state-owned and

[105] Apart from these categories, shares can be further classified into A shares, B shares, C shares, and N shares. For detailed discussion about the share structure in China, see C.X. Yao, *Stock Market and Futures Market in the People's Republic of China* (Oxford University Press, New York, 1998), p. 3-37.

[106] See (1994) 12 *Gazette of the People's Republic of China* (Oxford University Press, New York, 1998), p. 18.

state-controlled companies. Some studies have already showed that shares held by state played a negative role in corporate governance, domestic institutional and managerial shareholdings improved the firms' performance.[107]

b). Concentrated Share Ownership

In China, since a large portion of listed companies are restructured state-owned enterprises, there is a great degree of ownership concentration of state-owned shares. After more than twenty years of economic reforms, the proportion of the public sector in China has reduced significantly. However, this decrease of public sector does not mean that the private sector plays an important role in the national economy. The state-owned or the state-controlled companies are also the main part in the Chinese economy. In the two stock exchanges in China,[108] In terms of corporate governance, the most striking feature of China is that on average the state directly holds a 38% share in listed firms. In addition the state indirectly holds controlling positions through state controlled institutions termed "legal persons" which are referred to as domestic and placement institutions and total a further 21% of issued share capital. Legal persons, typically investment trusts and other asset management companies have been allocated shares in the listed companies to act as a form of quasi-institutional investor. They are expected to use their positions not as representatives of the state, but as professional investors. It is unclear who represent the state as a shareholder in the listed companies during the transaction.[109] The largest shareholder in listed companies has 44.9 percent of the total share averagely. In contrast, the second-largest shareholder typically owns a mere 8.2 percent.[110]

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[107] Chen, Jian. *Ownership Structure as Corporate Governance Mechanism: Evidence from Chinese Listed Companies,* Economics of Planning. Dordrecht: 2001. Vol. 34, Iss. 1-2; p. 53.

[108] Shanghai Stock Exchange and Shenzhen Stock Exchange. Both of them were established in 1990.

[109] The law authorizes a department or institution to supervise the operation of state assets in a state-owned or state-controlled company. However, the department or institution does not directly take part in corporate operations and can only influence the management by exercising shareholders' rights. However, on practice, these state agents do not exercise shareholders' rights and duties diligently and make the managers of these companies act in the interests of the shareholder (the State).

[110] See the issue of China Securities on July 2001.

Under such a scenario, majority shareholders can easily ignore minority investors and use information asymmetries.

The largest shareholder, which is different from that of Canadian corporations, is usually the state, holds almost 45% of the total shares in average in a listed company. The related party transactions between controlling shareholders or a group company and the listed company are often detrimental to minority shareholders in practice.

The 1994 Company Law also requires the state to subscribe at least 35 percent of the total shares issued.[111] The state shares in these corporations are not tradable on the market. In the state-owned or state-controlled companies, the control right belong to the bureaucrats. These bureaucrats can be thought of as having extremely concentrated rights, but no significant cash flow rights because the cash flow ownership of state firms is effectively dispersed amongst the taxpayers of the country.[112] From this perspective, the state ownership of Chinese system of corporate governance is an example of concentrated control with no cash flow rights and socially harmful objectives.[113] This structure of state ownership and control of firms accounts for their poor performance.[114] Furtherm ore increasing state ownership is negatively related to good corporate performance.[115]

c). Cross-Ownership of Chinese Companies

As noted above, there are diverse types of participants in Chinese corporate

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[111] Ma, Shu Y., "The Chinese Route to Privatization: The Evolution of the Shareholding Option," Asian Survey 38:4 (April 1998), pp. 379-397, at 381-382.

[112] Shleifer, A. and R.W. Vishny. "A Survey of Corporate Governance." *Journal of Finance*, 52 (1997), 737-783. p. 768.

[113] *Ibid.*

[114] See Tenev, S. and Zhang, C., *Corporate Governance and Enterprises Reform in China: Building the Institutions of Modern Markets*, World Bank and the International Finance Corporation, Washington, D.C., 2002

[115] Tian, G.L.H. (2001), *State Shareholding and the Value of Chinese Firms*, Working Paper, London Business School, at: http://forum.london.edu/lbsfacpubs.nsf/(httppublications)/085217AF53BA5AA180256A24003DF5FC (Access date: May 21, 2004).

ownership: state-owned, domestic institutional investors, employees, large blockholders, and foreign institutional investors.

This cross-ownership has a deep influence on the Chinese corporate governance. In China, state-assets stripping has taken place when new institutional property owners were created through complicated patterns of cross-ownership.[116] Th is cross-ownership pattern has a positive relation with the state-owned enterprises' (SOE) reform, however, this has a negative effect on the economy. State-assets stripping accrues when non-state but state-affiliated enterprises involve in selling their products and services. With the downward transfer of property rights, SOEs were either spun off into semi-public companies, leased, subcontracted, or even taken over by individuals or other SOEs, creating new categories of institutional property owners.[117]

II Institutions in Canadian and Chinese Corporate Governance

1. The Canadian and Chinese Board of Directors

The board of directors is the legal and accountable group responsible for all the corporation's actions and the results of those actions. From legal point of view, the patterns of corporate structure under the two legal systems are generally known as "two-tier boards (Board of Directors and Board of Supervisors) system" or "internal-regulation mode" and "one-tier board (Board of Directors) system" or "external-regulation mode".[118] Whether a corporation adopts "two-tier boards" or

[116] Xu, Yochong, *State-assets depletion and economic reform in China* Studies in Comparative International Development. New Brunswick: Spring 2000. Vol. 35, Iss. 1; pg. 73, 28 pgs.

[117] *Ibid.*

[118] The one-tier board model is academically considered as a shareholder and market-oriented model with a purpose to maximize shareholders' wealth and relies on external regulatory mechanisms. In contrast, the two-tier board model originated in a society with relatively less developed external regulatory mechanisms and there was thus a strong need for an internal control device such as the supervisory board to supervise corporate performance. For details, see Moerland, P. W. (1995). *Alternative Disciplinary Mechanisms in Different Corporate Systems*, Journal of Economic Behaviour

"one-tier board" corporate structure is subject to the applicable company law of its registration nation.

Boards of directors of companies in Anglo-Saxon countries including the United States, Canada, and United Kingdom are based on one-board system. In some European countries including Germany, Austria, the boards of directors of listed companies are based on two-tier system. Some other countries, such as France, are allowed to adopt either the one-tier model or the two-tier model by the national legislation. The two board models are designed to support the independence of board of directors. China, its corporate governance developed in the middle of last decade of 20th century which is greatly influenced by both the Anglo-Saxon system of corporate governance and the Continental-European system of corporate governance, adopts two-tier system as its board structure.

Evidences show that there is a strong relationship between board composition and corporate performance. Regardless of which board structure is adopted, the board that has a majority of independent directors behaves differently than the boards without a majority of independent directors and should operate within a corporate governance framework.[119] Also there may be different ways of organizing things, but the bottom line is that whatever board model is being followed, all corporations need an executive and supervisory function and to allocate responsibility.[120] Board

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and Organization, 26(1), pp. 17–34. and Shleifer, A. and R. Vishny (1997). *A Survey of Corporate Governance*, Journal of Finance, 52(2), pp. 737–782.

[119] The most widely debated question in the first line of research is whether having more outside directors is associated with better firm performance. For example, Baysinger and Butler (1985), who find weak evidence that firms with a higher percentage of outsiders on the board in 1970 had a higher industry-adjusted return on equity in 1980. Schellenger, Wood and Tashakori (1989) also show that outside director representation is positively related to return on assets and on risk-adjusted stock returns. Agrawal and Knoeber (1996) argue that board composition is one of a number of endogenously determined corporate governance mechanisms, including the use of debt, the labor market for managers, the market for corporate control, insider shareholdings, institutional shareholdings, block holdings and the use of independent board members. Also, other studies fail to find a significant relation, such as Hermalin and Weisbach (1991)

[120] See, *THE REVIEW OF THE OECD PRINCIPLES OF CORPORATE GOVERNANCE,* Report on a meeting of trade union experts held under the OECD Labour/Management Programme, (Paris, 19 June 2003), at 21.

independence is supported by a board structure that separates decision-management from decision-control.[121]

a). The One-tier Board System of Canada

i. Attributes of One-tier Board System of Canada

The one-tier board system is found in the United Kingdom and other Anglo-Saxon influenced countries including United States, Canada etc. In this system, executive and non-executive (independent) directors are brought together in a single structure, which assumes all directors are equal and share collective responsibility for decision.

The attributes of the one-tier model can be summarized that CEO-duality (role of CEO and chairperson held simultaneously) is allowed under this model and that a board composition (inside directors and outside directors) can be dominated by executive directors. Both CEO-duality and board composition are at least potential threads to the independence of board of directors practically and theoretically. In Canada, the functions of CEO and Chairman are still often combined. The CEO is often the member of nominating committee.

During these years, the international call for corporate governance reform is strongly reflected by a fierce and ongoing discussion on the attributes of one-tier boards. The one-tier board system is considered by some authors that these boards are no more than ceremonial rubber-stamping devices to support the objectives of management.[122] However, with a strong presence of independent directors, the one-tier board system can ensure the board accountability.

In Canada's perspective, the role of the board of directors has two basic functions:

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[121] Jensen, M.C. and Meckling W.H. (1976). *Theory of Firm – Managerial Behavior, Agency Costs and Ownership Structure,* Journal of Financial Economics, 3: 305-360.

[122] See, Rechner, P. L. and Dalton, D. R. (1991), *CEO Duality and Organizational Performance: A Longitudinal Analysis*, Strategic management Journal, 12: 155-160.

decision-making and supervision. The decision-making function is exercised with respect to the formulation with management of fundamental policies and strategic goals and through the approval of certain significant actions; the supervision function concerns the review of management decisions, the adequacy of systems and controls and the implementation of policies.[123]

The Dey committee goes beyond the traditional dichotomy of the one-tier system between inside and outside directors, and argues that every board of directors should have a majority of unrelated directors who are non-management directors and are free from any business or other relationship.[124] T he *Canada Business Corporations Act* currently requires at least two unrelated directors on the board of a public firm. Toronto Stock Exchange Committee on Corporate Governance in Canada (the Dey Committee) recommended that a majority of all directors of listed companies be unrelated.

The main difference between unrelated and outside directors lies with the fact that a director who is an employee or representative of a company that provides a service to the company, such as a banker, lawyer or accountant, is an outside director but may not be considered unrelated, according to the *Dey Report*. With regard to the differences between unrelated and independent directors, the term of "independent

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[123] The Dey Report, in its first set of guidelines, describes the roles of boards as following: (i) adoption of a strategic planning process; (ii) the identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks; (iii) succession planning, including appointing , training and monitoring senior management; (iv) a communications policy fro the corporation; (v) the integrity of the corporation's internal control and management information systems.

[124] Dey Report, the Guideline 4 says that "a director who is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding. An amendment of definition of unrelated director proposed recently by TSX as follows: "unrelated director" means a director who is: (a) not a member of management and is free from any interest and any business, family or other relationship which could reasonably be perceived to materially interfere with the director's ability to act wth a view to the best interests of the issuer, other than interests and relationships arising solely from holdings in the issuer (b) not currently, or has not been within the last three years, an officer, employee of or material service provider to the issuer or an of its subsidiaries or affiliates and (c) not a director (or similarly situated individual) officer, employee or significant shareholder of an entity that has a material business relationship with the issuer. TSX dos not consider a chair or vice chair of the board of director who is not a member of management to be a related diector.

directors" only occurs in a statutory or regulatory context in Canada in the OSC's Rule 61-501 and its Quebec counterpart QSC 27[125] as well as MI 52-110 audit committee[126]. In the regulation 58-101, a director is independent if he or she would be independent within the meaning of section 1.4 of Multilateral Instrument 52-110 *Audit Committees*.[127] T he purpose of the Audit Committee Rule is to encourage reporting issuers to establish and maintain strong, effective and independent audit committees. In this point, The *Dey Report* is different from the Chinese *Guidance.*[128] It fails to fully introduce the concept of independent director.

The past twenty years in Canada have seen a dramatic change in the way boards of directors are organized and operated. It is now accepted that boards must be active, must add value to the corporation, and be effective contributors to corporate competitiveness, and must be more responsible to its shareholders and stakeholders.[129]

ii. Board Structure

The number of directors on a board is a factor in the board's effectiveness. Studies show that the size of board has an inverse relationship with the corporate performance[130] or no significant relationship[131].[132] In the late 1960's, the report by

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[125] Carol Hansell, *What Directors Need to Know: Corporate Governance,* (Toronto: Carswell, 2003), p.76.

[126] In Canada, there is an exemption for controlled companies from the audit committee independence rules. This reflects an accommodation for the higher proportion of family-owned and other controlled public companies in the Canadian market. Also, audit committees are not required to hire and fire the independent auditors, because Canadian corporate law vests this power to the shareholders. Instead, the audit committee must make a recommendation to the board about the candidate who will be proposed to the shareholders for election as auditor. If the board does not follow the audit committee's recommendation, it must disclose this fact. In addition, independent auditors are prohibited from performing various non-audit services for their audit clients.

[127] See national instrument 58-101, *Disclosure of Corporate Governance Practices*

[128] Guidance to Establishment of Independent Board Director's System in Listed Company, see the following of this thesis.

[129] See J. Longair, *Choosing the board of Directors for the 90's* (Ottawa: The Conference Board of Canad, *1992) at 3.*

[130] See Bohren, O., and Bernt Arne Odegaard. 2001. *Corporate Governance and Economic Performance: A Closer Look.* In Working Paper.

Laurence Committee in Canada stressed the important effect of the non-executive board directors on the improvement of corporate profits, which predicted a trend that people started to regard the independent board directors as the major protectors of the shareholder's equity and public interests.[133] The Dey committee goes beyond the traditional dichotomy between inside and outside directors, and argues that every board of directors should have a majority of unrelated directors. The TSE adopted the Dey Committee recommendations as a listing requirement in 1995. Companies had to specify their specific corporate governance practices with reference to each of the guidelines either in the annual report or in the proxy statement. The board independence is the primary focus of the *Dey Report*; it includes recommendations that boards have a majority of unrelated directors and that the positions of board chair and CEO are held by different persons. The report of the Joint Committee on Corporate Governance set up by the TSX, CDNX and CICA in order to examine the effectiveness of the Dey recommendations.[134] Sauc ier's strategy was to focus more on behavior and less on its structure. However, the report has recommended that it be a condition of listing on the TSE that an issuer's board of directors have a designated "Independent Board Leader." The report also clearly expresses its preference for a non-executive chairman of the board.[135]

With regard to the number of directors, the number of directors on a board is a factor in the board's effectiveness. *Canadian Business Corporation Act* ("CBCA") does not impose a limit on the maximum number of directors, so that in theory, very

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[131] See Fuerst, O., and S.H. Kang. 2000. Corporate Governance, Expected Operating Performance and Pricing. *Draft.*

[132] See Foerster, Stephen R., Gross, Rob, Shapiro, Daniel and Toner, Martin, 2004, General Trends on Corporate Governance Practices Amongst Canadian Firms: 1999 – 2001 A preliminary analysis of select governance data for Canadian firms, For Industry Canada

[133] Zhuo, Chenggang *Independence: Foundation for Functions of Independent Board Directors,* USA-China Business Review, Volume 3,No.1 (Serial No.14), Jan.2003, at 68.

[134] Jo int Committee on Corporate Governance, "Beyond Compliance: Building a Governance Culture," (The Saucier Report) Toronto: Chartered Accountants of Canada, Toronto Stock Exchange, and Canadian Venture Exchange, November 2001.

[135] Kenn eth Wiener, William Gorman and Goodmans LLP, *The Saucier Report on Corporate Governance, at www.cba.org.*

large boards of directors are possible.[136][137] A variable number of directors permit the governance structure of a corporation to be adjusted to reflect changes in the make-up of the corporation.[138] The general view is that an appropriate board size is between five and sixteen directors. Empirical study[139] shows that the appropriate number of directors will vary with the size and nature of the corporation. However, the minimum number of directors with at least three directors for public companies is often imposed by the corporation acts.[140]

b). Two-tier Board System of China

The two-tier system prevails in Germany, Austria, Sweden, Finland, and Denmark as well as in major stock corporations in Netherlands. In this system, the supervisory and management functions are separated. The supervisory or upper-tier board is typically concerned with overseeing management of company and consists wholly of non-executive members. The lower-tier board (management board) is made up of executive directors.

Chinese system of corporate governance is a corporate governance system for socialist state which is influenced by the Anglo-Saxon system and the German, Japanese systems. However there is a gap between the model and the reality. In contrast to the Anglo-Saxon one-tier board, the Chinese board is similar to the German dual board system[141] which is divided between the management board and

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[136] For some provincial acts, such as *Ontario Business Corporation Act,* they also do not impose the limit on the maximum number of directors. For details, see Kevin Patrick McGuinness, *The Law and Practice of Canadian Business Corporations,* (Toronto and Vancouver: Butterworths, 1999), p.655.

[137] *La Loi sur les compagnie du Québec* indicate the number of board of directors is no less than three members. See art. 83 of the *Loi sur les compagnie du Québec.*

[138] *Ibid.* p.656.

[139] Foerster, Stephen R., Gross, Rob, Shapiro, Daniel and Toner, Martin, 2004, General Trends on Corporate Governance Practices Amongst Canadian Firms: 1999 – 2001 A preliminary analysis of select governance data for Canadian firms, For Industry Canada

[140] The board of directors of a corporation must consist of at least on director in the case of a corporation that is not an offering corporation, and at least three directors where the corporation is an offering corporation. See Subsection 115 (2) of the OBCA and CBCA, s. 6(1)(e).

[141] For a more detailed description of German and Anglo-American Board systems, see Jeremy Bacon & James K. Brown, *The Board of Directors: Perspectives and Practices in Nine Countries, Research*

the supervisory board. According to the Chinese legislation, Chinese listed companies adopt a two-tier board structure,[142] a Board of Directors (BOD) and a Board of Supervisors. They are also required to provide in their annual reports a supervisory board report (SBR).

The board of directors consists of insider directors (executive directors) and outsider directors (non-executive directors), the independence of director is a major topic with regard to the board of directors in the context of Chinese companies. The supervisory board has the primary duty to monitor the directors and managers' compliance with legal procedures. Due to this duty of supervisory board, the conflicts between the board of directors and the supervisory board is not avoidable.

i. Attributes of Two-tier Board System of China

Compared with the no limit on the maximum number of director in Canada, the *Company Law of China* imposes a strict limit on the minimum and maximum number of board of directors.[143] With respect to the state-owned and state-controlled companies, directors of state-owned companies, the board members in the state-controlled companies as well as the state shareholder representatives in the state-controlled companies are all appointed by the state asset management institutions at present. The board in these companies consists of mainly executive directors, few independent directors. All these professional ethics can lead to "insider control" as another attribute of the two-tier board system of Chinese companies. As in Canada, there are no provisions in the Chinese Company Law relating to the

Report from the Conference Board's Division of Management Research. (1977) at 81.

142 See *the Company Law of the People's Republic of China.* Article 112: A joint stock limited company shall have a board of directors, which shall be composed of not fewer than 5 but not more than 19 members. Article 124: A joint stock limited company shall have a board of supervisors, which shall be composed of not fewer than 3 members. The board of supervisors shall elect one member to serve as the person responsible for calling meetings

143 A limited liability company shall have a board of directors, which shall be composed of not fewer than 3 but not more than 13 directors. A joint stock limited company shall have a board of directors, which shall be composed of not fewer than 5 but not more than 19 members. See article 45 and 112 of company law for details.

composition of the Board of Directors. Research shows that boards of directors in Chinese listed companies have been dominated by representatives of state and legal person shareholders, to the effective exclusion of representatives of individual shareholders.[144]

ii. The Independence of Board of Directors

The independence of a board of directors from management is one of the important issues in the context of corporate governance. A board is ineffective when it is dominated by executive directors (managers or insiders) because the managers are monitoring themselves. The presence of non-executive directors (outsiders) can enhance the independence of a board.[145] Th e independent board director's system is brand new in China. Independence is the key to the functioning of the independent board directors.

Chinese Company Law does not stress this issue of independent directors, the Guidelines for Publicly-Listed Companies' Articles of Association (promulgated by the China Securities Regulatory Commission "CSRC" in December, 1997) suggests that publicly-listed companies may retain independent directors at their option, and makes further clarification for disqualification of independent directors as well.[146] Two other opinions promulgated by CSRC in the following two years with regard to overseas publicly-listed companies, which also allow for the retention,

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[144] See Xu, X. and Wang. Y., "*Ownership Structure, Corporate Governance, and Firms' Performance: The Case of Chinese Stock Companies.*" Working Paper, World Bank (1997). In this paper authors presented data based on the annual reports and sample surveys of more than 300 of these companies listed on the two exchanges and concluded that state or legal persons held respectively over 70% of the board seats on average. Government officials filled half of all board positions, a proportion significantly higher than the state's shareholding (held in the form of state-owned shares). As noted by On Kit Tam (*The Development of Corporate Governance in China,* Edward Elgar Publishing, 1999) p74, one of the obstacles facing active participation by individual shareholders in electing directors is that many companies restrict participation in the shareholders' meeting by reference to a minimum level of shareholding.

[145] Dalton, D R., Daily, C. M., Ellstrand, A. E., & Johnson, J. L. 1998. *Meta-analytic Reviews of Board Composition, Leadership Structure, and Financial Performance.* Strategic Management Journal, 19(3): 269-290.

[146] See *Guidelines for Publicly-Listed Companies' Articles of Association.*

disqualification, number and powers of independent directors by overseas publicly-listed companies. In 2000, the Shanghai Securities Exchange (SSE) also provides details for the retention and disqualification of independent directors in its Guidelines for Publicly-Listed Companies' Governing System. The newest development in this area is that On August 16, 2001, the Chinese Securities Supervision Commission issued the "*Guidance to Establishment of Independent Board Director's System in Listed Company*" (hereafter abbreviated as "Guidance"), which stipulates detailed provisions with regard to independent directors. Thus, even though the Chinese Company Law does not address their use, on the basis of the above descriptions elsewhere in Chinese regulation, it can be reasonably expected that independent directors may appear in more and more publicly-listed companies in the foreseeable future. Overhaul the insider-controlled board structure by promulgation a regulation requiring each listed company to have at least one-third of the board to be independent directors by June 2003.

However, in the perspective of Chinese state-owned or state-controlled companies, we argued that most independent directors can hardly be considered truly independent. These directors are not appointed through market decision but decided by the governmental administration. The outside directors normally have close ties with the big shareholder (the state) or the managers of the same company.

There are several reasons that the use of independent board directors can not play their full roles as might be expected in their true sense. First, there is the issue of independence. Since state-owned or state-owned companies hold significant percentages of most Chinese publicly-listed companies, the election, removal and remuneration of independent directors rely primarily on the consent of the controlling shareholder. This can cast a shadow on the true independence of those elected as independent directors. Secondly, there is still an absence of consistency in regulatory application. The "*Guidance*" is also hard to ensure the independence of the independent board directors.[147] Thirdly, internal conflicts of interest have not all been eliminated. Some powers of independent directors currently overlap with other organizations within their companies. There still needs to be some careful design to avoid causing internal conflicts with supervisory boards and the chairman. Finally, there are still liability questions. Due to the lack of detailed provision on the duty of care, duty of faith and business judgment rules under the Chinese Company Law, the liability of independent directors is still somewhat unclear under China's legal system.

Thus, although the use of independent directors can bring positive influences to Chinese companies, the practice is still young, leaving some areas that need to be worked out before the process is clear.

iii. The Supervisory Board

The supervisory board in China is a combination of the German-style supervisory committee and China's traditional concept of employees as masters of enterprises. According to Chinese company law, the Supervisory Board mainly supervises the board members and management staffs.[148] As part of its functions, the Supervisory Board must monitor the financial affaires, supervise the performances of directors and managers, propose the convening of an interim shareholders' meeting, and exercise other power stipulated by the law.

The supervisory board comprises representatives of the shareholders and

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[147] The "Guidance" stipulates that only the board of directors, supervision commission of a listed company and the shareholders who hold separately or jointly 1% of the issued shares may propose their candidates of the independent board directors. This stipulation is to present the right to nominate independent board directors to the large shareholders (since at present, the state is the largest shareholder in most Chinese listed companies, it control both the board of directors and supervision commission in a listed company). Also with regard to the nomination mechanism of independent board, the independent board directors are hard to be independent. As stipulated in the "Guidance", a listed company should offer an independent board director an appropriate amount of allowance. The allowance standard should be drafted first by the board of directors, and then discussed and passed by the stockholders' meeting. That is to say the nomination of independent directors is not decided through the market decision by appointed by local or central government administration. For more details, see, Chenggang Zhuo, *Independence: Foundation for Functions of Independent Board Directors,* USA-China Business Review. New York, Jan. 2003, Volume 3, No. 1 (Serial No. 14).

[148] See Art. 54 of *Company Law of P.R. China.*

employees and at least formally, has extensive powers to supervise the board of directors.[149] T he Company Law does not specify the proportion of shareholders' representatives and employees' representatives on supervisory committees but just requires that corporate charters properly stipulate the proportion. The chairman of the board of directors is designed as the legal representative of the company. The legal representative is in principle the person who must sign documents binding the company.[150]

Company Law and Code of Corporate Governance for Listed Companies provides the key role of supervisory board is to supervise the corporate finance as well as to supervise the due diligence of directors, management staff, to safeguard the corporate assets, to reduce the corporate operational and financial risks, and to protect the corporate and the shareholders' interests.

In China's corporate practice, however, there remains a strong need to improve the usefulness of the supervisory board and strengthen its function. The supervision of supervisory boards is more theoretical than practical. The published announcements of Supervisory boards of listed companies in China show that they rarely contest decisions made by boards of directors and company executives. Supervisors generally meet less often than boards of directors and their meetings are less well attended. Besides, the lower-quality and less professional experience of supervisors have led to supervisors' inability of supervision

2. The Role of Institutional Investors in Corporate Governance

Institutional investors have been holders of debt capital for over century. The institutional investors need this kind of investment for their own purposes. Proportions of equity held by institutional investors are rising significantly across the

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[149] See Art. 126 of *Company Law of P.R. China*

[150] See Art. 113 and 22 (9) of *Company Law of P.R. China*

world. Four paradigms of corporate governance are outlined, of which three involve a key role for institutions. These are characterized as market control via equity (the takeover sanction), market control via debt and direct control via equity (corporate governance activism). Empirical evidence shows that the rise in institutional shareholdings in recent decades has been associated with better corporate performance.[151]

However, some restrictions on the equity investment can be seen in some countries. There is also empirical evidence concerning the role of institutional investors as equity holders in countries that do not have restrictions on equity investments by financial institutions. The evidence is that if institutional investors who are equity holders are more effective monitors,[152] then agency problems in the countries, which permit to take large equity positions in firms, including firms to which they made loans, should be less than those in the other countries. These facts all have very significant influences on corporate governance. Evidence at a micro level for favorable influences of these mechanisms on corporate performance is mixed, but on balance positive. In the Canadian and Chinese perspectives, the former is showing an increase in direct influence of institutions in place of the previous reliance on the takeover mechanism to discipline managers. This has arguably led to improved corporate performance.[153] The latter remain more firmly in the bank-relationship based governance paradigm. The purpose of this part is to explain the role played by institutional investors in influencing corporate governance both in Canada and in China. At the same time, we also point out that such differences of institutional roles between the two systems should not be exaggerated, and the convergence is

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[151] See Parkinson, J., Gamble, A., and Kelly, G., *The Political Economy of the Company*, (Oxford and Portland: Hart Publishing, 2000), p.199.

[152] Hartzell, J. C. and L.T. Starks, 2000, "Institutional Investors and Executive Compensation," working paper New York University and University of Texas at Austin. They find evidence in this paper suggesting that institutional investors provide a monitoring role with regard to executive compensation contracts.

[153] See E Philip Davis, *Institutional Investors and Corporate Governance* at: http://www.brunel.ac.uk/depts/ecf/research/papers/00-19.pdf (access date: Aug. 12, 2004). p. 15.

discernible on a modified form of the Anglo-Saxon model where institutions are the primary actors in corporate governance generally.[154]

a). Canada

The development of institutional investors[155] and their growing dominance as owners of corporations has had a pervasive and increasing influence on Canadian corporate governance.[156] This influence is not surprising that they have become more active in the role as shareholders of a firm. The activism by these investors has been both private and public, with the public activism perhaps most visible and is progressively replacing the private activism in Canada. The institutions exercise a significant influence on corporate performance through their economic power due to their debt and equity holding.

MacIntosh and Schwartz[157] examine the performance measures for TSE 300 firms and find that the return on assets and return on equity of these firms is positively related to the size of institutional holdings. This study shows that there is a positive relationship between the institutional investors and firm performance in Canada. Moreover, this study also indicates that institutional investors have the function to both monitor and discipline controlling shareholders.

There are a number of different categories of institutional investors including public pension funds, corporate pension funds, union pension funds, retail mutual funds, banks and thrifts, insurance and annuity companies and private foundations.[158]

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[154] *Ibid.*

[155] Institutional investors in Canada include banks, insurance companies, pension funds, investment funds, etc.

[156] Financial institutions hold an important and ever growing volume of shares especially in Canadian public corporations. See S. Rousseau, *L'influence des Investisseurs Institutionnels sur la Régie d'Entreprise au Canada,* (1996) 37, Les Cahiers de Droit Université Laval 305-376.

[157] MacIntosh, J. G. and Schwartz, L. P., Do Institutional and Controlling Shareholders Increase Corporate Value? in Corporate Decision-Making in Canada, R.J. Daniels and R. Morck (eds.), Industry Canada Research Series, University of Calgary Press, 1995.

[158] See J. Barnard, *Institutional Investors and the New Corporate Governance,* (1991) 69 North Carolina Law Review p.1140-41.

Distinctions must be made between different types of institutional investors.

In Canada, banks are large and actively involved in corporate lending and recently in underwriting and brokerage activities. The big six Canadian banks,[159] which operate under the Bank Act, now occupy a dominant position in Canada's economic and monetary system. In the increasingly competitive global economy, dynamic suppliers of funds are a strategic asset that companies must have if they are to expand at home and abroad. However, in Canada, traditionally, banks were prohibited by law from holding equity in a firm. The ability of banks to control stakes in industrial firms and to invest over 60 percent of their capital portfolio has been limited: they have been prohibited from owning more than 25 percent of the equity or controlling more than 10 percent of the voting rights of a single issuer.[160]

Following the financial reforms of 1987 (which allowed banks to purchase or develop securities dealer subsidiaries) and the 1992 Bank Act (which granted them additional powers), banks have entered a range of new businesses.[161] For example, Since 30 June 1987, Ontario has allowed Canadian financial institutions to own up to 100 per cent of a securities dealer in that province.[162]

Although banks play a major role in Canadian corporate governance, other institutional investors, such as pension funds and mutual funds, have historically played no more than a minimal role on corporate governance.

With regard to the pension funds, over the past 10 years there has been widespread debate about the role and status of pension funds in relation to corporate

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[159] The big six Canadian banks are: Bank of Montreal, the Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada, and the Toronto-Dominion Bank.

[160] *Bank Act.*, c. B-1, art 466(1); *Saving and Credit Funds Act,* c. C-4.1, art. 257, 403, *Trust Companies and Saving Companies Act*, c. S-29.01, art. 208.

[161] Jim Armstrong *The changing business activities of banks in Canada*, p.12. at http://www.bankofcanada.ca/publications/review/r972a.pdf (access date: 9 Aug. 2004).

[162] *Ibid.* p.15.

governance.[163] C anadian pension fund assets have grown to make up a huge part of the TSX. In this regard, Canadian Coalition for Good Governance[164] is an organization set up by 33 Canadian pension funds and institutional investors with an aggregate of over $500 billion under management. The Coalition has published corporate governance standards and lobbies companies to adopt these standards. These standards closely reflect the existing TSX guidelines and the best practices proposed by the securities regulators.

In Canadian practice, unfortunately, many of the largest firms in Canada are all but impervious to pressure from pension funds to improve corporate governance and corporate productivity. Only a small minority of Canadian firms are widely held.[165]

Generally say, the institutional investors influence corporate governance in Canada by the following two ways: institutional investors' involvement in corporate governance and institutional investors' disengagement in corporate governance.

b). China

A healthy banking system is an absolute prerequisite for good corporate governance because banks provide the necessary capital and liquidity for corporate transactions and growth.[166] Furtherm ore, the participation of banks in corporate ownership and management structures can allow a firm to take a longer-term view in their decision-making and focus on the long-term profitability of the firm. In China, it is even more important that there is a good banking system as this will establish good governance since banks provide most of the finance. Chinese system of corporate

[163] See Clark, G. L., *Pension funds and corporate governance: An Anglo-American perspective,* paper presented at the European Pensions 2000 conference sponsored by Morgan Stanley Dean Witter, 5th & 6th October 2000, Trianon Palace, Versailles, France.

[164] The mission of the Canadian Coalition for Good Governance is to represent Canadian institutional shareholders through the promotion of best corporate governance practices and to align the interests of boards and management with those of the shareholder.

[165] Morck, R., *Pensions: Whose stock market is it, anyway?* Monday, June 24, 2002, National Post.

[166] Cheung, Stephen YL. and Zhou, Lynda, Instituting Corporate Governance in China, Department of Economic and Finance, City University of Hong Kong, at: www.iwep.org.cn.

governance should be a kind of system in which banks consciously play a dynamic role in corporate governance. Banks' ability to financial and supervise corporations should be widely utilized in China.[167] From the German and Japanese experience, in certain circumstances, banks have significant influence on corporate governance, and can be a more efficient and less expensive mechanism of monitoring corporate performance and rescuing distressed companies than the securities market.

As discussed above, the characteristics of corporate ownership structure in China make the banks become even more important in Chinese system of corporate governance. The four State-owned commercial banks (SOCBs) that dominate the market--Agricultural Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB), and Industrial and Commercial Bank of China (ICBC).

However, the primary source of financing for SOEs has been through the above state-owned banking system accustomed to poor lending practices and making political commitments to support failing companies, resulting in numerous non-performing loans[168] which impede the banks performance in recent years.

The heavy debt burden of state-owned enterprises is one of the important problems during the economic reform in China. The Chinese government has taken many policies and measures to reduce this burden. To write off the bad debts, especially the bad debts from banks, is one important measure. However, the asset-liability ratio remains high. The government launches a full attack on the problem by using the method of debt-equity swap. By converting debts into stocks, the state-banks can become the stock ownership of companies by writing off unrecoverable loans using the state's equity as well as their own profits and reserves.[169] The conversion of debt into stock is an important move for improving the

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[167] Wei, Yuwa, *Comparative Corporate Governance, A Chinese Perspective*, (Kluwer Law International, 2003), p. 25.

[168] Cheung, Stephen YL. and Zhou, Lynda, Instituting Corporate Governance in China, Department of Economic and Finance, City University of Hong Kong, at: www.iwep.org.cn.

[169] Under a reform plan of the year 2004 that includes a US$45billion capital injection, Bank of China

SOEs' asset-liability structure. It can reduce the financing costs of the companies and enable them to develop further. Moreover, it also helps banks participate in corporate governance. It is a step toward accelerating the establishment of a new-type bank-enterprise relationship.[170] A well-regulated banking system is crucial in formulating Chinese system of corporate governance. A bank-based system is less dependent on well defined property rights and a high quality of legal enforcement (take-over code, insider trade restrictions, and strict disclosure rules). This explains why many developing countries or transition economies have no other choice than to adopt a bank-based system.[171]

Besides the influence of strong banking system on corporate governance, there are few domestic pension funds and mutual funds which have deep influences on corporate governance. However, one of the most important tendencies which can be identified is the emergence of the institutions of mutual and pension funds which hold now a broad fraction of equity in China today.[172] Pension reform will increasingly bring a rise in popularity of mutual funds and thus additional pressure for good corporate governance. Good corporate governance will also help Chinese firms compete in the globalizing economy, and greatly attract foreign investment. The influence of foreign investors on Chinese corporate governance is significant because they have become such a large component of this emerging market.

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and China Construction Bank have been allowed to write off unrecoverable loans using the ministry's equity as well as their own profits and reserves, according to banking officials and analysts.

[170] Zeng, Peiyan, State-owned Entrprises Reforms, People's Daily, Tuesday, November 09, 1999, also at: http://fpeng.peopledaily.com.cn/special/soe/199911090OO101.html (access date: 18, Aug. 2004)

[171] Rajan R.G. and Zingales L. (1998) Which Capitalism? Lessons from the East Asian crisis, *Journal of Applied Corporate Governance*, 11: 40-48.

[172] However the institutional investors are still a weak group in China compared with other developed countries. By the end of 2003, proprietary trading and investment in the funds by securities companies accounted for less than 10 percent of the capitalization of the negotiable shares in China's stock market.

PART THREE: COMPARATIVE STUDY BETWEEN THE CANADIAN AND THE CHINESE SYSTEMS

Comparative study between different systems of corporate governance has been a major field since the last decade of 20th century. Corporate governance issues and impact on national competitiveness are a central subject matter both in the advanced economies, such as Canada and emerging, transitional economies, such as China.

I Is One Corporate Governance System Better than the Other

Corporate Governance mechanisms vary a great deal around the world. As we discussed in the previous chapters of this thesis, the Canadian and the Chinese systems of corporate governance differ significantly from each other in the different goals and consequent structures of the corporations. With regard to the legal protection of investors, firms in the Canada, like firms in other Anglo-Saxon countries, substantially rely on legal protection of investors. Studies have shown that countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets.[173]

When analyzing these two quite different systems, the question naturally arises as to whether one of them is better than the other. Generally stated, poor corporate governance is seen as risky, while good corporate governance is seen as a sign of strength.[174]

Good corporate governance systems are rooted in an appropriate combination of

[173] See La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (1997), "Legal Determinants of External Finance," *Journal of Finance,* 52, 1131-1150

[174] Lee, J. 2001. Corporate governance - and why you need it. Asiamoney 12 (9): 24-6.

legal protection of investors and some form of concentrated ownership.[175] C orporate governance scandals both in emerging and in developed markets indicate that there is no best corporate governance model in the world. A good corporate governance system is about good practice and not merely about good structure. That is to say, it should be capable of identifying corporate weaknesses before they develop into systemic problems, of learning from failures, and of taking prompt corrective actions. Critical ingredients of such a system are a credible threat of market failure. So we must be diligent in evaluating the performance of the boards of the companies whose shares we own to ensure that the governance system is working.

II. Characteristics of Corporate Governance Mechanisms

The corporate governance mechanisms are of interest to investors, corporate practitioners, regulators, and scholars. As discussed in the previous chapters, it is this typical constellation corporation that can lead to conflicts of interests. Without effective control mechanisms, the top managers may pursue their own interests and take the actions that deviate from those of shareholders.

The characteristics of corporate governance mechanisms can be classified as internal and external. Internal characteristics in the developed market economies focus on the role and functions of ownership structure, boards of directors, CEO duality, and directors and executive compensation. External characteristics concern the effectiveness of the managerial labor market, the market for corporate control, and government regulations.[176] In different systems of corporate governance, there are different characteristics. In this part, we focus on the characteristics both in Canadian

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[175] Shleifer, A. and R.W. Vishny. "A Survey of Corporate Governance." *Journal of Finance*, 52 (1997), 737-783

[176] See Cannella, A.A., & Monroe, M.J. 1997. *Contrasting Perspectives on Strategic Leader: Towards a More Realistics view of top managers.* Journal of Management, Vol. 23, No. 3. : 213-238.

system and Chinese system.

1. Characteristics of Corporate Governance Mechanisms in Canada

This section appraises the efficacy of the main governance mechanisms operating in the Canadian corporate governance. Besides the legislation and institutional investor introduced in this thesis, we mainly touch the internal mechanisms of control as principal topic.

Internal mechanisms of corporate governance aim primarily at coping with the agency problem between shareholders and directors. Directors are elected by the shareholders and represent the interests of the shareholders in corporate performance. This is a type of 'principal-agent relationship':[177] the shareholders are the 'principals' and the officers and directors are their 'agents'. Corporate directors and officers are required to perform in the best interests of the corporation, and that means the best interests of its legal owners — the shareholders. There is increased liability imposed on directors and officers in Canada in recent years.[178] The rational for this liability is that directors must have strong incentives to monitor corporate performance with a view to protect the shareholder value.

Foerster and Gross[179] point out in their study that the average size of the board of directors for Canadian firms decreased in the past few years. The average percentage of independent directors on the audit committee remained relatively stable in each successive year. Study shows that around two-thirds of directors on the board of directors of Canadian firms were independent with the average increasing annually.[180]

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[177] See Daniels, R. J. and Morck, R. Canadian Corporate Governance Policy Options, Working paper 1996.

[178] *Ibid.*

[179] Foerster, Stephen R., Gross, R., Shapiro, D. and Toner, M., 2004, General Trends on Corporate Governance Practices Amongst Canadian Firms: 1999 – 2001 A preliminary analysis of select governance data for Canadian firms, For Industry Canada. Working paper.

[180] *Ibid.*

Some empirical studies suggest that firms whose CEO is also the chair of the board of directors have poorer performance than firms where the two positions are separated.[181] The joint CEO/Chairperson position is a distinct characteristic of Canadian firms. Studies show that CEOs chaired more than two-fifths of Canadian boards.[182]

2. Characteristics of Corporate Governance Mechanisms in China

During the initial phase of transforming the socialist planned economies, an insider control model of corporate governance can often be produced when people privatize of state-owned enterprises (SOEs) combined with introducing an equity market. The later would serve as the market for corporate control, that is, as an instrument for corporate governance and, hence, as an effective mechanism for raising the external finance much needed by privatized enterprises for their restructuring projects.[183] This kind of insider control model of corporate governance can be incarnated in China is the Chinese "Key-man" model of corporate governance mentioned above.

One of the major characteristics of the corporation in the world today is the separation of ownership and managerial control which have generated serious potential conflicts of interest among various stakeholders.[184] During the period of Chinese economic transformation from socialist plan-oriented economy to the socialist market-oriented economy, it is of increased significance to study the corporate governance mechanisms of Chinese firms. In this part, the major objective is to analyze several internal corporate governance mechanisms of companies in the

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181 Fuerst and Kang 2000; Berg and Smith 1978

182 See Foerster, Stephen R., Gross, R., Shapiro, D. and Toner, M., 2004

183 Aoki, M & Kim, H. K. 1995. *Corporate governance in Transition economies.* Finance & Development, September 20-22, at 20.

184 See Chen, X.H. & Lau, C.M. 2000. *Enterprise Reform: A focus on State-owned Enterprises.* In C.M. Lau & J.F. Shen (eds), *China Review 2000:* 191-207. Hong: Chinese University Press.

Chinese context, particularly the listed companies.

The characteristics of corporate governance mechanism can be concluded as the following aspects: firstly, the level of shareholders' participation in corporate governance is low due to the lack of philosophy and mechanisms for common governance to facilitate their extensive involvement; secondly, SOEs in China are in period of transition from planning to market economy. The phenomenon of "control by insiders" is rampant; the supervision board has little influence on corporate governance. China's model is a mixed model of corporate governance. This hybrid model captures the characteristic of Anglo-Saxon model, which focuses on managers' self-realization of internal motivation and control, while the financial institutional environments are more like those in Japan and Germany in their early days.[185]

III The Bases of Divergence Between Canadian and Chinese Systems of Corporate Governance

Before we discuss the ongoing comparison and convergence between the two systems of corporate governance, we should analyze the main divergence in the development of corporate governance in Canada and in China which lies in the difference in basic economic, cultural and sociological ideologies. For example, the cultural differences have been core elements for both convergence argument and the third degree path dependence argument. In addition, the importance of the cultural differences based upon the cultural value and historical incidents that created traditional systems have been highly recognized as two critical elements that affect formulation of traditional corporate governance systems.[186]

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[185] Jing, Lihua, Zhou, Wenqun and Yuen-ching Tse, *Corporate Governance in China: Ethical and Legal Problems* Work Paper, City University of Hong Kong.

[186] See Licht, (2001).

Professor Colin Mayer[187] has generally classified corporate governance systems onto two: outsider-based and insider-based systems. The first depends on active external markets for shares which include the market for corporate control through takeovers. The second has more stable long-term shareholder relations with other companies holding shares and does not depend on external markets. The main difference between the Canadian system of corporate governance and Chinese one is that the first could be described as having an almost outsider-based system of corporate control, by contrast, the latter could be characterized as having a similar insider-based system. In an outsider system, corporate control is affected primarily through the takeover system, has large equity markets, dispersed ownership and active markets in corporate control. However, compared with standard outsider-based system, Canadian system is characterized by concentrated ownership. Chinese insider-based system of corporate governance is also not a standard insider-based system, but an insider control system, where there is a vacuum filled by existing management.[188] This system can be called the "keyman model system"[189] or has some inadequacies of "keyman model", including: 1. management and control power held in one person's hands, 2. lack of accountability, 3. pursue one's own interest instead of maximizing shareholders' values.

Despite all divergence between the two systems of corporate governance, we also point that not all divergence reflects inefficiency. Efficient divergence can arise either through adaptation to local social structures or through fortuity. It could survive for a considerable period of time. Still, though the rate of change may be slower, there is good reason to believe that even the extent of efficient divergence, like the extent of

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[187] C. Mayer, *Stock Market, Financial Institutions and Corporate Governance,* in N. Dimsdale and M. Preveser (eds), *Capital Market* and Corporate Governance, Clarendon Press, Oxford, 1994, at 179.

[188] See On Kit Tam, *The Development of Corporate Governance in China,* Edward Elgar, Cheltenham, UK, 1999, at 32.

[189] Some Chinese scholars call this "keyman model" "one-man rule". An all-powerful CEO (general manager) dominates the control and management of Chinese firms. Both company law and company charters stipulate that CEOs are to be elected by the shareholders' meeting. But in practice the process often involves the controlling shareholder (generally the state) appointing the board chairman and CEO and notifying other shareholders accordingly.

inefficient divergence, will continue to decrease relatively quickly.[190]

1. Path Dependence

The goal of a system of good corporate governance is to maximize the firm value and create benefits for shareholders, as well as for the public in general. As we have seen in this thesis that the corporate ownership and governance differ greatly between the Canadian system of corporate governance and Chinese system of corporate governance. During the half century since the Second World War, economic growth, business practices, and living standards have changed both in Canada and In China. But their corporate structures have remained different. Especially since the economic reform in China, international comparison proves that despite immense difference between the two systems of corporate governance, both economies perform very well.

The system of corporate governance of one country develops to respond to the needs of particular national economy, as well as the historical and judicial development. Where one aspect of corporate governance is less developed in a state system, the resulting inefficiencies are counterbalanced by efficiencies elsewhere, so to keep the respective system working efficiently in its respective historical, social and political environment.[191]

The reasons can be shed light on by showing that there are significant sources of path dependence in a country's patterns of corporate ownership structure.[192] Bebchuk and Roe argues that history has sowed considerable divergence into national systems which are "path-dependent" and, hence, unlikely to converge at least in the

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[190] See Hansmann, H. and R. Kraakman, *The end of history for corporate law* Georgetown Law Journal. Washington: Jan 2001. Vol. 89, Iss. 2; pg. 439, 30 pgs

[191] See Mark J. Roe, *Path Dependence, Political Options, and Governance Systems* in Klaus J. Hopt & Eddy Wymeersch (eds.), *Comparative Corporate Governance – Essays and Materials* (Berlin Walter de Gruyter, 1997), at 167.

[192] See Lucian Arye Bebchuk and Mark J. Roe, *A theory of Path Dependence in Corporate Ownership and Governance.* This paper can be downloaded from the Social Science Research Network electronic library at http://papers.ssrn.com/paper.taf?abstract_id=192414 (access date: Jan. 13, 2004), at 1.

medium-term, notwithstanding pressure from the capital markets. There are two sources of path dependence.[193] One type of path dependence is structure-driven path dependence, in which initial ownership structures in an economy directly influence subsequent ownership structures;[194] the other type of path dependence is rule-driven path dependence in which such rules can influence corporate ownership and governance structures.[195]

2. Impact of Cultural Factors on Corporate Governance

Canadian value system is based with the primary considerations being: rights, justice and utility. However, Sino-Confucian areas, on the other hand, have value systems based on the primacy of duty. In China this duty is owed particularly to family, with the aged being accorded more respect.

In this section, we will not do a comprehensive review of Canadian and Chinese culture. Instead we will give an overview of cultural highlights which impact corporate governance in the two countries profoundly.

Culture refers to the set of beliefs shared by members of a society or group as to how things ought to be.[196] Thes e shared beliefs emanate from institutions such as school systems and religious organizations as well as family relationships. Culture has a significant impact in the molding of a system of corporate governance because corporations are run by persons of different cultural backgrounds. Economic explanations are more convincing if they acknowledge culture.[197] Culture also has a pervasive influence on corporate performance and institutional behaviors. Harrison

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193 For detail of the two sources of path dependence, see Bebchuk and Roe (1999).

194 See Bebchuk and Roe (1999)

195 Bebchuk and Roe (1999)

196 See Schein, E.H. (1992) *Organizational Culture and Leadership: A Dynamic View*. Jossey Bass, San Francisco, p.7-12.

197 See G. Redding, *The Spirit of Chinese Capitalism* (Walter de Gruyter & Co., Berlin, 1990) at 14.

and Huntington (2000) have provided compelling evidence that national cultures and values shape human progress and influence economic prosperity.[198] J apanese system of corporate governance is one of an example of the influence of cultural factors. When talking about the Japanese corporate governance, one may summarize a few distinctive characteristics including "groupism", "familism", "lifetime employment" and the ideology that a corporation should be motivated towards national service rather than profit maximization. These characteristics have deep roots in Japanese culture.[199] It is clear from the experience of the Canada and China that cultural characteristics have a significant impact on their corporate governance systems respectively and have traditionally provided the foundations of corporate governance in countries with respective system.

a). Canada

Based on the pre-industrial history - a French colony of resource extraction built around the fur trade, and then a French and a British colony of settlement,[200] C anada can be described as a multicultural society whose racial and ethnic diversity is expressed in different ways. Study showed that Canada inherited from her French colonial history a disposition to mercantilist policies that invite official abuse, which led Canada to be a remarkably corrupt country until a few generations ago.[201] A remarkable pattern in Canadian corporate control is also affected by this kind of colony. A slight predominance of family controlled pyramidal business groups supplemented by a large phalanx of freestanding widely-held firms is popular in Canada today which is similar to its original pattern a century age.

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[198] Harrison, L. E., & Huntington, S. P. (Eds.) (2000). Culture matters: How values shape human progress. New York: Basic Books.

[199] H. Hazama, *Industrialization and Groupism,* in K. Nakagawa (ed.) *Social Order and Entrepreneurship* (Japan: University of Tokyo Press, 1977) at 199-223. See also J. Hirschmeier, *Entrepreneurs and the Social Order: America, Germany and Japan, 1887-1900,* in K. Nakagawa (ed.), *Social Order and Entrepeneurship, at 202, 203.*

[200] Morck, Randall, Michael Percy, Gloria Tian, and Bernard Yeung. 2004. The Rise and Fall of the Widely Held Firm: A History of corporate Ownership in Canada. National Bureau of Economic Research W orking Paper.

[201] *Ibid.*

A case in point is Canada where historic conflict between francophone and anglophone residents has culminated in the rise of a movement for political independence in the predominantly French-speaking province of Quebec.[202] While French-English conflict in Canada has taken on many forms in the past two hundred years, corporate culture and performance sometimes can reflect the conflict. It is broadly recognized that this cross-cultural factors act as invisible barriers in good corporate performance in Canada, especially in Quebec province. In recent years, a vigorous immigration policy has attracted a growing number of applicants from non-traditional sources. Canada's cultural diversity is manifest at the level of ethnic and immigrant composition. With the immigration of population from non-traditional sources, Canada inevitably absorbs some ideas of corporate governance from non-Canadian sources which influence the existing corporate governance system.

b). China

China's early cultural background is similar to that of Japan which was a feudal society with well-established social order under Confucian doctrines. Confucius has been the most powerful influence shaping the Chinese culture and Chinese society. Although Confucianism lacks either a deity or an organization, Confucian doctrines permeate the lives of Chinese peoples around the world. He emphasizes benevolence, goodness and humaneness. Confucianism prescribes a strict hierarchal order and harmony. Members of an organization are ordered to respect, abide by a leading authority, even a leading person. Two basic moral principles formed the essence of Confucianism – loyalty to the emperor and filial piety. The former requires the loyalty to the nation; and the latter requires the obligation to the family. Loyalty and filial piety extended to all the social relations even penetrate the today's corporate governance. Bureaucracy is a product when applying this idea to government organization. However, it causes disastrous effect on practicing corporate governance

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[202] Fenwicik R., (1982), Etimic Culture and Economic Structure: Determinants of French English Earnings Inequality in Quebec. Journal Title: Social Forces. Volume: 61. Issue: 1

in China.

China's recent cultural background is the enforcement of the principles of Leninist democratic centralism in the People's Republic of China. The effect of the two similar cultural traditions is an ingrained tradition of recognizing the norm of an authoritarian leader within the organization or clan. The prevalent in Chinese culture is a tradition of insiders vs. outsiders with a built-in convention of secrecy among insiders.[203]

In the past fifty years, Chinese society has changed significantly. Some traditional components of Chinese beliefs have been abandoned along the way. Benevolence and goodness has less value now, while hierarchy or authority is still dominating in Chinese culture.[204] With respect to the impact of socialist culture on Chinese system of corporate governance, China has more than 50 years of socialist culture in which worker were told that they were the real masters of the country and also the masters of their enterprises which belong to the state. Many Chinese workers want to participate positively in corporate governance. The modern theory of separation of corporate ownership and management can not be widely accepted by most of the Chinese workers at the beginning of economic reform. The conflicts between capital and labors are counter-productive and may destabilize society.[205]

In addition to national culture, other kinds of cultures such as professional culture and foreign culture may also have an influence on the corporate performance. The rapid Chinese booming economy during the past two decade and its accession to the WTO has placed China among the major international business players. Although corporate governance has increasingly become key point of corporate operations in a

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[203] See Cyril Lin, *Corporatisation and Corporate Governance in China's Economic Transition,* Economics of Planning 34: 5-35, 2001. Kluwer Academic Publishers.

[204] See Jing, Lihua, Zhou, Wenqun and Yuen-ching Tse, *Corporate Governance in China: Ethical and Legal Problems* Work Paper, City University of Hong Kong.

[205] Wei, Yuwa, *Comparative Corporate Governance, A Chinese Perspective*, (Kluwer Law International, 2003), p.186.

globalized economic environment, a lack of general knowledge of different cultures and cultural competency remains a hindrance in corporate governance improvement, including those between Western cultures and China.[206]

In sum, we can conclude that, one hand, the actual practice of Chinese system of corporate governance bears many of characteristics of the legacy of the above Chinese cultural tradition; another hand, China's economic reforms have also created a real challenge to many traditional culture which impacts the present corporate governance system vice verse. Its culture is quite different to the western countries as well as the countries of the former Soviet bloc, which have undergone a rapid transition from a planned economy to a market economy. Adoption of the modern corporate form for SOEs in China was grafted onto an ideological position that remained essentially collectivist and socialist in its outlook.[207]

3. Historical Legal Development on Corporate Governance

Laws and the quality of the enforcement of courts in one country are essential elements of corporate governance.[208] Legal systems of most countries derive from relatively few "legal families," including the English (common law), the French, and the German, the latter two is civil law which derived from the Roman Law. In the 19th century, these systems spread throughout the world through conquest, colonization, and voluntary adoption. Apart from the two main "legal families", Socialist countries had a legal tradition based on former Soviet law.

Because legal origins are highly correlated with the content of the law and because legal families originated before financial markets had developed, it is

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[206] Chen, L. and Sheer V. C., Successful Sino-Western Business Negotiation: Participants' Accounts of National and Professional Cultures, The Journal of Business Communication, Vol. 40, 2003.

[207] For the detailed ideological context within which enterprise reform in China has been pursued, see Crane, G., *Globalization in China* 4(2) New Political Economy (1995), at 215.

[208] See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., 1997. Legal determinants of external finance. Journal of Finance 52, 1131-1150 for detail.

unlikely that laws were written primarily in response to market pressures. Rather, the legal families appear to shape the legal rules, which in turn influence financial markets.[209]

England and its former colonies, including the U.S., Canada, Australia, New Zealand, and many countries in Africa and South East Asia, have the common law system. France and many French colonies, including Dutch, Belgian, and Spanish colonies and Quebec province in Canada have the French civil law system. Germany, Germanic countries in Europe, and a number of countries in East Asia are influenced by the German civil law tradition. The Scandinavian countries form their own tradition.

Socialist countries had a legal tradition based on Soviet law, but because the laws of these countries are changing rapidly during the transition out of socialism, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) do not consider them.

a). Canada

The historical legal development root of Canadian corporate governance can be derived from British law and practice. Even the province of Québec, which uses the Napoleonic *Code civile* as the root of its commercial law, has adopted similar forms of corporate structure and governance of other Canadian provinces. For example, the first major company in Canada was the Hudson's Bay Company, which was incorporated in London as a joint-stock company in 1670. In 1867, the four colonies of Nova Scotia, New Brunswick, Lower Canada (Québec) and Upper Canada (Ontario) were united as a new Dominion of the British Empire through the *British North America (BNA) Act*, now called the *Constitution Act (1867).*

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[209] See La Porta R. et al., *Investor Protection and Corporate Governance*, 58 Journal of Financial Economics 3 (2000).

b). China

China was an agricultural society with a sophisticated commercial system but no idea of a corporation as a legal individual before the legal concept of the corporation was imported into China at the end of the nineteenth century. The first corporate legislation in Chinese history - the *Great Qing Commercial Code* was enacted in January 1904, during Qing Dynasty. Out of 140 articles, the *Commercial Code* contained 131 articles concerning company matters. The Republic government promulgated the Company Regulations in 1914. From 1927 the Nationalist government ruled China. The new government promulgated a *Company Law* in 1929. This was the first comparatively complete legislation concerning companies in Chinese history.[210] In 1949, due to the importation of the highly centralized economy model from the former Soviet Union by the People's Republic of China, business companies gradually disappeared. During this period, the development of the corporate legislation in China was very slow. In the late 1970s, with the introduction of a market economy in China, the efforts were continually made to improve the performance of state owned enterprises. These included contracting out, leasing, and joint operation. However, all these efforts did not solve the problems of SOEs. The definition of "juristic person" was firstly introduced by *Economic Contract Law* in 1981, and then by *Civil Code* in 1986. The defect of the two laws is that it only provides for a person, representative of a juristic person, but does not specify the internal organization. This defect has its historical causes.

Since the *Company law* was enacted in 1994, SOEs were redefined as business companies, and private companies were incorporated since then. The *Company Law* of 1994 prescribes a relatively detailed outline of corporatisation in China.

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[210] Xu Y, *Principles of Company Law*, Publishing House of Law, Beijing (1997) at 16.

4. Other Bases of Divergence

a). Differences of Firms and Market

As discussed above, although China's Company Law of 1994 follows the old Continental style of company legislation, the 1994 Company Law has the following distinctive features which are different from the western company laws as well as from the former Soviet-bloc company law: (a) Two types of company can be formed with private capital prescribed by company law: Limited Liability Company and Joint Stock Company. They bear some resemblance to private and public companies in Canada, but there are some differences. A limited liability company must have between two and fifty shareholders[211] and cannot offer its shares to the public. Shareholders have preemptive rights over any sale of shares by another shareholder.[212] Joint Stock Companies (JSCs, sometimes referred to as companies limited by shares) are designed to allow capital to be raised through either by sponsorship or public share offer.[213] (b) The Chinese concept of the legal personality of a company differs from Canadian model. This is most apparent in two areas. First, every company must have a "legal representative", who is the natural person authorized to act on behalf of the company.[214] Second, the company law provides that the state assets of a company belong to the State. This provision has resulted from confusion over the ownership rights of the state in the SOEs' reform. (c) There is more extensive reliance on mandatory rules in the structure of Chinese company law than the case in common

[211] See Art. 20 and 45 of *CLPRC (The Company Law of the People's Republic of China)*

[212] See Art. 35 of *CLPRC*. It prescribes that transfer of his share of capital contribution by a shareholder to anyone other than another shareholder is subject to consent by a majority of all the shareholders; shareholders who do not consent to the transfer shall purchase the share of capital contribution to be assigned, and failure by those shareholders to make such purchase is deemed to be their consent to the assignment. Where the shareholders consent to the assignment of share of capital contribution, other shareholders have the preemptive right of purchase under the same conditions.

[213] See Art. 74 of *CLPRC*.

[214] Normally, the chairman of the board is the legal representative of the company.

law jurisdictions, indicating a rejection of the contractarian model of company law. (d) Despite the rejection of a contractarian model of company law apparent in the heavy reliance on mandatory rules, the Articles of Association[215] have a contractual status that appears to be even more extensive than the concept of the "s" and "d" contracts"[216] in the Canada. The latter is a contract between the directors and shareholders and between shareholders inter se. (e) Chinese companies are required to limit their business to that described in the scope of business at the time of registration (or as subsequently amended). Contracts outside the scope of business are illegal contracts and therefore not enforceable. (f) The participation of workers in companies is ensured through the requirement for JSCs to have a supervisory board that includes worker representatives[217]. The board of directors is accountable to the supervisory board, whose members are entitled to attend meeting of the board of directors in a non-voting capacity. The Company Law also requires the Board of Directors to consult employees and trade unions on matters affecting their interests

China is distinctive in that it has produced regulations over market forces with regard to a number of issues, i.e. the separation of regulation of the main financial sectors. This separation is regarded to be a characteristic of its regulatory system in China. The China Securities Regulatory Commission (CSRC) is designated as the regulator for securities activities. The Securities Law provides wide-ranging powers to the CSRC with regard to authorization, rule making, investigation and enforcement of all aspects of the securities market. In the past, the Central Bank (People's Bank of China) had been responsible for the entire system of financial regulation. Following the Asian financial crisis of 1998, the government began to restructure the financial system and pursued a policy of separation of regulation of the four main

215 See Art. 79 of *CLPRC*.

216 The Shareholder Contract ('s' Contract) and the Directors' Contract ('d' Contract). See Jason W. Neyers, *Canadian Corporate Law, Veil-piercing, and the Private Law Model Corporation*, University of Toronto Law Journal - Volume L, Number 2, Spring 2000. The first of these relationships is the contract between the original shareholders. The second relationship that establishes limited liability is the contract between the directors and the totality of shareholders.

217 See Art. 124 of *CLPRC*.

financial sectors - banking, securities, insurance and trust. This changed structure in the financial market was regarded as an important part of economic reform in China. This resulted in the emergence of the CSRC in its current form, the creation of a new regulator for the insurance sector (China Insurance Regulatory Commission, CIRC) and the limitation of the regulatory role of the central bank to banking and trust business.

Financial markets, and in particular the legal and regulatory environment in which they operate, are closely related to the development of national systems of corporate governance.[218] The results of academic study showed that the national legal environment had a deep influence on the size and extent of a country's capital markets.[219]

b). Political Base of Divergence

With regard to divergence of corporate governance systems, most study researches focus on the quality of corporate law, private bonding mechanisms, legal culture, and economic competition. Most peoples neglect the politics as an important base of divergence of corporate governance. It is not that people don't know politics matters, but rather most experts don't build it in systematically into explanations.[220]

With regard to the influence of politics on corporate governance, some studies are in favor of the point of positive influence that markets drive governance, and markets are politically determined; thus, politics drives corporate governance. Roe stresses the relationship between the politics and ownership separation.[221] Roe argues in his book

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[218] See, La Porta, R., Lopez-de-Silane, F., Shleifer, A. and Vishny, R.W., "Legal determinants of external finance" 52 *Jnl of Finance* 1131-1150 (1997) and A. Shleifer and R. Vishny, "A survey of corporate governance" 52(2) *Jnl of Finance* 737-783 (1997).

[219] See the conclusion of See, La Porta, R., Lopez-de-Silane, F., Shleifer, A. and Vishny, R.W., "Legal determinants of external finance" 52 *Jnl of Finance* 1131-1150 (1997).

[220] Peter Gourevitch, Richard Carney, Michael Hawes *Testing Political Explanations of Corporate Governance Patterns,* February 8, 9, 2003. Conference on Economics, Political Institutions, and Financial Markets Social Science History Institute Stanford University.

[221] Mark J. Roe, Political Determinants of Corporate Governance Political Context, Corporate

that where social democracy is strong, shareholder rights are weak, and shareholder diffusion is low.[222] Paga no and Volpin[223] analyze the political determinants of investor and employment protection. They predict that proportional electoral systems are conducive to weaker investor protection and stronger employment protection than majoritarian systems. They note that the structure of political institutions might influence the victory of coalitions. They compare worker-manager vs. owner alliances and note that corporatist systems may facilitate these. The argument can be extended and systemized.[224]

In Chinese context, Chinese politics and economies are undergoing rapid changes; however the traditional single party rule is not changed. This political system deeply influences its corporate governance. Coalition politics involving alliances of disparate groups will be the scenario of the western both in Parliament and the state assemblies. Coalitions are a type of competitive politics in most countries. Just as competition in a market economy leads to better production and services. Competitive coalition politics should in theory at least lead to better corporate governance in one country.

Another characteristic of Chinese politics is that the working class has been the leading class in China since the New China was established in 1949, and workers are regarded as owners and enjoy democratic rights in China's SOEs and can participate in all operations and decision-making of the enterprise. Labor disputes over enterprise management in the past and money, benefits today, often peppered with charges of official corruption due to present political system, have become frequent as China

Impact (Oxford, New York: Oxford University Press, 2003). Roe argues in this book that all the major variables that shape the incentives structuring corporate governance derive from conditions set by politics.

222 Roe's ownership structure is based on the social democracy.

223 Pagano, Marco and Volpin, Paolo F., "The Political Economy of Corporate Governance" (October 1999). AFA 2002 Atlanta Meetings; Univ. of Salerno Working Paper No. 29. http://ssrn.com/abstract=209314 (access date: Jul. 19, 2004).

224 See Peter Gourevitch, Richard Carney, Michael Hawes *Testing Political Explanations of Corporate Governance Patterns*, February 8, 9, 2003. Conference on Economics, Political Institutions, and Financial Markets Social Science History Institute Stanford University.

seeks to streamline or shed its bloated SOEs. This trend indicates that the workers focus on the individual profits other than the status of the owners. In line with China's following reform of its SOEs, the shareholders, not the workers, will become the decision-makers of the future state-owned or state-held corporations. Furthermore, with the privatization of China's SOEs, the owner's theory of working class has been weakened today.[225]

IV Stock Exchange as Corporate Regulators in Canada and in China

First, Canada does not have a national securities commission. Securities regulation is carried out at the provincial and territorial level; while the Canadian securities laws are uniform across all the provinces and territories which are substantially similar to those in China; The second divergence is that a much higher percentage of Canadian public companies have a controlling shareholder which is different from the controlling shareholder in Chinese companies – the state. The controlling shareholder in Chinese companies is continually to decrease it percentage; The third divergence is that many Canadian public companies have relatively low market capitalization. For those companies, the Toronto Stock Exchange (TSX)[226] corporate governance would be a very significant financial and administrative burden. It seems that these companies have limited capacity to attract more independent directors.

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225 However, according to the statement of Chinese government: "Workers are still owners of the SOEs. But that doesn't mean all workers will participate in all operations and decision-making of the enterprise, or they would rely on the enterprise and the nation forever."

226 The TSE has changed the composition of its Board. This body includes now 15 directors comprised of 7 members from participating organizations, 7 other independent members and the President of the Exchange. The independence of the Board has been the paramount consideration in adopting this new composition. The Board has five sub-committees on its governance which includes Finance and Audit, human Resources, Strategic Policy and Regulation. Three other committees on Stock List, Trading Policy and Hearing also fulfill distinct duties. For more detail, see TSE's annual report.

1. The TSX's Role in Shaping Corporate Governance

As the third largest in North America and the eighth largest in the world,[227] the TSX has made important steps in the field of Canadian system of corporate governance emphasizing the relationship between corporate governance and investor confidence. In the early 1990's, the TSX commissioned a major report that examined the state of corporate governance in Canada.[228] C anada's stock exchanges and self-regulating professions must monitor the resulting pattern of behavior and decide whether and when it may be beneficial to make certain provisions mandatory within their areas of competence.[229] Its leadership role in Canada is illustrated through two considerable studies on corporate governance that it has sponsored: sponsorship of 1994 study of Canadian corporate governance by the Dey Commission, which produced the landmark report,[230] named "*Where were the directors*", in which the Exchange adopted 14 recommendations as "best practices" guidelines and require listed companies to annually disclose the extent to which they comply with these corporate governance guideline. The second report is a study "Five Years to the DEY" which measured the impact of the 14 guidelines proposed in Dey Report.

a). Dey Report

Over the past 10 years, the topic of corporate governance has become more and more important. The first comprehensive and relatively recent discussion of enhanced corporate governance seems to be the 1994 report, *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada* (the "Dey Report").[231]

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[227] See TSX Group 2002 Annual Report.

[228] In 1995, as a result of this report, the TSX adopted 14 non-mandatory corporate governance best practices which required Canadian incorporated listed companies to annually disclose their corporate governance practices, comparing their practices to the best practices.

[229] J. A. Levin, Canadian Corporate Governance Developments. Working paper at http://www.fasken.com

[230] See Toronto Stock Exchange Annual Report 1999.

[231] Report of the Toronto Stock Exchange Commission on Corporate Governance in Canada, December 1994.

Corporate governance has been described as "the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value"[232].

The Dey Report pointed out the need for improved corporate governance in publicly-traded corporations. It also led to the Toronto Stocks Exchange (the "TSE") adopting what were then viewed as extensive corporate governance guidelines for effective corporate governance.[233] However, implementation of the guidelines is voluntary, and a key goal of the guidelines is to describe the corporate governance system in place at each of the corporations, so as to allow shareholders to assess the appropriateness and effectiveness of each firm's corporate governance system.[234]

b). Saucier Report

The Joint Committee on Corporate Governance ("JCCG") released its report, *Beyond Compliance: Building a Governance Culture.*[235] The Saucier Report is broad ranging and emphasizes the importance of good corporate governance. It outlines 15 recommendations focused on specific areas where action can be taken aimed at improving the effectiveness of governance in Canadian public corporations, such as the condition of listing on a Canadian stock exchange, all boards should have an independent board leader chosen by the full board who is accountable for activities including succession planning and responsible for leading regular meetings that include outside directors and exclude management.

The Saucier Report recommended certain changes to TSX's corporate governance guidelines and the introduction of a new condition of continued listing that would

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[232] See Dey Report, 1994: 7.

[233] See *TSX Company Manual,* section 473

[234] Bujahi, M. and McConamy, B.J., *Corporate governance: Factors influencing voluntary disclosure by publicly traded Canadian Firms,* Canadian Accounting Perspectives, Toronto 2002, Vol. 1, Iss. 2.

[235] The Joint Committee on Corporate Governance (known as the "Saucier Committee" for its chair, Guylaine Saucier) issued its final report entitled "Beyond Compliance: Building a Governance Culture" in November, 2001.

require the board of every TSX listed company to have an "independent board leader" who would perform certain functions described in the Saucier Report. This Report proposes recommendations to strengthen the TSE Guidelines and the role of boards and committees in oversight, reporting, risk management and internal controls.

b). Multilateral Instruments

Effective March 30, 2004, the Canadian Securities Administrators made amendments to various national and multilateral instruments ("MI") that will have an impact, either directly or indirectly, upon certain TSX Venture Exchange Policies. These instruments include Multilateral Instrument 52-109 *Certification of Disclosure in Issuer's Annual and Interim Filings* ("MI 52-109"); and Multilateral Instrument 52-110 *Audit Committees* ("MI 52-110"). The financial statement certification requirements prescribed by MI 52-109 and the responsibilities and certain disclosure requirements applicable to audit committees, as prescribed by MI 52-110, will apply to all Issuers. On February 4, 2005 members of the Canadian Securities Administrators, other than British Columbia, released proposals for one new instrument (MI 52-111) and one revised instrument (MI 52-109). These Instruments deal with regulations pertaining to the certification and reporting on disclosure controls and internal controls over financial reporting. According to these instruments, upon listing on the Exchange, and in accordance with applicable Securities Laws, every issuer becomes a reporting issuer.

The corporate governance practices already include a number of the reforms recently adopted and proposed by TSX in Canada. In September 2003, the TSX announced it was relinquishing responsibility for setting corporate governance standards to provincial securities regulators.[236] O n October 29, 2004, TSX published for comment its proposal to replace its current corporate governance requirement with

[236] See Stéphane Rousseau, *Le rôle des tribunaux et du conseil d'administration dans la gouvernance des sociétés ouvertes : réflexions sur la règle du jugement d'affaires*, Les Cahiers de Droit, vol. 45, no. 3, septembre 2004, at 503.

the requirement for issuers to disclose corporate governance practices in accordance with NI 58-101. As a result, TSX has proposed to remove its guidelines and disclosure requirement for corporate governance.

2. Chinese Stock Exchange's Role in Shaping Corporate Governance

Stock companies and stock markets did not exist until the late 1980s when the Chinese government decided to restructure the industrial sector then dominated by SOEs. A department store in Beijing was given permission for issuing shares in 1984, the very first time since the founding of the People's Republic in 1949. Shareholders were confined, however, solely to the employees of the store. A more direct cause of this bold step was the heavy losses incurred by SOEs. In the following few years, more SOEs were "incorporated" through selling shares to their own employees or other stock companies and SOEs. New joint stock companies were organized in a similar way. Stock trading was also prohibited and low liquidity of stocks made it difficult for the companies to market their initial offerings. Consequently, curb markets emerged in several large cities. To end the chaotic black-market trading, in the drive to achieve a modern enterprise system, the State Council decided in 1989 to introduced two national stock exchanges into its centrally planned economy. The Shanghai Stock Exchange (SHSE) was inaugurated in December of 1990, and the Shenzhen Stock Exchange (SZSE) opened in July, 1991.[237] The regulation authority is the China Securities Regulation Commission (CSRC), founded in October 1992.

a). Guideline on the Management of Listed Companies

According to the introduction, the Guideline aims at encouraging domestically listed companies to establish and develop a modern enterprise system; regulating the operations of domestically listed companies; and promoting the healthy development

[237] The Shanghai Stock Exchange (SSE) was established in 1984 and officially opened in December 1990. The Shenzhen Stock Exchange (SZE) was established in 1987 and officially opened on 3 July 1991. Separating the stock market into two stock exchanges aims at encouraging competition between them.

of PRC securities market.

The guideline represents a significant step forward for the proper governance of Chinese listed companies. Adopting most of the international best practices, The Chinese corporate governance framework represents one of the most comprehensive and demanding frameworks in the world. The effectiveness of these requirements in ensuring a good corporate governance framework will depend on effective practical implementation.

The Guideline sets out the basic principles on the governance of domestically listed companies, the measures needed for protecting the interests of the investors, the behavior and professional ethics of the directors, members of the supervisory board and executive staff of the listed companies.

V Developments of the Canadian and Chinese systems of corporate governance

Over the past few years, corporate governance has become a topic of substantial concern for all corporate participants including shareholders, boards of directors, management teams and employees. The fallout from a series of high profile corporate recent failures in the United States influences the development of corporate governance world-widely. The introduction of sweeping legislative and regulatory changes in Canada and China has led to a change in the way in which companies are expected to govern themselves in both the two countries. In Canada, the most significant developments have been the passing of Bill 198, Keeping the Promise for a Strong Economy Act (Budget Measures), 2002 (Bill 198), proposed Ontario Securities Commission rules promulgated pursuant to Bill 198 and proposed revised listing standards and corporate governance guidelines of the Toronto Stock Exchange. In China, The development of corporate governance depends on both the efforts at the individual company level to close the gap with global best performance and the legislation at the country level to guide the corporate governance implementation. The most recent development in corporate governance in China is the promulgation of thr corporate governance guidelines for listed companies.[238]

1. Canada

The 1994 report, *"Where Were the Directors? Guidelines for Improved Corporate Governance in Canada" (the "Dey Report")* is considered the first comprehensive and relatively recent discussion of enhanced corporate governance in Canada. The *Dey Report* was innovative when it first appeared and led to the TSX in 1995 adopting what were then viewed as extensive corporate governance guidelines.

Following the issuance of the *Dey Report*, the Saucier Committee issued its interim report entitled *"Beyond Compliance: Building a Governance Culture"*. The Saucier Committee's report is broad ranging and emphasizes the importance of good corporate governance. The Saucier Committee's report have largely been followed by the TSX and reflected in the proposed disclosure requirements and amended guidelines approved by the TSX board of directors on March 26, 2002.[239]. On November 28, 2002 the TSX updated the TSX Proposed Guidelines by issuing proposed *"Revised Requirements, Guidelines and Practice Notes"*[240]. The TSX Revised Guidelines offer the following comments relative to corporate governance, i.e. difference between a "related director" who is a member of management, and an "unrelated director" who is not a member of management; r esponsibility for the stewardship of the board of directors of each company; audit committee composed entirely of unrelated directors of each company;[241] etc.

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[238] Promulgated by the CSRC on 7 January 2002 and effective from that date.

[239] the "TSX Proposed Guidelines"

[240] the "TSX Revised Guidelines"

[241] See section 475(13) of the TSX Revised Guidelines.

In September 2002, a report entitled *"Governance, Values and Competitiveness - A Commitment to Leadership"* issued by the Canadian Council of Chief Executives, [242] w hich contains some measures for the corporate governance improvement, such as Certification, Legal Penalties Sanctions Within Compensation, Access to Capital Markets, Ethics and Corporate Citizenship, Board Independence, Board Leadership, Audit Committee, Equity Compensation, Transparency and Disclosure, etc. In 2004, Canadian securities administrators introduced a series of new rules that set out new standards with regard to certification of financial statements, audit committee independence and auditor oversight.[243]

2. China

A report issued by CIPE[244] prescribe that the need for corporate governance in developing, emerging and transitional economies extends far beyond resolving problems stemming from the separation of ownership and control. Developing and emerging economies are constantly confronted with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing.

China, as one of the biggest emerging and transitional economies in the world today, really has a rapid development of corporate governance which is necessary for its emerging and transitional economies. In the mid-1980s corporate governance started to gain wide interest and attention in China. The issue of which model of corporate governance was right for this emerging market has become a highly

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[242] The full text of this report can be found at www.ceocouncil.ca.

[243] Multilateral Instrument 52-108 *Auditor Oversight*, Multilateral Instrument 52-109 *Certification of Disclosure in Companies' Annual and Interim Filings*, and Multilateral Instrument 52-110 *Audit Committees*

[244] The Center for International Private Enterprise (CIPE) is an affiliate of the U.S. Chamber of Commerce, established in 1983 to promote private enterprise and market-oriented reform worldwide. See *Instituting Corporate Governance in Developing, Emerging and Transitional Economies* (March, 2002) at 9.

sensitive one at that time in the academic field. It was widely believed that "one size does not fit all", meaning neither the Anglo-Saxon model nor the Continental-German model of corporate governance fit China and that an international code of best practice is unworkable. Legal systems, business cultures and corporate structures are just too different, even among developed nations. The OECD reflects this view in the preamble to its "Principles of Corporate Governance", where it states: "There is no single model of good corporate governance."[245]

Corporate governance is about maximizing value subject to meeting a corporation's financial and other legal and contractual obligations.[246] As a result, corporate restructuring programs adopted by both the advanced economies and emerging economies focuses on the expanded privatization and securitization policies of stated-owned enterprises, the improvement of transparency levels in the operation and behavior of listed companies, the establishment of efficient management and the resolution of conflicts of interest among the different agents in the corporation. Today, China is also facing pressures to become more integrated into the global economy. What integration requires in practice is adopting programs of economic liberalization and deregulation. As a result of these pressures, the government has introduced reforms in several key areas with regards to corporate governance.

The process of competitive transformation in corporate governance practices is already under way in China. CCP's the 4th meeting of 15th National Congress in 1999 has expressed its interest in the establishment of efficient corporate governance practices in China by accepting the corporate governance as a core of modern enterprises system, recognizing the importance of corporate governance in the continuous development of Chinese system of corporate governance, almost immediately following its announcement of the *Guiding Opinion for Listed*

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[245] *OECD Principles of Corporate Governance*, Preamble, at 2. (The Principles can be downloaded from: www.oecd.org/daf/governance/principles.html)

[246] See *Corporate Governance: An issue of Global Concern*, the website of the World Bank at: http://www.worldbank.org/html/fpd/privatesector/cg/aboutus.htm (access date: 7 January 2004).

Companies on the Establishment of an Independent Non-Executive Directors System, [247] th e Chinese Securities Regulatory Commission ("CSRC") issued a consultation paper and the corresponding final version of *Guideline on the Management of Listed Companies* on 11 September 2001 and 7 January 2002 respectively.[248]

The People's Republic of China has been implementing a series of state owned enterprise (SOE) reform policies since 1979. Its emphasis of reform turned to changing the structure of enterprise ownership since 1992, China initiated the "modern enterprise system,"[249] which aimed to transform the SOEs into modern corporations. It involves the transformation of SOEs into shareholding corporations, in which the owners elect a board of directors to monitor the daily operation of the firm by professional managers. This ownership structure is intended to clarify the property rights in SOEs and to free them from administrative interference. Some of these corporations then go on to list shares on the Chinese stock exchanges in Shanghai and Shenzhen. Since 1998, the government also encourages mergers and acquisitions between SOEs as a new mean of SOE reform.

All these reforms have been considered quite successful with regard to improvement in total factor productivity (TFP) by many scholars including Dollar (1990), Jefferson, Rawski and Zhen (1992), Groves et al (1994, 1995). However, other domestic scholars argue that the reform in which shareholding was introduced

[247] The *Guiding Opinion for Listed Companies on the Establishment of an Independent Non-Executive Directors System* was announced on 16 August 2001 and requires that there be a minimum of two independent non-executive directors on the board of a listed companies by 30 June 2002, and that the number of independent non-executive directors be over one-third of the board of director by 30 June 2003.

[248] This guidance is considered the most recent development in the legal framework of corporate governance in China is the promulgation by the CSRC of corporate governance guidelines for listed companies. The guidelines contain 95 articles and, once implemented, will represent a substantial modernization of corporate governance in Chinese Listed companies.

[249] The former leader, Mr. Deng Xiaoping, called for an introduction of the market economy in China in 1992, one of the official goals of SOE reform was to set up a modern enterprise system in the majority of large and medium-sized SOEs. SOE reform policy also accelerated the process of corporate legislation, which was perceived as an essential legal instrument for corporatization of SOEs.

represents a significant move away from socialism.

With respect to corporate governance, China's SOE reform has been relatively successful in terms of solving the short-term managerial incentive problem; but in terms of solving the management selection mechanism and the long-term managerial incentive problem, this reform has it own defects.

Some strategies and theories were introduced to increase managerial incentives and autonomy in SOE. In the beginning of SOE's reform, a contractual mechanism was introduced into the enterprise system, under which the owner of an enterprise, (usually the state of a governmental organization) agreed for a contractor (usually the enterprise or another enterprise) to run it.[250] As the above discussion of contract theory of firm, the main idea behind this strategy is that independent and rational individuals enter into voluntary and freely bargained contract, thereby forming the institution of a firm. The purpose of this strategy was to introduce incentives into the SOE's system in order to increase managerial efficiency by maximizing the total income of enterprises.

Another notable reform strategy was the introduction of a directors' liability mechanism.[251] Directors should faithfully perform their duties to the company and should uphold the interests of the company. The directors should not use their position to seek personal gain. Directors are forbidden from engaging in the business operation of another company carrying out the same business as the company that he or she is serving, and engaging in activities which may adversely affect the interests of the company.[252]

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[250] Wei, Yuwa, *Comparative Corporate Governance, A Chinese Perspective*, (Kluwer Law International, 2003), at 110.

[251] *Ibid* at 111.

[252] *Company Law 1994*, art 59, 60, and 61

PART FOUR: CONVERGENCE BETWEEN THE CANADIAN AND CHINESE SYSTEMS

Convergence in national systems of corporate governance is a matter of some disputes by integrating academic viewpoints, statistical evidence, as well as field surveys. The debates are grouped into three categories: convergence into the direction of the market-oriented model (with the Anglo-Saxon model as the reference base), convergence towards another type of model, namely in the direction of a hybrid corporate governance model (based on cross-reference between different leading governance models), and diversity of corporate governance models (those that do not believe in global convergence but adhere to diversity of governance models).[253]

Gilson gives the formal, functional and contractual change in the convergence of different systems of corporate governance.[254] Formal convergence involves change in the legal infrastructure and therefore requires political support and resort to the legislative process. This type of convergence is often associated with international harmonization in the form of treaties, conventions or legislation; Functional convergence occurs without any change in the legal infrastructure and the existing legal system is sufficiently flexible to respond to new circumstances without resorting to the legal change; Contractual convergence adopts the form of contract because existing governance institutions lack the flexibility to respond without formal change, and political barriers restrict the capacity for formal institutional change.[255] Besides the above three changes in the convergence of different systems of corporate governance, the hybrid of formal and functional convergence can be seen in some

[253] Lut gart Van den Berghe prescribes the three categories of convergence of national corporate governance in her book: *Corporate governance in a globalising world: convergence or divergence? : a European perspective*, (Boston : Kluwer Academic Publishers, 2002).

[254] Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function,* Stanford Law School Working Paper No. 192, May 2000, http://papers.ssrn.com/paper.taf?abstract_id=229517 (access date: Aug. 16, 2004).

[255] *Ibid. at 35.*

countries' systems of corporate governance.

I Possibility of National Corporate Governance Convergence

Hansmann and Kraakman[256] argue that there is a strong likelihood of convergence towards a single governance model. They believe that there are three principal factors driving economies towards consensus: the failure of alternative, the competitive pressures of global commerce, and the shift of interest group influence in favor of an emerging shareholder class. Convergence towards stronger legal protection of investors is likely to result in increased investment and growth. It is not clear whether or how quickly such convergence will occur. Convergence in other aspects of corporate governance, such as board composition and ownership structure – is evident in different corporate governance practices; however, other parts of corporate governance convergence in different systems, especially between Canadian system and Chinese system, are vague. The possibilities of convergence between different systems, especially between Canadian and Chinese system with regard to this thesis should be analyzed.

As we stated in the previous parts, China's special social, cultural and economic conditions render little support to the prospect of complete convergence of Chinese corporate governance practices with international models. However, convergence in some areas would be possible and beneficial, partial divergence from international best practices will be inevitable. It is therefore vital for China to develop its own socially and economically based corporate governance system and directors' duties to protect and maximize stakeholders' interests. As the above statement, the characteristics of state-owned and state-controlled companies in China decide its insider control model of corporate governance. Due to this model of corporate

[256] See Hansmann, H. and R. Kraakman, *The end of history for corporate law* Georgetown Law Journal. Washington: Jan 2001. Vol. 89, Iss. 2; pg. 439, 30 pgs.

governance in Chinese state-owned and state-controlled, it is essential to introduce appreciate mechanisms to prevent the problem of insider control and maintain the accountability of the board of directors.

As one of the Anglo-Saxon model countries, Canadian system of corporate governance has the characteristics of its system. However, it also has its own peculiarity which is different from other Anglo-Saxon countries, i.e. the concentration of its ownership structure.

A number of factors that influence the development of national systems of corporate governance, although it is not always clear whether these factors are the cause or outcome of systems of corporate governance.[257] The following discussions are the factors that stipulate and impede convergence of corporate governance in the Canadian and Chinese perspectives.

1. Issues for Convergence of National Systems of Corporate Governance

a) Globalization and Drive toward Efficient Corporate Structure

In Canada, corporate governance belongs to the Anglo-Saxon model, whereas China favors the Continental-German model where they have a supervisory committee in the company and the banks are very much involved in the ownership of the firms. The world is converging into one model, when you have a global environment where people trade with each other very closely. With the globalization and the drive towards efficient corporate governance, all the talk of different models in corporate governance will die down because the world is getting smaller and there are a lot of transactions, trade, cross-ownership of companies and trading of shares around the world. With the trend of globalization, there are many forces such as product and capital markets competition around the world, flow of rapid information

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[257] See generally, M. Bradley, C. Schipani, A. Sundaram and J. Walsh, *The purposes and accountability of the corporation in contemporary society: Corporate governance at a crossroads,* Law and Contemporary Problems. Durham: Summer 1999. Vol. 62, Iss. 3; p. 9.

across national boundaries, dissemination of best corporate practices that will induce different systems of corporate governance to converge rapidly in the world's globalizing economics.

Several factors affect the process of corporate convergence world-widely. These are the increasing globalization of financial markets, the introduction of the common currency (i.e., the Euro), the effective progress in real convergence among countries, the rapid and full incorporation of different economies in the international system of settlement and payments and the rapid developments in transactions and trading technologies. Among them, the growing globalization of financial markets is a key factor of convergence of corporate governance systems. Different scholars have different views with regard to the impacts of globalization on corporate governance convergence. Some scholars have argued that globalization should pressure firms to adopt a common set of the most efficient corporate governance practices, while others maintain that such convergence will not occur because of a variety of forms of path-dependence.[258] From the author's point of view, globalization, as an increasing outside pressure, leads to an observable result which appears indistinguishable from convergence.[259]

The term "globalization" appears to have been given currency by Theodore Levitt[260] in the 1985 OECD publication "The Globalization of Markets" and served to heighten awareness of reconfiguration of the international economy, including increasing mobility and diversity of world capital, investment, production and

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[258] Khanna, T., J. Kogan, and K. Palepu. "Globalization and Corporate Governance Convergence? A Cross-Country Analysis." Working Paper, Harvard Business School (2002).

[259] Reinhard H. Schmidt and Gerald Spindler, *Path Dependence, Corporate Governance and Complementarity*, p.8. This paper is provided by Goethe University Frankfurt am Main in its series Working Paper Series: Finance and Accounting with number 27. at: http://finance.uni-frankfurt.de/ (Access date: Feb. 26, 2004).

[260] Theodore (Ted) Levitt is the Edward W. Carter Professor of Business Administration Emeritus at the Harvard Business School and former editor of the *Harvard Business Review.* His first article of "The Globalization of Markets." Published on May 1, 1983, his recent publication of "The Globalization of Markets" Published on January, 2004. For detail, see *Levitt, Theodore.* "The Globalization of Markets" *Harvard Business Review.* Boston: May/Jun 1983. Vol. 61, Iss. 3; p. 92

consumption. Globalization entails a lofting of barriers to the mobility of capital, products, and labor, leading to an intensification of competition for these factors across borders by firms and countries.[261]

The recent studies show that the interest in financial markets may well attest to the so-called globalisation of such markets. The globalization of financial markets impacts on corporate governance by the way of changing the long-established domestic patterns of finance in different countries.

With China's entry into the World Trade Organization, its financial system will face enormous changes and increasing pressure from foreign competition in the coming years. China has made wide-ranging commitments across the whole financial sector. In the banking sector, it has agreed to full market access in five years for foreign banks. Foreign banks will be able to conduct local currency business with Chinese enterprises and Chinese individuals two years and five years, respectively, since China's accession to WTO. In China's securities' market, the controversial issuance quota system has been abandoned, according to a plan of CSRC. Controls over primary market prices will be relaxed, and eventually prices will be determined by market forces. A series of reforms with respect to the Chinese financial market have been implemented since China's open to the world. The more globalized China's financial market makes the convergence of Chinese system of corporate governance possible.

International economies, through organization such as WTO, are already taking the place of national and regional economies. Currencies will be merged and banking will be more international than ever.

Globalization seems not to be about convergence to best practice, but rather about

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[261] See Krishna Palepu, Tarun Khanna and Joe Kogan, *Globalization and Similarities in Corporate Governance: A Cross-Country Analysis,* Working Paper No. 02-31, at: ssrn.com (access date: Jun. 21, 2004), p.4.

leveraging difference in an increasingly borderless world.[262] Nat ions which have opened themselves to the global markets with their different legal systems, providing protection to the global investors and having attracted more capital in the process of globalization. With the growth of capitalization in both the developed and the developing, transitional economies, such as Canada and China, the need to establish good corporate governance practices has push them minimize the gap of difference between different nations to keep pace with the globalization process. However, corporate governance practices of different nations are not uniform. This diversity may be particularly because of the different legal structures and cultural settings adopted by different nations.

b). International Convergence in Corporate Governance Systems

For as long as the studies that there is tendency of convergence in different corporate governance systems across countries, there has been debate about the convergence in different corporate governance systems.

Shleifer and Vishny[263] assert that good corporate governance systems are rooted in an appropriate combination of legal protection of investors and some form of concentrated ownership. The Canadian system relies somewhat more heavily on both stronger legal protection and concentrated ownership, while the Chinese systems is characterized by weaker legal protection but much more concentrated equity ownership.

Hansmann and Kraakman[264] assert the possibility of convergence towards one single governance model. In their point, several features of the modern corporate form are nearly universally adopted; i.e. the managers should act in the interests of

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[262] See Guillén, Mauro F. *Diversity in Globalization: Organizational Change in Argentina, South Korea, and Spain.* (Princeton, NJ: Princeton University Press. 2000.

[263] Shleifer, A. and R.W. Vishny. "A Survey of Corporate Governance." *Journal of Finance*, 52 (1997), 737-783.

[264] See Hansmann, H. and R. Kraakman, *The end of history for corporate law* Georgetown Law Journal. Washington: Jan 2001. Vol. 89, Iss. 2; pg. 439, 30 pgs.

shareholders in an approaching global economy. They believe three principal factors driving economies towards consensus: the failure of alternative models (manager-oriented, labor-oriented, and state-oriented models of corporate law), the competitive pressures of global commerce, and the shift of interest group influence in favor of an emerging shareholder class. They admit that convergence in corporate governance practices proceeds faster than convergence in corporate law; however they expect that the pressure for convergence in law will be strong and ultimately successful.

China is increasingly influenced by the common law model. In China, such laws are meant to reduce asset stripping by directors and managers of state-owned companies.[265]

Historical analysis shows that fiduciary duties in common law system is an element that attracts different corporate governance practices to close the Anglo-Saxon model. The world "fiduciary" is from the Latin, "*fiducia,*" which means trust. The fiduciary duty is described as follows: 'A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principle is entitled to the single-minded loyalty of his fiduciary'.[266] The fiduciary duty is a mechanism invented by the legal system for filling in the unspecified terms of shareholders contingent contracts.[267] In

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[265] Liu , Lawrence s. "Chinese Characteristics Compared: *A Legal and Policy Perspective of Corporate Finance and Governance in Taiwan and China* at ssrn.com (http://papers.ssrn.com/sol3/delivery.cfm/delivery.cfm/SSRN_ID273174_code010612560.pdf?abstractid=273174 access date: Apr. 26, 2004).

[266] See Dine, J., *The Governance of Corporate Groups,* (Cambridge University Press, 2000) p.190, cites from Deakin, S. and Hughes, A., in Company Directors, 236-7. In *Hospital Products Ltd. V. United States Surgical Corp.* (1984), 156 C.L.R. 41 (H.C.Aust.) *per* Gibbs C.J. at p.68. Fiduciary is defined that "A person who has agreed, or who has undertaken, to act for or on behalf of, or in the interest of, another person in respect of the exercise of a power of discretion which will affect the interest of that other person in a legal or practical sense.

[267] See Macey, Jonathan R. and Miller, Geoffrey P., *Corporate Stakeholders: A Contractual Perspective* (1993) 43 U. T. L. J. p.401.

a fiduciary relationship, good faith and fair dealing, rather than legal obligation, form the basis of the transaction.[268]

The imposition of fiduciary duties on directors of companies has long been consideration by academics.[269] Angl o-Saxon company law is permeated by trust law concepts – the fiduciary duty. Continental European Law has no comparable concept.[270] As noted above, China's Company Law, based on Continental European Law commercial and civil models, and also does not introduce the concept of fiduciary duty of directors and managers. Instead, directors are imposed upon the duty to "faithfully perform their duties and protect the interests of the company." However, some scholars think that it depots the "codification" of Anglo-Saxon fiduciary duties and could ultimately work to protect the fiduciary relations inherent in a corporate setting.[271] Moreover, CSRC Opinions is relatively more specific. CSRC Opinions adds fiduciary duty to the basic requirements of independent directors. Independent director shall comply with laws and regulations of the state and shall be responsible to all the shareholders with fairness and impartiality.

The fiduciary duties that grow out of the fiduciary relationship between directors and their corporations supplement the statutory duties set out in the OBCA and the CBCA.[272]

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[268] See Enoch Larbi Aboagye, *Debt Financing: An Emerging Influence on Corporate Governance?* (LL.M. Thesis, McGill University, 2001), p.33, cite from Schwarch, S. L., *Re-thinking a Corporations' Obligations to Creditors* (1996) 17 Cardozo L. Rev. 647. at 655.

[269] L. Sealy, *Fiduciary Relationships* (1962) Cambridge Law Journal 69; A. Boyle, *A-G v Reid: The Company Law Implications* 16 Company Lawyer (5), 131; L. Sealy, *The Director as Trustee* in E. McKendrick (ed.) *Commercial Aspects of Trusts and Fiduciary Obligations* (Oxford University Press, Oxford, 1992); etc..

[270] See Cally Jordan, *Law matters: Corporate governance Legal reforms*, 2000, at:worldbank.org.

[271] See Nikkel, M. I., *"Chinese characteristic" in corporate clothing: questions of fiduciary duty in China's Company Law*, 80 Minn. L. Rev. 526 (1995-1996), p.526.

[272] See McGuinness, K.P., *The Law and Practice of Canadian Business Corporations*, (Toronto and Vancouver: Butterworths, 1999), p.715-715.

c). Influence of Institutional investors on Convergence

The interest of institutional investors in transparent, comparable and consistent international environment may well force the invested firms to operate at the global level to converge upon a common mode of corporate governance. Institutional investors are becoming more influential in corporate governance around the world, even in bank-dominated countries.[273] The Anglo-Saxon model of corporate governance which depends on global financial markets may become the reference mode for such firms whatever their national origins. The arrival of Canadian institutional investors on Chinese market has led to a resurgence of interest in the issues of convergence of corporate governance in China. Two competing models of corporate governance were thought to exist in separate spheres prior to the diversification policy of institutional investors. The demands of institutional investors for a strategic focus are increasingly converging with China national interests. The demand of exploring the biggest potential market in the world is the drive of Canadian corporations as well as Canadian national interests.

The growing dominance of both domestic and international institutional investors is casting a sharp focus on their corporate performance. It has been suggested that there are some considerations which are useful to separate discussion of the convergence in Canadian model and Chinese model. The former is showing an increase in direct influence of institutional investors.[274] The latter remain more firmly in the bank-relationship based corporate governance model. Moreover, such differences in the institutional investors should not be exaggerated, and the convergence is discernible.

Recent empirical and academic studies show that institutional investors are

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[273] See Davis, E. Philip Institutional investors, corporate governance and the performance of the corporate sector Economic Systems Vol: 26, Issue: 3, September, 2002 pp. 203-229.

[274] As one of the Anglo-Saxon model countries, Canada has the institutional investors who are influences by poor performance of Canadian firms, and the scope for such pressure offered by the loosening grip of foreign multinationals and family owners. See Simon B (1993), "Investors revolt in sleepy Canada", Financial Times, 18/5/93.

gaining importance as shareholders in all nations, and institutional investors are now becoming international in outlook. Either through active portfolio selection or through "investor activism", institutional investors are seeking means to require better governance to give greater concern to shareholder financial return when formulating corporate strategy. Moreover, institutional investors tend to apply uniform corporate performance globally and put great pressure on different corporate governance models to produce competitive returns and resort to international standards concerning the non-controlling shareholders protection.

d). De facto Convergence of One and Two tier board

In Canada, as in most Anglo-Saxon countries, shareholders are represented by the board of directors in monitoring and controlling management. In the case of China, a two-tier structure is used in which a supervisory board is imposed and charged with overseeing both the board of directors and executive managers. The pros and cons of the one-tier and two-tier board system have been and still are the subject of extensive academic discussion. One of the major corporate governance differences between Canada and China is the board structure – one-tier and two-tier board system. However, notwithstanding this difference between one-tier and two-tier board systems, the similarities in actual board practices are significant.

Theoretical and empirical studies show that supervisory function and a managerial function are recognized by either one-tier or two-tier board system, although the distinctions between the two functions tend to be more formalized in the Chinese two-tier structure. The Canadian one-tier system may result in a closer relation and better information flow between the supervisory and managerial bodies; however, the Chinese two-tier system encompasses a clearer, formal separation between the supervisory board and board of directors. The tendency of the good corporate governance adoption worldly influences each system to lessen the differences as practices converge.

With regard to the supervisory function, non-executive directors in Canadian one-tier board system and the supervisory board in Chinese two-tier board system have the same fundamental responsibilities and the same important role to play in the overall corporate governance system respectively. As well as the audit committee as a permanent committee of the Board of Directors in Canadian one-tier board system has the same function of the Supervisory Board in Chinese two-tier board system.

Canadian board structures have changed in the direction of two-tier boards in which the functions of decision management and decision control are separated. The use of subcommittees composed of outsiders for remuneration, auditing, nomination and other issues introduces elements of a two-tier system. And so does the increasing separation of the positions as chairman of the board and chief executive officer / managerial director.

2. Issues against Convergence in National Systems of Corporate Governance

Although the foregoing discussion has stressed the issues for convergence in corporate governance, significant legal and economic transitions in both countries, there are some issues against convergence in national systems of corporate governance. The following discussions will touch these issues in Canadian and Chinese contexts.

a). Path Dependency

The political and historical reasons for national idiosyncrasies in economic organization have been the topic of many discussions among scholars. "Path dependence", which was discussed in the Part Four, is the most argument rebutting the possibility of convergence, and has been considered as a significant factor in determining national systems of corporate governance. One version of its role is that the corporate structures at any point in time will depend on those that existed at the outset, and that corporate rules affecting ownership will also depend on those initial structures.[275] Another is that differing national cultures and values can de directly associated with characteristics of a system of corporate governance and are likely to defeat attempts to import elements of governance systems from countries with fundamentally different culture and values.[276]

The advocates of theory argue that systems of corporate governance do not develop in a vacuum, but that they are shaped by the social and political factors specific the time and place where they developed, as well as the structure of firms to they relate.[277]

b). Legal Issues

Although legal infrastructure and its dynamics are included in the path dependency argument as they are an important part of the institutional apparatus,[278] research report showed that corporate legislations in different countries have the signs of convergence towards each other. However, due to legislative action, legal convergence proceeds more slowly than convergence in corporate governance practices.

National special social, cultural and economic as well as legislative conditions render also little support to adopt directly appreciate legal framework leading to efficient corporate governance. This does not mean that there is no legal convergence. This contrariety means that sooner or later domestic business activity will move to places and countries which offer more flexible, properly supervised and

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[275] See L.A. Bebchuk and MJ Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" Columbia Law School Center for Law and Economic Studies Working Paper no 131 at ssrn.com or *Stanford Law Review, Vol. 52, pp. 127-170, 1999*

[276] See A N Licht, "The Mother of All Path Dependencies, Towards a Cross-Cultural Theory of Corporate Governance Systems" 26. Del. J. Corp. Law 147- 209 (2001).

[277] See Lucian Arye Bebchuk and Mark J. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stanford L. Rev. 6 .

[278] Nestor, S. and Thompson, J. (1999). Corporate governance patterns in OECD Economies: is convergence under way? Conference on Corporate governance in Asia: A comparative perspective, Seoul, March 3-5, p. 22. at: http://www.oecd.org/dataoecd/7/10/1931460.pdf (access date: Aug. 12, 2004)

business-oriented environments.

In the Canadian tradition, the corporate concept is based on a fiduciary relationship between shareholders and the managers. In the Chinese tradition, the company has an independent will, i.e. in theory, what is good for the corporations might not be good for its shareholders. These differences penetrate down to company law particulars such as shareholder rights, the role of statutory capital and the responsibility of the board.

It seems that corporate governance-related legislation has been converging over the past few years. Gilson provides a useful categorization of the different forms of convergence that occur in the field of corporate regulation. Formal convergence involves change in the legal infrastructure and therefore requires political support and resort to the legislative process.

Canada, since the last three decades of 20th century, has been increasingly influenced by United States' corporate legislative ideas. The US influence was strong on the Ontario reforms of the 1970s and also the Dickerson Report, which led to the *Canadian Business Corporations Act.*

China's Company Law of 1994 follows the old Continental style of corporate legislation. As the superstructure to corporate laws, China's securities law did not follow the civil law style of securities laws and is increasingly influenced by the American common law model.[279] R ecent Chinese legislation has substantially tilted the control of the decision making process toward shareholders and has increased transparency in the way accounts are prepared, especially as regards consolidation; it has also made important steps in facilitating takeovers.

The motivation behind the Canadian system of corporate governance is the

[279] Liu, L.S. "Chinese Characteristics Compared: A Legal and Policy Perspective of Corporate Finance and Governance in Taiwan and China." P. 2. Working Paper (2001), at: ssrn.com.

natural development of economy and the industry in the Canada. Relevant statutes in the Canada are based on the "judge-made law" that was pushed by the economic requirement. While in China, the motivation of promulgation of Company Law is the reform of state-owned enterprises. China's government hoped to establish a modern corporate system and to create a tool to promote China's economic development.

Although the impediment of legal issues to the convergence of corporate governance, some researchers believe that legal convergence is increasingly happening around the world. Shleifer and Vishny (1997) conclude that the successful corporate governance systems, such as the U.S., the U.K., Germany and Japan rely on some combination of concentrated ownership and investors' protection. They also argue that other countries which lack the necessary legal protection tend to develop good corporate governance systems.

c). Political Issue against Convergence

Institutional investors are increasingly seeking to diversify their portfolios and invest overseas. They then look for reassurances that their investment will be protected. As the above statement, institutional investors are increasingly leading the domestic system of corporate governance to the good corporate governance. Political issue is an important element in this process. Different political systems determine the absorption of institutional investors.

Political systems around the world can be described as the socialism and capitalism. Both of them influence the domestic model of corporate governance. The failed experiments with socialist in the post World War II era reflect the conclusion that state ownership and control over business does not best serve the public interest or promote corporate performance. With all of the capitalist system's failures, its commitment to competition enabled it to outperform socialism. Any number of former Soviet republics and Czechoslovakia has distributed "ownership vouchers" to their citizens as a means of transition to private ownership. Countries that have been capitalist have become even more so with privatization of former SOEs. In China's perspective, China's political system also impedes the convergence of corporate governance. However, under the constraints of socialist ideology and economic and political institutions, Chinese government adopts a gradual approach of political and economic reform and is generally very cautious and selective in accepting the policy suggestions proposed by western economists and international organizations with regard to the governance convergence, which is quite different from that of the former Soviet republics and Eastern European countries. In fact, convergence with other systems of corporate governance has enhanced the corporate performance, and facilitated the spread of modern corporate governance in China

In the corporate perspective, due to the conflict of interests, political resistance poses a major obstacle to governance reform which leads to good corporate governance. The benefits of reformed corporate governance are not distributed evenly; interest groups of a company, such as labor unions, banks, controlling shareholders, and managers may prevent governance reform from leading to the good one.[280] I n this condition, those who control corporations feel considerable pressure to adopt the good corporate practices and structures gleaned from a global inventory.[281]

II Evidence of Convergence between the Systems of Corporate Governance in Canada and in China

Canada and China are adopting different corporate governance models. From these comparisons, we found that although these two countries are adopting different corporate governance models, they have developed some mechanisms to narrow down the differences. Therefore, by the above analysis, we may conclude that the

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[280] See, Bebchuk and Roe[1999], Coffee [1999].

[281] Branson, Douglas M., 2000. The Very Uncertain Prospect of "Global" Convergence in Corporate Governance. SSRN working paper. at 3.

corporate governance systems adopted by the two countries have evidence of convergence in the following aspects:

1. Corporate Structure

a). Ownership Structure

Berle & Means identified ownership structure as a key issue[282] in the development of national systems of corporate governance, although it is not clear whether these issues are the cause or outcome of systems of corporate governance.[283] While both Canada and China have many large firms with concentrated ownership, both countries also contain a far larger number of corporations that are dispersedly held. And the number of such firms is evidently growing. It follows that each of the two jurisdictions must have an individual system of corporate law that is adequate to handle the full range of ownership structures. This tendency can be seen in all the concentrated ownership countries.

Corporate legislation and codes of Best Practice around the world are consistent with convergence towards an Anglo-Saxon governance structure.[284] From the beginning of corporate practice, China has constantly adopted corporate forms and practices from western systems. For example, 1994 Company Law imports two types of companies: limited companies and stock companies, which are similar to those of Anglo-Saxon system (private companies and public companies). Furthermore, the Code of Corporate Governance of Listed Companies in China issued by CSRC in January is used the US legal and regulatory systems as models.

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[282] A Berle and G Means, *The Modern Corporation and Private Property* (Transaction Publishers NJ 1991).

[283] See generally, M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a CrossRoads" 62(3) (1999) *Law and Contemporary Problems 9. (supra note 66)*

[284] Denis, Diane K. and McConnell, John J., "International Corporate Governance" (January 2003), at:ssrn.com. p. 33.

The market for corporate control serves as a cornerstone of corporate governance theory by ensuring that resources are directed toward their most efficacious use.[285] Conventional wisdom suggests that if management are running a firm effectively, share price will fall, making the firm ripe for a takeover.[286] The takeover is occurred when government requests a healthy firm to take over another one. The significant increase in merger and acquisition activity for Chinese firms in recent years is a progress in the corporate governance and indicates another sign that the governance structure of these corporations is changing toward a more Anglo-Saxon system.

Finally, the number of Chinese firms that recently have listed their shares on the New York Stock Exchange indicates a trend toward a more Anglo-Saxon governance structure.

> Since the early 1980s a kind of competition among systems of corporate governance has emerged. Despite the twentieth century international hegemony of first the United Kingdom, followed by the United States, it is by no means certain that the Anglo-American system of governance as currently configured will win this competition.[287]

Although governance rules for concentrated corporations are similar to those of publicly held corporations, Chapter 2 of the Chinese Corporate Law contains a number of special provisions applicable only to these concentrated corporations. For example, a corporation with "few shareholders" is not required to set up a board of directors, but rather is only required to have a single executive director who may serve concurrently as the manager. In addition, this type of corporation does not need an entire board of supervisors, as one or two supervisors will suffice. The Chinese Company Law also has different rules for concentrated corporations wholly-owned by

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[285] Young, M.N., & McGuinness, P.B. 2001. The missing link: Why stock markets have been ineffective in Chinese SOE reform. Business Horizons, July-August: 55-62, p.58.

[286] *Ibid.*

[287] See Kester, Gilson, and Roe refer to the latter set of issues as the workings of a contractual--as opposed to corporate--governance system. W. Carl Kester, *Industrial Groups as Systems of Contractual Governance*, 8 OXFORD REV. ECON. POL'Y 24 (1992); also see Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993). At 874.

the State and those that include a foreign investor.

b). Two-tier Board Structure vs. One-tier Board Structure

Two-tier board models are associated with independent board structure, whose attributes are positively associated with the separation of decision-management from decision-control; one-tier board models resemble dual structures, whose attributes are negatively associated with this separation.[288] Studies around the world show that there is a tendency of two-tier board to transform towards a one-tier board structure.[289]

Although the Chinese model resembles the German two-tier system with a board of directors and a supervisory board, a closer look reveals significant differences. For example, in China, there is no hierarchical relation between the board of directors and the board of supervisors, and both directors and supervisors are appointed by, and may be dismissed by shareholders. In contrast, the German supervisory board oversees the board of directors, and the members of the board of directors are appointed by, and may be dismissed by the board of supervisors.

From this point, the corporate board structure of Chinese companies is in essence the one-tier board structure, although they have a so-called supervisory board which is similar to German board system.[290] The Chinese supervisory board is in charge of supervising whether there are illegal behaviors of the managers and directors and it

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[288] Gregory F. Maassen and Frans A. J van de Bosch, *Comparing Anglo-Saxon and Continental-European Corporate Governance Models: A tendency towards convergence of one-tier and two-tier board models?* (Version: Jan. 26, 1997)

[289] *Ibid.*

[290] Comparing a sample of ten largest German DAX non-financial companies (www.onvista.de) with ten largest Chinese domestically listed non-financial firms by total assets, it can be seen that the average size of supervisory board is 21 and 5 for German and Chinese companies respectively. While some 38% of German supervisors are employee representatives, the number is about 30% in China. Many German employee representatives are officers of workers councils in other companies whereas Chinese employee representatives come exclusively within the company. In addition, there is a strong representation of the Communist Party on the supervisory board in state-owned or state-controlled companies. We can see from this comparison, this is fundamentally different from the supervisory board in Germany. For details, see Xiao, J.Z., Dahya, J., and Lin, Z., (2004).

has no rights to interfere with corporate management and strategy. A theoretical study from interviews data show that the Supervisory Board in Chinese companies plays one of four roles: (1) an honored guest; (2) a friendly advisor; (3) a censored watchdog; or (4) an independent watchdog, in response to both internal and/or external stimuli.[291] A s a result, the corporate board structure in China is often seen as close to the Anglo-Saxon type one-tier board.[292]

2. Stock Exchanges and Financial Markets

Listing requirements are considered to be a very promising possible element with regard to the convergence of different corporate governance systems. As a company, from its own interest, the stock exchange has the right to decide the listing conditions for all its investors. The companies have to adjust their governance performance to reach the minimum requirements in order to be listed. Listing requirements are less drastic than national legislation. Moreover they support harmonization, because a common reason for listing is to expand the shareholder base worldwide.[293]

Listing on foreign exchanges is considered an important step of China's domestic reform and its governance convergence with foreign governance. By selecting a tightly regulated foreign exchange, a firm pre-commits to adhere to high standards of corporate governance and/or disclosure.[294] Convergence by hybrid method through Chinese companies voluntarily listing their securities on Foreign exchanges is made possible by a form of regulatory competition. By choosing a foreign listing, a Chinese company selects a significant element of related governance rules in preference to

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[291] See Xiao, J.Z., Dahya, J., and Lin, Z., *A Grounded Theory Exposition of the Role of the Supervisory Board in China* British Journal of Management Vol. 15, 39–55 (2004), p.40.

[292] See Tian, G.L.H. (2001), State Shareholding and the Value of Chinese Firms, Working Paper, London Business School.

[293] Braendle, Udo C and Noll, Juergen, On the Convergence of National Corporate Governance Systems, at 14, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=506522 (access date: Jul. 22, 2004).

[294] Chemmanur, T.J., Fulghieri, P. (1999), A Theory of the Going-Public Decision, 12 Review of Financial Studies, 249-279

those of its own jurisdiction. A similar convergence mechanism has always been available in listing countries with respect to corporate law.

Recent studies[295] show that more and more Chinese companies have listed or aspire to list on US, Canada or other Anglo-American countries exchanges and have adapted their own corporate codes and standards to comply with the exchanges' stringent requirements. In the corporate perspective, the reasons for doing so are very pragmatic, and aim to increase the valuation of their companies. Under the Memorandum of Understanding[296] on regulatory cooperation with China, Chinese enterprises can list on stock exchanges of any of the 21 countries, including Canada. Corporate governance is strongly related to a firm's potential market value. Listing of Chinese companies on Canadian exchange can promote companies to gain good practices of Canadian system of corporate governance as well as the experiences of Canadian well-established markets. Some evidences show the trend of listing of Chinese companies on Canadian exchange, however, up to now, the number of companies which has been listed on Canadian exchange is not ideal.[297]

The Memorandum of Understanding is also important for Canadian companies to list on Chinese exchange and participate in joint ventures with Chinese companies in China. Listing of Chinese companies on Canadian exchanges will give Canadian investors a chance to share directly in returns from the high growth in China, particularly by top-notch Chinese companies with lower risks, as listed enterprises would have to meet Canadian securities standards.[298] This can push Canadian companies to introduce its Anglo-Saxon model to Chinese companies and take

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[295] According to the study of Asia Pacific Foundation of Canada, 82 Chinese enterprises had been listed overseas by the end of August 2003, raising more than US$21 billion.

[296] *Memorandum of Understanding between The China Securities Regulatory Commission and The Participating Members of Canadian Securities Administrators regarding securities and futures regulatory cooperation.*

[297] The only Chinese company currently listed in Canada – Hanfeng Evergreen Inc., on the Toronto Venture Exchange – gained its listing by way of a merger with an already-listed Canadian stock.

[298] See the web site of Asia Pacific Foundation of Canada, at: www.asiapacificbusiness.ca

advantage of the good part of Chinese model of corporate governance.

3. Legal Legislation in Chinese context

The experience in establishing a regulatory regime for listed companies in China provides some indication of the extent to which convergence towards international norms is a significant improvement in Chinese system of corporate governance. This is of particular interest in China, in view of the stated objective of the company and securities law of promoting a "socialist market economy". In particular, the experience in China may provide some guidance as to elements of the corporate governance framework effectively mandated by global capital markets and the residual power left to individual countries to pursue their own objectives.

The Guidelines of 2002[299] have considerable evidence of convergence with western models of corporate governance as almost all the articles contained in the guidance have parallel provisions in the law or codes of corporate governance of Canada and other Anglo-Saxon countries, such as the United Kingdom or United States.

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[299] *Guideline on the Management of Listed Companies*

CONCLUSION

This thesis presents possibilities and empirical evidence about convergence between the two countries – Canada and China – in the context of corporate governance. An analysis of theories of firm and corporate governance from the related academia, drawing on the features from two systems of corporate governance, giving the detailed cooperation between the systems in cultural psychology, demonstrates that national corporate governance exhibit its own characteristics during the process of convergence.

Corporate governance has become an important issue in all the economies around the world. As mentioned in this thesis, the debate on convergence and divergence in corporate governance systems both in Canada and in China has forced us to reconsider our assumptions on which legal rules and corporate governance system promote efficient corporate performance and profitability. The contributions to this thesis have offered insights on different approaches to the attributes of the internal organization and power structure of the firm, the function of board of directors both in one-tier and two tier system, the ownership structure of the firm, the role of securities markets, the relationship among the board, management staff, shareholders in the two systems respectively.

Influenced by the different political and legislative systems, national systems of corporate governance take different modes in different countries. Rooted in different political and legislative environments, the Canadian and Chinese systems of corporate governance are also based on historical and cultural context resulting in distinct national ownership and control features of firms. With the development of economic globalization and other possibilities discussed in this thesis, convergence between the two systems in most aspects of the law and practice of corporate governance is sure to follow.

With regard to the individual characteristics, as the above analysis, the Canada model of corporate governance is characterized by a concentrated ownership structure, mutual and pension funds as key shareholders, high market transparency, active securities markets, and the importance of the market of corporate control as a disciplining mechanism; the Chinese model of corporate governance has been associated with a concentrated ownership structure, state as an important shareholders, low market transparency, underdeveloped securities markets, and the absence of hostile takeovers. The thesis has not argued that the Chinese system and Canadian system of corporate governance have already converged towards each other. It has merely identified an increasing tendency and predicts an intensification of this tendency in the coming decades. It also focus on convergence that has not been based on any functionalist assumption of a necessity to imitate the most successful economic model but on the belief that it would be dangerous to underestimate or ignore such tendencies.

With respect to the issue of convergence, most of the convergence studies of different systems of corporate governance focus on the two generic governance systems, bank based (insider) systems and market based (outsider) systems around the world. For the market centered systems, convergence would require changes that permitted more bank/financial institution ownership and hence monitoring of companies; for the bank based systems, changes to induce convergence would require improvement in capital markets, reduction of control by banks, and monitoring for shareholder interests.[300]

Through the analysis, we agree that one can not say the Canadian nor Chinese system of corporate governance is superior to the other; the issue thus arises as to whether there is a tendency in the two systems towards convergence.

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[300] Paul Halpern System Perspectives on Corporate Governance Systems prepared for Conference and Symposium on Corporate Governance and Globalization September 1, 1999, at: http://www.rotman.utoronto.ca/cmi/papers/paper1-1.htm (access date: Aug. 2, 2004).

This thesis is to demonstrate that there is a tendency towards convergence, and both different systems are gradually changing and becoming increasingly similar even if both of the two systems are not typical ones in the world today.

To put the evolving system of Chinese corporate governance in context, some reforms with regard to corporate governance have been taken place both on the governmental and corporate levels. Reforms in Chinese system of corporate governance reflect the convergence towards Anglo-Saxon system. However, due to China's political attitudes, its legal framework, cultural and historical elements and its particular path development, China's corporate development can not be as same as that of other countries. Chinese current governance system has been designed under a number of institutional constraints. The capital market is not yet completely reformed and therefore is not effective.[301] There are only very weak external governance mechanisms in place. The internal governance mechanism, which relies heavily on the board of directors, is also in a transitional stage. The nomination of directors, CEOs and even the members of supervisory board is still controlled to a large extent by the state. The listed firms are not totally independent entities. All these problems reflect the weak condition of Chinese system of corporate governance. It is important that the successful models of corporate governance give necessary consideration to the Chinese system of corporate governance.

Due to the little influence of Chinese system on other systems of corporate governance, there is no apparent convergence of Canadian system of corporate governance to the Chinese system of corporate governance. However, some changes in Canadian system of corporate governance have also been found.

Although the tendencies as well as the empirical evidences of convergence, it is clear from this thesis that convergence between Canadian system of corporate governance and Chinese system of corporate governance mean neither the victory of

[301] Young, M.N., & McGuinness, P.B. 2001. The missing link: Why stock markets have been ineffective in Chinese SOE reform. *Business Horizons*, July-August: 55-62.

one system over another, nor the uniformity of corporate governance norms and behaviors. It should rather be seen as giving more choices to the firms, when it comes to following a corporate finance and governance "path". In fact, the patterns of ownership and control should ultimately correspond more to the needs and characteristics of a particular firm than to the "system" prevalent in the two countries. Firms should have the possibility to move smoothly from one system to another as they grow and their needs and constituencies change.

On the basis of corporate governance, the strong economic accomplishment in Canada and the emerging economic development in China would generally suggest that their respective systems of corporate governance function well in their national economic structures.

However, this does not guarantee that the economic accomplishment or development achieved in the past has proven the efficiency and success of one national system of corporate governance. An increasing economic globalization and corporate scandals in boardrooms make the scholars around the world to reassess and critically analyze different systems of corporate governance.

Although there is convergence tendency and evidences between the two systems of corporate governance, this thesis also aims to illustrate the limitation of such convergence. This thesis presents some issues which impede such convergence.

One key issue discussed in this thesis regarding the persistence of national system is the path dependency. Much national variation in corporate governance reflects the impact of path dependency upon the evolution of economic systems.[302] On the path dependency bases for divergence: reasons arising from the differing initial conditions with which countries started. We can take other two countries for example, assume that, except of their initial differences in corporate governance due to path dependency,

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[302] Coffee, J. C., (1999), *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications,* at: ssrn.com. p.41.

they have the similar economies, similar type of firms, and even the similar ideologies, the initial difference in corporate governance will tend to persist rather than disappear or converge completely. In Canada's context, an economy which shares a number of similarities to the United States in terms of legal framework and corporate structures and with an active capital market, there are very important differences in the actual governance systems.[303] In China's context, we also contend that the Chinese evolving system of corporate governance will over time increasingly reflect China's own situation, including its institutions, as well as its culture, traditions, and values. It is important to note that simply copying either a model or mixed features of some models may not generate desirable effects. This is because the different models rely on their specific corporate governance environments and have their own historical, social and economic origins, but it is unlikely that the same broad environmental factors exist in one country.

In the outlook perspective, the development of corporate governance convergence and divergence of different national systems are not inconsistent. The former refers to the ongoing movement of national corporate legislations and performances toward a common global standard. Ownership structures are changing very slowly in this process, but motivated by market forces. Firm transparency and shareholder protections are being increased in order to attract institutional investments which are increasingly influencing the governance vice versa. The proliferation of corporate governance guidelines and codes of best practice underscore both convergence and divergence. The latter refers to the different maintenance of individual corporate rules and best practices in the global convergence situation.

In the end, we can conclude that good corporate governance in either Canada or China, however, will neither result from mere changes in the Corporate or Securities laws, nor result from the convergence between the two systems of corporate

[303] Paul Halpern System Perspectives on Corporate Governance Systems prepared for Conference and Symposium on Corporate Governance and Globalization September 1, 1999, at: http://www.rotman.utoronto.ca/cmi/papers/paper1-1.htm (access date: Aug. 2, 2004).

governance. Good corporate governance will also depend mainly upon the successful reform of government agencies and the legal system. Good corporate governance systems and practices cannot only be legislated, nor is there only one model. There is no perfect or best system or model in practice; it involves tradeoffs between competing goals. Convergence is inevitable; however, it has its limits. Globalization is an impact on convergence, and a singular mode of governance is unlikely. A singular mode of corporate governance would require a reorganization of central institutional structures and relationships, as well as a restructuring of interest-group relations and perhaps, of their constitution and organization.[304]

[304] See Corporate Governance and the Lack of Critical Reflexi vity: China and the Process or Principles of Corporate Governance: Loong Wong, University of Newcastle, Australia

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